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Reese v. Malone[1]

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I. INTRODUCTION

In *Reese v. Malone*, the Ninth Circuit Court of Appeals revived a class action securities fraud suit against BP. The court overturned the district court's finding and held that statements made by BP and its executives in the wake of two separate oil pipeline leaks in Alaska were actionable as being intentionally misleading. The court held that all but one of the statements at issue had the potential to mislead the public and, more specifically, BP's investors. While BP has already been found criminally and civilly liable for the harm that these oil spills caused to the environment, BP will again face civil liability for its alleged attempts to conceal its degree of fault in causing and allowing that harm to occur.

II. FACTS AND HOLDING

Appellants are BP shareholders ("Appellants"), who filed a class action suit against BP; BP Exploration Alaska ("BP-Alaska"), an Alaska-based, wholly-owned subsidiary of BP; John Browne, BP's CEO during the class period; and Maureen Johnson, who was BP-Alaska's Senior Vice President during the class period.[2] Appellants' action is based on two oil spills from leaks in separate oil pipelines operated by BP-Alaska in the Prudhoe Bay area of northern Alaska.[3] The first spill was discovered on March 2, 2006, coming from a hole in the Western Operating Area ("WOA") line.[4] It is estimated the leak went undetected for at least five days, and

[1] Reese v. Malone, 747 F.3d 557 (9th Cir. 2014).
[2] *Id.* at 563.
[3] *Id.*
[4] *Id.* at 564.

spilled approximately 4,800 barrels of oil onto Alaskan tundra.[5] In August of the same year, the second spill was detected as another twenty-five barrels of oil leaked from the Eastern Operating Area ("EOA") line on the opposite side of Prudhoe Bay.[6] As a result, BP temporarily shut down operations in the Prudhoe Bay oil field.[7]

Both spills were the result of internal corrosion in the WOA and EOA pipelines, which BP knew to have similar characteristics that caused them to have the same high level of risk for corrosion.[8] The main process of pipeline maintenance in the oil and gas industries is known as "pigging," in which a cleaning tool is sent through the line.[9] "Smart pigging" is a process used to detect the presence of corrosion and cracks in the pipeline.[10] BP eventually admitted that it pigged its Prudhoe Bay lines infrequently, at a rate significantly below industry standards for that type of pipeline, and used less accurate methods of monitoring for internal corrosion.[11] Investigations revealed that BP had not tested the WOA's integrity with a smart pig since 1998,[12] nor the EOA since 1990.[13]

On March 15, 2006, the U.S. Department of Transportation Pipeline and Hazardous Materials Safety Administration ("PHMSA") issued a Corrective Action Order ("CAO") to BP-Alaska, addressed to Maureen Johnson, Vice President of BP-Alaska, as well as the Greater Prudhoe Bay Performance Unit Leader.[14] The CAO's preliminary findings identified multiple additional spots with severe corrosion, including one area with only 0.04 inches of wall remaining, and also noted the similarities in conditions

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[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *Id.* at 566. These factors included low crude oil flow velocities, corrosivity of the material being transported, the presence of water and sediments, and lack of or ineffective maintenance. *Id.*
[9] *Id.* at 563.
[10] *Id.* at 563-64.
[11] *Id.* at 564.
[12] *Id.*
[13] *Id.* at 573.
[14] *Id.* at 564.

and risks for corrosion between all three of BP's Prudhoe Bay pipelines.[15] The CAO stated that "'continued operation of BP's WOA, EOA, and Lisburne hazardous liquid pipelines without corrective measures would be hazardous to life, property and the environment,'" and ordered, among other things, that BP smart pig all three lines within certain deadlines.[16] BP's inspection of the EOA line (which missed its deadline by a month and was completed only two weeks before the second spill) revealed numerous severely corroded areas in that line as well.[17]

Following the second spill, in 2007, BP-Alaska pled guilty to a violation of the Clean Water Act, agreeing to pay a $20 million fine.[18] In the plea agreement, BP admitted that it was aware of corrosion in the WOA pipeline in 2005, the company's "'insufficient inspection data'" on the EOA line, and the risk factors for corrosion in both lines.[19] In 2011, BP settled civil suits brought by the Department of Justice and the State of Alaska, agreeing to pay $25 million in damages and to make $60 million in improvements to its pipelines in Alaska.[20]

In the instant case, appellants allege that BP knowingly, or with deliberate recklessness, made false and misleading statements about the condition of its pipelines, and its pipeline maintenance and leak detection practices, prior to and after the first spill.[21] Appellants seek relief under the Securities Exchange Act of 1934 for investment losses incurred when the spills and subsequent shutdown allegedly caused a significant decline in BP's share price.[22] The shareholders' appeal focuses on four types of false or misleading statements: (1) a press statement made by Maureen Johnson two weeks after the March spill that stated inspection data from prior to the spill indicated that corrosion was occurring at a low and manageable rate; (2) two press statements by Johnson suggesting that the first spill was anomalous and distinguishing the WOA line from the others in Prudhoe Bay; (3) a press statement by BP's CEO John Browne that the March spill occurred "'in spite

