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**UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA**

ALBERT SNELLINK, ZACHARY
LEWY, SAMPSON DARUVALLA, and
WILLIAM SPIEGELBERG, on behalf of
themselves and all others similarly
situated,

Plaintiffs,

v.

GULF RESOURCES, INC., XIAOBIN
LIU, MIN LI, and MING YANG,

Defendants.

Case No. CV 11-03722-ODW(MRWx)

**ORDER DENYING MOTION TO
DISMISS PLAINTIFFS' AMENDED
CLASS ACTION COMPLAINT [33]**

Pending before the Court is Defendant Gulf Resources, Inc.'s motion to dismiss Plaintiffs' amended class action complaint ("AC") under Federal Rule of Civil Procedure 12(b)(6). (Dkt. No. 33.) Having considered the papers filed in support of and in opposition to the instant motion, the Court deems the matter appropriate for decision without oral argument. Fed. R. Civ. P. 78; L.R. 7-15.

I. FACTUAL BACKGROUND

Plaintiffs brought this class action against Gulf and some of its directors and officers for violations under the federal securities laws. During the period between March 16, 2009 and April 26, 2011, Plaintiffs purchased Gulf's common stock. (AC

1 ¶ 1.) Gulf is a Delaware Corporation with its principal executive offices located in the
2 People’s Republic of China. (*Id.* ¶ 23.)

3 Gulf conducts operations through its two subsidiaries, Shouguang City
4 Haoyuan Chemical Co., Ltd. (“SCHC”) and Shouguang Yuxing Chemical Industry
5 Co., Ltd. (“SYCI”), both of which are organized under Chinese law. (*Id.* ¶ 24.)
6 SCHC manufactures bromide and crude salt. (*Id.*) SYCI manufactures industrial
7 chemical products used in oil and gas field exploration, oil field drilling, wastewater
8 processing, as well as papermaking chemical agents and inorganic chemicals. (*Id.*)
9 All of Gulf’s revenue and income is generated by SCHC and SYCI. (*Id.* ¶ 25.) Gulf’s
10 common stock was actively traded under the ticker “GFRE” on the NASDAQ and the
11 OTC BB (Over-The-Counter Bulletin Board). (*Id.* ¶ 26.) Defendant Ming Yang was
12 Chairman of Gulf’s Board of Directors and was the legal representative of SCHC and
13 SYCI; Defendant Xiaobin Liu was Gulf’s Chief Executive Officer and one of its
14 Directors; Defendant Min Li was Gulf’s Chief Financial Officer.¹ (*Id.* ¶¶ 27–28, 31–
15 32.)

16 According to Plaintiffs, Gulf deceived the investing public through its SEC
17 filings by making false and misleading statements, withholding relevant business and
18 financial information, and engaging in accounting fraud. In particular, Plaintiffs point
19 out the following six issues.

20 First, a review of SCHC and SYCI’s filings to the State Administration for
21 Industry and Commerce (“SAIC”) and to the State Administration of Taxation
22 (“SAT”) suggests that Gulf maintained two different sets of accounting books.² (*Id.*
23 ¶ 97.) SCHC and SYCI’s SAIC filings provide inventory and sales figures that are in
24 line with those of their competitors. (*Id.* ¶¶ 91–92.) Assuming the SCHC and SYCI
25

26 ¹ The Court notes these individual Defendants have not been served and have not yet appeared in
27 this lawsuit.

28 ² SAIC is the Chinese government body that regulates industry and commerce in China. All Chinese
companies are required to file audited financial statements with the SAIC at least annually. SAT is
the Chinese equivalent to the United States Internal Revenue Service.

1 figures are correct, and given the fact that all of Gulf's revenue comes from these two
2 subsidiaries, Gulf grossly overstated its financial position in its SEC filings. (*Id.*
3 ¶¶ 96–97.) Further, the enormous discrepancy in the financial information between
4 Gulf's SEC filings and the SAIC and SAT filings of SCHC and SYCI cannot be
5 attributed to the insignificant differences between Chinese and U.S. accounting rules.
6 (*Id.* ¶¶ 98–101.)

7 Second, Gulf's reported inventory and sales figures are incredible. (*Id.* ¶¶ 84–
8 85.) Gulf's figures suggest that it realized a 50% profit margin based on an inventory
9 turnover rate between 59 to 209 times in the years 2008–2010. (*Id.* ¶¶ 85–86.) Gulf's
10 data appears false on its face when similarly situated competitors operate under a
11 inventory turnover rate of 7 times and a profit margin below 20%. (*Id.* ¶¶ 87–90.)

