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Seventh Circuit: Respondents in Pending SEC Administrative Proceedings May Not Bypass the Judicial Review Process Established in 15 U.S.C. § 78y by Bringing Constitutional Challenges to the SEC's Authority Directly in Federal Court

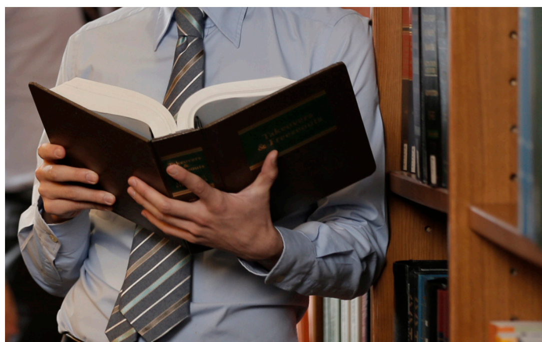
On August 24, 2015, the Seventh Circuit held that a respondent in a pending SEC administrative enforcement proceeding may not "skip the administrative and judicial review process" established in 15 U.S.C. § 78y by bringing suit in federal court to "challeng[e] on constitutional grounds the authority of the SEC to conduct the proceeding." *Bebo v. SEC*, 2015 WL 4998489 (7th Cir. 2015) (Hamilton, J.) (*Bebo II*). The court found it "'fairly discernible'" from the statute that Congress intended respondents in SEC administrative proceedings "'to proceed exclusively through the statutory review scheme' set forth in 15 U.S.C. § 78y" (quoting *Elgin v. Dep't of Treasury*, 132 S. Ct. 2126 (2012)).

Background

Pursuant to § 929(P) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC has a choice of fora when seeking monetary penalties against non-regulated individuals. The SEC may either "proceed in federal district court or conduct its own administrative enforcement proceeding." There are "procedural consequences" to the SEC's choice of forum. For instance, the SEC's Rules of Practice, rather than the Federal Rules of Evidence and Civil Procedure, govern SEC enforcement proceedings. Respondents in SEC enforcement proceedings therefore have "fewer rights to discovery" than do respondents in district court proceedings, and "no right to a jury trial before the SEC." However, respondents in SEC proceedings do have the right to seek federal appellate review of final SEC decisions in the circuit court for the district in which they reside or

work, or before the District of Columbia Court of Appeals. *See* 15 U.S.C. § 78y(a)(1). The appellate court may then affirm, modify, or set aside the SEC's final decision entirely.

In December 2014, the SEC filed an administrative enforcement action alleging securities law violations against the former CEO of Assisted Living Concepts, Inc., Laurie Bebo. "Rather than wait[ing] for the administrative process to end and pursu[ing] judicial review as prescribed by § 78y," Bebo brought suit in the Eastern District of Wisconsin challenging the SEC's authority to conduct the administrative proceeding on constitutional grounds. Plaintiff asserted that "§ 929P(a) of Dodd-Frank [was] facially unconstitutional under the Fifth Amendment because it provide[d] the SEC [with] 'unguided' authority to choose which respondents [would] and which [would] not receive the procedural protections of a federal district court, in violation of equal protection and due process guarantees." Plaintiff further "contend[ed] that the SEC's administrative proceedings [were] unconstitutional under Article II because the [administrative law judges] who preside[d] over SEC enforcement proceedings [were] protected from removal by multiple layers of for-cause protection." Plaintiff claimed that "[t]his set-up violate[d] Article II … because it interfere[d] with the President's obligation to ensure the faithful execution of the laws."



The district court found plaintiff's claims "compelling and meritorious," but determined that her claims were "subject to the exclusive remedial scheme" established by the Dodd-Frank Act governing SEC enforcement proceedings. *Bebo v. SEC,* 2015 WL 905349 (E.D. Wis. Mar. 3, 2015) (Randa, J.). The court held that plaintiff was required to "litigate her claims before the SEC and then, if necessary, on appeal to the Court of Appeals for the Seventh Circuit." Plaintiff appealed.

Seventh Circuit Holds Respondents in Pending SEC Administrative Enforcement Proceedings May Not Bring Constitutional Challenges to the SEC's Authority in Federal Court Because 15 U.S.C. § 78y Provides for Meaningful Judicial Review of Such Challenges

On appeal, the Seventh Circuit explained that the question before it was "a jurisdictional one: whether the statutory judicial review process under 15 U.S.C. § 78y bars district court jurisdiction over a constitutional challenge to the SEC's authority when the plaintiff is the respondent in a pending enforcement proceeding." The court recognized that, in *Free Enterprise Fund v. Public Company Accounting Oversight Board.*, 561 U.S. 477 (2010), the Supreme Court "held that § 78y does not strip district courts of jurisdiction to hear at least certain types of constitutional claims." The *Bebo II* court explained that its "focus in this appeal" was to assess "whether Bebo's case [was] sufficiently similar to *Free Enterprise Fund* to allow her to bypass the [SEC administrative enforcement proceeding] and judicial review under § 78y."

