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Client Alert

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Second Circuit Holds That Post-Disclosure Price Rebound Does Not Preclude Loss Causation

In a case of first impression for the Second Circuit Court of Appeals, the court in *Acticon AG v. China N. E. Petroleum Holdings Ltd.* held that a securities fraud plaintiff is not unable to plead, as a matter of law, the requisite element of loss causation simply because the plaintiff had the opportunity to sell his stock for a gain shortly after the alleged fraud was revealed. The Second Circuit concluded that the temporary ability of a plaintiff to "mitigate" his damages by selling his stock for a profit was irrelevant under longstanding precedent and the Private Securities Litigation Reform Act of 1995 (PSLRA).

Case Background

"[A] plaintiff's failure to mitigate its losses plays no part in determining loss causation at the pleading stage."

Between January and May 2010, lead plaintiff Acticon AG ("Acticon") bought 60,000 shares in China North, a Chinese energy firm that develops oilfields in northern China, at an average price of $7.25 per share.[1] In a series of statements in February and April 2010, the company reported that it intended to restate financial statements and revise downward its financial projections as a result of accounting errors and overvaluation of its oil and gas properties, and that as a result, it faced delisting by the NYSE.[2] In May 2010, China North announced that the NYSE had suspended trading of its stock and that several members of management had resigned in connection with financial improprieties.[3] The company's stock price declined dramatically after each disclosure. When the stock resumed trading in September 2010 following the company's filing of its restated financial statements, the stock price declined by nearly 20% on heavy trading.[4]

In June 2010, Acticon filed a purported class action brought pursuant to Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 and was subsequently named lead plaintiff. The consolidated complaint named the company, its officers and directors and a third party engineering firm that had valued the company's oil assets, alleging that defendants mislead investors by misstating the company's proven oil reserves and improperly accounting for outstanding stock warrants.[5] Acticon began to divest its China North holdings in December 2010, and it ultimately sold the stock at prices as low as $3.50 per share. However, by waiting several months after the last curative disclosure, Acticon passed on several opportunities to sell its shares at a profit. In particular, on twelve trading days between October and November 2010, China North stock closed above Acticon's average purchase price of $7.25.

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The District Court's Analysis

Judge Cedarbaum of the Southern District of New York granted motions to dismiss filed by the company and two executives after concluding that the lead plaintiff had not suffered a recoverable economic loss as a result of the company's alleged misstatements. The court emphasized that while Acticon ultimately realized a loss on its China North shares, the company's stock price exceeded Acticon's purchase price over a twelve day period during the two months following the last allegedly corrective disclosure.[6] Because Acticon had forsaken the opportunity to profit from the sale, the court held, it "cannot logically ascribe a later loss to devaluation caused by the disclosure."[7] The district court's decision was based on the Supreme Court's statement in *Dura Pharmaceuticals, Inc. v. Broudo* that "an inflated purchase price will not itself constitute … economic loss" because "at the moment the transaction takes place, the plaintiff has suffered no loss."[8] Instead, plaintiff owns a share that possesses the exact value he paid to obtain it. Judge Cedarbaum joined several district courts in holding that an investor cannot demonstrate a loss if it failed to mitigate its damages by selling the stock for a gain. As one such court observed, "a price fluctuation without any realization of an economic loss is functionally equivalent to the Supreme Court's rejection [in Dura] of an artificially inflated purchase price alone as economic loss."[9]

The Second Circuit Rejects the District Court's Analysis

On appeal, the Second Circuit rejected the District Court's approach to assessing loss causation in securities fraud cases. Relying on the test established by the Supreme Court in *Affiliated Ute*, the Court noted that the traditional calculation of a plaintiff's loss is the purchase price minus the true value of the security if there had been no fraud, *i.e.*, a plaintiff's "out of pocket" damages.[10] The Court also observed that the PSLRA modified the traditional calculation by adopting a "bounce back" provision that capped recoverable damages by the difference between the purchase price and the average daily price of the stock in the ninety days after the fraud's disclosure.[11] Taken together, these operative principles required the district court to evaluate the lead plaintiff's losses in light of (i) its purchase price and (ii) the average value of China North stock in the three months following its last curative disclosure. Accordingly, a plaintiff's failure to mitigate its losses plays no part in determining loss causation at the pleading stage, and the district court erred in finding that a momentary post-disclosure stock price above the purchase price precluded an inference that the plaintiff had suffered a loss as a result of the stock price decline.[12]

