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UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

JEFF FEYKO, individually and on behalf of all others similarly situated,)	Case No. CV 11-05511 DDP (PJWx)
)	
Plaintiff,)	ORDER GRANTING IN PART AND DENYING IN PART MOTIONS TO DISMISS AND STRIKE
)	
v.)	[Docket Nos. 79-83]
)	
YUHE INTERNATIONAL, INC., GAO ZHENTAO and HU GANG.,)	
)	
Defendants.)	
_____)	

I. Background

Lead Plaintiff aAd Partners LP alleges that it purchased shares of common stock of Yuhe International, Inc. ("Yuhe"), during the class period, including in the October 20, 2010 secondary offering of Yuhe shares. (Supplemental Consolidated Class Action Complaint ("CAC") ¶ 17, Docket No. 70.) There are three groups of Defendants in this case (collectively "Defendants"). The "Yuhe Defendants" are comprised of Yuhe ("Yuhe"), and the "Individual Defendants": Zhentao Gao ("Gao"), Yuhe's CEO, Chairman of the Board, and largest shareholder, Hu Gang ("Gang"), Yuhe's CFO; and

1 Jiang Yingjun ("Yingjun"), Yuhe's Chief Accounting Officer. (Id.
2 ¶¶ 19-21.) The second group is comprised only of Child, Van
3 Wagoner & Bradshaw ("the Auditor Defendant"), which was Yuhe's
4 independent auditor from March 12, 2008 to December 7, 2009, and
5 from March 9, 2010 to June 17, 2011. (Id. ¶ 27.) The third group
6 is called the "Underwriter Defendants." They are Roth Capital
7 Partners, LLC ("Roth"); Brean Murray, Carret & Co., LLC; and
8 Global Hunter Securities, LLC, and they were the underwriters for
9 Yuhe's October 20, 2010 public offering, with Roth serving as the
10 "book-running manager of the Offering". (Id. ¶¶ 23, 25-26.)¹

11 The CAC alleges four claims, with the first and second falling
12 under the Securities Exchange Act of 1934 and the third and fourth
13 under the Securities Act of 1933. Lead Plaintiff's first claim
14 alleges the Yuhe Defendants violated Section 10(b) of the Exchange
15 Act. The second claim alleges the Individual Defendants were
16 control persons, who violated Section 20(a) of the Exchange Act.
17 The third claim alleges that all Defendants violated Sections 11
18 and 15 of the Securities Act. Lead Plaintiff's fourth claim
19 alleges that the Underwriter Defendants violated Section 12(a)(2)
20 of the Securities Act. All Defendants have moved to dismiss all
21 claims against them. The Yuhe Defendants and the Underwriter
22 Defendants have also moved to strike Lead Plaintiff's CAC. For the
23 reasons stated below, the Court DENIES the Defendants' motions,
24 with the exception of GRANTING dismissal of the Section 11 claim

25

26 ¹Rodman & Renshaw, LLC ("Rodman") was also an underwriter, and was also
27 named as a defendant in this action. (Id. at ¶ 24.) However, Rodman has filed
28 for bankruptcy. (Docket No. 126.) Pursuant to section 326 of the Bankruptcy
Code, the instant action is stayed as to Rodman only. The Court notes that Lead
Plaintiff has not objected to staying the action against Rodman.

1 against the Underwriter Defendants, GRANTING Dismissal of the
2 Section 10(b) claim against Gang, and GRANTING dismissal of the
3 Section 12(a)(2) and Section 11 claims of all subclass members
4 whose Yuhe shares are only traceable to the second offering.
5 Dismissal is without prejudice, except as to the Section 12(a)(2)
6 claims.

7 Yuhe sells broiler chickens. (CAC ¶ 18.) On December 31,
8 2010, Yuhe filed a Form 8-K announcing that it entered into an
9 agreement with Waifang Dajiang ("Dajiang") to purchase thirteen
10 breeder farms, and that Yuhe had already paid the first of two
11 installments on those farms. (Id. ¶ 44.) Another Form 8-K, filed
12 on January 4, 2010, attached a press release that was entitled
13 "Yuhe International, Inc. Increases Number of Breeder Farms to 27."
14 (Id. ¶ 45.) Gao was quoted in this press release as stating, "By
15 purchasing these thirteen breeder farms, we are able to quickly
16 increase our production capacity of day-old broilers." (Id.) The
17 acquisition was touted as increasing Yuhe's "capacity by 60%."
18 (Id. ¶ 46.) On March 11, 2010, Yuhe reported that its independent
19 auditor, Grant Thornton, resigned on March 5, 2010. (Id. ¶ 47.)
20 Yuhe's Form-10k Annual Report for 2009 was filed on March 31, 2010,
21 and repeated that Yuhe contracted to purchase thirteen breeder
22 farms from Dajiang, and had paid 80% of the total consideration by
23 December 31, 2009. (Id. ¶ 49.) Gao, Gang, and Yingjun signed the
24 Form 10-K, and Gao and Gang signed its Sarbanes-Oxley
25 certification. (Id. at ¶ 50.) Between March and October 2010 a
26 number of Yuhe's SEC filings indicated that it had acquired the
27 thirteen breeder farms from Dajiang. (Id. at ¶¶ 46, 48, 49, 53-
28 59.) Yuhe's October 20, 2010 Prospectus Supplement incorporated

1 many of the SEC filings discussed above. (Id. at ¶¶ 71-72.) It
2 also incorporated the Auditor Defendant's opinion, which contained
3 various alleged misrepresentations about the Dajiang acquisition.
4 (Id. at ¶¶ 90-101.) From October 20, 2010, to November 2, 2010,
5 Yuhe sold \$4,140,000 newly-issued shares at \$7 each pursuant to its
6 second offering. (Id. at ¶¶ 60,61.) The Underwriter Defendants
7 were awarded shares pursuant to this offering. (Id.)