[15] *Id.* at 564-65.
[16] *Id.* at 565.
[17] *Id.*
[18] *Id.* at 566.
[19] *Id.*
[20] *Id.*
[21] *Id.* at 563.
[22] *Id.*

of the fact that [BP] has both world class corrosion monitoring and leak detection systems'"; and (4) a statement in BP's 2005 Annual Report (which was issued in June of 2006)[23] stating that management believed BP was in compliance, in all material respects, with applicable environmental laws and regulations.[24]

Appellees argue that Johnson, Browne, and other BP executives made those statements, not with the intent to mislead or deceive investors, but because they misunderstood or did not have access to BP's data,[25] and because some of the data was incomplete.[26] As to the statement in the annual report, Appellees argue that it was not intentionally false or misleading because the report used the phrases "'management believes,'" and "'compliance in all *material* respects'" (emphasis added).[27]

Initially, the trial court granted in part and denied in part Appellees' motion to dismiss, finding that only one of twenty-five allegedly false and misleading statements was actionable under the Securities Exchange Act of 1934.[28] On interlocutory appeal, the Ninth Circuit Court reversed, concluding that the statement was not false or misleading.[29] Appellants amended their complaint to include several facts and allegations, based on information that came to light during the investigations and lawsuits arising from the spills.[30] The trial court dismissed the amended complaint in its entirety, with prejudice, for failure to state a claim.[31] It found that, while some of Appellees' statements were actionably false, Appellants did not plead facts giving rise to a strong inference of scienter.[32]

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[23] *Id.* at 569, 572-73, 577.
[24] *Id.* at 567.
[25] *Id.* at 571.
[26] *Id.* at 573.
[27] *Id.* at 578-79.
[28] *Id.* at 566.
[29] *Id.*; *See* Reese v. BP Exploration (Alaska) Inc., 643 F.3d 681 (9th Cir. 2011).
[30] *Reese*, 747 F.3d at 567.
[31] *Id.*
[32] *Id.*

On appeal, the Ninth Circuit affirmed in part and reversed in part, remanding the case back to the trial court.[33] The instant court agreed with the trial court that the statement made by Browne[34] was not actionable,[35] but held that the other three types of statements[36] were.[37] The court ultimately held that a securities fraud claim is adequately pled, with respect to the elements of material falsity and scienter (which are required to state a securities fraud claim),[38] when the complaint specifies each statement alleged to have been false or misleading and the reasons why it is so,[39] and suffices to raise a reasonable expectation that discovery will reveal evidence satisfying the materiality requirement.[40] When the complaint states with particularity facts, that when taken together and reviewed holistically, give rise to a strong inference that the defendant acted with scienter, this inference is at least as compelling as any opposing inference of non-fraudulent intent.[41]

III. LEGAL BACKGROUND

Appellants' complaint arises in part under § 10(b) of the Securities Exchange Act of 1934, which makes it unlawful "[t]o use or employ, in connection with the purchase of any security . . . any manipulative or deceptive device or contrivance . . . ."[42] The complaint also arises under Rule 10b-5 of the Securities Exchange Act of 1934, which was promulgated by the

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[33] *Id.* at 581.
[34] I.e. the press statement by BP's CEO John Browne that the March spill occurred "'in spite of the fact that [BP] has both world class corrosion monitoring and leak detection systems.'" *Id.* at 577.
[35] *Id.* at 577.
[36] I.e. the press statement made by Maureen Johnson two weeks after the March spill that stated inspection data from prior to the spill indicated that corrosion was occurring at a low and manageable rate; the two press statements by Johnson suggesting that the first spill was anomalous and distinguishing the WOA line from the others in Prudhoe Bay; and the statement in BP's 2005 Annual Report stating that management believed BP was in compliance, in all material respects, with applicable environmental laws and regulations. *Id.* at 59, 573-73, 577.
[37] *Id.* at 577, 581.
[38] *Id.* at 567 (citing Thompson v. Paul, 547 F.3d 1055, 1061 (9th Cir. 2008)).
[39] *Id.* at 568 (citing 15 U.S.C. § 78u-4(b)(1)(B) (2012)).
[40] *Id.* (citing Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1323 (2011)).
[41] *Id.* at 568-69 (citing 15 U.S.C. § 78u-4(b)(2)(A) (2012); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322 (2007); *Matrixx Initiatives, Inc.*, 131 S. Ct. at 1324).
[42] 747 F.3d at 563; 15 U.S.C. § 78j(b) (2012).

