

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES - GENERAL

Case No.	CV 10-9239 CAS (JCx)	Date	October 11, 2011
Title	IN RE CHINA EDUCATION ALLIANCE, INC. SECURITIES LITIGATION		

Present: The Honorable	CHRISTINA A. SNYDER, U.S. DISTRICT JUDGE		
RITA SANCHEZ	N/A	N/A	N/A
Deputy Clerk	Court Reporter / Recorder		Tape No.
Attorneys Present for Plaintiffs:	Attorneys Present for Defendants:		
N/A	N/A		

Proceedings: (In Chambers:) **DEFENDANT CEU'S MOTION TO DISMISS CONSOLIDATED AMENDED COMPLAINT** (filed 7/1/2011)

LEAD PLAINTIFFS' MOTION TO STRIKE (filed 7/14/2011)

I. INTRODUCTION

The Court finds this motion appropriate for decision without oral argument. Fed. R. Civ. P. 78; Local Rule 7-15.

On December 2, 2010, plaintiff Vinnie Apicella commenced this putative class action alleging violations of the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (“the Exchange Act”), against defendants China Education Alliance, Inc. (“CEU”); Xiqun Yu (“Yu”), CEU’s chairman and chief executive officer; Zibing Pan (“Pan”), CEU’s former chief financial officer; and Susan Liu (“Liu”), Pan’s predecessor as CFO. The May 2, 2011 Consolidated Amended Complaint (“CAC”) added four additional defendants: Chunqing Wang (“Wang”), Liu’s predecessor as CFO; and James Hsu (“Hsu”), Lianzheng Zhang (“L. Zhang”), and Yizhao Zhang (“Zhang”), all of whom were non-executive directors of CEU. CAC ¶¶ 28–33. The CAC alleges two claims for relief: (1) violation of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder (17 C.F.R. § 240) against all defendants, and (2) violation of Section 20(a) of the Exchange Act against all individual defendants. Plaintiffs allege that the class period ran from May 15, 2008, through December 7, 2010 (the “Class Period”). CAC ¶ 3.

On July 1, 2011, CEU filed a motion to dismiss the first claim; plaintiffs filed their opposition on August 30, 2011; and CEU replied on September 29, 2011. On July 14,

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2011, plaintiffs filed a motion to strike portions of CEU's motion to dismiss; CEU opposed the motion to strike on August 1, 2011; and plaintiffs replied on August 8, 2011. After carefully considering the arguments set forth by each party, the Court finds and concludes as follows.

II. BACKGROUND

CEU is a Chinese-based corporation that purports to provide for-profit education services in Northeast China through its wholly owned principal subsidiary, Harbin Zhong He Li Da Education Technology ("ZHLD"). CAC ¶ 4. CEU has two business segments: online educational tools for use and purchase (run by ZHLD), and on-site tutoring at CEU's training center in China. *Id.* ¶ 5. These two business segments represented approximately eighty-nine percent (\$22.3 million) and ninety-nine percent (\$34.3 million) of CEU's total revenue for the 2008 and 2009 fiscal years, respectively. *Id.* ¶ 6. The online segment made up sixty-seven percent (or \$16.7 million) of CEU's revenues in 2008 and sixty percent (or \$22.2 million) in 2009. *Id.* The training center represented twenty-two percent and thirty-three percent, respectively. *Id.*

According to plaintiffs, CEU overstated its revenue and profits during the Class Period by "exponential proportions." *Id.* ¶ 8. Specifically, plaintiffs allege that CEU "fraudulently maintained" two sets of books: (1) an accurate set of financial statements filed with Chinese regulators, "because CEU and the individual defendants are subject to fines and serious criminal penalties" in China if the accounts are false; and (2) a second set of "false financial statements filed with the SEC, an entity that has no ability to enforce violations of U.S. criminal laws over the defendants who are domiciled in [China]." *Id.* ¶ 9. Plaintiffs aver that ZHLD's filings with the State Administration of Industry and Commerce ("SAIC") in China reveal that CEU's online component claimed only only \$616,643 and \$700,000 in revenue for 2008 and 2009, respectively, in "stark contrast" to the \$16.7 million and \$22.2 million allegedly filed with the SEC during those same two years. *Id.* ¶¶ 10–11.