8 On May 16, 2011, Yuhe filed Form 10-Q with the SEC, with Gao
9 and Gang signing its accompanying Sarbanes-Oxley certifications,
10 which reaffirmed that Yuhe acquired thirteen breeder farms from
11 Dajiang in December 2009, and had already paid Dajiang over \$12
12 million in this transaction. (Id. ¶ 67.)

13 On June 8, 2011, GeoInvesting spoke with Mr. Xuejing Zheng
14 ("Zheng"), Chairman and General Manager of Dajiang. (Id. ¶ 76.)
15 Zheng told GeoInvesting that Yuhe never purchased breeding farms
16 from Dajiang, nor had the two discussed such an acquisition. (Id.
17 ¶ 77.) The next day, GeoInvesting again spoke with Zheng, in part
18 because it heard that Dajiang and Yuhe actually engaged in
19 acquisition negotiations with Yuhe in 2009. (Id. ¶ 78.) Zheng
20 admitted that the two did talk, but that it was only once, and that
21 Dajiang "did not proceed with this deal." (Id.) Zheng also stated
22 that the only deal Yuhe proposed was a fake deal: "They told us to
23 make a fake deal-it's like I lease your facilities to make a fake
24 deal for my US listing. . . ." (Id. ¶ 78 (internal quotation mark
25 omitted).)

26 On June 13, 2011, GeoInvesting released transcripts of its
27 conversations with Zheng, and Yuhe's stock price dropped 12.77%
28 that day. (Id. ¶¶ 75-76, 103-104.) The next day, Yuhe held a

1 conference call, where it asserted that Zheng was asked misleading
2 questions, and that Zheng would cooperate with Yuhe to clear up the
3 "misunderstandings." (Id. ¶ 80.) Yuhe's stock closed at \$4.35 on
4 that day. (Id. ¶ 105.)

5 The next day, GeoInvesting had another conversation with
6 Zheng, where he insisted Dajiang and Yuhe never reached an
7 agreement: "Did not reach the agreement. After the failure to do a
8 deal with us, I don't know why Yuhe claims this in the United
9 States. Maybe for cheating money or for cheating to list in the
10 United States?" (Id. ¶ 81.) GeoInvesting released this
11 conversation on June 16, and Yuhe's stock dropped to \$1.96 per
12 share that day. (Id. ¶ 107.)

13 On June 17, 2011, Yuhe hosted a conference call, where its
14 representatives stated that the contract with Dajiang had been
15 retracted, and that the funds for that transaction were put into a
16 different company. (Id. ¶ 83.) Below are excerpts of what the CEO
17 (Gao), CFO, and CAO said on the conference call about what happened
18 with the Dajiang deal, why it was not disclosed, and what the
19 company did with the money it previously asserted was already paid
20 in that deal:

- 21 • CAO: "[W]e worried that the cancellation of the contract and
22 refunded cash would provoke negative reactions from the
23 capital market."
- 24 • CEO: "[M]anagement was under huge pressure to deliver what we
25 had previously promised."
- 26 • CFO: "The contract retract happened after our previous auditor
27 Grant Thornton resigned [March 5, 2010], so CEO worried that a
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1 retracted contract would increase negative investor sentiments
2 and adversely affected [sic] the share price."

3 • CEO: "[I]f the Company just put these [sic] money aside for
4 cash reservation of purchasing additional breeder farms other
5 than those farms from Dajiang, it wouldn't impact the
6 financials or the Company and hence no volatility in the share
7 price."

8 • When one individual on the call "pointed out that as of May
9 16, 2011, Yuhe represented that it had possession of the
10 thirteen Dajiang breeding farms," the CEO responded: "After
11 the incident, the management was under huge pressure to
12 deliver what we had previously promised. . . The CEO takes
13 full responsibility for not disclosing the change in a timely
14 manner. . . ."

15 (Id. ¶¶ 47, 83.)

16 On June 17, 2011, the Auditor Defendant resigned, in light of
17 the "Company's management's misrepresentation and failure to
18 disclose material facts surrounding certain acquisition
19 transactions and off-balance sheet related party transactions."

20 (Id. ¶ 84.) On June 28, 2011, NASDAQ delisted Yuhe, citing the
21 company's "false public disclosures, which persisted for well over
22 a year, related to the Company's purported acquisition of farms
23 Dajiang." (Id. ¶ 85.)

24 **II. Legal Standard**

25 A complaint will survive a motion to dismiss when it contains
26 "sufficient factual matter, accepted as true, to state a claim to
27 relief that is plausible on its face." Ashcroft v. Iqbal, 556 U.S.
28 662, 678 (2009) (quoting Bell Atl. Corp. v. Twombly, 550 U.S. 544,

1 570 (2007)). When considering a Rule 12(b)(6) motion, a court must
2 "accept as true all allegations of material fact and must construe
3 those facts in the light most favorable to the plaintiff." Resnick
4 v. Hayes, 213 F.3d 443, 447 (9th Cir. 2000). Although a complaint
5 need not include "detailed factual allegations," it must offer
6 "more than an unadorned, the-defendant-unlawfully-harmed-me
7 accusation." Iqbal, 556 U.S. at 678. Conclusory allegations or
8 allegations that are no more than a statement of a legal conclusion
9 "are not entitled to the assumption of truth." Id. at 679. In
10 other words, a pleading that merely offers "labels and
11 conclusions," a "formulaic recitation of the elements," or "naked
12 assertions" will not be sufficient to state a claim upon which
13 relief can be granted. Id. at 678 (citations and internal
14 quotation marks omitted).