Securities and Exchange Commission.[43] Similar to §10(b), Rule 10b-5 makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[44] The Supreme Court of the United States has established that to state a claim of securities fraud, a plaintiff must plead: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[45]

At the pleading stage of claims under § 10(b) and Rule 10b-5, a complaint must satisfy the dual pleading requirements of Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act ("PSLRA").[46] Rule 9(b) requires that claims alleging fraud be subject to a heightened pleading requirement. As such, a party must "state with particularity the circumstances constituting fraud or mistake."[47] In addition, private securities fraud complaints are subject to the requirements of the PSLRA which requires that such a complaint plead with particularity both falsity and scienter.[48] As a result, the two issues reached in the instant case were whether the appellants' complaint had adequately pled (i.e. with particularity) material falsity and scienter.[49]

A. *Falsity and Materiality*

In order to plead falsity, a complaint must "specify each statement alleged to have been misleading, [and] the reason why the statement is

[43] Reese, 747 F.3d at 567 (citing 17 C.F.R. § 240.10b-5(b)).
[44] 17 C.F.R. § 240.10b-5(b) (2014).
[45] Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008).
[46] *Reese*, 747 F.3d at 568 (citing In re VeriFone Holdings, Inc. Sec. Litig., 704 F.3d 694, 701 (9th Cir. 2012)).
[47] Fed. R. Civ. P. 9(b).
[48] *Reese*, 747 F.3d at 568 (citing Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 990 (9th Cir. 2009)).
[49] *Id.* at 568-69.

misleading."[50] If an allegation regarding the statement or omission is made on information and belief, the complaint must "state with particularity all facts on which that belief is formed."[51] Such a statement of belief is a "'factual' misstatement actionable under Section 10(b) if (1) the statement is not actually believed, (2) there is no reasonable basis for the belief, or (3) the speaker is aware of undisclosed facts tending seriously to undermine the statement's accuracy."[52]

In *Glazer Capital Mgmt. v. Magistri,* the court held that statements of legal compliance are adequately pled with regards to falsity when a complaint references documents detailing specific violations of law that existed at the time the warranties were made.[53] In *Glazer*, the court held that a statement averring "compliance in all material respects" was actionably false because the complaint pointed to an SEC cease and desist order detailing violations of law, even though the order was issued eleven months after the statement was made.[54] Courts have also held that statements are misleading, and thus actionable, when they create the idea of certainty in a situation that previously indicated risk.[55] For example, in *Berson v. Applied Signal Tech, Inc.*, the court stated that "[i]t goes without saying that investors would treat [risk and certainty] differently."[56]

In addition to falsity, the materiality of a misrepresentation or omission of fact is central to a 10b-5 claim.[57] A statement is material when there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered

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[50] 15 U.S.C. § 78u(b)(1)(B) (2012).
[51] *Id.*
[52] Kaplan v. Rose, 49 F.3d 1363, 1375 (9th Cir. 1994).
[53] *Glazer*, 549 F.3d 736, 741-42 (9th Cir. 2008).
[54] *Id.*
[55] *See, e.g.*, Berson v. Applied Signal Tech., Inc., 527 F.3d 982, 987 (9th Cir. 2008).
[56] *Id.* In *Berson*, the court held that, in a claim of violations of Securities and Exchange Act § 10(b) and 10b-5 for losses allegedly incurred due to a company's misleading practice of counting as "backlog" contracted work not yet performed but for which the dollar value was reported, without disclosing that backlog included millions of dollars of halted contract work for which stop-work orders had been issued, the reporting of backlog would have misled reasonable investors. *Id.* at 984-87.
[57] *Reese*, 747 F.3d at 568 (citing In re Cutera Sec. Litig., 610 F.3d 1103, 1108 (9th Cir. 2010)).

the 'total mix' of information made available."[58] In order to adequately plead materiality, a complaint's allegations must suffice to "'raise a reasonable expectation that discovery will reveal evidence' satisfying the materiality requirement,"[59] and "'allow the court to draw the reasonable inference [of liability].'"[60] Conclusory allegations of law and spurious inferences are not enough to defeat a motion to dismiss for failure to state a claim.[61]

Facts demonstrating public interest in withheld information support the information's materiality.[62] In *In re 2themart.com, Inc. Sec. Litig.*, the court found that public interest in the company's website development on an online message board was evidence of materiality.[63]

B. *Scienter*

Scienter is defined as a mental state of intent to deceive, manipulate, or defraud.[64] For a complaint to adequately plead scienter, it must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[65] In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, a class action suit brought by investors alleging securities fraud, the Supreme Court set forth an analysis for determining whether a complaint gives rise to a strong inference of scienter, specifically when reviewing a Rule 12(b)(6) motion to dismiss.[66]