12 Third, Gulf stated that it was one of the largest bromine producers in China, but
13 Gulf nor its subsidiaries are listed among the top 30 Chinese bromine producers in a
14 2010 market report. (*Id.* ¶¶ 75–79.) According to Gulf's SEC filings, its bromine
15 output would have placed Gulf as the number one producer, accounting for over 40%
16 of China's bromine production in 2010. (*Id.* ¶¶ 79–82.)

17 Fourth, Gulf failed to disclose related party transactions by hiding the fact that
18 Shouguang City Rongyuan Chemical Co., Ltd. ("Rongyuan"), Gulf's biggest
19 customer in 2010 and its second biggest customer in 2008 and 2009, is a company
20 related to Gulf. (*Id.* ¶¶ 104–108.) Rongyuan's SAIC filing shows that Yang and
21 another Gulf Director own over 90% of Rongyuan. (*Id.* ¶¶ 110–111.) Rongyuan's
22 website and contact information suggest that it is a subsidiary of Shandong Haoyuan
23 Industry Group Ltd. ("Haoyuan"), which is owned by Yang and his wife. (*Id.* ¶¶ 109,
24 111–116.) Yang is also the founder and Chairman of the Board of Haoyuan. (*Id.*
25 ¶ 106.) Moreover, Gulf hid the fact that Shouguang Hongye Trading Co., Ltd.
26 ("Hongye"), one of Gulf's largest suppliers of raw materials, is owned and controlled
27 by Haoyuan, Yang, and his family. (*Id.* ¶¶ 60–62.)

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1 Fifth, Gulf concealed the fact that Haoyuan, owned by Yang and his wife, is a
2 direct competitor of SYCI. (*Id.* ¶¶ 116–119.) The relationship between Gulf and
3 Haoyuan is further evidenced by the fact they use the same address in its filings—
4 Gulf’s SEC filings and Haoyuan’s SAIC filings. (*Id.* ¶¶ 120–121.)

5 Finally, Gulf’s SEC filings did not disclose that Liu, Gulf’s Chief Executive
6 Officer, was previously employed as the Chief Financial Officer of China Finance, a
7 firm affiliated with listing a number of fraudulent Chinese companies in the United
8 States. (*Id.* ¶¶ 122–128.)

9 Plaintiffs further claim that the alleged fraud was publically disclosed in a
10 report issued by Glaucus Research on April 26, 2011. (*Id.* ¶ 15.) The revelation by
11 the Glaucus report caused Gulf’s stock price to fall \$1.16 per share or over thirty
12 percent on heavy trading volume, causing substantial financial damages to investors.
13 (*Id.* ¶ 17.) Plaintiffs also state that prior to 2011, Yang and his family sold shares of
14 Gulf, reaping between \$11–\$20 million. (*Id.* ¶¶ 29–30.)

15 Plaintiffs also aver that Gulf acted with scienter, and the material
16 misrepresentations caused Plaintiffs’ losses in connection with their purchase of
17 Gulf’s securities. (*Id.* ¶¶ 149–58.)

18 Gulf brought this Rule 12(b)(6) motion, contending that Plaintiffs’ AC should
19 be dismissed for failure to state a claim. Gulf argues Plaintiffs fail to meet the
20 heightened pleading standard required in securities actions because they lack
21 sufficient facts to show falsity, scienter, and loss causation.

22 II. LEGAL STANDARD

23 Dismissal under Rule 12(b)(6) can be based on “the lack of a cognizable legal
24 theory” or “the absence of sufficient facts alleged under a cognizable legal theory.”
25 *Balistreri v. Pacifica Police Dep’t*, 901 F.2d 696, 699 (9th Cir. 1990). A complaint
26 need only satisfy the minimal notice pleading requirements of Rule 8(a)(2)—a short
27 and plain statement—to survive a motion to dismiss for failure to state a claim under
28 Rule 12(b)(6). *Porter v. Jones*, 319 F.3d 483, 494 (9th Cir. 2003); Fed. R. Civ. P.

1 8(a)(2). For a complaint to sufficiently state a claim, its “[f]actual allegations must be
2 enough to raise a right to relief above the speculative level.” *Bell Atl. Corp. v.*
3 *Twombly*, 550 U.S. 544, 555 (2007). While specific facts are not necessary so long as
4 the complaint gives the defendant fair notice of the claim and the grounds upon which
5 the claim rests, a complaint must nevertheless “contain sufficient factual matter,
6 accepted as true, to state a claim to relief that is plausible on its face.” *Ashcroft v.*
7 *Iqbal*, 556 U.S. 662, 678 (2009).

