

## Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION— S.D.N.Y.: Investors in Chinese coal company that was stripped of assets by chairman allowed to proceed on 10(b) claim, (Oct. 2, 2013)

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By Lene Powell, J.D.

The federal district court for the Southern District of New York certified a class action by investors in a Chinese coal company whose assets were stripped by its chairman and whose share price subsequently declined, determining that although the investors lacked standing on their claims under Section 11 and 12 of the Securities Act, all investors in the class except “in-and-out purchasers” could proceed with their Section 10(b) claim under the Exchange Act (*In re Puda Coal Securities Litigation*, October 1, 2013, Forrest, K.).

**Background.** According to the investors, they had every reason to believe that Puda Coal owned 90 percent of an operating company, Shanxi Puda Coal Group Co. Ltd., which was a supplier of coking coal used for steel manufacturing in China. However, Puda Coal did not own a 90 percent interest in Shanxi during the relevant time. The investors alleged that its chairman and major shareholder, defendant Ming Zhao, improperly transferred Puda Coal's 90 percent interest in Shanxi to himself, then transferred part of that interest to an unrelated investment fund controlled by CITIC, and then pledged the remaining portion to CITIC to secure a loan. Allegedly, Puda Coal did not receive any consideration for these transactions.

In April 2011, Alfred Little published a research report that revealed Zhao's actions, and Puda Coal's security prices subsequently decreased. The investors sued Puda Coal and its inside officers and directors, two outside directors, the underwriters of the December 2010 offering, and Puda Coal's external auditors. The defendants moved for summary judgment on certain claims, and the plaintiffs moved for class certification and appointment of class representatives and class counsel. No defendant disputed that a fraud occurred in connection with Puda Coal's transfer through Zhao of its interest in Shanxi. Rather, the issue was whether the defendants could be held responsible under the theories on which they were sued.

**No Section 11 standing.** Section 11 of the Securities Act gives purchasers of registered securities strict liability protection for material misstatements or omissions in registration statements filed with the SEC. Standing for Section 11 claims is limited to those who have purchased securities that are the direct subject of a specified prospectus or registration statement. In other words, the shares purchased must be demonstrably “new”; they cannot be previously issued shares. Plaintiffs bore the burden of showing that Thomas Rosenberger, the only named plaintiff asserting a claim under Section 11, in fact bought his shares in an offering or could trace the shares to an offering.

The court discussed the “direct trace,” “fungible mass,” “contrabroker,” and “heritage” methods of tracing shares to an offering, and concluded that Rosenberger could not trace the shares. It was not enough that that he bought shares on the day of an offering in a marketplace actively trading issued shares; he could not rely on the similarity of date and share price to demonstrate that the shares were issued pursuant to, or were traceable to, the December 2010 offering.

**No Section 12 standing.** Section 12(2) of the Securities Act provides for standing as to statutory “sellers” of securities, that is, people who directly sold securities or solicited their purchase. The court said that to survive summary judgment, if Rosenberger could raise a triable issue as to whether he purchased his securities from a defendant, he must demonstrate that he at least purchased them as a result of a defendant's solicitation. However, Rosenberger conceded that not only did he not buy any securities directly from any defendant, he also did not read a prospectus, speak to anyone at Puda Coal, or attend a road show. In fact, he did not proffer a single fact sufficient to support Section 12 standing. Accordingly, the court ruled that he did not have standing.

**Intervention not allowed.** Plaintiffs asserted that even if summary judgment was granted as to the traceability of Rosenberg's shares or his standing under Section 12, the claims should survive because institutional investment firm Trellus had moved to intervene, and if its motion was granted, then Trellus would be able to assert such

claims. However, the court denied the motion to intervene as untimely, so the Section 11 and 12 claims could not be salvaged.

**Class certification.** On the remaining 10(b) claim, the court found that the class was sufficiently numerous to meet Rule 23(a) requirements, and commonality was also uncontested.

As to typicality, the auditor defendants asserted that in-and-out purchasers are subject to unique defenses (including negative loss causation) that made them atypical of the class. The plaintiffs conceded that that among the purchasers of Puda Coal shares would be in-and-out purchasers, but urged the court to include in-and-out purchasers according to a new "leakage" theory—that news leaked into the market prior to April 8, 2011, and that significant price declines had occurred by that date. The court found that based on the trading activity, it did appear that there was a significant possibility of negative loss causation for in-and-out traders, and the plaintiffs did not carry their burden as to the typicality of in-and-out traders. It therefore excluded these traders from the class.

The court found that the Rule 23 predominance requirement was met, but again excluded in-and-out purchasers. The case is 11 Civ. 2598 (KEF).

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