

Second Circuit Holds that Stock Price Rebound after Disclosure of Fraud Does Not Negate Inference of Economic Loss at Pleading Stage of Securities Fraud Suit

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Introduction

In a case of first impression, the Second Circuit reinstated a putative securities fraud class action that had been dismissed for failure to plead economic loss where the defendant's stock price rebounded soon after the fraud became known. The court held that price recovery does not negate an inference of economic loss at the pleading stage. *Acticon AG v. China N.East Petroleum Holdings Ltd.*, No. 11-4544-CV, 2012 WL 3104589 (2d Cir. Aug. 1, 2012). The decision is also noteworthy as it comes in one of the numerous "reverse-merger" securities fraud lawsuits that have been brought against U.S.-listed Chinese companies in the past 18 months. Indeed, the district court's dismissal of plaintiff Acticon's suit against China North East Petroleum Holdings Limited ("NEP") was the first dismissal of such claims made against a Chinese company.

Factual Background

The plaintiffs in *Acticon* alleged that over a two-year period, NEP misled investors about its reported earnings, the extent of its oil reserves, and its internal controls, and that in the trading days after each of the corrective disclosures NEP issued on those subjects, its stock price dropped. NEP filed a motion to dismiss the complaint, arguing that the plaintiffs had not pled economic loss because NEP's share price actually rebounded on certain days following the initial price drops to a point where the plaintiffs could have sold their holdings and avoided a loss. Citing Acticon's failure to sell its NEP shares at a higher price, the district court granted NEP's motion to dismiss, holding as a matter of law that Acticon did not suffer an economic loss.

The district court based its decision on a line of lower court cases applying the Supreme Court's decision in *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336 (2005). According to the district court, "[s]ince *Dura*, courts have held as a matter of law that a purchaser suffers no economic loss if he

holds stock whose post-disclosure price has risen above the purchase price – even if that price had initially fallen after the corrective disclosure was made.” *In re China North East Petroleum Holdings Ltd. Sec. Litig.*, 819 F.Supp. 2d 351, 352 (S.D.N.Y. 2011). Applying the reasoning of those decisions to the facts alleged in the complaint, the district court concluded that “[a] plaintiff who foregoes a chance to sell at a profit following a corrective disclosure cannot logically ascribe a later loss to devaluation caused by the disclosure.” *Id.* at 353. The Second Circuit reversed, holding that NEP’s theory of “price recovery” could not defeat an inference of economic loss at the pleading stage.

Acticon Reined in an Expansive Application of Dura

In reversing the district court, the Second Circuit squarely rejected the “expansive view” of *Dura* on which the district court relied, finding that *Acticon* met *Dura*’s pleading requirements as to loss causation by specifically alleging that the price of NEP stock dropped after the alleged fraud became known. *Acticon*, 2012 WL 3104589, at *6. The Second Circuit found the district court’s reasoning with respect to the impact of the price rebounds contrary to both the traditional “out of pocket” measure of damages and the “bounce back” provision of the Private Securities Litigation Reform Act (“PSLRA”) that caps the amount of damages available in a securities fraud action. *Id.*

Under the “out of pocket” measure of damages, the proper measure of “actual damages” under a Section 10(b) securities fraud claim is the difference between the fair value of what the plaintiff received, and the fair value of what the plaintiff would have received had there been no fraud. The “bounce back” provision was intended to limit the plaintiff’s damages to losses caused by the fraud, as opposed to other unrelated market conditions. The provision caps damages to the difference between the artificially inflated purchase price paid for the security and the average of the daily trading price of the security during the PSLRA’s 90-day period following corrective disclosure. 15 U.S.C. § 78u-4(e)(1). If the average trading price during the 90-day period is less than the plaintiff’s purchase price, the plaintiff may plead “out of pocket” damages.

The district court engaged in an “offset” analysis in which the court offset post-disclosure stock price gains that NEP realized against the losses Acticon incurred when it sold its holdings in NEP during the 90-day bounce back period. According to the Second Circuit, the fact that NEP’s stock regained its value after disclosure of the fraud doesn’t make the stock “functionally equivalent to an inflated share that has never lost its value.” The court found it “significant” that

Congress did not base its bounce back limitation on damages on the lower court's analysis, explaining that:

This analysis takes two snapshots of the plaintiff's economic situation and equates them without taking into account anything that happened in between; it assumes that if there are any intervening losses, they can be offset by intervening gains. But it is improper to offset gains that the plaintiff recovers after the fraud becomes known against losses caused by the revelation of the fraud if the stock recovers value for completely unrelated reasons.

Acticon, 2012 WL 3104589, at *6-7. For these reasons, the Second Circuit held that NEP's stock price rebound after the close of the class period did not negate the inference that Acticon suffered an economic loss at the pleading stage. But the court made clear that the issue of whether it was proper to offset NEP's share price recovery against Acticon's losses was fair game once the parties proceeded to the merits of the case and were able to engage in discovery to determine the reasons for the price recovery. *Id.*

Impact of *Acticon*

Acticon is significant in several respects. It is the first circuit court decision to address the question of whether a price rebound defeats an inference of economic loss at the motion to dismiss stage. Second, it may give life to other Chinese company reverse-merger cases that are still at the pleading stage. Indeed, the Second Circuit's decision was promptly followed in another putative securities fraud class action brought against a U.S.-listed Chinese company, China Automotive Systems, Inc. ("China Automotive"), in which the company's stock price rebounded after disclosure of an alleged fraud. See *George v. China Automotive Sys., Inc.*, No. 11 Civ. 7533(KBF), 2012 WL 3205062 (S.D.N.Y. Aug. 8, 2010). The district court rejected China Automotive's attempt to use its post-class period price recovery to argue that the plaintiff did not adequately plead loss causation, saying that argument was "foreclosed" by the Second Circuit's recent decision in *Acticon*. *Id.* at *12. The *George* court also rejected China Automotive's other arguments as to why plaintiffs had not pleaded loss causation. Notably, one of those arguments was based on the assertion that there was no causal link between the alleged misstatements and the drop in the defendants' stock price, because the price declines were actually caused by increased market scrutiny of other Chinese reverse-merger companies. *Id.*



At least in the Second Circuit, and in other courts that follow Acticon, defendants in securities fraud cases will have a difficult time getting those complaints dismissed at the pleading stage based on a stock price rebound challenge to allegations of loss causation.

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