15 "When there are well-pleaded factual allegations, a court should
16 assume their veracity and then determine whether they plausibly
17 give rise to an entitlement of relief." Id. at 679. Plaintiffs
18 must allege "plausible grounds to infer" that their claims rise
19 "above the speculative level." Twombly, 550 U.S. at 555-56.
20 "Determining whether a complaint states a plausible claim for
21 relief" is a "context-specific task that requires the reviewing
22 court to draw on its judicial experience and common sense." Iqbal,
23 556 U.S. at 679.

24 **III. Analysis**

25 **A. Yuhe Defendants' Motion to Dismiss the Section 10(b)**

26 **Claim**

27 To state a claim for securities fraud under Section 10(b) of
28 the Securities Exchange Act and Rule 10b-5 promulgated thereunder,

1 plaintiffs must plead particularized facts demonstrating "(1) a
2 material misrepresentation or omission of fact, (2) scienter, (3) a
3 connection with the purchase or sale of a security, (4) transaction
4 and loss causation, and (5) economic loss." Zucco Partners, LLC v.
5 Digimarc Corp., 552 F.3d 981, 990 (9th Cir. 2009) (citations and
6 internal quotation marks omitted).

7 The Yuhe Defendants argue Lead Plaintiff's Section 10(b) claim
8 should be dismissed for several reasons. First they argue that
9 "allegations based on the" GeoInvesting report "should be
10 rejected." (See generally Docket No. 82 at 7:3-9:20.) Because the
11 Yuhe Defendants' argument on this point closely parallels its
12 motion to strike, it will be discussed in the analysis of that
13 motion. Although the standard for a motion to strike is different
14 from one to dismiss, the Yuhe Defendants' motion to dismiss
15 argument fails for the same reason its motion to strike argument
16 fails.

17 The Yuhe Defendants next state that the CAC does not plead
18 material misrepresentations. (Id. at 9:21-10:13, 16:8-17:5.) In
19 alleging a Section 10(b) claim under the Private Securities and
20 Litigation Reform Act, a plaintiff must meet heightened standards
21 for alleging falsity and scienter. In alleging falsity, a
22 Plaintiff must "specify each statement alleged to have been
23 misleading, the reason or reasons why the statement is misleading,
24 and, if an allegation regarding the statement or omission is made
25 on information and belief, the complaint shall state with
26 particularity all facts on which that belief is formed." 15 U.S.C.
27 78u-4(b)(1). A statement must be false when made to be actionable.
28 In re Am. Apparel, Inc. S'holder Litig., 855 F. Supp. 2d 1043, 1071

1 (C.D. Cal. 2012). "For purposes of securities fraud, materiality
2 depends on the significance the reasonable investor would place on
3 the withheld or misrepresented information. . . . A statement is
4 material if a reasonable investor would have considered it useful
5 or significant." United States v. Jenkins, 633 F.3d 788, 802 (9th
6 Cir. 2011) (internal quotation marks and citations omitted).
7 "Questions of materiality . . . involv[e] assessments peculiarly
8 within the province of the trier of fact. . . . Thus, the ultimate
9 issue of materiality [is] appropriately resolved as a matter of law
10 only where the omissions are so obviously important to an investor,
11 that reasonable minds cannot differ. . ." Siracusano v. Matrixx
12 Initiatives, Inc., 585 F.3d 1167, 1178 (9th Cir. 2009), aff'd, 131
13 S. Ct. 1309 (U.S. 2011) (internal quotation marks and citations
14 omitted).

15 Lead Plaintiff has pled that a material misrepresentation
16 occurred.² As discussed, Zheng told GeoInvesting that no agreement
17 was ever reached between Yuhe and Dajiang, thus making all Yuhe's
18 SEC filings, at least one of which all of the Individual Defendants
19 signed, reporting the contrary false.

20 Putting the statements that Zheng made to GeoInvesting aside,
21 Lead Plaintiff has still shown that there was a misrepresentation.
22 Although the Individual Defendants stated in the June 17, 2011
23 conference call that they had a contract with Dajiang, the CEO
24 makes clear that the contract was cancelled by in March 2010: "From

25
26 ²The Court is under no obligation to evaluate every misrepresentation that
27 was made in the CAC, because Plaintiff can survive a motion to dismiss by
28 alleging a single material misrepresentation. See Cunha v. Hansen Natural Corp.,
No. EDCV 08-1249-GW JCX, 2011 WL 8993148 (C.D. Cal. May 12, 2011) (holding that
"there is no reason that [the Court] must address parts of the CAC that do not
work.")

1 March 2010 to the present, the company had completed the
2 acquisition of eleven breeder farms with the cash refunds from
3 Dajiang." (CAC ¶ 83.) However, and as discussed, from March 2010
4 through May 2011 Yuhe represented to the SEC on a number of
5 occasions that it had an agreement with Dajiang, and on one such
6 occasion, all of the Individual Defendants signed a document
7 containing the misrepresentation. (Id. ¶ 83.)