Under the *Tellabs* analysis, a court must accept a complaint's factual allegations as true, and must consider the complaint in its entirety, including

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[58] Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1976) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).
[59] Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1323 (2011) (quoting Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 556 (2007)).
[60] *Id.* (quoting Aschroft v. Iqbal, 556 U.S. 662, 678 (2008)).
[61] In re Cutera Sec. Litig., 610 F.3d 1103, 1108 (9th Circ. 2010).
[62] In re 2themart.com, Inc. Sec. Litig., 114 F. Supp. 2d 955, 961 (C.D. Ca. 2000).
[63] *Id.* (the court held that, in deciding whether materiality has been adequately pled in a Securities and Exchange Act § 10 b-5 claim, public interest in the company's website development on an online message board was evidence of materiality). *Id*.
[64] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n. 12 (1976).
[65] 15 U.S.C. § 78u-4(b)(2)(A) (2012).
[66] *See* Tellabs, Inc. v. Makor Issues & Rights, LTD.,et al., 551 U.S. 308 (2007).

documents incorporated into the complaint by reference, as well as matters of which a court may take judicial notice.[67] The court must review all of the allegations holistically to determine whether scienter is adequately pled.[68] The key question is "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard."[69] In this analysis, a strong inference of scienter need not be irrefutable, but "must be more than merely plausible or reasonable — it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent."[70] In other words, the court must weigh inferences of scienter against plausible, nonculpable explanations for the defendant's conduct.[71]

To satisfy the scienter requirement, it must be inferred that the defendant made false or misleading statements "'either intentionally or with deliberate recklessness.'"[72] In the context of securities fraud, an actor is deliberately reckless "'if he had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain or disclose such facts although he could have done so without extraordinary effort.'"[73] Evidence, such as internal documents or disclosures, of an actor's contemporaneous knowledge of facts, which shows her statements to be false or misleading, is the most direct way to create a strong inference of scienter.[74] For example, if an actor directly references relevant data that is contradictory to her statements, or if the complaint makes detailed and specific allegations about management's exposure to factual information within the company, there is a strong inference of scienter.[75] On the other hand, if the defendant can show that information was obscured from the actor or high-level executives, this can outweigh any inference of scienter.[76] This

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[67] *Id.* at 322.
[68] *Id.* at 309-10; Matrixx Initiatives, Inc. v. Siacusana, 131 S. Ct. 1309, 1324 (2011).
[69] *Tellabs*, 551 U.S. at 323.
[70] *Id.* at 309.
[71] *Id.* at 323-24.
[72] Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 991 (9th Cir. 2009) (quoting *In re Daou Sys., Inc.*, 411 F.3d 1006, 1014-15 (9th Cir. 2005)).
[73] Reese v. Malone, 747 F.3d 557, 569 (9th Cir. 2014) (quoting In re Oracle Corp. Sec. Litig., 627 F.3d 376, 390 (9th Cir. 2010)).
[74] *Id.* at 572 (citing Nursing Home Pension Fund, Local 144 v. Oracle Corp., 380 F.3d 1226, 1230 (9th Cir. 2004)).
[75] S. Ferry LP, No. 2 v. Killinger, 542 F.3d 776, 783, 785 (9th Cir. 2008).
[76] Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736, 746-47 (9th Cir. 2008).

was the case in *Glazer Capital Management*, where there were no facts showing that the company's CEO was personally aware of illegal activity within the company.[77]

However, mere temporal proximity between the statements and later disclosures or documents is circumstantial evidence of scienter, and can only bolster the inference.[78] Likewise, facts showing mere recklessness or a motive and opportunity to commit fraud provide some reasonable inference of intent and should be considered as part of the totality of the circumstances, but are not independently sufficient to create a strong inference of scienter.[79]

In addition to allegations being viewed holistically, to create a strong inference of scienter under the *Tellabs* standard, allegations may help satisfy the PSLRA scienter requirement in two other circumstances.[80] One of these circumstances is when the allegations are particular and suggest that the defendants had actual access to the disputed information.[81] In *In re Daou Systems*, the Court held that the plaintiffs pled scienter based on specific allegations of the defendants' direct involvement in the making of false accounting statements and reports.[82] In *Nursing Home Pension Fund, Local 144 v. Oracle*, the Court held that it was reasonable to infer that the defendant-executives were aware of major accounting irregularities because of specific allegations regarding the executives' detail-oriented management style.[83]