In *Free Enterprise Fund,* plaintiffs brought suit in federal district court challenging the constitutionality of provisions of the Sarbanes-Oxley Act of 2002 that established a special SEC-appointed oversight board for accounting firms. Final decisions of the special oversight board were subject to federal appellate review pursuant to 15 U.S.C. § 78y. Significantly, plaintiffs were not subject to any pending SEC enforcement actions at the time they brought suit.

The *Free Enterprise Fund* Court found that "plaintiffs would not [have] be[en] able to receive meaningful judicial review without access to the district courts" because § 78y "provides [only] for judicial review of final orders of the SEC and not every adverse action by the [special oversight] board would be 'encapsulated in a final Commission order or rule.'" To obtain judicial review under § 78y, plaintiffs would have been required either to (1) seek SEC review of one or more of the "board's auditing standards, registration requirements or other rules"; or (2) "invite a sanction from which to appeal by intentionally violating one of the board's rules or by ignoring a request for documents or

testimony." The *Free Enterprise Fund* Court therefore held that the district court could exercise jurisdiction over plaintiffs' claims.

The *Bebo II* court found that, "[u]nlike in *Free Enterprise Fund*, meaningful judicial review [was] available to [plaintiff] under § 78y." The court reasoned that since plaintiff was "already the respondent in a pending enforcement proceeding," she would not have to "select and challenge a Board rule at random" or "risk incurring a sanction voluntarily just to bring her constitutional challenges before a court of competent jurisdiction." The court explained that "[a]fter the pending enforcement action ha[d] run its course, [plaintiff could] raise her objections in a circuit court of appeals established under Article III."

Significantly, the *Bebo II* court found "no evidence … that Congress intended for plaintiffs like Bebo who [were] already subject to ongoing administrative enforcement proceedings to be able to stop those proceedings by challenging the constitutionality of the enabling legislation or the structural authority of the SEC." The court found it "'fairly discernible' that Congress intended Bebo to proceed exclusively through the statutory review scheme established by § 78y because that scheme provides for meaningful judicial review in 'an Article III court fully competent to adjudicate petitioners' claims'" (quoting *Elgin v. Dep't of Treasury*, 132 S. Ct. 2126 (2012)).

The court therefore affirmed dismissal of plaintiffs' claims for lack of subject matter jurisdiction.

Tenth Circuit: Failure to Comply with a Securities Regulation Disclosure Requirement Is Insufficient, Standing Alone, to Raise a Strong Inference of Scienter

On August 18, 2015, the Tenth Circuit affirmed dismissal of a securities fraud action alleging that ZAGG, Inc. had failed to disclose the number of company shares pledged as collateral in a margin account by the company's then-CEO, in violation of Item 403(b) of Regulation S-K. *In re ZAGG, Inc. Sec. Litig.*, 2015 WL 4901893 (10th Cir. 2015) (Tymkovich, J.) (*ZAGG II*). The court agreed with defendants that "the bare identification of a securities regulation violation is not enough," standing alone, to raise a strong inference of scienter.

Background

Item 403(b) of Regulation S-K requires companies to disclose "the amount of shares that are pledged as security" in accounts held by the company's directors and officers. 17 C.F.R. § 229.403(b). Plaintiffs asserted that Robert Pedersen, ZAGG's former CEO and Chairman, had "failed to disclose in several of ZAGG's SEC filings the fact that he had pledged nearly half of his ZAGG shares, amounting to approximately 9 percent of the company, as collateral in a margin account." ZAGG's SEC filings during the class period "revealed Pedersen's total share of ownership but did not … indicat[e] the amount of his

shares pledged as security" as required under Item 403(b).

Between December 2011 and August 2012, Pedersen sold ZAGG shares on three separate occasions in order to meet margin calls. Each time, Pedersen filed a Form 4 disclosing the sale. On August 17, 2012, ZAGG announced that Pedersen was stepping down as CEO and Chairman. The company also "filed a Form 8-K with the SEC stating that the company had implemented a policy prohibiting officers, directors, and 10 percent shareholders from pledging ZAGG securities on margin."