Plaintiffs claim that this "fraud" was publically disclosed on November 29, 2010, when analyst firm Kerrisdale Capital ("Kerrisdale") published a 29 page report regarding CEU's misdeeds. *Id.* ¶ 13. According to plaintiffs, the Kerrisdale Report discloses, *inter alia*:

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- ZHLD’s SAIC filings regarding CEU’s online segment for 2006, 2007, and 2008 “show a fraction of the revenue that CEU reported in its SEC filings”;
- CEU’s principal website and other websites do not work as demonstrated by three videos depicting Kerrisdale employees attempting to use them;
- CEU’s websites receive a “fraction” of the internet traffic when compared to a competitor that generates lower revenue and profit margins; and
- CEU’s training center (comprising 22–33% of CEU’s 2008 and 2009 revenues) is a “sham,” because “the 36,600 square foot training center facility is an empty building with no classrooms.”

Id. ¶ 14.

The Kerrisdale Report also disclaims on its cover that “[t]he authors of this report make no representation, express or implied, as to the accuracy, timeliness, or completeness.” CAC Exh. 1 at 1. The Report also discloses that Kerrisdale and other contributors to the report “have short positions” in CEU stock and “stand to realize gains in the event that the price of stock declines.” Id. Finally, it states that “the authors and contributors may transact in the securities of the company covered herein.” Id.

Plaintiffs allege that the Kerrisdale Report “shocked the market,” causing CEU’s stock price to fall 33.5 percent on November 29, 2010, and an additional 7.9 percent on November 30, 2010. Id. ¶ 15. On December 7, 2010, CEU addressed the Kerrisdale Report to investors and widely disputed its findings. Id. ¶ 16a–e. In part, CEU claimed that the SAIC filings are not as reliable as the documents filed with the Chinese State Administration of Taxation (“SAT”) because SAIC filings “are generally inaccurate in order to prevent competitors from gaining an advantage by reviewing them.” Id. ¶ 16b–c. Plaintiffs dispute CEU’s December 7, 2010 assertions by alleging that “Plaintiffs’ counsel’s investigators obtained ZHLD’s SAT filings and they are consistent with the SAIC filings for ZHLD.” Id. ¶ 18b. Moreover, plaintiffs aver that “[t]he market did not believe CEU’s December 7, 2010 response either, and CEU’s stock fell an additional 28 percent on December 7, 2010.” Id. ¶ 19. CEU’s allegedly fraudulent SEC filings formed the basis for the instant action.

III. LEGAL STANDARD

A Rule 12(b)(6) motion tests the legal sufficiency of the claims asserted in a

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complaint. “While a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations, a plaintiff’s obligation to provide the ‘grounds’ of his ‘entitlement to relief’ requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do.” Bell Atlantic Corp. v. Twombly, 127 S. Ct. 1955, 1964–65 (2007). “[F]actual allegations must be enough to raise a right to relief above the speculative level.” Id. at 1965.

In considering a motion pursuant to Fed. R. Civ. P. 12(b)(6), a court must accept as true all material allegations in the complaint, as well as all reasonable inferences to be drawn from them. Pareto v. F.D.I.C., 139 F.3d 696, 699 (9th Cir. 1998). The complaint must be read in the light most favorable to the nonmoving party. Sprewell v. Golden State Warriors, 266 F.3d 979, 988 (9th Cir. 2001); Parks Sch. of Bus., Inc. v. Symington, 51 F.3d 1480, 1484 (9th Cir. 1995). However, a court need not accept as true unreasonable inferences or conclusory legal allegations cast in the form of factual allegations. Sprewell, 266 F.3d at 988; W. Mining Council v. Watt, 643 F.2d 618, 624 (9th Cir. 1981).

Dismissal pursuant to Rule 12(b)(6) is proper only where there is either a “lack of a cognizable legal theory or the absence of sufficient facts alleged under a cognizable legal theory.” Balistreri v. Pac. Police Dept., 901 F.2d 696, 699 (9th Cir. 1990).