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[77] *Id.* at 745.
[78] *Reese*, 747 F.3d at 574-75. *See* Ronconi v. Larkin, 253 F.3d 423, 437 (9th Cir. 2001).
[79] *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999). *See also* Tellabs Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 (2007*); see also In re Daou Systems*, 411 F.3d 1006, 1024 (9th Cir. 2005).
[80] *Reese*, 747 F.3d 557, 575-76 (9th Cir. 2014).
[81] S. Ferry LP, No. 2 v. Killinger, 542 F.3d 776, 786 (9th Cir. 2008); *See* Nursing Home Pension Fund, Local 144 v. Oracle, 380 F.3d 1226, 1233-34 (9th Cir. 2004).
[82] *Daou*, 411 F.3d at 1023 (holding that, in deciding whether scienter has been adequately pled in a Securities and Exchange Act § 10(b) claim (i.e. whether allegations satisfy the PLSRA standard), plaintiffs' making specific allegations of the defendants' direct involvement in the making of false accounting statements and reports helped satisfy the standard because they were particular and suggested that the defendants had actual access to the disputed information). *Id*.
[83] *Oracle*, 380 F.3d at 1234 (holding that, in deciding whether scienter has been

In another circumstance, allegations may be sufficient to satisfy the PSLRA scienter requirement, without being particular, when the relevant facts are so prominent that it would be "absurd" to suggest management did not have knowledge of the matter.[84] This is based off of the principle that it is often reasonable to conclude high-ranking corporate officers have knowledge of the critical core operations of their companies, and this "core operations inference" may be enough to raise a strong inference of scienter.[85] In *Berson*, the plaintiffs alleged no specific facts to demonstrate that individually named corporate officers (i.e. defendants) had actual knowledge about customers' stop-work orders on large contracts.[86] These stop-work orders caused a significant drop in the defendant company's actual revenue, but continued to be counted as revenue via a misleading accounting trick, which formed the basis of the suit.[87] Despite the lack of specific facts showing the officers' knowledge, the court held that there was a strong inference of scienter based on the officers' positions and the nature of the misstatements.[88] The court held that the officers were "directly responsible for [the company's] day-to-day operations," and the stop-work orders "were prominent enough that it would be 'absurd to suggest' that top management was unaware of them."[89]

IV. INSTANT DECISION

In the instant case, the Court of Appeals for the Ninth Circuit analyzed separately whether falsity and scienter were adequately pled for each of the four statements at issue.

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adequately pled in Securities and Exchange Act § 10(b) and 10 b-5 claims (i,e. whether allegations satisfy the PLSRA standard), it was reasonable to infer that the defendant-executives were aware of major accounting irregularities because of specific allegations regarding the executives' detail-oriented management style, and that those allegations helped satisfy the standard because they were particular and suggested that the defendants had actual access to the disputed information). *Id*.

[84] Berson v. Applied Signal Tech., Inc., 527 F.3d 982, 988 (9th Cir. 2008).

[85] *S. Ferry*, 542 F.3d at 785-86.

[86] *Berson*, 527 F.3d at 987.

[87] *Id.* at 983.

[88] *Id.* at 987-88.

[89] *Id.*

A. *Johnson's Assurances About the Low Manageable Corrosion Rate*

The court began by discussing the press statement made by BP-Alaska's VP, Maureen Johnson, two weeks after the March spill, in which she stated corrosion had been seen in the WOA pipeline in a September 2005 inspection, "'but appeared to be occurring at a "low manageable. . . . corrosion rate."'"[90]

In assessing falsity, the court considered the allegation that BP's internal documents showed the corrosion rate in one tested area was 32 mills[91] per year ("MPY") in 2005, compared to just 3 MPY in 2004.[92] A rate above 30 MPY is the highest of three levels in BP's own classification system, and an expert for the Appellants opined that such a corrosion rate was "high" and "not manageable."[93] Appellees argued that Johnson's statement was simply incomplete because only one of many tested locations had a corrosion rate of 32 MPY.[94] However, the court held Johnson's statement effectively denied that BP had any warning of high corrosion before the first spill, and was thus objectively misleading.[95] BP's awareness of the corrosion level was a key question raised by media and government investigators, demonstrating public interest in the withheld information; the court held this supported the statement's materiality.[96] As such, the court agreed with the trial court that the Appellants had adequately pled material falsity of this statement.[97]

The larger issue is whether Appellants adequately pled Johnson's scienter. The court noted Johnson was directly responsible for pipeline operations in Prudhoe Bay, and holds a Ph.D. in Environmental Science and Engineering. Following the first spill, Johnson had every reason to review and understand BP's corrosion monitoring data to determine what happened

[90] Reese v. Malone, 747 F.3d 557, 569 (9th Cir. 2014).
[91] A mill is equal to one thousandth of an inch. *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.* at 569-70.
[95] *Id.*
[96] *Id.* at 570.
[97] *Id.* at 569.