Plaintiffs subsequently brought suit alleging that "the company's SEC filings [had] omitted material information regarding Pedersen's pledged shares," and that this omission "resulted in the artificial inflation of ZAGG's share price." Defendants moved to dismiss. On February 7, 2014, the District of Utah dismissed plaintiffs' complaint on scienter grounds. *In re ZAGG Sec. Litig.*, 2014 WL 505152 (D. Utah. 2014) (Benson, J.). The court found plaintiffs had neither "allege[d] any facts [showing] that Pedersen knew that his failure to reveal his pledges would likely mislead investors," nor pled "any particularized facts that might give rise to a strong inference that the pledged shares were 'so obviously material' that Pedersen must have been aware that [his] non-disclosure would likely mislead investors." Plaintiffs appealed.

Tenth Circuit Finds a Failure to Comply with a Securities Regulation Disclosure Obligation Insufficient to Raise an Inference of Scienter Absent Particularized Allegations Showing Defendant Knew of or Recklessly Disregarded the Disclosure Requirement

On appeal, the Tenth Circuit found it "undisputed that ZAGG's annual reports and proxy statements filed during the class period should have disclosed both Pedersen's total ownership and 'by footnote or otherwise, the amount of shares that [were] pledged as security.'" *ZAGG II*, 2015 WL 4901893 (quoting 17 C.F.R. § 229.403(b)). The court held, however, that "the fact of [an Item 403(b) disclosure] violation [was] insufficient" to raise an inference of scienter "without some other facts evidencing Pedersen signed the filings with the knowledge that they omitted a required disclosure."

The court rejected plaintiffs' contention that it was "implausible that Pedersen did not know of [Item 403(b)'s] requirement to disclose his pledged shares." The court explained that plaintiffs' argument "assume[d] that Pedersen [had] read and prepared the disclosures, and knew the omission would mislead investors." The court found plaintiffs had alleged no particularized facts showing that "Pedersen appreciated [this] risk at the time the disclosures were made." The court further found that "Pedersen's position in the company [was] also an insufficient basis from which to impute his knowledge of the reporting violation." Finally, the court deemed "unpersuasive" the fact that Pedersen had "executed Sarbanes-Oxley (SOX) certifications stating that he [had] reviewed the filings and the information contained therein was accurate." The court determined that plaintiffs had not alleged any facts showing that Pedersen knew these "sworn SOX statements were false at the time they were made."

Plaintiffs alternatively claimed that Pedersen had "acted with a reckless disregard of a substantial likelihood of misleading investors" in failing to comply with Item 403(b)'s disclosure requirements. The Tenth Circuit explained that "recklessness in [the securities fraud] context is a particularly high standard, … something closer to a state of mind approximating actual intent." The court found that it could not "say that … a failure to comply with Item 403(b)[ ] … [was] evidence of conduct that was an extreme departure from the standards of ordinary care, … or akin to conscious disregard," particularly given that Pedersen had "personally disclosed the margin account after each margin call."

Tenth Circuit Finds Company's Subsequent Margin Account Policy Changes Did Not Support an Inference of Scienter

The Tenth Circuit further determined that "neither Pedersen's forced resignation nor ZAGG's implementation of a new policy prohibiting officers, directors, and 10 percent shareholders from pledging company securities in margin accounts help[ed] to establish an earlier intent to defraud." The court found that ZAGG's margin

account policy changes and Pedersen's forced resignation were "at most an acknowledgement that the company [had] identified a better way of doing things moving forward, not an indicator that fraudulent intent existed at the time the alleged omissions occurred."

The court found that any inference of scienter was not "at least as compelling" as "the plausible, nonculpable inference that Pedersen did not know Item 403(b)'s requirement and … believed he [had] appropriately disclosed the margin account … following each margin call." The Tenth Circuit therefore affirmed dismissal of plaintiffs' complaint for failure to allege scienter.

Northern District of Texas: Court Applies *Halliburton* II to Deny Class Certification as to Certain Alleged Corrective Disclosures Where Halliburton Proved Those Disclosures Had No Price Impact

In *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014) (*Halliburton II*), the Supreme Court held that defendants are entitled to rebut the presumption of reliance set forth in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) at the class certification stage by presenting evidence that the alleged misrepresentation or corrective disclosure had no price impact.[1] The *Halliburton II* Court vacated the district court's class certification order in a long-running securities fraud action against Halliburton Company, and remanded the action for further proceedings consistent with its opinion.

On July 25, 2015, the Northern District of Texas applied the Court's guidance in *Halliburton II* to deny plaintiffs' motion for class certification in the *Halliburton* action as to claims involving five of the six alleged corrective disclosures at issue. *Erica P. John Fund, Inc. v. Halliburton Co.*, 2015 WL 4522863 (N.D. Tex. 2015) (Lynn, J.) (*Halliburton III*). The court found that Halliburton had successfully rebutted the *Basic* presumption by proving that these five alleged corrective disclosures had no impact on the company's stock price. However, the court determined that Halliburton had failed to prove a lack of price impact as to one of the alleged corrective disclosures, and granted plaintiffs' motion for class certification with respect to claims concerning that disclosure.