Furthermore, unless a court converts a Rule 12(b)(6) motion into a motion for summary judgment, a court cannot consider material outside of the complaint (*e.g.*, facts presented in briefs, affidavits, or discovery materials). In re American Cont’l Corp./Lincoln Sav. & Loan Sec. Litig., 102 F.3d 1524, 1537 (9th Cir. 1996), *rev’d on other grounds sub nom* Lexecon, Inc. v. Milberg Weiss Bershad Hynes & Lerach, 523 U.S. 26 (1998). A court may, however, consider exhibits submitted with or alleged in the complaint and matters that may be judicially noticed pursuant to Federal Rule of Evidence 201. In re Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 986 (9th Cir. 1999); Lee v. City of Los Angeles, 250 F.3d 668, 689 (9th Cir. 2001).

For all of these reasons, it is only under extraordinary circumstances that dismissal is proper under Rule 12(b)(6). United States v. City of Redwood City, 640 F.2d 963, 966 (9th Cir. 1981).

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As a general rule, leave to amend a complaint which has been dismissed should be freely granted. Fed. R. Civ. P. 15(a). However, leave to amend may be denied when “the court determines that the allegation of other facts consistent with the challenged pleading could not possibly cure the deficiency.” Schreiber Distrib. Co. v. Serv-Well Furniture Co., 806 F.2d 1393, 1401 (9th Cir. 1986); see Lopez v. Smith, 203 F.3d 1122, 1127 (9th Cir. 2000).

IV. DISCUSSION

CEU moves to dismiss plaintiffs’ first claim for violation of Section 10(b) and Rule 10b-5.¹ To state a 10(b) claim under the Private Securities Litigation Reform Act (“PSLRA”), a plaintiff must allege particularized facts demonstrating (1) a material misrepresentation, (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss. Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 990 (9th Cir. 2009); Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341 (2005).

CEU contends that its motion should be granted for three reasons: the Kerrisdale Report is anonymous and therefore fails the PSLRA’s heightened pleading standard; its Chinese filings are consistent with its SEC filings; and there is no evidence that any defendant acted with the requisite fraudulent intent. Mot. at 10, 13, 19. Each basis for dismissal will be discussed in turn.

A. The Anonymity of the Kerrisdale Report

CEU contends that the Kerrisdale Report is an “anonymous” source because it does not list any authors anywhere on the document. Mot. at 10. According to CEU, because plaintiffs rely on the Kerrisdale Report in their CAC, the Report must meet the heightened requirements for anonymous sources under the PSLRA. Id. (citing In re Daou Sys., Inc. Sec. Litig., 411 F.3d 1006, 1015 (9th Cir. 2005)). This requires a showing that the source is described “with sufficient particularity to establish their reliability and

¹The second claim, for violation of Section 20(a) of the Exchange Act, is asserted against only the individual defendants and is not at issue in the present motion.

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personal knowledge.” Zucco, 552 F.3d at 995. CEU asserts that plaintiffs have not described the reliability of the Kerrisdale Report anywhere in the CAC and therefore have failed to meet PSLRA pleading requirements. Mot. at 11–12 (citing In re NVIDIA Corp. Sec. Litig., Case No. CV 08-4260 RS, 2010 WL 4117561 (N.D. Cal. Oct. 19, 2010)). Moreover, CEU contends that the Kerrisdale Report “affirmatively demonstrates its *unreliability*” by disavowing its own “accuracy” and “completeness” on the cover page. Id. at 12 (emphasis in original) (citing CAC Exh. 1 at 1). CEU argues that the financial motivation by Kerrisdale in releasing its report leaves a “strong indicia of unreliability and bias” and therefore plaintiffs’ allegations based thereon “do not create the ‘strong inference’ of fraudulent intent required to state a claim for securities fraud.” Id. at 13 (citing Tellabs, 551 U.S. at 321).

Plaintiffs respond that CEU’s “novel” argument regarding the Kerrisdale Report’s authorship is “nonsense.” Opp’n at 13. Plaintiffs argue that “[t]he report authored by Kerrisdale Capital was not authored by an anonymous author; it was authored by Kerrisdale Capital.” Id. (citing Henning v. Orient Paper Inc., Case No. CV 10-5887 VBF, 2011 WL 2909322, *2 (C.D. Cal. Jul. 20, 2011)). Plaintiffs contend that CEU’s argument “would have the consequence that any unsigned analyst report—say by Goldman Sachs—would be considered an ‘anonymous source.’” Opp’n at 13. According to plaintiffs, what qualifies as an anonymous or confidential witness has a “special meaning” in securities litigation that is not implicated where the source is named. Id. at 14.