and assess the possibility of future spills.[98] Based on this belief, the court held that if anyone knew of the deficiencies in BP's monitoring program and the likelihood of pipeline failures, it was Johnson.[99] The complaint stated Johnson's involvement in working with government organizations to comply with the CAO, and her responsibility for reporting to BP executives about the first spill.[100] Because BP's corrosion monitoring practices and the spill's preventability were the focus of public and government inquiries, the court held Johnson had a clear motive for omitting information about the presence of high corrosion levels.[101] The court also held the appellants did not need to show Johnson had the intent to deceive investors about the likelihood of future spills, as the trial court found necessary, rather it was enough to show she had known her statement was materially misleading.[102]

The Ninth Circuit Court then went on to discuss the *Tellabs* analysis conducted by the trial court, which concluded the inference that Johnson intended to mislead investors was outweighed by opposing inferences that she misunderstood or did not have access to BP's data.[103] The instant court noted that in a *Tellabs* analysis, courts must only weigh *plausible* competing inferences.[104] Because the detected corrosion levels were the highest in BP's classification system and had dramatically increased, and because of Johnson's role, the responsibilities of her position, and her expertise as a doctor of engineering, the court held that it was simply implausible that she had misunderstood BP's data.[105] The fact that Johnson specifically addressed the corrosion data in her statement directly contradicts the inference that she did not have access to the data, making it implausible as well, according to the court.[106] Thus, the court held that when considering the totality of the circumstances, the Appellants pled facts which created a strong inference of scienter that outweighed opposing inferences.[107]

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[98] *Id.* at 570-71.
[99] *Id.* at 571.
[100] *Id.* at 570.
[101] *Id.* at 571.
[102] *Id.*
[103] *Id.*
[104] *Id.*
[105] *Id.* at 572.
[106] *Id.*
[107] *Id.*

B. *Johnson's Statements Distinguishing the WOA and EOA Lines*

The court next looked at two press statements made by Johnson after the first spill. In the first statement, she stated the problems that caused the March spill were unique to the WOA line. In the other statement, she said that none of the other transit lines had the same combination of factors which contributed to the first spill, including bacteria within the pipeline and a low flow rate.[108]

The court noted that after the second spill, BP-Alaska admitted to regulators the causal factors most influential to corrosion, including low flow velocity leading to microbiologically induced corrosion, were present in both the WOA and EOA lines.[109] The court referenced two more documents from 2006 and 2007 showing BP's acknowledgement that microbiologically induced corrosion was the cause of both spills, promoted by several similar characteristics of both lines, including low flow velocities and a lack of maintenance pigging.[110] Based on those documents, the court held that the appellants had adequately pled the falsity of Johnson's statement.[111]

Appellees argued that the statements were not false or materially misleading because they were based on BP-Alaska's preliminary assessments, which were subject to change.[112] However, the statements do not imply that the findings were preliminary or incomplete, and the second statement indicates it was based on post-spill inspections.[113] Because of this, and the fact that the complaint contained information suggesting BP was aware of the high risk of corrosion and the deficiencies in its monitoring and maintenance practices, the court rejected this argument.[114] It also rejected the argument that the statements were not misleading because the public was aware of the

[108] *Id.* at 572-73.
[109] *Id.* at 573.
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] *Id.*

lines' similarities; the statements directly, and with certainty, contradicted the general similarities noted in the CAO.[115]

Again, the more contentious issue was whether Johnson's scienter was pled adequately. The trial court found it plausible that Johnson's statements only summarized preliminary results of an ongoing investigation, and that Appellants did not show Johnson was aware her statements were false.[116] The trial court dismissed each of the three documents contradicting Johnson's statements, and other information gleaned through discovery and admissions, as inconclusive evidence of scienter because the documents and information were dated after Johnson made her statements.[117] The instant court noted that, although the subsequent statements and disclosures cannot, standing alone, establish scienter, they provide strong circumstantial evidence towards the inference of scienter considering the relatively constant, long-term nature of the information.[118] Furthermore, the court stated there was nothing in the record to suggest that flow velocity or risk of corrosion were ever factors that differed between the WOA and EOA lines.[119] Based on the circumstantial evidence, and the inference that key officers have knowledge of the "core operations" of a company, the court held it could impute scienter to Johnson given the totality of the circumstances.[120]

The court engaged in further analyses expounding on the core operations inference.[121] Due to Johnson's roles in overseeing pipeline operations in Prudhoe Bay and communicating directly with regulators, BP leadership, and the press after the March spill, the court concluded that Johnson appeared to have been both the external and internal gatekeeper of information on the Prudhoe Bay pipelines.[122] In conducting an absurdity analysis, the court noted BP admitted to treating the pipelines identically for monitoring purposes based on their similarity, and that Johnson must have been aware of the lack of data on the EOA line because she would have to

