

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

UNITED STATES DISTRICT COURT  
CENTRAL DISTRICT OF CALIFORNIA

IN RE CHINA MEDICINE  
SECURITIES LITIGATION

CASE NO. SACV 11-1061-JST (ANx)

**ORDER DENYING DEFENDANT  
CHINA MEDICINE  
CORPORATION'S MOTION TO  
DISMISS (Doc. 22)**

1 Before the Court is a Motion to Dismiss the Consolidated Class Action Complaint  
2 (“Motion”) filed by Defendant China Medicine Corporation (“CMC”). (Mot., Doc. 22.)  
3 Lead Plaintiff Michael Fruchter filed an Opposition (Opp’n, Doc. 27), and CMC filed a  
4 Reply (Reply, Doc. 31). The Court finds these matters appropriate for disposition without  
5 oral argument. Fed. R. Civ. P. 78(b); C.D. Cal. R. 7-15. Accordingly, the hearing set for  
6 May 14, 2012, at 10:00 a.m. is VACATED. For the reasons discussed below, the Court  
7 DENIES the Motion.

### 8 9 **I. BACKGROUND**

10 CMC operates in the People’s Republic of China (“China”) through two wholly-  
11 owned subsidiaries, Guangzhou Konzern Medicine Co., Ltd. (“Konzern”) and Guangzhou  
12 LifeTech Pharmaceutical Co., Ltd. (“LifeTech”). (Consolidated Class Action Compl.  
13 (“Compl.”) ¶ 2, Doc. 17.) These subsidiaries engage in the wholesale distribution,  
14 research and development, and manufacturing of prescription and over-the-counter  
15 medicines, and sales of medical technology in China. (*Id.*)

16 CMC originally began as Konzern, a formerly state-owned medicine distribution  
17 center in China that was privatized in 2000. (*Id.* ¶ 3.) In February 2006, Konzern entered  
18 into a reverse merger with an existing shell company in the United States. (*Id.* ¶¶ 3-4.) In  
19 that transaction, the shell company acquired all of the equity in Konzern in exchange for  
20 nearly all of the shell company’s outstanding stock. (*Id.* ¶ 4.) Konzern remained the only  
21 operating subsidiary of the U.S. corporation, which was renamed CMC. (*Id.*) Since  
22 completing its reverse merger on February 8, 2006, CMC stock has traded over-the-  
23 counter on “pink sheets.” (*Id.* ¶ 7.) CMC acquired LifeTech in October 2009. (*Id.* ¶ 9.)

24 In March 2010, CMC applied to be listed on the NASDAQ stock exchange, in order  
25 to “broaden its shareholder base, improve trading liquidity and raise [its] profile in the  
26 investment community . . . .” (*Id.* ¶ 8.) To be listed on the NASDAQ exchange, CMC  
27 stock was required to trade above the minimum listing price of \$4.00 per share. (*Id.*)  
28

1 Although CMC stock met this requirement on March 9, 2010, by March 29, 2010, it was  
2 trading below \$4.00 and has not traded above that threshold since. (*Id.*)

3 On March 23, 2011, CMC announced that it had withdrawn its application for  
4 listing on the NASDAQ and disclosed that it had discovered “accounting and reporting  
5 errors” in its financial statements as a result of “improper activities” at its primary  
6 operating subsidiary Konzern and at its operating subsidiary LifeTech. (*Id.* ¶ 9.) Investors  
7 were told that CMC’s previously filed financial results for the fiscal years 2008 and 2009,  
8 as well as for interim reporting periods in 2008, 2009, and 2010, “should no longer be  
9 relied upon,” and that those financial statements would be restated after an internal  
10 investigation. (*Id.*) The next day, CMC’s stock price fell over 53%. (*Id.*)

11 On July 8, 2011, CMC announced that its internal investigation revealed additional  
12 “accounting and reporting errors” in its previously issued financial statements for the fiscal  
13 years 2006 and 2007, as well as interim reporting periods during those years. (*Id.* ¶ 10.)  
14 The following day, CMC’s stock price fell an additional 10%. (*Id.*)

15 Upon further investigation, Lead Plaintiff learned that there were significant  
16 differences between CMC’s filings with the U.S. Securities and Exchange Commission  
17 (“SEC”), and the financial results reported by CMC’s subsidiaries to the Chinese State  
18 Administration of Industry and Commerce (“SAIC”). (*Id.* ¶ 12.) In 2006, CMC reported  
19 approximately \$24 million in Total Revenues, \$9 million in Gross Profit, \$6 million in  
20 Income from Operations, and \$5 million in Net Income to the SEC. (*Id.* ¶ 66.) On the  
21 other hand, CMC reported Total Revenues of \$16 million, Gross Profit of \$2 million, a *net*  
22 *loss* of \$18,000 in Income from Operations, and only \$10,000 in Net Income to the SAIC.  
23 (*Id.*) Lead Plaintiff alleges that the discrepancies between the two sets of filings are too  
24 great to be explained by differences in the applicable rules and accounting methods. (*Id.* ¶  
25 67.)