8 The Court does not find that these misrepresentations were
9 immaterial as a matter of law. Materiality is rarely appropriate
10 to decide at the motion to dismiss stage. Siracusano, 585 F.3d at
11 1178. The Yuhe Defendants' best argument that the
12 misrepresentations were immaterial is that Yuhe began purchasing
13 other breeding farms when the Dajiang deal failed. (CAC ¶ 83.) As
14 the complaint states, eleven were acquired from March 2010 to June
15 2011. (Id.) However, acquiring different farms at a later date
16 does not moot the materiality of the Dajiang misrepresentations.

17 The Yuhe Defendants also assert that Lead Plaintiff cannot
18 show scienter. The scienter requirement is satisfied when "a
19 complaint . . . allege[s] that the defendant made false or
20 misleading statements either intentionally or with deliberate
21 recklessness." In re VeriFone Holdings, Inc. Sec. Litig., No.
22 11-15860, 2012 WL 6634351, at *4 (9th Cir. Dec. 21, 2012)
23 (quotation marks omitted). Scienter is shown "only if a reasonable
24 person would deem the inference of scienter cogent and at least as
25 compelling as any opposing inference one could draw from the facts
26 alleged." Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 991
27 (9th Cir. 2009) (quotation marks omitted). To determine scienter,
28 the complaint's allegations must be read "holistically." In re

1 VeriFone, 2012 WL 6634351, at *5. The Ninth Circuit has recently
2 made clear that courts do not need to consider whether each
3 allegation of scienter creates a strong inference of that mental
4 state, because a holistic review will suffice. Id. at *6 (engaging
5 in a holistic analysis, but noting a dual analysis, where
6 allegations are analyzed individually and then holistically, is
7 "permissible").

8 Lead Plaintiff has sufficiently alleged scienter as to Gao,
9 and thus has also successfully alleged it as to Yuhe. See Glazer
10 Capital Mgmt., LP v. Magistri, 549 F.3d 736, 744 (9th Cir. 2008).
11 The CEO, Gao, proposed a "fake deal" to Zheng in order to lure
12 American investment. (CAC ¶ 78.) Moreover, Gao and the CAO,
13 Yingjun, both made remarks at the June 17 conference call
14 indicating that they intentionally did not reveal that the Dajiang
15 deal was "retract[ed]":

- 16 • CAO: "[W]e worried that the cancellation of the contract and
17 refunded cash would provoke negative reactions from the
18 capital market."
- 19 • CEO: "[M]anagement was under huge pressure to deliver what we
20 had previously promised."
- 21 • CFO: "The contract retract happened after our previous auditor
22 Grant Thornton resigned, so CEO worried that a retracted
23 contract would increase negative investor sentiments and
24 adversely affected [sic] the share price."
- 25 • CEO: "[I]f the Company just put these [sic] money aside for
26 cash reservation of purchasing additional breeder farms other
27 than those farms from Dajiang, it wouldn't impact the
28

1 financials of the Company and hence no volatility in the share
2 price.”

3 (Id. ¶ 83.)

4 There is also sufficient scienter regarding Yingjun. On the
5 June 17, 2011, conference call he expressed taking part in a scheme
6 to hide the fact that the Dajiang deal fell through, which on that
7 call was claimed to have occurred by March 2010: “Since we had a
8 contract signed with Dajiang and the contract was disclosed, we
9 worried that the cancellation of the contract and refunded cash
10 would provoke negative reactions from the capital market.” (Id.)
11 The heightened scienter standard is not met for Gang, the CFO,
12 though. The CAC avers that the CEO hid the breakdown of the
13 Dajiang deal from Gang. (Id.) Additionally, the CAC does not
14 provide enough information about Gao’s duties as CFO for the Court
15 to infer that he would have had knowledge of something the CEO
16 actively hid from him. (See id. ¶ 116) (describing the Individual
17 Defendants’ job duties generally, and not specifically discussing
18 Gao’s).

19 **B. The Section 11 Claim Against All Defendants**

20 The CAC states that all Defendants are liable under Section 11
21 of the Securities Act, because there were materially false
22 statements about the Dajiang acquisition in the Prospectus and
23 Prospectus Supplement for Yuhe’s second stock offering. (CAC ¶¶
24 129-44.) The Yuhe Defendants and the Underwriter Defendants argue
25 Lead Plaintiff does not have standing to pursue a Section 11
26 claim.³

27
28 ³The Underwriter Defendants also argue that the Section 11 claim should be
(continued...)

1 Section 11 of the Securities act "provides a cause of action
2 to any person who buys a security issued under a materially false
3 or misleading registration statement." In re Century Aluminum Co.
4 Sec. Litig., No. 11-15599, 2013 WL 11887, at *1 (9th Cir. Jan. 2,
5 2013). To have standing to sue under Section 11 plaintiffs must
6 show they "have purchased shares in the offering made under the
7 misleading registration statement," or if they purchased their
8 shares in the aftermarket standing will be found "provided they can
9 trace their shares back to the relevant offering." Id. The latter
10 approach is "often impossible," and conclusory allegations in the
11 complaint that the shares are traceable will not suffice. Id. at
12 *1-2.