The Court agrees with plaintiffs. In Henning, the court upheld plaintiffs’ reliance on an “independent industry analyst and research firm known as Muddy Waters” that issued a report regarding defendants’ alleged violations of the PSLRA to withstand a motion to dismiss. 2011 WL 2909322 at *2, *8. Although the authorship of the Muddy Waters report was not explicitly challenged by defendants, the court implicitly and repeatedly attributed its findings to “Muddy Waters,” and not any individual author. See id. at *2 (“Muddy Waters issued a report . . . bringing to light various alleged frauds . . . Muddy Waters and another analyst outfit continued to issue successive reports on [defendant’s] alleged frauds.”). The same is true here—the report was issued by Kerrisdale Capital and does not implicate the same skepticism as a “traditional” anonymous source. Cf. NVIDIA, 2010 WL 4117561 at *6 (noting plaintiffs’ failure to demonstrate individual confidential witnesses’ personal knowledge by asserting blanket

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statements that “well-placed NVIDIA employees knowledgeable of the defects at issue” could offer evidence of scienter). The other key issue CEU raises is whether Kerrisdale had a motive to cause CEU’s stock to decline as the impetus for issuing its report. That question, however, is “a factual dispute not appropriate for resolution at this stage.” Henning, 2011 WL 2909322 at *4; In re LDK Solar Secs. Litig., 584 F. Supp. 2d 1230, 1260 (N.D. Cal. 2008).

Accordingly, neither the Kerrisdale Report’s authorship nor its allegedly self-interested disclaimer provides grounds to dismiss the CAC.²

B. Whether CEU’s Chinese Filings are Consistent With its SEC Filings

CEU disputes plaintiffs’ allegation that CEU’s SEC filings were overstated “by exponential proportions.” Mot. at 13 (citing CAC ¶ 8). CEU offers its own SAT figures which, according to CEU, “indisputably demonstrate that the SAT figures were consistent” with CEU’s SEC filings. Mot. at 14. Defendants seek to have the Court take judicial notice of the documents that purport to be CEU’s 2008 and 2009 SAT filings based on the incorporation by reference doctrine.³ See Def. RJN, Declaration of Stephen D. Hibbard (“Hibbard Decl.”) Exhs. H and I. These “official SAT reports,” according to CEU, demonstrate a “close correspondence” between the SAT and SEC filings which

²It is noteworthy that the Muddy Waters report in Henning contained a similar disclaimer of interest on its cover. See Def. 9/29/2011 RJN Exh. A at 1 (“As of the publication date of this report, Muddy Waters, LLC . . . has a short position in the stock . . . covered herein, and therefore stands to realize significant gains in the event that the price of the stock declines. Following publication of this report, we intend to continue transacting in the securities covered herein.”). The court nevertheless denied defendant’s motion to dismiss because the reliability of the report is a question of fact. Henning, 2011 WL 2909322 at *4, *8.

³Federal Rule of Evidence 201 authorizes a court to take judicial notice of “matters of public record,” Mack v. S. Bay Beer Distrib., 798 F.2d 1279, 1282 (9th Cir.1986), or any other “adjudicative” facts, which are “facts concerning the immediate parties.” See United States v. Gould, 536 F.2d 216, 219 (8th Cir. 1976).

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believe plaintiffs' allegations. Mot. at 15. CEU also argues that plaintiffs' counsel's independent investigations occurred in "April 2011, five months after the end of the class period," so they do not bear on CEU's SEC filings during the class period. *Id.* at 18.