26 Lead Plaintiff filed this action on July 15, 2011. (Doc. 1.) On October 21, 2011,  
27 the Court consolidated two actions pending against CMC and its officers into this action,  
28

1 appointed Michael Fruchter as Lead Plaintiff, and approved Lead Plaintiff's selection of  
2 Abraham, Fruchter & Twersky as lead counsel. (Order for Consolidation, Appointment as  
3 Lead Plaintiff, and Approval of Selection of Counsel, Doc. 14.) On December 20, 2011,  
4 Lead Plaintiff filed the Complaint against CMC and five of its corporate officers, "on  
5 behalf of a class consisting of all persons and entities, other than Defendants and their  
6 affiliates, who purchased or otherwise acquired the common stock of China Medicine  
7 Corporation . . . between December 4, 2006, through and including March 23, 2011 (the  
8 'Class Period'), and who were damaged thereby." (Compl. ¶ 1.) The Complaint asserts  
9 claims for violation of Section 10(b) of the Exchange Act and Rule 10b-5 (the "section  
10 10(b) claim") against all Defendants, and violation of Section 20(a) of the Exchange Act  
11 (the "section 20(a) claim") against the individual Defendants. CMC filed this Motion on  
12 February 17, 2012, seeking to dismiss the section 10(b) claim for failure to meet the  
13 heightened pleading standards under Rule 9(b) and the Private Securities Litigation  
14 Reform Act ("PSLRA"), and to dismiss the section 20(a) claim for failure to sufficiently  
15 allege a predicate violation of section 10(b).

## 16 17 **II. LEGAL STANDARD**

18 The elements of a § 10(b) claim are: "(1) a material misrepresentation or omission  
19 of fact, (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction  
20 and loss causation, and (5) economic loss." *In re Daou Sys., Inc.*, 411 F.3d 1006, 1014  
21 (9th Cir. 2005) (citing *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005)).

22 "[F]aced with a Rule 12(b)(6) motion to dismiss a § 10(b) action, courts must, as  
23 with any motion to dismiss for failure to plead a claim on which relief can be granted,  
24 accept all factual allegations in the complaint as true." *Tellabs, Inc. v. Makor Issues &*  
25 *Rights, Ltd.*, 551 U.S. 308, 322 (2007).

26 Furthermore, "[i]t is well established that claims brought under Rule 10b-5 and  
27 section 10(b) must meet the particularity requirements of Federal Rule of Civil Procedure  
28

1 9(b).” *Daou*, 411 F.3d at 1014. Rule 9(b) requires that “[i]n alleging fraud or mistake, a  
 2 party must state with particularity the circumstances constituting fraud or mistake. Malice,  
 3 intent, knowledge, and other condition of mind of a person may be alleged generally.”  
 4 Fed. R. Civ. P. 9(b).

5 Additionally, the PSLRA heightened the pleading requirements for falsity and  
 6 scienter. *Daou*, 411 F.3d at 1014-1015. Specifically, “any private securities complaint  
 7 alleging that the defendant made a false or misleading statement must: (1) ‘specify each  
 8 statement to have been misleading and the reason or reasons why the statement is  
 9 misleading,’ and (2) ‘state with particularity facts giving rise to a strong inference that the  
 10 defendant acted with the required state of mind.’” *Tellabs*, 551 U.S. at 321 (citations  
 11 omitted).

### 13 **III. DISCUSSION**

#### 14 *a. Falsity*

15 Lead Plaintiff has alleged that CMC announced “accounting and reporting errors”  
 16 due to “improper activities” at both of its operating subsidiaries, and also announced that  
 17 its financials from 2006 to 2010 could “no longer be relied upon.” Lead Plaintiff has also  
 18 alleged that the financial results—specifically the figures for total revenues, gross profit,  
 19 income from operations, and net income—reported to the SAIC and those reported to the  
 20 SEC differed significantly during the Class Period, and that those differences are not  
 21 attributable to variations in reporting rules or accounting methods. Taken together, this  
 22 amounts to an allegation that the SEC filings were misleading because CMC’s financial  
 23 results were overstated by approximately the difference between the amounts reported to  
 24 the SEC and the amounts reported to the SAIC. In *Redwen v. Sino Clean Energy, Inc.*,  
 25 Judge Anderson found that allegations of inconsistency between SEC and foreign filings  
 26 were insufficient to meet the pleading standard for falsity, noting that “Plaintiff must plead  
 27 with greater specificity to make plausible the claim that the SEC numbers, not the [foreign]  
 28

1 numbers, are false.” CV 11-3936 PA (SSx), 2012 U.S. Dist. LEXIS 47049, at \*10-11  
2 (C.D. Cal. Jan. 30, 2012). Here, however, CMC has *admitted* that the numbers reported to  
3 the SEC cannot be relied upon. Accordingly, the Court concludes that Plaintiff has  
4 sufficiently alleged falsity.