8 *Iqbal*’s plausibility standard “asks for more than a sheer possibility that a
9 defendant has acted unlawfully.” *Id.* Rule 8 demands more than a complaint that is
10 merely consistent with a defendant’s liability—labels and conclusions, or formulaic
11 recitals of the elements of a cause of action do not suffice. *Id.* The determination
12 whether a complaint satisfies the plausibility standard is a “context-specific task that
13 requires the reviewing court to draw on its judicial experience and common sense.”
14 *Id.* at 679.

15 When considering a Rule 12(b)(6) motion, a court is generally limited to the
16 pleadings and must construe “[a]ll factual allegations set forth in the complaint . . . as
17 true and . . . in the light most favorable to [the plaintiff].” *Lee v. City of L.A.*, 250 F.3d
18 668, 688 (9th Cir. 2001). Conclusory allegations, unwarranted deductions of fact, and
19 unreasonable inferences need not be blindly accepted as true by the court. *Sprewell v.*
20 *Golden State Warriors*, 266 F.3d 979, 988 (9th Cir. 2001). Yet, a complaint should be
21 dismissed only if “it appears beyond doubt that the plaintiff can prove no set of facts”
22 supporting plaintiff’s claim for relief. *Morley v. Walker*, 175 F.3d 756, 759 (9th Cir.
23 1999).

24 III. DISCUSSION

25 To assert a claim under section 10(b) and Rule 10b-5 of the Securities
26 Exchange Act of 1934, the complaint must satisfy the dual pleading requirements of
27 Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act
28 of 1995 (“PSLRA”). *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 990 (9th

1 Cir. 2009). Under Rule 9(b), claims alleging fraud are subject to a heightened
2 pleading requirement, which requires that a party “state with particularity the
3 circumstances constituting fraud.” Fed. R. Civ. P. 9(b). PSLRA was enacted to
4 prevent plaintiffs from asserting baseless securities fraud claims. Under PSLRA, any
5 securities fraud claim shall “[s]pecify each statement alleged to have been misleading,
6 [and the] reasons why the statement is misleading.” 15 U.S.C. § 78u-4(b)(1). If an
7 allegation regarding the statement or omission is made on information and belief, the
8 plaintiff must state with particularity all facts on which that belief is formed.
9 15 U.S.C. § 78u-4(b)(1); *Gompper v. VISX, Inc.*, 298 F.3d 893, 895 (9th Cir. 2002).
10 For each alleged misleading statement, PSLRA further requires the complaint state
11 with “particularity facts giving rise to a strong inference that the defendant acted with
12 the required state of mind.” 15 U.S.C. § 78u-4(b)(2).

13 To state a claim for securities fraud under section 10(b) and Rule 10b-5, a
14 plaintiff must adequately plead the following elements: (1) falsity, i.e., a material
15 misrepresentation or omission, (2) scienter, i.e., a wrongful state of mind, (3) a
16 connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and
17 (6) loss causation, i.e., a causal connection between the material misrepresentation and
18 the loss. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005).

19 In this case, Plaintiffs’ AC points to a number of misrepresentations and
20 omissions made during the class period, which were material, made with scienter, and
21 caused Plaintiffs’ financial loss. Gulf’s motion to dismiss argues Plaintiffs’ AC
22 inadequately pleads the elements of falsity, scienter, and loss causation. The Court
23 examines these three elements in turn.

24 **A. Falsity**

25 Gulf’s motion argues Plaintiffs have failed to plead sufficient facts to show
26 falsity. Gulf’s alleged misrepresentations and omissions may be grouped into six
27 categories of falsity. These six falsities are: (1) two sets of books; (2) high inventory
28 turnover rates and profit margins; (3) top bromine producer; (4) related party

1 transactions; (5) related party competitors; and (6) concealed CEO employment
2 history. The following discussion tracks this order.

3 *1. The two sets of books allegation*

4 Plaintiffs' core allegation is that Gulf kept two sets of financial records—one
5 filed with the SEC, which significantly overstated its financial results; the other filed
6 with Chinese regulators, which showed the company was actually much less
7 prosperous. (AC ¶¶ 91–96.) Gulf conducts operations solely through its two Chinese
8 subsidiaries, SCHC and SYCI. (*Id.* ¶ 24.) Plaintiffs' counsel allegedly obtained
9 SCHC and SYCI's SAIC and SAT filings and found that these two subsidiaries only
10 earned a fraction of the revenue and income reported by Gulf to the SEC. (*Id.* ¶¶ 43–
11 44.) Plaintiffs claim that the SAIC and SAT filings indicate Gulf's true performance,
12 while Gulf's SEC filings contain fraudulent financial data. (*Id.* ¶ 45.)

