CLEARY GOTTLIEB

Alert Memo

AUGUST 9, 2012

www.clearygottlieb.com

Acticon AG v. China North East Petroleum: The Second Circuit Clarifies the Standard For Pleading Loss Causation in Section 10(b) Actions, and the Impact on Damages for Post-Corrective Disclosure Stock Price Increases

On August 1, 2012, the Second Circuit issued *Acticon AG v. China North East Petroleum Holdings Limited*, 2012 WL 3104589, holding that economic loss, which is a necessary element to maintain a private damages action under Section 10(b) of the Exchange Act, is not conclusively negated at the pleading stage where the price of a stock rebounds after declines following an alleged corrective disclosure. Importantly, the Court of Appeals clarified that damages incurred after a corrective disclosure may be properly reduced (or eliminated) where discovery establishes that a subsequent stock price rise can be linked to the corrective disclosure (and, by contrast, that there can be no damage reduction "if the stock recovers value for completely unrelated reasons.")

I. Background

Acticon AG involved a securities class action filed against China North East Petroleum Holdings Limited ("NEP"), several of its officers and directors, and an additional corporate defendant. Acticon, the lead plaintiff in the consolidated class action, alleged that the defendants violated Section 10(b) of the Exchange Act and Rule 10b-5 by misleading investors about NEP's earnings, oil reserves, and internal controls. Acticon's complaint further alleged that the truth about NEP's condition became public through a series of corrective disclosures made between February 23, 2010 and September 1, 2010, and that these revelations caused the value of NEP's stock to decline sharply.

By October and November 2010, however, the price of NEP's stock had recovered much of the value it lost following the alleged corrective disclosures. Indeed, according to the District Court's calculations, Acticon could have sold its shares at a profit on at least 12 days during these two months. Adopting the reasoning of several prior decisions issued by district courts within the Second Circuit and elsewhere, the District Court held that Acticon had not, and could not, adequately plead that it suffered any cognizable economic loss because it had foregone multiple opportunities to sell its shares at a profit after the revelation of the alleged fraud. Accordingly, the District Court granted the defendants' motion to dismiss Acticon's complaint in its entirety.

II. The Second Circuit's Decision

The Second Circuit vacated the District Court's Rule 12(b)(6) dismissal of the plaintiff's Section 10(b) claims, noting that damages in Section 10(b) cases have traditionally been determined by use of an "out-of-pocket" measure of damages, which permits a defrauded investor to recover the difference between the price it paid for the security and the true value of the security on the purchase date in the absence of the alleged fraud. *See Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972). The Circuit concluded that the District Court's holding was inconsistent with this "out-of-pocket" damages measure, and its underlying purpose of making a plaintiff whole, because such a rule would allow a plaintiff's recovery to be improperly diminished by subsequent stock price gains that were "completely unrelated" to the corrective disclosure. In the panel's view, the District Court's rule could therefore place the plaintiff in a worse position than it would have been absent the fraud, by depriving the plaintiff of the ability to benefit from stock price increases that would have occurred regardless of the corrective disclosure.

The Circuit found additional support for its holding in the "bounce back" provision of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), which caps the amount of damages available in securities fraud actions to the difference between the price paid by the plaintiff and the average trading price of the security during the 90-day period after the revelation of the fraud. Upon reviewing the legislative history of the PSLRA, the panel concluded that this "bounce back" provision was intended to limit damages to losses caused by the fraud (rather than other market conditions), but did not otherwise disturb the traditional out-of-pocket method for calculating damages for Section 10(b) claims. The panel therefore concluded that the District Court's holding was inconsistent with the PSLRA's "bounce back" provision for the reasons described above. The panel also found significance in the fact that, while the PSLRA did impose the 90-day "bounce back" cap on damages, it did not impose the additional open-ended limitation on damages adopted by the District Court.

But the Second Circuit was careful to note that it was considering a motion to dismiss, and was therefore required to draw all reasonable inferences in the plaintiff's favor, including to assume that the stock price rose after the corrective disclosure for reasons "completely unrelated" to the revelation of the fraud. And it confirmed that it would be proper at a later stage in the proceedings to reduce Section 10(b) damages by post-disclosure stock price increases (including beyond the 90-day bounce-back period) if those were related to "the market's reactions to the disclosure of the alleged fraud" rather than recoveries that represented other "unrelated gains."

III. Implications of the Decision

Acticon AG clarifies that a stock price rebound at some point after a corrective disclosure, without more, does not mean that the plaintiff has failed to plead loss causation as a matter of law.

The opinion also shows that damages under Section 10(b) may be reduced by such rebounds where they are related to the disclosure of the alleged fraud. In effect, the damages analysis must embrace all news -- negative and positive -- that flows from a corrective disclosure. Put another way, in a but for world, there would have been no fraud inflation but also no post-corrective disclosure price rebound. Class members whose purchase price included "fraud inflation" would therefore have their damages reduced by gains resulting from the revelation of that fraud, with the difference being true to the "out-of-pocket" loss measure traditionally used for Section 10(b) damages. A defendant's potential liability under Section 10(b) will accordingly be reduced in situations where the price of the relevant stock rises after the alleged fraud is revealed, and there is a connection between that price rebound and the market events leading to the price decline. Specific examples of such connections will depend on the facts and circumstances, but by way of example the possibilities include that the revelation of the alleged misconduct caused a change in company management or corporate strategy (such as the willingness to consider a change in corporate control), the revelations of which generated statistically significant upward stock price movements.

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Securities Litigation" in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299