The Court explained that *Dura* did not require a contrary conclusion. Rather, the Supreme Court had held only that a securities fraud plaintiff cannot claim a loss solely because it purchased stock at an inflated price that later fell. A plaintiff must also plead facts showing that the price fell *because* defendant's misrepresentations were revealed, a standard that Acticon had satisfied. The district court's "more expansive" interpretation that Dura precluded an economic loss whenever the plaintiff has a fleeting opportunity to avoid the loss by selling the stock both misconstrued the decision and was inconsistent with the "bounce back" provision.[14]

In dicta, the panel also observed that "to offset gains that the plaintiff recovers after the fraud becomes known against losses caused by the revelation of the fraud" is improper "if the stock recovers value for completely unrelated reasons," such as broad-based stock market movements or positive industry developments.[15] The Court stated that "[i]n the absence of fraud, the plaintiff would have purchased the

security at an uninflated price and would have also benefited from the unrelated gain in stock price." This led the Court to conclude that offsetting a plaintiff's losses by these unrelated gains "would place the plaintiff in a worse position than he would have been absent the fraud."[16]

Conclusion

The *China North* decision is noteworthy in that, at least at the pleading stage, it eliminates a defendant's ability to argue that an individual plaintiff's failure to mitigate its damages by selling its stock for a profit precludes the plaintiff from pleading a recoverable loss. Only if the stock price appreciation after the curative disclosure was of sufficient size and/or duration to cause the average trading price over the 90-day bounceback period to exceed the plaintiff's purchase price would a defendant be able to demonstrate that the plaintiff did not suffer a recoverable loss.

However, the Court's dicta suggesting an assessment of the "cause" of the post-disclosure price movement is inconsistent with the plain language of the bounceback provision. The statute relies solely on arithmetic to determine the maximum amount of damages, leaving no room for a subjective analysis of why the stock price increased. Moreover, the Court's analysis is premised on the mistaken assumption that "[i]n the absence of fraud, the plaintiff would have purchased the security at an uninflated price and would have also benefited from the unrelated gain in stock price." In additional to loss causation, a securities plaintiff must also prove "transaction causation," *i.e.* that the plaintiff purchased the stock because it relied on the alleged fraudulent statements or conduct.[17] Thus, "in the absence of fraud" the plaintiff would not have purchased the stock at all and would not have enjoyed any post-curative disclosure price increase. It is therefore appropriate to offset losses attributable to the fraud by gains similarly attributable to the fraud, a concept that is captured by the formula of the bounceback provision.

Endnotes

[1] *In re China N.E. Petroleum Holdings Ltd. Secs. Litig.*, 819 F. Supp. 2d 351, 353 (S.D.N.Y. 2011).

[2] *Acticon AG v. China N. E. Petroleum Holdings Ltd.* — F.3d —, No. 11-4544-cv, 2012 WL 3104589 at *1 (2d Cir. Aug. 1, 2012).

[3] *Id*.

[4] *Id*.

[5] *Id*. at 2.

[6] *In re China N.E.*, 819 F. Supp. 2d at 353.

[7] *Id*.

[8] 544 U.S. 336, 342 (2005).

[9] *In re China N. E.*, 819 F. Supp. 2d at 352-53 (quoting *Malin v. XL Capital Ltd*., No. 03 Civ. 2001, 2005 WL 2146089 at *4 (D. Conn. Sept 1., 2005)).

[10] *Acticon*, 2012 WL 3104589 at *3 (discussing *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972)).

[11] *Id*. at 4 (noting that damages for a plaintiff who sells prior to the end of the 90-day period are capped at the difference between the purchase price and the average trading price between the date of disclosure and the sale date).

[12] *Id*.

[13] *Id*. at 5-6.

[14] *Id*. at 6.

[15] *Id*.

[16] *Id*.

[17] *Id*. at 2 (quoting *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008)).

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

J. Christian Word
+1.202.637.2223
christian.word@lw.com
Washington, D.C.

Jennifer Greenberg
+1.212.906.1871
jennifer.greenberg@lw.com
New York

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