13 Gulf states that its outside counsel made a trip to the SAIC office in China,
14 obtained copies of SCHC and SYCI's SAIC filings, and had them notarized by a
15 Chinese government agency. (Mot. 8–9.) Gulf then compared these SAIC filings
16 with Gulf's SEC filings and concluded there is no significant discrepancy between the
17 two sets of financial data. (*Id.*) In response, Plaintiffs challenge the authenticity of
18 the SAIC filings that Gulf's counsel brought back from China. (Opp'n 6–7.)

19 The Court must first resolve whether the Court can take judicial notice of the
20 SAIC filings proffered by Gulf's counsel. Courts have held that documents forming
21 the basis of a plaintiff's case, but not attached to the complaint, may be judicially
22 noticeable only if neither party questions the document's authenticity. *In re*
23 *Easysaver*, 737 F. Supp. 2d 1159, 1166 (S.D. Cal. 2010) (citing *Branch v. Tunnell*, 14
24 F.3d 449, 453 (9th Cir. 1994)). A district court cannot take judicial notice of a fact
25 simply because it is contained within the public record if the fact is subject to
26 reasonable dispute. *Lee*, 250 F.3d at 689–90.

27 In a factually similar case, the court found it inappropriate to take judicial
28 notice of defendant's own SAT filings when plaintiffs disputed the authenticity of

1 those documents. *In re China Educ. Alliance, Inc.*, CV 10-9239 CAS (JCx), 2011
2 U.S. Dist. LEXIS 117416, at *16 (C.D. Cal. Oct. 11, 2011). Further, the defendant, a
3 U.S.-listed Chinese company, conceded that these were not foreign public documents.
4 *Id.* at *15. The court stated the authenticity of defendant’s proffered documents was a
5 question of fact not suited for resolution at the motion to dismiss stage. *Id.* at *16
6 (“The PSLRA in no way turns [a Rule 12(b)(6) motion to dismiss] into a trial-type,
7 papers-only proceeding, much less one in which defendants get the benefit of every
8 conceivable doubt, including credibility calls.” (quoting *In re LDK*, 584 F. Supp. 2d
9 1230, 1260 (N.D. Cal. 2008))).

10 Here, Plaintiffs dispute the authenticity of SCHC and SYCI’s SAIC documents
11 obtained by Gulf. (Opp’n 6.) The Court notes these SAIC documents were not
12 publicly available because authorization of a Gulf company representative was
13 required for access. (Wang Decl. ¶¶ 2–6.) Further, even if these SAIC documents are
14 public record, whether the documents contained truthful financial data is a question of
15 fact. For these reasons, the Court finds it inappropriate to take judicial notice of
16 SCHC and SYCI’s SAIC documents obtained by Gulf.

17 Without the Gulf-obtained SAIC documents, the Court now must decide
18 whether Plaintiffs’ AC sufficiently pleads that Gulf overstated its financials to the
19 SEC. This case closely resembles other Chinese securities cases in which courts have
20 found falsity, where: (1) defendant is a U.S.-listed Chinese company, whose stock
21 price plunged after certain Internet articles revealed that the company overstated its
22 financials to the SEC; (2) plaintiffs (stock purchasers) sued for securities fraud;
23 (3) plaintiffs relied on the comparison of defendant’s SEC, SAIC, and SAT filings to
24 show falsity, noting that defendant reported revenue numbers in the United States that
25 were inconsistent with those in China; and (4) plaintiffs claimed the Chinese and U.S.
26 accounting standards were sufficiently similar such that the figures should have been
27 substantially the same. *See China Educ. Alliance*, 2011 U.S. Dist. LEXIS 117416, at
28 *3–4, 13–16; *Henning v. Orient Paper, Inc.*, CV 10-5887-VBF(AJWx), 2011 U.S.

1 Dist. LEXIS 79135 (C.D. Cal. Jul. 20, 2011); *Katz v. China Century Dragon Media,*
2 *Inc.*, LA CV11-02769 JAK (SSx), 2011 U.S. Dist. LEXIS 142664 (C.D. Cal. Nov. 30,
3 2011).