13 The CAC alleges that on October 20, 2010 there was a second
14 offering for Yuhe stock at a price of \$7 per share. (CAC ¶ 60.)
15 It is also alleged that Lead Plaintiff bought shares "pursuant to
16 the October 20, 2010 Prospectus Supplement," and that it purchased
17 stock "pursuant to the offering." (CAC ¶¶ 17, 60, 130, 139.) When
18 plaintiffs purchase stock pursuant to an offering or a prospectus,
19 it means that they have purchased stock from its issuer. See In re
20 Levi Strauss & Co. Sec. Litig., 527 F. Supp. 2d 965, 983 (N.D. Cal.
21 2007); In re Nat'l Golf Properties, Inc., No. CV 02-1383GHK(RZX),
22 2003 WL 23018761, at *2. A conclusory statement that stock is
23 traceable to a particular offering will not suffice, because it is
24 difficult to trace the chain of custody of stock in the
25 aftermarket. In re Century Aluminum Co. Sec. Litig., 2013 WL

26
27 ³(...continued)
28 stricken for this same reason. The Underwriter Defendants motion to strike
argument, thus, fails for the same reason its motion to dismiss argument does.

1 11887, at *2 (9th Cir. Jan. 2, 2013). However no such difficulty
2 exists when stock is purchased pursuant to a prospectus or
3 offering, so Plaintiff's allegations in paragraphs 17, 60, 130, and
4 139 will suffice. Nevertheless, since Plaintiff seeks to represent
5 members of the Subclass who purchased Yuhe stock that is traceable
6 to the secondary offering, and since Lead Plaintiff does not
7 provide any detailed analysis as to how these Subclass members'
8 shares can be traced to the relevant offering, the Court dismisses
9 the Section 11 claims of these subclass members. (CAC ¶ 1; See
10 generally CAC); See In re Century Aluminum Co. Sec. Litig., 2013 WL
11 11887, at *1-2.

12 The Yuhe Defendants next state that Lead Plaintiff's Section
13 11 claim sounds in fraud, and that Lead Plaintiff has not alleged
14 sufficient facts to prove such a claim. "To ascertain whether a
15 complaint 'sounds in fraud' we must normally determine, after a
16 close examination of the language and structure of the complaint,
17 whether the complaint 'allege[s] a unified course of fraudulent
18 conduct' and 'rel[ies] entirely on that course of conduct as the
19 basis of a claim.'" Rubke v. Capitol Bancorp Ltd, 551 F.3d 1156,
20 1161 (9th Cir. 2009) (citation omitted). Lead Plaintiff does not
21 seriously contest whether the Section 11 claim against the Yuhe
22 Defendants sounds in fraud; it only argues that it satisfied its
23 pleading obligations should the Court find that it does. (Docket
24 No. 111 at 22:14-19.) Lead Plaintiff has, thus, conceded that this

1 claim against the Yuhe Defendants sounds in fraud.⁴ Cent. Dist.
2 L.R. 7-12.

3 A Section 11 claim that sounds in fraud does not need to meet
4 the "heightened pleading requirements of the PSLRA," but under Rule
5 9(b) the claim must "set forth what is false or misleading about a
6 statement, and why it is false." Rubke, 551 F.3d at 1161
7 (citations omitted). As discussed, the October 20, 2010 Prospectus
8 Supplement incorporated by reference a number of previous SEC
9 filings that falsely claimed, among other misrepresentations, that
10 Yuhe had an agreement with Dajiang. (CAC ¶¶ 71-72.) Therefore,
11 Lead Plaintiff has met its burden regarding alleging a Section 11
12 claim that sounds in fraud. The Auditor Defendant argues that it
13 is entitled to a loss causation affirmative defense as a matter of
14 law. "To establish a 'loss causation' defense under Section 11(e),
15 [defendant] needed to prove that the depreciation in value . . .
16 resulted from factors other than the . . . material misstatement."
17 In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1422 (9th Cir.
18 1994) (internal quotations and citation omitted). Because of the
19 "fact-intensive" nature of a causation analysis, it usually must be
20 established in summary judgment or trial, not a motion to dismiss.
21 In re Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132,
22 1171 (C.D. Cal. 2008). The burden for proving loss causation is

23
24 ⁴Although Lead Plaintiff's Section 11 claim against the Yuhe Defendants
25 sounds in fraud, this ruling does not automatically apply to the other
26 Defendants. Mallen v. Alphatec Holdings, Inc., 861 F. Supp. 2d 1111, 1125 (S.D.
27 Cal. 2012); In re Fuwei Films Sec. Litig., 634 F. Supp. 2d 419, 437 (S.D.N.Y.
28 2009). The Underwriter Defendants do not argue this point. The Auditor
Defendant seems to argue it in the reply brief, (Docket No. 120 at 2:8-25), but
the Court need not consider new arguments first raised in a reply brief. See
Zamani v. Carnes, 491 F.3d 990, 997 (9th Cir. 2007) (affirming district court's
decision to reject points raised for the first time in reply).

1 "heavy," and the defense "can be used as a ground for dismissal on
2 a Rule 12(b)(6) motion to dismiss only if the merits of the defense
3 are apparent on the [complaint's] face. . ." In re DDi Corp. Sec.
4 Litig., No. CV 03-7063 NM, 2005 WL 3090882 (C.D. Cal. July 21,
5 2005) (internal quotation marks and citations omitted).