5  
6 *b. Scierter*

7 In determining whether a plaintiff has sufficiently plead scierter, the Court must  
8 consider “whether *all* of the facts alleged, taken collectively, give rise to a strong inference  
9 of scierter, not whether any individual allegation, scrutinized in isolation, meets that  
10 standard.” *Tellabs*, 551 U.S. at 323. Furthermore, “[t]he strength of an inference cannot  
11 be decided in a vacuum.” *Id.* “To determine whether the plaintiff has alleged facts that  
12 give rise to the requisite ‘strong inference’ of scierter, a court must consider plausible,  
13 nonculpable explanations for the defendant’s conduct, as well as inferences favoring the  
14 plaintiff.” *Id.* at 323-24. However, “[t]he inference that the defendant acted with scierter  
15 need not be irrefutable, *i.e.*, of the ‘smoking-gun’ genre, or even the ‘most plausible of  
16 competing inferences.’” *Id.* at 324 (citation omitted). Thus, “[a] complaint will survive . .  
17 . only if a reasonable person would deem the inference of scierter cogent and at least as  
18 compelling as any opposing inference one could draw from the facts alleged.” *Id.*

19 Discussing the holding in *Tellabs*, the Ninth Circuit has stated that “*Tellabs* permits  
20 a series of less precise allegations to be read together to meet the PSLRA requirement.”  
21 *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 1006 (9th Cir. 2009) (citation and  
22 internal quotation marks omitted). “Accordingly, even vague or ambiguous allegations are  
23 now properly considered as part of a holistic review when considering whether the  
24 complaint raises a strong inference of scierter.” *Id.* (citation and internal quotation marks  
25 omitted).

26 Here, Lead Plaintiff asserts that the following facts give rise to a strong inference of  
27 scierter: (1) the disparity between the SEC and SAIC filings, which were both signed and  
28

1 certified by CMC's executives; (2) the rapid turnover of CMC's CFOs during the Class  
 2 Period; (3) CMC's and its officers' financial incentive to list CMC's stock on NASDAQ;  
 3 and (4) CMC's admission that its financials from 2006 to 2010 could no longer be relied  
 4 upon because of improper activities. (Opp'n at 13- 17.) Lead Plaintiff specifically  
 5 emphasizes the allegation that CMC admitted improper activity at both of its operating  
 6 subsidiaries over a five-year period. (*Id.* at 16.)

7 In *Zucco Partners*, the Ninth Circuit stated that "[i]n general, the mere publication  
 8 of a restatement is not enough to create a strong inference of scienter." 552 F.3d at 1000.  
 9 However, the Court noted two exceptions to this general rule, including "where the nature  
 10 of the relevant fact is of such prominence that it would be absurd to suggest that  
 11 management was without knowledge of the matter." *Id.* (citation and internal quotation  
 12 marks omitted). The Court concludes that this case falls within that exception. It would be  
 13 absurd to assume that management was unaware of admittedly "improper activities" for  
 14 the entirety of the five-year period during which CMC stock traded over-the-counter in the  
 15 United States, particularly where such improper activity occurred at *both* operating  
 16 subsidiaries, one of which was managed by the CEO of CMC. (*See* Compl. ¶ 22.) The  
 17 fact that CMC experienced rapid turnover of CFOs during the Class Period only adds to  
 18 the inference of scienter. While it is plausible that the CEO and the several CFOs were not  
 19 aware of these improprieties at the time they were occurring, an inference of scienter is "at  
 20 least as compelling as any opposing inference."

21  
 22 *c. Transaction Causation (Reliance)*

23 A plaintiff is entitled to a presumption of transaction causation, or reliance, "when a  
 24 plaintiff alleges that a defendant made material misrepresentations or omissions  
 25 concerning a security that is actively traded in an 'efficient market,' thereby establishing a  
 26 'fraud on the market.'" *Binder v. Gillespie*, 184 F.3d 1059, 1064 (9th Cir. 1999) (citation  
 27 omitted). The Ninth Circuit has adopted the five factors articulated in *Cammer v. Bloom*,  
 28

1 711 F. Supp. 1264, 1286-87 (D.N.J. 1989) as relevant when considering whether there is  
 2 an efficient market. The *Cammer* factors include: (1) “whether the stock trades at high  
 3 weekly volume”; (2) “whether securities analysts follow and report on the stock”; (3)  
 4 “whether the stock has market makers and arbitrageurs”; (4) whether the company is  
 5 eligible to file a Form S-3 registration statement with the SEC; and (5) “whether there are  
 6 ‘empirical facts showing a cause and effect relationship between unexpected corporate  
 7 events or financial releases and an immediate response in the stock price.’” *Binder*, 184  
 8 F.3d at 1065 (quoting *Cammer*, 711 F. Supp. at 1286-87).