4 In this case, Plaintiffs offer data showing that revenue and net income reported
5 in Gulf's SEC filings are demonstrably higher than the figures reported in SCHC and
6 SYCI's SAIC and SAT filings. (AC ¶¶ 41–74; 91–97.) Plaintiffs allege Gulf's
7 revenues come exclusively from its two subsidiaries, SCHC and SYCI—thus,
8 assuming SCHC and SYCI's SAIC and SAT filings are accurate, Gulf grossly
9 overstated its financial position in its SEC filings. (*Id.* ¶¶ 96–97.) Plaintiffs also
10 allege that the differences between the Chinese and U.S. accounting standards cannot
11 rationally explain the substantial differences between the numbers reported in China
12 and the United States. (*Id.* ¶¶ 98–101.) These allegations, like those in *China Educ.*
13 *Alliance* and similar cases, are stated with sufficient particularity and adequately
14 pleads falsity. Though the accuracy of Plaintiffs' financial data may be disputed, it
15 would be premature to dismiss the case in light of these factual disputes at the
16 pleading stage.

17 2. *The high inventory turnover rates and profit margins allegation*

18 Plaintiffs offer other evidence to show that Gulf's financial statements were
19 fraudulent—that Gulf's inventory turnover rates and profit margins were absurdly
20 high compared to its U.S. and Chinese competitors. The AC includes the following
21 facts.

22 First, according to the SEC 2010 10-K, Gulf's profit margin is high, over fifty
23 percent. (*Id.* ¶ 86.) Second, a comparison of the turnover rates and profit margins
24 between Gulf, a U.S. competitor, and a Chinese competitor suggests that Gulf's
25 numbers are so high that its financial statements must be false—a 50% profit margin
26 based on an inventory turnover rate between 59 to 209 times for Gulf in the years
27 2008–2010, compared to a profit margin below 20% based on an inventory turnover
28 rate of 7 times for Gulf's competitors. (*Id.* ¶¶ 85–90.) Third, the reported sales and

1 inventory figures reported by SCHC and SYCI are much lower than that reported by
2 Gulf, but are in line with competitors' figures. (*Id.* ¶¶ 91–93.) Fourth, Plaintiffs point
3 to a Chinese article suspecting Gulf of inflating revenues, which has the side effect of
4 causing the “extremely high turnover rate and abnormally low expenses ratio.” (*Id.*
5 ¶¶ 94–95.)

6 Gulf proffers an exculpable explanation that Gulf produces bromine on demand.
7 (Mot. 12.) Even so, this explanation creates a factual dispute that should not be
8 resolved at the pleading stage. The Court finds that Plaintiffs' allegations give rise to
9 the plausible inference that Gulf reported false financials to the SEC. Thus, these
10 allegations adequately plead falsity.

11 3. *The top bromine producer allegation*

12 Plaintiffs also allege that Gulf is a much smaller company than it claimed to be
13 in its SEC filings. According to Plaintiffs, Gulf's SEC filings state that it is “one of
14 the largest manufacturers of bromine in China.” (*Id.* ¶ 75.) As evidence of falsity,
15 Plaintiffs point to a report issued by CCM International Ltd. in December 2010 that
16 fails to list Gulf or its two subsidiaries among the top 30 bromine producers in China.
17 (*Id.* ¶ 77.) Further, the comprehensiveness of the CCM report, which considered over
18 100 Chinese bromine producers, makes it improbable that Gulf was missed as “one of
19 the largest manufacturers of bromine in China” if it truly was a top bromide producer.
20 (*Id.* ¶¶ 78–80.) Based on the industry data presented in the CCM report, Gulf's
21 bromine output as reported in its SEC filings would have placed Gulf as the number
22 one Chinese producer, accounting for over 40% of China's bromine production in
23 2010. (*Id.* ¶¶ 79–82.) This, Plaintiffs assert, cannot possibly be true. (*Id.*)

24 Gulf attacks the credibility of Plaintiffs' allegation, indicating that Plaintiffs do
25 not actually possess or have access to the CCM report, but relied on an Internet article
26 published by Kerrisdale, a known short seller, which allegedly used the information
27 contained in the CCM report. (Mot. 13–14.) Gulf further disputes the relevance and
28 accuracy of the CCM report itself. (Mot. 14–15.)

1 It is permissible for Plaintiffs to rely on a short seller report, such as the
2 Kerrisdale article, to allege falsity at the pleading stage. *See China Educ. Alliance*,
3 2011 U.S. Dist. LEXIS 117416, at *10–13; *Henning*, 2011 U.S. Dist. LEXIS 79135,
4 at *4–5. At this pleading stage, it is inappropriate to decide the accuracy or the truth
5 of the Kerrisdale report. Thus, the Court finds these allegations adequately plead
6 falsity.

7 4. *The related party transactions allegation*

8 Plaintiffs contend that Gulf’s SEC filings failed to disclose related party
9 transactions by hiding the fact that Rongyuan and Hongye are companies related to
10 Gulf. Plaintiffs assert that Gulf is related to Rongyuan and Hongye through
11 ownership and control by Gulf’s directors (mainly Yang, Gulf’s Chairman of the
12 Board of Directors.) (AC ¶¶ 57–62.) Under SEC Regulation S-K, a public company
13 must disclose related party transactions over \$120,000. 17 C.F.R. § 229.404(a).