6 The Auditor Defendant is alleged to have reported Yuhe's
7 finances in a way that falsely made it look like Yuhe had purchased
8 the Dajiang farms, when Yuhe had not. (CAC ¶¶ 91-92.)
9 Principally, the Auditor Defendant argues: "[T]he conclusion is
10 inescapable that the decline in the value of Yuhe's shares was due
11 to the combination of [the Auditor Defendant's] resignation driven
12 by events that occurred in connection with the report of
13 GeoInvesting . . ." (Docket No. 80 at 10:1-5.) However, the
14 Auditor Defendant's resignation and the GeoInvesting Report are not
15 so separable from the Auditor Defendant's alleged misstatements.
16 GeoInvesting's report exposed Yuhe's misrepresentation about
17 acquiring breeder farms from Dajiang, a misrepresentation that the
18 Auditor Defendant's analysis of Yuhe's finances further propagated.
19 Because the Auditor Defendant's alleged misrepresentation is
20 interrelated to Yuhe's, because Yuhe's stock dropped when that
21 misrepresentation was exposed, and because causation is rarely
22 appropriate at the motion to dismiss stage, the Court cannot find
23 that the Auditor Defendant is entitled to the loss causation
24 defense as a matter of law.

25 The Auditor Defendant also seeks dismissal of Lead Plaintiff's
26 Section 11 claim on grounds that the CAC has not alleged facts
27 sufficient to prove negligence. (Docket No. 80 at 5:18-20.)
28 However, Section 11 only requires a plaintiff to prove "(1) that

1 the registration statement contained an omission or
2 misrepresentation, and (2) that the omission or misrepresentation
3 was material, that is, it would have misled a reasonable investor
4 about the nature of his or her investment." Rubke, 551 F.3d at
5 1161 (internal quotation marks and citation omitted). Section 11
6 generally holds "the issuer of the securities . . . absolutely
7 liable." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208 (1976).
8 However, experts, like the Auditor Defendant here, "who have
9 prepared portions of the registration statement are accorded a 'due
10 diligence' defense. In effect, this is a negligence standard."
11 Id. The expert must prove it acted with due diligence. Id.
12 Accordingly, with respect to the Auditor Defendant, Lead Plaintiff
13 "need not affirmatively plead negligence." In re Initial Pub.
14 Offering Sec. Litig., 241 F. Supp. 2d 281, 396 (S.D.N.Y. 2003).⁵
15 The Auditor Defendant only argues that the CAC does not allege
16 negligence. It fails, because it does not argue that the CAC
17 alleges it acted reasonably, which would be required to establish

19 ⁵At oral argument, the parties discussed whether Lead Plaintiff had to
20 plead that the Auditor Defendant and the Underwriter Defendants were negligent.
21 Cases often state that non-issuer defendants will be liable for negligence.
22 See, e.g., In re Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 359 (2d
23 Cir. 2010). However, this language indicates that a Section 11 claim against
24 non-issuer defendants will ultimately come down to negligence, because these
25 defendants may avoid liability if they prove they acted diligently. Thus, the
26 burden is not on Plaintiff to plead negligence. A recent case from the Second
27 Circuit is illustrative of this point. After holding that non-issuers "may be
28 held liable for mere negligence," the Second Circuit clarified in a footnote
that:

More specifically, section 11 provides several due diligence
defenses available to non-issuer defendants, see 15 U.S.C. §
77k(b), and section 12(a)(2) contains a "reasonable care"
defense, id. § 771 (a)(2). . . . Generally speaking, defendants
bear the burden of demonstrating the applicability of each of
these defenses, which are therefore unavailing as a means of
defeating a motion to dismiss pursuant to Rule 12(b)(6).

Id. at 359, n.7.

1 an affirmative defense at the motion to dismiss stage. McCalden v.
2 California Library Ass'n, 955 F.2d 1214, 1219 (9th Cir. 1990)
3 (holding that "[f]or a complaint to be dismissed because the
4 allegations give rise to an affirmative defense 'the defense
5 clearly must appear on the face of the pleading.'").

6 The Underwriter Defendants assert that the face of the CAC
7 establishes their due diligence defense. They argue that their
8 work on the offering and prospectus relied on the auditors'
9 financial statements and certified expert opinions, which they were
10 entitled to do, and which, thus, justifies their dismissal. "An
11 underwriter need not conduct due diligence into the 'expertised'
12 parts of a prospectus, such as certified financial statements." In
13 re Software Toolworks Inc., 50 F.3d 615, 623 (9th Cir. 1994). An
14 underwriter "need only show that it 'had no reasonable ground to
15 believe, and did not believe ... that the statements therein were
16 untrue or that there was an omission to state a material fact
17 required to be stated therein or necessary to make the statements
18 therein not misleading.'" Id. Although an underwriter must prove
19 the due diligence defense, courts look to plaintiffs to point to
20 red flags that should have indicated to the underwriter that the
21 financial statements were not trustworthy. See id. at 623-24.

22 While In re Software Toolworks was decided at the summary
23 judgment stage, in In re Countrywide a district court allowed a
24 defendant underwriter to establish the due diligence defense at the
25 motion to dismiss stage, because "underwriters may reasonably rely
26 on auditors' statements, absent red flags that the underwriters
27 were in a position to see." 588 F.Supp.2d at 1175. At least one
28 unpublished decision in this district has disagreed with In re

1 Countrywide. In re China Intelligent Lighting and Electronics,
2 Inc. Sec. Litig., No. CV-112768-PSG (SSx), at * 11. However, this
3 court did not fully address the very basis of In re Countrywide's
4 ruling: that underwriters occupy a special place in Section 11
5 jurisprudence because they are allowed to rely on auditors' work,
6 absent red flags. The Court here agrees with In re Countrywide.