Background

The Northern District of Texas first considered plaintiffs' motion for class certification in 2008. The court declined to certify the class on the ground that plaintiffs had not proved loss causation, as required under applicable Fifth Circuit precedent. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 2008 WL 4791492 (N.D. Tex. Nov. 4, 2008). The Fifth Circuit affirmed. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010). The Supreme Court subsequently vacated the Fifth Circuit's decision, holding that plaintiffs "need not" "prove loss causation in order to obtain class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (*Halliburton I*).[2] The Court remanded the action for further proceedings consistent with its opinion.

On remand, Halliburton sought to overcome the *Basic* presumption by presenting evidence that the alleged misrepresentations had no price impact. The Northern District of Texas found that consideration of price-impact evidence was not appropriate at the class certification stage, and granted plaintiffs' motion for class certification. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 2012 WL 565997 (N.D. Tex. Jan. 27, 2012). The Fifth Circuit affirmed. *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423 (5th Cir. 2013). Once again, the Supreme Court granted *certiorari*.

In *Halliburton II*, the Supreme Court held that "defendants must be afforded an opportunity before class certification to defeat the [*Basic*] presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock." 134 S. Ct. 2398. The Court explained that under *Basic*, "'[a]ny showing

1. Click here to read our prior discussion of the *Halliburton II* decision.

2. Click here to read our prior discussion of the *Halliburton I* decision.

that severs the link between the alleged misrepresentation and ... the price received (or paid) by the plaintiff ... will be sufficient to rebut the presumption of reliance' because 'the basis for finding that the fraud had been transmitted through market price would be gone'" (quoting *Basic*, 485 U.S. 224). The *Halliburton II* Court found that "[p]rice impact is thus an essential precondition for any Rule 10b-5 class action." The Court determined that, "[w]hile *Basic* allows plaintiffs to establish that precondition indirectly, it does not require courts to ignore a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption does not apply."

The Supreme Court vacated the class certification order in the *Halliburton* case and remanded the action for further proceedings consistent with its opinion in *Halliburton II*. Plaintiffs subsequently moved for class certification as to claims in connection with six allegedly corrective disclosures. Prior to ruling on plaintiffs' motion for class certification, the Northern District of Texas held an evidentiary hearing in which both parties presented expert testimony on whether the alleged corrective disclosures impacted Halliburton's stock price.

Court Finds Defendants Have the Burden of Both Production and Persuasion on the Issue of Price Impact at the Class Certification Stage

As an initial matter, the Northern District of Texas noted that "[t]he Supreme Court did not state expressly in *Halliburton II* whether plaintiffs or defendants must carry the burden of persuasion to show price impact or lack thereof." *Halliburton III*, 2015 WL 4522863. Based on its "analysis of ... *Halliburton II*, and decisions by other district courts since *Halliburton II*," the court determined that Halliburton bore "the burdens of production and persuasion to show lack of price impact." The court held that it was up to Halliburton to "persuade the [c]ourt that its expert's event studies [were] more probative of price impact than [plaintiffs'] expert's event studies." The court reasoned that if it required "plaintiffs to carry the burden of persuasion to show price impact at the class certification stage," then it "would, in effect, be requiring [plaintiffs] to prove price impact directly, a proposition the Supreme Court [in *Halliburton II*] refused to adopt."

The court also rejected Halliburton's attempt to rely on Rule 301 of the Federal Rules of Evidence to claim "that it should bear only the burden of production" on the issue of price impact. Rule 301 provides that "unless a federal statute or [the Federal Rules of Evidence] provide otherwise, the party against whom a presumption is directed has the burden of producing evidence to rebut the presumption." Rule 301 further provides that it "does not shift the burden of persuasion, which remains on the party who had it originally." The court found that "the fraud-on-the-market presumption is atypical, and as a result, does not neatly fit into the Rule 301 framework." *Halliburton III*, 2015 WL 4522863. The court explained that "a literal application of Rule 301 to the fraud-on-the-market presumption in a class certification hearing would allow defendants to preclude class certification by merely putting on a reputable expert ... [who could] opine with 95% confidence that a corrective disclosure had no effect on price." Pursuant to "Halliburton's position on Rule 301," plaintiffs "would then be forced to move forward and prove reliance without the aid of the presumption, which would doom the class on predominance grounds." The court determined that "the Supreme Court would not have modified the fraud-on-the-market presumption so substantially without explicitly saying so."