14 Rongyuan was Gulf’s largest customer in 2010 and its second biggest customer
15 in 2008 and 2009. (*Id.* ¶¶ 107–108.) But Rongyuan’s SAIC filing shows that Yang
16 and another Gulf Director own over 90% of Rongyuan. (*Id.* ¶¶ 110–111.) Further,
17 Rongyuan has the same phone number, fax number, address, and website as Haoyuan,
18 suggesting that it is a subsidiary of Haoyuan. (*Id.* ¶¶ 109, 111–112.). Haoyuan is
19 owned by Yang and his wife; Yang is also the founder and Chairman of the Board of
20 Haoyuan. (*Id.* ¶¶ 106, 115–116.)

21 In addition, Hongye was one of Gulf’s three largest suppliers of raw materials.
22 (*Id.* ¶ 60.) But like Rongyuan, Hongye is a subsidiary of Haoyuan and is owned and
23 controlled by Haoyuan, Yang, and his family. (*Id.* ¶¶ 60–62.)

24 Gulf argues that related party transactions with Hongye were disclosed in 2010
25 and Hongye was not a related party in 2009. (Mot. 15.) Gulf concludes that the
26 nondisclosure of Hongye in 2009 was not an actionable misstatement. (*Id.*) Gulf does
27 not raise any objections to Plaintiffs’ Rongyuan allegations.

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1 The question whether Hongye was a related party in 2009 is a question of fact,
2 and is inappropriate to resolve at this stage of litigation. The fact remains that
3 transactions with Rongyuan and Hongye were not disclosed. Thus, based on these
4 allegations, the Court finds that Plaintiffs adequately pleaded falsity.

5 5. *The related party competitors allegation*

6 Plaintiffs further allege that Gulf's SEC filings failed to disclose that a direct
7 competitor of Gulf is also company related to Gulf. Specifically, Gulf concealed that
8 Haoyuan is a direct competitor to Gulf's subsidiary SYCI. (*Id.* ¶¶ 116–119.)
9 Plaintiffs allege that these two companies share a similar business scope: for example,
10 both companies produce plastic woven bags and petroleum machinery parts. (*Id.*
11 ¶ 117.) As mentioned above, Haoyuan is controlled by Yang and owned by Yang and
12 his wife. (*Id.* ¶¶ 106, 115–116.) Moreover, Plaintiffs assert that Gulf's SEC filings
13 and Haoyuan's SAIC filings use the same address; thus, this evidences their
14 relationship. (*Id.* ¶¶ 120–121.)

15 Gulf argues that Plaintiffs' accusations lack specificity and fails to show that
16 the two companies are direct competitors. (Mot. 16–17.) Even if the two companies
17 are competitors, Gulf contends it had no obligation to disclose this relationship. (*Id.*)

18 Gulf is correct that Regulation S-K does not mandate disclosure of competitors'
19 names. 17 C.F.R. § 229.101(c)(1)(x). Yet, this situation is not typical. Here, Gulf's
20 competitor is closely related. And so, this relationship alone suggests that the general
21 rule not requiring disclosure of competitors does not apply. Indeed, the goal of
22 Regulation S-K is to require disclosure of all information material to investors'
23 understanding of a registrant's business. *See* 17 C.F.R. § 229.101(c)(1). Thus, based
24 on these allegations, the Court finds that Plaintiffs adequately pleaded falsity.

25 6. *The concealed CEO employment history allegation*

26 Finally, Plaintiffs allege that Gulf did not disclose in its SEC filings that Liu,
27 Gulf's Chief Executive Officer, was previously employed as the Chief Financial
28 Officer of China Finance, a firm allegedly affiliated with listing a number of

1 fraudulent Chinese companies in the United States. (AC ¶ 51.) Regulation S-K
2 requires registrants to describe the business experience of each director and officer
3 during the past five years, and if material, the disclosure should cover more than the
4 past five years and include information about the person’s particular areas of expertise
5 or other relevant qualifications. 17 C.F.R. § 229.401(e)(1).

6 Gulf does not dispute that it was required to disclose its officers’ and directors’
7 employment history in its annual filings. Instead, Gulf argues that Plaintiffs cannot
8 show that China Finance previously promoted fraud or that Liu was promoting frauds
9 while he was employed there. (Mot. 17–18.)

