

## U.S. COURT REFUSES TO ALLOW SECURITIES CASE AGAINST CHINESE COMPANY TO PROCEED AS A CLASS ACTION BECAUSE ITS SECURITIES WERE TOO THINLY TRADED

May 23, 2012

To Our Clients and Friends:

In a recent ruling of interest to Chinese companies whose shares trade in the United States, a U.S. trial court declined to allow a class of shareholders to pursue a collective lawsuit because the court found the market for the Chinese company's securities was not efficient. See *Dean v. China Agritech*, CV 11-01331 (C.D. Cal. May 3, 2012).

Claims brought in United States courts under the U.S. securities laws can proceed as class actions — in other words, on behalf of *all* current and former holders of the company's U.S. shares, not just on behalf of the shareholders who actually filed the lawsuit — if the plaintiff shareholders can show that the defendant's U.S. securities traded on an efficient market. If a company is a subject of press coverage and professional market analysis and its securities are widely traded, courts presume that any new information, even if false, is immediately and completely absorbed into the market and promptly affects the price at which shares are bought and sold. If a company's securities are thinly traded and the company is not the subject of press coverage, investors may have different levels of knowledge about the company and their reliance on particular statements cannot be presumed.

A large number of purported class action lawsuits have been filed in the past 18 months against Chinese companies. Some of the defendants' securities are thinly traded. The *China Agritech* case appears to be the first China-focused case to reach the procedural stage at which the court had to consider whether the plaintiffs could satisfy the efficient market test and the other requirements for class certification. The *China Agritech* plaintiffs' failure to satisfy that test may have a significant impact on other China-focused securities cases if the defendants can show that their securities were as thinly traded as China Agritech's.

The factors the *China Agritech* court was required by U.S. law to consider were (1) the average weekly trading volume of the security; (2) the number of professional securities analysts who were following the security; (3) the extent to which market-makers trade in the security; (4) the company's eligibility to file an SEC Form S3 (a short form registration statement for the sale of new shares); and (5) the existence of a cause-effect relationship between the disclosure and a change in the price of the stock. The last factor has been recognized by several courts as the most important.

The court ruled that plaintiffs established three of the factors, but that plaintiffs failed to prove there were enough securities analysts following China Agritech's stock and that there was a cause-effect relationship between company disclosures and the price of the stock. Based on this analysis, the Court found that plaintiffs could not establish that there was an efficient market and were unable to rely on the fraud-on-the-market presumption. Without this presumption, plaintiffs could not establish reliance as to each plaintiff, precluding them from satisfying the requirements for a class action proceeding. The plaintiffs who brought the case still can pursue claims on their own behalf. Their inability to pursue claims on behalf of all potentially affected shareholders significantly limits the potential damages that can be awarded in the case.

Chinese and other foreign companies that list their stocks in the U.S. face an increasing risk of securities fraud class actions. The issues of an efficient market and reliance may play a significant role in whether courts grant class certification in such cases and raise doubts as to the overall viability of such claims.

\* \* \*

Please do not hesitate to contact us if you have any questions.

Jeffrey S. Jacobson  
+1 212 909 6479  
jsjacobson@debevoise.com

Colby A. Smith  
+1 202 383 8095  
casmith@debevoise.com

Philip Rohlik  
+852 2160 9856  
prohlik@debevoise.com

Tingting Wu  
+86 21 5047 1800  
twu@debevoise.com