7 The CAC is essentially silent about the underwriters, other
8 than identifying them. (CAC ¶¶ 23-26.) Lead Plaintiff's
9 opposition argues that various red flags should have alerted the
10 Underwriter Defendants to the misleading statements in the Auditor
11 Defendant's work. Most notable among these are that the prior
12 auditor, Grant Thornton, resigned. However, nothing in the
13 disclosure regarding Grant Thornton's resignation would have
14 alerted the Underwriter Defendants to the Dajiang deal being
15 fraudulent. (See id. ¶ 47.) Lead Plaintiff also suggests that the
16 Auditor Defendant's production of an audit opinion in twenty-two
17 days after Grant Thornton's resignation should have been a red
18 flag. However, nothing before the court shows that the audit was
19 performed too quickly. Such a determination would depend on how
20 much information the auditors had to analyze, and how many auditors
21 they devoted to the audit, among other factors. However, the CAC
22 does not allege sufficient information about these matters.

23 Moreover, the Auditor Defendant was Yuhe's auditor from March 12,
24 2008 until December 7, 2009, when Grant Thornton assumed that role.
25 (Id. ¶ 47.) After Grant Thrornton's resignation three months
26 later, the Auditor Defendant was reappointed. (Id.) Thus the
27 emphasis on the twenty-two day time span is not particularly
28 probative, because the Auditor Defendants were likely already

1 familiar with Yuhe. The Section 11 claim against the Underwriter
2 Defendants is, therefore, dismissed without prejudice.

3 **C. The Section 12(a)(2) Claim**

4 The Underwriter Defendants ask this Court to dismiss Lead
5 Plaintiff's Section 12(a)(2) claim. "Section 12(a)(2) provides for
6 civil liability of securities sellers to purchasers if the seller
7 used certain instruments, including a prospectus, containing untrue
8 statements or material omissions." In re Levi, 527 F. Supp. at
9 980; 15 U.S.C. § 771(a)(2). Section 12 "permits suit against a
10 seller of a security by prospectus only by 'the person purchasing
11 such security from him,' thus specifying that a plaintiff must have
12 purchased the security directly from the issuer of the prospectus."
13 Hertzberg v. Dignity Partners, Inc., 191 F.3d 1076, 1081 (9th Cir.
14 1999)(quoting 15 U.S.C. § 771 (a)(2)). A plaintiff who purchased
15 shares in the aftermarket will not have standing under Section 12,
16 even if he can trace those shares back to the relevant offering.
17 In re DDi Corp., 2005 WL 3090882, at *17 (C.D. Cal. July 21, 2005).
18 When plaintiffs purchase stock pursuant to an offering or a
19 prospectus, it means that they have purchased stock from its
20 issuer. In re Levi Strauss, 527 F. Supp. 2d at 983; In re Nat'l
21 Golf Properties, Inc., 2003 WL 23018761, at *2.

22 Paragraphs 17, 139, and 146 make clear that Lead Plaintiff and
23 at least some class members purchased stock "pursuant to" the
24 offering and "pursuant" to the prospectus. Accordingly, Lead
25 Plaintiff has stated a claim on behalf of itself and all class
26 members who purchased pursuant to the offering, and that is all
27 that is needed to survive a motion to dismiss. See In re Levi
28 Strauss & Co. Sec. Litig., 527 F. Supp. 2d at 983; In re Nat'l Golf

1 Properties, 2003 WL 23018761, at *2. However, to the extent
2 members of the subclass hold shares that are only traceable to the
3 second offering, (see CAC ¶ 1), their claims are dismissed with
4 prejudice. In re DDi Corp., 2005 WL 3090882, at *17 (C.D. Cal.
5 July 21, 2005).

6 **D. Defendant Yuhe's Motion to Strike**

7 Yuhe has moved to strike paragraphs 2-4, 75-81, and 107 from
8 the CAC. (Docket No. 83 at 5:23-25.) Because these paragraphs
9 improperly rely on an outside report, Yuhe argues, they violate
10 Plaintiffs Rule 11 duty to conduct an independent investigation on
11 matters alleged in the complaint. (See generally id. at 3:19-
12 5:25.)

13 Portions of a CAC that do not comport with Rule 11's
14 independent investigation requirement may be stricken. See In re
15 Connetics Corp. Sec. Litig., 542 F. Supp. 2d 996, 1004-05 (N.D.
16 Cal. 2008); Fraker v. Bayer Corp., No. CVF08-1564 AWI GSA, 2009 WL
17 5865687 (E.D. Cal. Oct. 6, 2009). Under Rule 11(b), an attorney
18 who files pleadings with a court "certifies that to the best of the
19 person's knowledge, information, and belief, formed after an
20 inquiry reasonable under the circumstances: . . . the factual
21 contentions have evidentiary support or, if specifically so
22 identified, will likely have evidentiary support after a reasonable
23 opportunity for further investigation or discovery." Fed. R. Civ.
24 P. 11(b). Rule 11(b) recognizes a "nondelegable responsibility"
25 for an attorney to "personally . . . validate the truth and legal
26 reasonableness of the papers filed," Pavelic & LeFlore v. Marvel
27 Entm't Group, 493 U.S. 120, 126 (1989), and "to conduct a
28

1 reasonable factual investigation," Christian v. Mattel Inc., 286
2 F.3d 1118, 1127 (9th Cir. 2002).