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[115] *Id.* at 573-74.
[116] *Id.* at 574.
[117] *Id.*
[118] *Id.* at 574-75.
[119] *Id.* at 575.
[120] *Id.*
[121] *Id.*
[122] *Id.* at 576.

have known it had not been smart pigged in sixteen years.[123] The court held such information is the epitome of "core" to pipeline operations in Prudhoe Bay, and the information it imputes to Johnson was fundamental to the operations of her business.[124] Thus, the court concluded it is absurd to think Johnson was unaware of the information.[125]

The court then conducted the "actual access" analysis, holding Johnson's statements were her own specific representations of the company's findings and reflect her access to the information at issue.[126] Noting there is a stronger inference of scienter here than in situations where executives are held responsible for the falsity of accounting statements, the court held the actual access analysis supports scienter.[127] The court concluded by holding that the absurdity and actual access analyses, as well as the totality of the circumstances under the *Tellabs* analysis, make the inference of scienter irresistible, and outweighs the opposing, speculative inference that Johnson was merely summarizing a preliminary investigation.[128]

C. *Statement Regarding BP's "World Class" Leak Detection and Corrosion Monitoring Systems*

Next, the court looked at the third statement type in the complaint, a press statement on April 25, 2006, by BP's CEO John Browne to the effect that the March spill occurred "in spite of the fact that [BP has] both world class corrosion monitoring and leak detection systems, both being applied within regulation set by the Alaskan authorities."[129] The court agreed with the trial court that the statement was false, as investigations revealed the pipelines were under-inspected, under-maintained, and had a severe risk of corrosion-related failure.[130]

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[123] *Id.*
[124] *Id.*
[125] *Id.*
[126] *Id.*
[127] *Id.*
[128] *Id.* at 577.
[129] *Id.*
[130] *Id.*

The court also agreed with the district court that the appellants did not allege facts that independently created a strong inference of scienter based on the timing of the statement and the totality of the circumstances.[131] The appellants did not set forth facts supporting the inference that Browne had actual access to contradictory information, because BP's Board of Directors did not receive a detailed update until ten days after Browne made the statement, and the CAO against BP-Alaska did not speak of specific legal violations.[132] Accordingly, the instant court upheld the trial court with respect to Browne's statement.[133]

D. *Annual Report Statement Regarding Compliance with Environmental Laws and Regulations*

The final statement analyzed by the court was contained in BP's 2005 annual report, which was issued on June 30, 2006: "Management believes that the Group's activities are in compliance in all material respects with applicable environmental laws and regulations."[134]

The court noted that statements of legal compliance are pled with adequate falsity when documents detail specific violations of law existing at the time the warranties were made.[135] The court held the appellants' complaint cited evidence of a number of violations of environmental laws and regulations, including the Clean Water Act (evidenced by BP's 2007 guilty plea), Alaskan laws (evidenced by BP's civil settlement with the state), and pipeline safety laws (evidenced by BP-Alaska's failure to comply with PHMSA's COA).[136] The court also held that, while the company may have shown some effort to achieve compliance after the March spill, that effort could not negate the egregious violations cited in the complaint.[137]

The court then looked at the question of whether BP could escape possible liability by using the phrase "management believes" and the qualifier "*material* compliance," addressing the district court's finding that

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[131] *Id.*
[132] *Id.*
[133] *Id.*
[134] *Id.*
[135] *Id.* at 578.
[136] *Id.*
[137] *Id.*

the statement was too "vague and ambiguous" to support the allegation of falsity.[138] While the court noted those terms weigh against falsity, it stated it could not find any facts supporting management's "belief" in material compliance given the severity of the violations of environmental law, of which management was aware.[139] The court held the fact of ongoing "discussions" with regulators was insufficient to foster a belief in "material compliance."[140] Thus, the court concluded the falsity of this statement was adequately pled.[141]

To determine whether there was a strong inference of scienter, the court applied the *Berson* absurdity test to determine whether it would be absurd to suggest BP's management was unaware of BP's non-compliance with environmental laws and regulations.[142] The court noted the complaint established the prominence of the issue of compliance: the complaint referenced the fact the annual report discussed the spill and the CAO, as well as the fact BP's then CEO requested updates on the company's response to the spill.[143] The court also noted the magnitude of the violations, the significant public attention on BP following the spills, and the existence of contemporaneous documents which demonstrated management's awareness of BP's non-compliance with the CAO.[144] On those grounds, the court held it was absurd to claim management was not aware of BP's significant, ongoing compliance issues that made the statement misleading.[145]

The court also held the language in the annual report contradicted an inference of non-culpability.[146] The opinion notes the language alerts investors about the potential for future compliance issues to have an adverse impact on the company, but puts the emphasis on unpredictable risks that would not disproportionately affect BP, while denying belief in risks unique

