

Central District of California: (1) Plaintiffs Cannot Plead Failure to Disclose a Material Risk Through Allegations of Fraud by Hindsight, and (2) “Absurd to Suggest” Exception to Core Operations Theory Requires More Than “Vague Quantifiers”

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On March 15, 2017, the Central District of California dismissed a putative securities fraud class action against a solar energy company (the “Company”). *Knox v. Yingli Green Energy Holding Co.*, 2017 WL 1013293 (C.D. Cal. 2017) (Wright, II, J.)^[1]. The court held plaintiffs could not plead failure to disclose a material risk simply by contrasting the Company’s optimistic statements concerning a Chinese government subsidy program with subsequent adverse developments impacting the profitability of that program. The court further held plaintiffs could not rely on the “absurd to suggest” exception to the “core operations doctrine” to plead scienter by offering only “vague quantifiers.” The court explained that this exception usually requires allegations of “concrete numbers” concerning the alleged fraud.

Background

The Company manufactured and sold solar panels to companies around the world and had a growing presence in the China market, where the government was encouraging the adoption of solar technology through a subsidy program called “Golden Sun.” The case before the court concerned statements the Company had made concerning the Golden Sun program. Plaintiffs claimed the Company’s statements were misleading because they failed to disclose that a significant percentage of Golden Sun subsidies were “procured through ‘outright fraud,’” including by allegedly “overstating project costs in subsidy applications” and deliberately delaying construction of approved Golden Sun projects until the cost of materials dropped, thus putting the entire Golden Sun program at risk of cancellation.

In March 2013, reports emerged predicting that the Chinese government would end the Golden Sun subsidy program. These reports allegedly caused a 22% drop in the Company’s share price. The following month, the Chinese government issued clawback notices to certain subsidy recipients that had not completed their solar projects within certain deadlines.

Plaintiffs Failed to Allege the Company Had an Obligation to Disclose the Risk of Clawbacks

The court deemed meritless plaintiffs’ claim that the Company’s “optimistic statements about the Golden Sun Program were misleading because [the Company] failed to disclose the risk that the Chinese government . . . could clawback subsidies for projects that were not finished on time.”

The court recognized that Section 10(b) “require[s] that a company disclose the *risk* that a future event might occur if that risk is material.” However, the court emphasized that “Section 10(b) does not require that companies predict the future.” The court explained that “[a] plaintiff may not plead fraud by hindsight” by “simply contrast[ing] a defendant’s past optimism with less favorable actual results in support of a claim of securities fraud.” *Id.* (internal quotation marks and citation omitted).

Here, the court found that plaintiffs had “not presented particular facts in existence at the time of [the Company’s] optimistic statements showing *any* likelihood that its customers would not meet their project deadlines.” The court determined there was “nothing [in the complaint] to show that potential clawbacks presented a material risk to [the Company’s] involvement in Golden Sun at [the] time” the statements at issue were made, and the Company therefore “need not have disclosed that risk.”

Plaintiffs Failed to Allege Scienter as to the Possibility That the Chinese Government Could Discontinue the Golden Sun Program

The court found plaintiffs failed to allege scienter with respect to their claims that the Company did not “disclose the risk that the Chinese government . . . would [allegedly] likely discontinue the program due to [alleged] widespread fraud in procuring subsidies.”

Plaintiffs attempted to “rely on the ‘absurd to suggest’ exception to the core operations theory—i.e., that Golden Sun was so important to [the Company], and [the Company] was so involved in the fraud, that it would be absurd to suggest that [the Company] did not know of it.” The court explained that “[t]he core operations theory posits that facts critical to a business’s core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers.” *Id.* (internal quotation marks and citation omitted). While plaintiffs in the Ninth Circuit “cannot rely[] exclusively on the core operations inference to plead scienter under the” Private Securities Litigation Reform Act, the court noted that the “only exception is the rare instance where the nature of the relevant fact is of such prominence that it would be absurd to suggest that management was without knowledge of the matter.” *Id.* (internal quotation marks and citation omitted).

In the case before it, the court found plaintiffs’ generalized “allegations . . . insufficient to show that [the Company’s] upper management knew of even [the Company’s] *own* alleged fraud, let alone industry-wide fraud.” For example, plaintiffs alleged that the Company engaged in a “widespread” practice of substituting cheaper solar panels for more expensive ones. The court stated that it could not “draw any meaningful inferences about what [the Company’s] executives knew” based on such “vague quantifiers.” The court emphasized that “[t]he Ninth Circuit cases relying on the ‘absurd to suggest’ doctrine are usually based on concrete numbers, not majestic generalities” of the type plaintiffs alleged.

The court also found plaintiffs failed to plead scienter as to claims alleging the Company improperly delayed the recognition of accounts for which collectability was not reasonably assured. The court dismissed plaintiffs’ complaint in its entirety, with leave to amend only certain of plaintiffs’ claims.

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