9 Here, Lead Plaintiff has alleged that CMC’s stock was traded on an efficient  
 10 market, and in support of that conclusion, has further alleged that “[s]ecurities analysts  
 11 followed and published research reports regarding [CMC] that were publicly available to  
 12 investors,” “[CMC] securities were actively traded through the Class Period, with  
 13 substantial trading volume,” and “[t]he market price of [CMC’s] securities reacted  
 14 promptly to the dissemination of public information regarding the Company.” (Compl. ¶¶  
 15 116(d)-(f).) CMC asserts that these allegations are insufficient to entitle Lead Plaintiff to a  
 16 presumption of reliance because the Complaint does not allege “a majority of the *Cammer*  
 17 factors through specific factual allegations . . . .” (Reply at 13.) However, the Court  
 18 declines to adopt a rigid requirement for the number of *Cammer* factors that a plaintiff  
 19 must allege. In fact, the court in *Cammer* specifically cautioned that “[i]t is not logical to  
 20 draw bright line tests” to determine if a stock is traded on an open and efficient market.  
 21 711 F. Supp. at 1287.

22 The Court concludes that “[a] showing of whether the [*Cammer*] elements are met  
 23 requires a factual exploration which is premature at the motion to dismiss stage[,  
 24 particularly because] the applicable pleading standards for a fraud-on-the-market theory  
 25 have not been heightened by the PSLRA.” *In re USA Talks.com Sec. Litig.*, No. 99-CV-  
 26 0162-L(JA), 2000 WL 1887516, at \*6 (S.D. Cal. Sept. 14, 2000). Lead Plaintiff has  
 27 provided more than a conclusory statement that CMC stock was traded on an efficient  
 28



1 market, and has specifically identified some of the *Cammer* factors. Perhaps most  
2 importantly, the Complaint alleges that the market price of CMC's stock reacted promptly  
3 to dissemination of public information, including the announcement about "accounting and  
4 reporting errors" and withdrawal of CMC's application to be listed on NASDAQ. This  
5 suggests that the market is efficient, such that "prices immediately reflect all publicly  
6 available information." *Miller v. Thane Int'l, Inc.*, 615 F.3d 1095, 1103 (9th Cir. 2010).  
7 Accordingly, the Court concludes that Lead Plaintiff has sufficiently plead transaction  
8 causation.

9  
10 *d. Loss Causation*

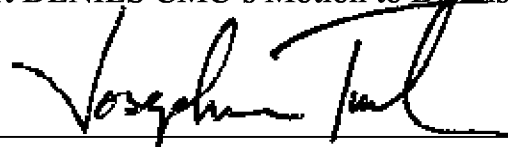
11 "[T]o prove loss causation, the plaintiff must demonstrate a causal connection between  
12 the deceptive acts that form the basis for the claim of securities fraud and the injury  
13 suffered by the plaintiff." *Daou*, 411 F.3d at 1025. Here, Plaintiff has alleged that CMC's  
14 stock fell by 53% when CMC announced that it had discovered "accounting and reporting  
15 errors" due to "improper activities," and that its financials from 2006 to 2010 could no  
16 longer be relied upon. Particularly the admission to "improper activities" amounts to a  
17 corrective disclosure. In other words, when CMC made this announcement, it was  
18 tantamount to announcing that its previous SEC filings were incorrect, and the stock price  
19 fell accordingly. CMC asserts that Lead Plaintiff cannot establish loss causation based on  
20 this announcement because CMC also announced at the same time that it was withdrawing  
21 its application for a NASDAQ listing. (Mem. of P. & A. at 21-22, Doc. 22-1.) Even if the  
22 withdrawal of the NASDAQ application is a separate cause of the stock price decline, and  
23 not simply another consequence of the revelation of improper activities, "[a] plaintiff is not  
24 required to show that a misrepresentation was the *sole* reason for the investment's decline  
25 in value in order to establish loss causation." *Daou*, 411 F.3d at 1025 (citation and internal  
26 quotation marks omitted). Accordingly, the Court concludes that Lead Plaintiff has  
27 sufficiently alleged loss causation.

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

**IV.CONCLUSION**

For the foregoing reasons, the Court DENIES CMC's Motion to Dismiss.

DATED: May 10, 2012

A handwritten signature in black ink, appearing to read 'Josephine Staton Tucker', written over a horizontal line.

JOSEPHINE STATON TUCKER  
UNITED STATES DISTRICT JUDGE