Court Finds Class Certification Is Not the Proper Stage at Which to Determine Whether Disclosures Are Corrective

The court declined to address Halliburton's contention that "each of the alleged corrective disclosures were not, in fact[,] corrective." The court found that the Supreme Court's decisions in *Halliburton I, Halliburton II*, and *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 133 S. Ct. 1184 (2013)[3] "strongly suggest that the issue of whether disclosures are corrective is not a

3. The court noted that, in *Amgen*, "the Supreme Court held that securities fraud plaintiffs need not prove materiality at the class certification stage" because materiality is "an element of a Rule 10b-5 cause of action," any challenge to "which is more properly dealt with at trial or on a motion for summary judgment." Please click here to read our prior discussion of the *Amgen* decision.

proper inquiry at the certification stage." The court explained that "*Basic* presupposes that a *misrepresentation* is reflected in the market price at the time of the transaction." For purposes of class certification, the court therefore "conclude[d] that the asserted misrepresentations were, in fact, misrepresentations, and assume[d] that the asserted corrective disclosures were corrective of the alleged misrepresentations." The court reasoned that "hold[ing] otherwise would require the [c]ourt to pass judgment on the merits of the allegations after the dismissal stage and before summary judgment—in effect, giving a third bite at the apple to Halliburton."

The court further found that "Halliburton's arguments regarding whether the disclosures were corrective [were], in effect, a veiled attempt to assert the 'truth on the market' defense, which pertain[ed] to materiality and [was] not properly before the [c]ourt" at the class certification stage. The court explained that, if it determined that a particular disclosure was not corrective, such a finding would not "cause[ ] individual questions of law and fact to predominate over common questions." Rather, "it would end [the] controversy altogether."

Court Holds Five of the Six Alleged Corrective Disclosures Had No Price Impact

The court then turned to whether Halliburton had proved that the alleged corrective disclosures had no price impact. The court explained that in order "[t]o show that a corrective disclosure had a negative impact on a company's share price, courts generally require a party's expert to testify based on an event study that meets the 95% confidence standard, which means 'one can reject with 95% confidence the null hypothesis that the corrective disclosure had no impact on price.'" The court further noted that "[a]n event study is generally comprised of two parts: (1) a calculation of the market-adjusted price change in the issuer's share price at the time the corrective disclosure became public … ; and (2) a determination of whether the corrective disclosure is among the [company-related] news that affected the price on the date the disclosure became public."

In the case before it, Halliburton's expert determined that there were 35 separate dates on which plaintiffs alleged either a misrepresentation or a corrective disclosure. Halliburton's expert found that none of the alleged misrepresentations or corrective disclosures had any price impact except for Halliburton's December 7, 2001 disclosure of an adverse asbestos-related verdict against the company. As to that particular disclosure, Halliburton's expert opined that "there was no price reaction *as to the alleged misrepresentation*, which the [c]ourt interpret[ed] to mean that the price reaction was caused by [other] factors." Plaintiffs' expert conducted an event study only with respect to the six alleged corrective disclosures at issue, and found that "the market responded significantly to each of these six events."

Court Finds a Multiple-Comparison Adjustment Was Warranted to Correct for the Possibility of False Positives

Halliburton's expert contended that a multiple-comparison adjustment was warranted where, as here, "a large number of price reactions are tested for statistical significance, because the more price reactions tested, the greater the odds are of finding statistical significance simply due to chance." While the court recognized that "multiple comparison adjustments are rarely utilized in event studies for securities litigation," the court found that "the use of a multiple comparison adjustment [was] proper in this case because of the substantial number of comparisons, thirty-five comparisons, being tested for statistical significance in [Halliburton's expert's] analysis." However, the court determined that the particular multiple-comparison adjustment that Halliburton's expert applied (the "Bonferroni adjustment") "generate[d] a relatively high incidence of … false negatives." The court therefore applied a different adjustment (the "Holm-Bonferroni adjustment"), which, in the court's view, "addresse[d] the multiple comparison problem [of false positives]… while also guarding against the prospect of unacceptably high levels of [false negatives]."

Court Finds Plaintiffs' Expert's Peer Index Should Be Used to Evaluate Price Impact

As to the relevant indices against which to measure Halliburton's stock price movement, Halliburton's expert "selected an index for each of Halliburton's two main lines of business—(1) energy services, and

(2) engineering and construction (E&C)." Halliburton's expert used the S&P 500 Energy Index and a Fortune E&C index. Plaintiffs' expert, on the other hand, "constructed a peer index composed of companies identified by analysts as being Halliburton's peers ('Analyst Index')." The court determined that this Analyst Index "increase[d] the explanatory power of [Halliburton's expert's model]," and found that "it should be utilized in measuring the statistical significance of the price reaction on the six dates in question."