Plaintiffs respond that the "official" SAT reports offered by CEU are "actually documents prepared by ZHLD—ZHLD's tax returns." Opp'n at 9. According to plaintiffs, CEU's position is that "it did not commit securities fraud because, despite all other evidence, an internal document it created says it didn't." *Id.* In their motion to strike, plaintiffs explicitly question the authenticity of the offered documents and contend the Court cannot take judicial notice of them because CEU has not complied with Fed. R. Civ. P. 44(a)'s requirements for authenticating a foreign document. Mot. to Strike at 3–4. Specifically, plaintiffs assert that CEU has not provided an apostille nor a certification from a U.S. consular official demonstrating the authenticity of CEU's "official" SAT reports. *Id.* at 4. Moreover, plaintiffs argue that the incorporation by reference doctrine does not apply because plaintiffs have questioned the documents' validity. *Id.* at 2 (citing In re Easysaver Rewards Litig., 737 F. Supp. 2d 1159, 1166 (S.D. Cal. 2010)). Plaintiffs maintain that the offered documents are merely CEU's in-house tax returns and that CEU has not published them "to avoid scrutiny from the Chinese tax authorities." Mot. to Strike at 7.

CEU contends in its opposition to plaintiffs' motion to strike that the documents are not actually foreign public documents and thus have been properly authenticated by an attorney's declaration "attesting that the copies submitted . . . were true and correct copies." Opp'n to Mot. to Strike at 3.

The Court finds that it is inappropriate to take judicial notice of Exhs. H and I from the Hibbard Declaration. Although plaintiffs rely on CEU's SAT filings in their amended complaint, plaintiffs dispute that the documents offered by CEU are authentic and CEU concedes that the documents are not foreign public documents; accordingly, they may be judicially noticeable only if "no party questions" their authenticity. See In re Easysaver, 737 F. Supp. 2d at 1166; Branch v. Tunnell, 14 F.3d 449, 453 (9th Cir. 1994). Here, however, plaintiffs have explicitly questioned their authenticity. E.g., Opp'n at 9; Mot. to Strike at 7. Whether CEU's proffered documents are authentic is a question of fact not suited for resolution at this stage of litigation. See In re LDK, 584 F. Supp. 2d at 1260 ("The PSLRA in no way turns FRCP 12 into a trial-type, papers-only proceeding, much

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less one in which defendants get the benefit of every conceivable doubt, including credibility calls.). The Court is thus left with the allegations set forth in the CAC, which adequately allege that CEU's SEC filings are demonstrably higher than its Chinese filings. CAC ¶¶ 10–11. It would be premature to grant a motion to dismiss in light of these factual disputes.

C. Scierter

CEU contends that none of the defendants acted with fraudulent intent as required by the PSLRA. Mot. at 19. First, CEU argues that plaintiffs have not alleged facts establishing that any of the individual defendants knew the figures in the SEC filings were false. *Id.* at 20. Second, CEU asserts that plaintiffs have not alleged any stock sales by the defendants during the class period which negates an inference of scierter. *Id.* at 20–21. Third, CEU maintains that to the extent that the plaintiffs rely on allegations regarding CEU's training center and websites to support scierter, such allegations "do not give rise to a strong inference of fraudulent intent." *Id.* at 21–22. Fourth, CEU contends that no other facts, such as CEU's 2006 filings, give rise to scierter because they occurred outside the class period. *Id.* at 22–23. Finally, CEU argues that CEU's common stock offering in September 2009 does not support scierter because the offering's purpose was "to fund our operations and for other general corporate purposes." *Id.* at 24.

Plaintiffs counter that defendant Yu, both CEU and ZHLD's CEO, acted with fraudulent intent by "sign[ing] both SEC and SAIC filings" and certifying their accuracy. Opp'n at 12. Moreover, plaintiffs argue that these additional facts give rise to a strong inference of scierter: (1) CEU keeping two different sets of books; (2) CEU reporting different revenues to the SAIC and SEC; (3) various witnesses' testimony during Kerrisdale's and plaintiffs' investigations disputing the breadth of CEU's business; (4) the rapid turnover of CEU's CFOs during the class period; (5) the empty condition of CEU's Chinese-based training center both during and after the class period; and (6) the inoperability of CEU's website. *Id.* at 12–13, 19. Plaintiffs assert that, viewed holistically, the CAC alleges sufficient facts to give rise to an inference of scierter. *Id.* at 21–23.

The Court finds that plaintiffs have adequately alleged scierter. The Supreme