3 Yuhe states that GeoInvesting was a short-seller "seeking to
4 benefit from the publication of negative information" about Yuhe,
5 and that reliance on the GeoInvesting Report is insufficient to
6 satisfy Rule 11(b)'s independent investigation requirement.

7 (Docket No. 119 at 1:20-22, 2:7-9.) Lead Plaintiff, however,
8 states that multiple sources informed their allegations in the
9 challenged portions of the CAC. Lead Plaintiff states:

10 The paragraphs Yuhe seeks to strike, on Rule 11
11 grounds no less, contain facts obtained from a Form
12 8-K Yuhe filed on June 20, 2011 attaching its June 14,
13 2011 press release, including five documents Yuhe
14 disseminated to investors in support of its purported
15 purchase of Dajiang's thirteen breeder farms (¶79);
16 excerpts from four publicly-available transcripts of
17 telephone calls wherein the Chairman of Dajiang
repeatedly denies [to a GeoInvesting investigator]
that it sold its breeder farms to Yuhe and never
received any money from it (¶¶76, 77, 78, and 81); and
an investigatory report by GeoInvesting LLC (¶¶2, 75)
along with a few website postings regarding its
participation in an investor conference call with Yuhe
(¶¶3, 4, 80).

18 (Docket No. 112 at 1:11-20.) Since Yuhe does not respond to
19 Plaintiff's argument, they have conceded it. Cent. Dist. L.R. 7-
20 12; See also Figueroa v. Baja Fresh Westlake Vill., Inc., CV 12-
21 769-GHK SPX, 2012 WL 2373254, at *2 (C.D. Cal. May 24, 2012);
22 Richter v. Mut. of Omaha Ins. Co., CV 05-498 ABC, 2007 WL 6723708,
23 at *5 (C.D. Cal. Feb. 1, 2007) aff'd, 286 F. App'x 427 (9th Cir.
24 2008); Westerfield v. Wade, No. CV05-6645 ABCCWX, 2006 WL 5668264,
25 at *4 (C.D. Cal. Oct. 4, 2006).

26 This leaves some paragraphs where the GeoInvesting report,
27 supplemented by Lead Plaintiff's attorney's "multiple"
28 conversations with GeoInvesting about the "basis for its

1 investigatory report and its communications with Mr. Zheng," is the
2 only source. (Markert Decl. ¶ 113, Docket No. 113.) The Yuhe
3 Defendants argue that the GeoInvesting Report is not reliable, and
4 their principle case for the point is Zucco Partners, LLC v.
5 Digimarc Corp., 552 F.3d 981, 995 (9th Cir. 2009). But the portion
6 of Zucco they cite deals with the appropriate way for a court to
7 analyze a pleadings that rely on a confidential witness. Id. In
8 the present case, the Yuhe Defendants do not argue, nor could they,
9 that the GeoInvesting report is a confidential source. While the
10 Yuhe Defendants argue that the GeoInvesting report is not credible,
11 because, among other reasons, GeoInvesting was a short seller with
12 an interest in diminishing Yuhe's stock value, the effects
13 GeoInvesting's motive is "a factual dispute not appropriate for
14 resolution at this stage." See In re China Educ. Alliance, Inc.
15 Sec. Litig., No. CV 10-9239 CAS JCX, 2011 WL 4978483, at *4 (C.D.
16 Cal. Oct. 11, 2011) (refusing to analyze motives of a short seller)
17 (quoting Henning v. Orient Paper Inc ., No. CV 10-5887 VBF, 2011 WL
18 2909322, at *4 (C.D.Cal. Jul.20, 2011)).

19 The Yuhe Defendants seek to distinguish In re China Educ. by
20 arguing that in the instant case particular facts in the
21 GeoInvesting report suggest that it is unreliable. Particularly,
22 the Yuhe Defendants note that: GeoInvesting gathered its
23 information in part by speaking to an individual, Mr. Zheng, under
24 false pretenses, and, further, that Mr. Zheng gave contradicting
25 statements at one point as to whether Yuhe ever talked with Dajiang
26 about acquiring farms. However, just because GeoInvesting
27 allegedly used false pretenses to speak with Zheng, does not mean
28 it did not learn the truth from him. Additionally, it is not clear

1 Zheng gave contradictory statements. Although he first denied that
2 negotiations happened, when he later stated they did occur, he said
3 the negotiation was for a "fake deal." (CAC ¶ 78.) Zheng's
4 statements could be seen as consistent, as a negotiations for a
5 fake deal might be considered as a non-negotiation. Any further
6 analysis into the "truth" of the GeoInvesting report would be
7 inappropriate, because doing so would implicate a factual dispute
8 that should not be decided at this stage. See Henning, 2011 WL
9 2909322, at *4.

10 Accordingly, the Yuhe Defendants' motion to strike is DENIED.

11 **IV. Conclusion**

12 For the reasons stated, the Court DENIES the Defendants'
13 motions, with the exception of GRANTING dismissal of the Section 11
14 claim against the Underwriter Defendants, GRANTING Dismissal of the
15 Section 10(b) claim against Gang, and GRANTING dismissal of the
16 Section 12(a)(2) and Section 11 claims of all subclass members
17 whose Yuhe shares are only traceable to the second offering.
18 Dismissal is without prejudice, except as to the Section 12(a)(2)
19 claims.

20
21 IT IS SO ORDERED.

22
23
24 Dated: March 5, 2013


25 DEAN D. PREGERSON
26 United States District Judge
27
28