Court Holds a Two-Day Window Cannot Be Used to Measure Price Impact in an Efficient Market

The court also considered whether the question of price impact should be analyzed over a one- or two-day window following the alleged corrective disclosure. Significantly, the court held that, "in this case, the use of a two-day window [was] inappropriate to measure price impact in an efficient market." The court reasoned that "[a]n efficient market is said to digest or impound news into the stock price in a matter of minutes." As a result, the court determined that "an alleged corrective disclosure released to the market at the start of Day 1, … followed by a price impact on Day 2, will not show price impact as to the alleged corrective disclosure."

Court Finds Halliburton Successfully Rebutted the *Basic* Presumption of Reliance with Respect to Five of the Six Alleged Corrective Disclosures

The court next assessed the evidence of price impact as to each of the six corrective disclosures alleged. The court found that Halliburton had succeeded in rebutting the *Basic* presumption of reliance by proving a lack of price impact as to five of these corrective disclosures.

With respect to Halliburton's December 21, 2000 announcement of a $120 million after-tax charge in connection with restructuring and charges on the company's fixed-price engineering and construction contracts, the court found plaintiffs' expert's "use of a two-day window [was] inconsistent with an efficient market, especially where the relevant disclosure was made before the market opened on Day 1." As to Halliburton's August 9, 2001 announcement concerning an "upward trend" in new asbestos claims and an increase in the company's gross asbestos liability, the court found that this information "*both* [was] already disclosed *and* caused no statistically significant price reaction." The court similarly found that Halliburton's October 30, 2001 disclosure of an adverse asbestos-related jury verdict had no price impact because "[p]ublic announcements [of the jury verdict] preceded Halliburton's press release" and there was no statistically significant price reaction to those announcements. The court likewise found that Halliburton had proved a lack of price impact as to asbestos-related disclosures on June 28, 2001 and December 4, 2001.

However, the court found that Halliburton had failed to prove a lack of price impact with respect to its December 7, 2001 announcement of an adverse asbestos-related jury verdict finding Dresser, a Halliburton subsidiary, liable for $30 million in damages. On the date of the announcement, Halliburton's stock price dropped by 40%. Halliburton contended that the announcement had no price impact by pointing to a stock price rebound on December 10th, the second day of trading following the announcement. The court held that Halliburton could not rely on this Day 2 price rebound to show an absence of price impact "because to do so would be inconsistent with an efficient market, which is said to digest or impound news into the stock price in a matter of minutes."

While the court found that "at least some of Halliburton's stock price decline … [was] likely attributable to uncertainty in the asbestos environment that also impacted other companies with asbestos exposure," the court held that Halliburton had failed to prove that this "uncertainty caused the entirety of Halliburton's substantial price decline" on December 7, 2001. The court determined that "the price impact on December 7 likely reflected the market's view of Halliburton's prior representations regarding its asbestos liability *and* increased uncertainty in the asbestos environment."

The court therefore granted plaintiffs' motion for class certification "only with respect to the alleged corrective disclosure of December 7, 2001."

Southern District of New York: "Adverse Interest" Exception to the General Rule Attributing a Corporate Executive's Scienter to the Corporation Does Not Apply If the Corporation Benefited From the Executive's Fraud

Under the "adverse interest" exception, a corporate executive's scienter will not be imputed to the corporation if the executive acted purely self-interestedly and against the corporation's interests. On July 30, 2015, the Southern District of New York held that the adverse interest exception did not apply in a securities fraud action brought in connection with an alleged bribery and kickback scheme involving Petróleo Brasileiro S.A. ("Petrobras"). *In re Petrobras Sec. Litig.*, 2015 WL 4557364 (S.D.N.Y. 2015) (Rakoff, J.).[4] The court found that the allegations did not "conclusively establish" that Petrobras had "received no benefit from the [c]orrupt [e]xecutives' actions, as required to render the adverse interest exception applicable."

The court further held that it could not "conclude that … alleged misrepresentations in Petrobras' financial statements were immaterial as a matter of law" even though the alleged misstatements did not necessarily "reach[ ] the five percent" threshold of presumptive materiality set forth in the SEC's Staff Accounting Bulletin ("SAB") No. 99. The court found that the qualitative factors discussed in SAB No. 99 "strongly favor[ed] a finding of materiality" because the alleged misstatements concerned the company's core business and its corporate integrity.