10 The Court does not need to probe whether Liu or China Finance were involved
11 with fraudulent securities schemes. The falsity pleaded in Plaintiffs’ AC concerns the
12 concealment of Liu’s employment history. (AC ¶¶ 122-128.) Plaintiffs contend that
13 the concealed information is material because China Finance is a suspect company
14 with a record of dealings with fraudulent Chinese companies. (*Id.*) Taking these
15 allegations as true, the Court finds that Plaintiffs have adequately pleaded falsity.

16 **B. Scier**

17 Turning to scier, the heightened pleading standard imposed by PSLRA
18 requires a plaintiff to “state with particularity facts giving rise to a strong inference
19 that the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2);
20 *Gompper*, 298 F.3d at 895. A “strong inference” of scier is not merely plausible,
21 but must be “cogent and at least as compelling as any opposing inference of
22 nonfraudulent intent.” *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314
23 (2007). The Supreme Court laid out three prescriptions for courts faced with a Rule
24 12(b)(6) motion to dismiss a section 10(b) action—the court must: (1) accept all of the
25 factual allegations in the complaint as true; (2) consider the complaint in its entirety
26 along with matters of which a court may take judicial notice; and (3) take into account
27 plausible opposing inferences. *Id.* at 322–323.

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1 With this guidance, the Court notes that other courts have found a strong
2 inference of scienter when U.S. listed Chinese companies overstated their financials in
3 SEC filings and failed to disclose related party transactions. *See China Educ.*
4 *Alliance*, 2011 U.S. Dist. LEXIS 117416, at *17–18; *Henning*, 2011 U.S. Dist. LEXIS
5 79135, at *16–18. In comparison with these cases, this case has even more facts:
6 significantly different U.S. and Chinese financial filings; high turnover rates and profit
7 margin compared to competitors; related party transactions disclosed in 2010 but not
8 in 2009; concealment of related party competitor; concealment of the CEO’s
9 employment history. Viewing these facts holistically, the Court is compelled to find
10 scienter. For instance, Gulf’s financials are so grossly overstated compared to that of
11 its two subsidiaries that it cannot be mere negligence. Similarly, Gulf’s high turnover
12 rates, profit margin, and status as a top Chinese bromine producer are essential metrics
13 that are known, and should be known by all executives and directors for their
14 respective industries. To blatantly overstate these metrics on a SEC filing amounts to
15 either brazen defiance or reckless negligence. In addition, the omission of Gulf’s
16 related parties cannot be unintentional—it would be absurd to suggest that Yang did
17 not know about the operations of his various companies. The opposite is more likely
18 true, that Yang used these related companies to generate business for one another.
19 Finally, Gulf’s omission of its CEO’s previous employment with China Finance
20 appears to be intentional. Gulf offers no explanation why it was not mentioned. It
21 was likely omitted because its inclusion would have sullied Gulf’s reputation—thus,
22 the purpose in omitting the connection is manifest.

23 Gulf offer several nonculpable explanations. First, Gulf suggests that its
24 offices, directors, and accountants did not have actual knowledge of the alleged
25 falsities. (Mot. 19.) As discussed above, the magnitude of those errors suggest that
26 the errors would have been noticed if they were unintentional. Second, Gulf argues
27 that the discrepancies arise from different accounting rules between China and the
28 United States. (Mot. 21.) Yet, the discrepancies are so great that a mere accounting

1 difference cannot be a plausible reason. Third, Gulf contends that because Gulf was
2 new to the U.S. capital market, Gulf did not fully appreciate the stringent SEC
3 disclosure requirements requiring disclosure of related party transactions. (Reply 10.)
4 While this may be true, this does not negate a finding that scienter was adequately
5 pleaded. The omission of related party transactions is not a trifle. Common sense
6 dictates that this is material information and indeed, Regulation S-K devotes an entire
7 section and notes that it is one of the core disclosures that companies have to report.
8 17 C.F.R. § 229.404; *see* 17 C.F.R. § 229.10(f). Further, this excuse lacks merit
9 because Gulf’s SEC filings were independently audited. (AC ¶¶ 129–135.)

10 What is more, Gulf attempts to negate the inference of scienter by arguing lack
11 of motive—that the individual Defendants did not sell Gulf’s stock during the class
12 period, but instead increased their holdings. (Mot. 20–21.) Plaintiffs refute by
13 pointing out that Yang’s wife sold a large number of shares. (Opp’n 20.) Though
14 Gulf proposes a countervailing inference, this merely raises a factual dispute. Further,
15 the absence of motive to profit is relevant but not dispositive. *See Matrixx Initiatives,*
16 *Inc. v. Siracusano*, 131 S. Ct. 1309, 1324 (2011).