Background

Plaintiffs contended that Petrobras, its subsidiaries, and certain former officers and directors of the company and its subsidiaries had "made two categories of false and misleading statements" in connection with an alleged "multi-year, multi-billion dollar bribery and kickback scheme." First, plaintiffs alleged that "the corruption scheme rendered the [c]ompany's financial statements materially false and misleading." Specifically, plaintiffs claimed that the reported value of Petrobras' property, plant, and equipment ("PP&E") was "inflated by … bribe payments and overcharges from [a construction] cartel," which were incorporated into the price of Petrobras' construction contracts. Second, plaintiffs alleged that "Petrobras [had] made false and misleading statements regarding the integrity of its management and the effectiveness of its financial controls." Plaintiffs asserted claims under Section 10(b) and Rule 10b-5, among other claims.

Court Finds the Adverse Interest Exception Inapplicable Because Petrobras Allegedly Benefited from the Corrupt Executives' Alleged Fraud

With respect to the complaint's allegations, defendants did not dispute that plaintiffs had adequately pled scienter as to the company executives who had allegedly "carried out the bribery scheme" (the "Corrupt Executives"). However, defendants contended that "the adverse interest exception applie[d]" to shield the Petrobras entities from any imputation of corporate scienter based on the Corporate Executives' knowledge "because the Corrupt Executives acted entirely to benefit themselves and their political patrons, at the [c]ompany's expense."

The court explained that the "so-called 'adverse interest' exception to the general rule that a corporate executive's scienter is attributable to the corporation … applies [only] where 'an officer acts entirely in his own interests and adversely to the interests of the corporation'" (quoting *Kirschner v. Grant Thornton LLP*, 2009 WL 1286326 (S.D.N.Y. Apr. 14, 2009), *aff'd sub nom. Kirschner v KPMG LLP*, 626 F. 3d 673 (2d Cir. 2010)). The court underscored that a corporation's "agents cannot be said to have 'totally abandoned' the interests of the corporation" for purposes of the adverse interest exception if the "corporation benefit[ed] to *any* extent from the fraudulent acts of its agents."

Here, the court found the complaint plausibly alleged that the bribery scheme caused the value of Petrobras' PP&E to appear higher than it actually was, "which in turn inflated the value of Petrobras' securities." The court determined that "the inflation of the [c]ompany's PP & E operated as a fraud on

4. The court's July 30, 2015 opinion explained the reasoning for its July 9, 2015 order granting in part and denying in part defendants' motion to dismiss plaintiffs' claims.

the investing public, not on Petrobras itself." The court further found that the Corrupt Executives' alleged "failure to correct" the company's compliance and internal control-related statements "clearly benefited the [c]ompany, which was able to continue to attract investment and to complete its large-scale expansion plans." Finally, the court found that Petrobras allegedly "benefited from" the corruption scheme by "remaining in favor with its political patrons."

The court held that the allegations did "not conclusively establish that the [c]ompany received no benefit from the Corrupt Executives' actions, as required to render the adverse interest exception applicable." The court therefore determined that the Corrupt Executives' alleged scienter could be imputed to the corporation.[5]

Court Applies the Qualitative Factors in SAB No. 99 to Find That Alleged Misstatements Concerning the Value of Petrobras' Assets Were Not Presumptively Immaterial

With respect to alleged overstatements of the value of Petrobras' assets, defendants claimed that the company [had] "paid only three percent more on the cartel contracts than it would have under an honest bidding system." Defendants contended that "the three percent bribe payment built into the cartel contracts did not materially affect the accuracy of Petrobras' financial statements" under SAB No. 99, which "establishes a 'rule of thumb' that changes of less than five percent to financial statements are presumptively immaterial."

As an initial matter, the court found that the public documents on which the complaint relied "permit[ted] the inference that the contracts were inflated by much more than three percent." The court determined that it was "not clear whether Petrobras' alleged misstatement[s] reach[ed] the five percent 'rule of thumb,'" but found that "there [was] a plausible possibility that [they] might."

"In any event," the court stated that this "quantitative analysis [was] not dispositive of materiality." The court found that "[h]ere, the qualitative factors [set forth in SAB No. 99] strongly favor[ed] a finding of materiality."[6] The court explained that "[t]he errors in Petrobras' financial statements were directly related to its concealment of the unlawful bribery scheme, revelation of which would [have] 'call[ed] into question the integrity of the company as a whole.'" The court also deemed it significant that the alleged "misstatements related to the value of Petrobras' oil-producing infrastructure, which [was] the core of its business." Finally, because Petrobras' share price "dropped dramatically when news of the corruption scheme emerged," the court found that investors did, in fact, consider the information material.

The court therefore determined that it could not "conclude that the alleged misrepresentations in Petrobras' financial statements were immaterial as a matter of law."

Court Finds Alleged Misstatements of Opinion Actionable Under the Supreme Court's Decision in *Omnicare* Because Defendants Allegedly Disbelieved the Statements at the Time They Were Made

Defendants contended that "many of their allegedly false and misleading statements were statements of opinion," and claimed that plaintiffs had not "plausibly alleged that those opinions were not honestly held" as required under the Supreme Court's decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015).[7]

5. The Southern District of New York recently reached the same conclusion with respect to the adverse interest exception in a different case that also involved an alleged bribery and kickback scheme. *See In re PetroChina Co. Sec. Litig.*, 2015 WL 4619797 (S.D.N.Y. Aug. 3, 2015). In the *PetroChina* case, the court emphasized that the adverse interest exception is "narrow" and does not apply when "insiders defraud third parties *for* the corporation." *PetroChina*, 2015 WL 4619797. The court found that the adverse interest exception did not apply in the *PetroChina* case because "[p]resumably, it was in PetroChina's interest for any corruption occurring within the [c]ompany to remain undisclosed in order to preserve its shareholders' confidence." The court explained that cases applying the adverse interest exception have "involved corporate actors that were deemed to have acted to the company's detriment," and found that the *PetroChina* case "present[ed] no such scenario."

6. In SAB No. 99, the SEC stated that "[q]ualitative factors may cause misstatements of quantitatively small amounts to be material." 1999 WL 1123073. Qualitative factors that the SEC may consider include "whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability," and "whether the misstatement involves concealment of an unlawful transaction."

7. Please click here to read our prior discussion of the *Omnicare* decision.

The court explained that under *Omnicare*, "[a] statement of opinion is not materially false just because it is incorrect unless it is not 'honestly held' or omits facts about the speaker's basis for holding that view, and those facts conflict with what a reasonable investor would understand from the statement itself." Here, the court found that plaintiffs had adequately alleged that defendants did not believe their statements of opinion concerning the company's business operations at the time those statements were made. For example, "plaintiffs allege[d] that at the time the [c]ompany's management was professing its opinion that the company's internal controls were effective, that same management was well aware of the extensive corruption in the [c]ompany's procurement activities." The court therefore determined that the alleged statements of opinion were actionable under *Omnicare*.

The court also found that the alleged misstatements were not inactionable puffery. "[W]hen, (as here alleged) the statements were made repeatedly in an effort to reassure the investing public about the [c]ompany's integrity," the court found that "a reasonable investor could rely on [those statements] as reflective of the true state of affairs at the [c]ompany."

The court therefore denied defendants' motion to dismiss plaintiffs' Section 10(b) and Rule 10b-5 claims for failure to plead materiality and scienter.

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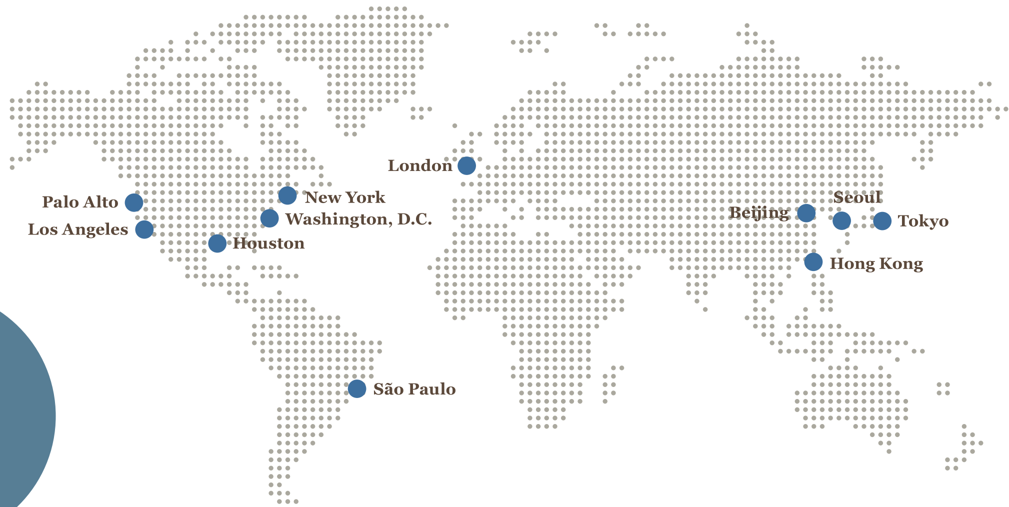

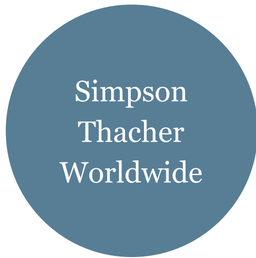

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