17 In sum, when Plaintiffs’ allegations are viewed collectively, the Court finds that
18 the inference that Gulf acted with intent is “at least as compelling as any opposing
19 inference one could draw from the facts alleged.” *Tellabs*, 551 U.S. at 324. Plaintiffs
20 have adequately pleaded scienter, but whether they can prove their allegations and
21 establish scienter is another question.

22 **C. Loss Causation**

23 The final issue is whether Plaintiffs have sufficiently pleaded loss causation.
24 PSLRA requires plaintiffs to prove that “the act or omission of the defendant . . .
25 caused the loss for which the plaintiff seeks to recover damages.” 15 U.S.C. § 78u-
26 4(b)(4). In a securities fraud action, “loss causation is the causal connection between
27 a defendant’s material misrepresentation and a plaintiff’s loss.” *Metzler Inv. GMBH*
28 *v. Corinthian Colls., Inc.*, 540 F.3d 1049, 1062 (9th Cir. 2008) (citing *Dura Pharm.*,

1 544 U.S. at 342). The complaint must allege that the defendant’s share price fell
2 significantly after the truth became known. *Id.* But a plaintiff need not show that a
3 defendant’s “misrepresentation was the sole reason for [an] investment’s decline in
4 value in order to establish loss causation.” *Id.* Plaintiff needs only show “some
5 indication that the drop in [defendant’s] stock price was causally related to [its]
6 financial misstatements.” *In re Daou Sys., Inc.*, 411 F.3d 1006, 1026 (9th Cir. 2005).

7 Furthermore, “loss causation becomes most critical at the proof stage . . . and it
8 is normally inappropriate to rule on loss causation at the pleading stage.” *In re Gilead*
9 *Scis. Sec. Litig.*, 536 F.3d 1049, 1057 (9th Cir. 2008). Thus, for this element of a
10 section 10(b) claim, a pleading needs enough facts “to raise a reasonable expectation
11 that discovery will reveal evidence of loss causation.” *Id.*

12 Here, Plaintiffs allege that once the fraud was publically disclosed by the
13 Glaucus report on April 26, 2011, Gulf’s stock price fell \$1.16 per share, or over thirty
14 percent, on heavy trading volume, causing substantial financial damages to investors.
15 (*Id.* ¶¶ 15–17.) A short seller report may be used to establish loss causation. In
16 *Henning*, the court found that the plaintiff sufficiently pleaded loss causation by
17 relying on a short seller report, because “Plaintiffs’ losses stem from the [short seller]
18 report’s revelation of these alleged frauds.” *Henning*, 2011 U.S. Dist. LEXIS 79135,
19 at *22. Likewise, the Court finds that the Glaucus report publicly revealed Gulf’s
20 alleged fraud and as a result, Gulf’s stock price immediately fell over thirty percent
21 after the revelation. (AC ¶¶ 15, 17.)

22 Gulf makes a truth on the market defense and argues that the negative facts
23 concerning Gulf were disclosed prior to the Glaucus report and were already priced
24 into its stock. (Mot. 23–24.) Yet, there is no evidence to suggest that these negative
25 facts were already publically known. For example, Gulf’s SAIC filings were not
26 public, and even if they were, they are not readily accessible for U.S. investors. *In re*
27 *Fuwei Films Sec. Litig.*, 634 F. Supp. 2d 419, 438 (S.D.N.Y. 2009) (Chinese-language
28 article in Chinese news media not public information.)

1 Finally, Gulf's suggestion that Plaintiffs cannot suffer any loss as a result of
2 fraud that was not disclosed until after the close of the class period is incorrect.
3 (Mot. 25.) Court have held otherwise. *In re Dura Pharm., Inc. Sec. Litig.*, 452 F.
4 Supp. 2d 1005, 1023 (S.D. Cal. 2006) (rejecting the notion that loss causation is
5 absent when the corrective disclosures occur after the close of the class period).

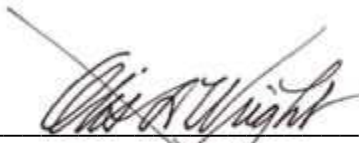
6 Thus, the Court finds that Plaintiffs have adequately pleaded loss causation by
7 tying their economic loss to the Glaucus report.

8 IV. CONCLUSION

9 For the reasons discussed above, Plaintiffs have adequately plead falsity,
10 scienter, and loss causation. Accordingly, Gulf's motion to dismiss is **DENIED**.

11 **IT IS SO ORDERED.**

12
13 May 15, 2012

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16 _____
17 **OTIS D. WRIGHT, II**
18 **UNITED STATES DISTRICT JUDGE**