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[138] *Id.* at 579.
[139] *Id.*
[140] *Id.*
[141] *Id.*
[142] *Id.*
[143] *Id.*
[144] *Id.* at 579-80.
[145] *Id.* at 580.
[146] *Id.*

to the company in the spill's aftermath.[147] The court held that in this context, the statement appears to be made with the intent to downplay BP's non-compliance with existing laws and regulations.[148] As such, there is a strong inference of an intent to mislead investors regarding the March spill that is as compelling as the opposing possibility that BP's top management lacked information about the company's compliance problems.[149]

Thus, the court reversed the trial court with respect to all but one of the four statements at issue on appeal.[150]

V. COMMENT

The immediate consequence of this appellate decision is to revive shareholders' securities fraud claims against BP. Based on the court's discussion of falsity and scienter with regards to BP's statements, it seems likely that on remand a trial court will now find BP liable for violation of § 10b of the Securities Exchange Act of 1934 (assuming the other elements of a 10b claim are met).[151] Should the trial court find BP liable, BP's damages could equal the entire loss incurred in the value of class members' stock in BP during the class period (i.e. in the wake of the spills) if the plaintiffs can prove full loss causation. The spills and resultant shutdown of production allegedly caused a four percent decline in BP's share price.[152] Since the class of plaintiffs includes pension and trust funds and investment banks,[153] which likely own large quantities of BP's stock, the potential damages could be quite significant.

This ruling serves to compound BP's extensive legal problems extending from the 2006 Alaskan oil spills and other spills, most notably the 2010 Deepwater Horizon oil spill in the Gulf of Mexico, for which BP was also at fault.[154] One can expect BP's reputation to suffer again following a

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[147] *Id.*
[148] *Id.*
[149] *Id.*
[150] *Id.* at 581.
[151] *See* 17 C.F.R. § 240.10b-5(b) (2014).
[152] *Reese*, 747 F.3d at 563.
[153] *Id.*
[154] *See* Campbell Robertson & Clifford Krauss, *BP May Be Fined Up to $18 Billion for Spill in Gulf*, N.Y. TIMES (Sept. 4, 2014),

finding of liability in this case, among both investors and the public at large, as it did after the Deepwater Horizon spill. However, it will by no means break BP, especially considering the fact that the Deepwater Horizon spill, which was much larger and more economically and environmentally harmful, did not do so either.

The Ninth Circuit Court of Appeals reached this decision by following, and ultimately strengthening, precedent from other cases dealing with the issue of securities fraud. This case is environmentally significant because it is one of relatively few cases in which a set of environmentally relevant facts was at the core of securities fraud litigation. Noteworthy is the fact this is the first case in which the Ninth Circuit applied the *Berson* absurdity test to such a set of environmental facts,[155] which widens the breadth of possibilities for showing scienter in this type of securities fraud case in the future.

The Ninth Circuit Court's application of precedent was proper here, as the facts strongly suggest BP and its executives were dishonest with regards to the spills at issue. The relevant public statements were either false or materially misleading to investors and the rest of the public. The most likely inference from the facts is that the statements were intentionally dishonest, as opposed to the weak inference that the statements were simply uninformed.

In *Reese*, the court weighed the policy interest of holding companies accountable for knowingly making false statements to investors against the high evidentiary burden for showing such statements were known to be false at the time they were made and that the statements were made with the intent

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http://www.nytimes.com/2014/09/05/business/bp-negligent-in-2010-oil-spill-us-judge-rules.html?_r=0; Robert Force et al., *Deepwater Horizon: Removal Costs, Civil Damages, Crimes, Civil Penalties, and State Remedies in Oil Spill Cases*, 85 TUL. L. REV. 889 (Mar. 2011).

[155] *See* Berson v. Applied Signal Tech., Inc., *Citing References*, Westlaw, *available at* https://a.next.westlaw.com/RelatedInformation/I3a84e3d5330a11ddb7e483ba170699a5/kcCitingReferences.html?docSource=75da040cdb324fd299316a22bcfa66a2&pageNumber=1&facetGuid=hcdf126054129a605cce6de48011070a6&transitionType=ListViewType&contextData=(sc.History*oc.DocLink).

to deceive or mislead investors. The court looked at the evidence of securities fraud, direct and circumstantial, raised by the appellants and balanced this against the possibility that the appellees' statements were unintentionally false. Ultimately, the court correctly decided in favor of holding companies accountable for lying to investors, holding that BP's and its employees' statements were actionable.

By this ruling, the court upheld the idea that companies that harm the environment, and then lie about it, should be held liable for their fraudulent behavior and for the harm to the environment itself. The ruling in *Reese* serves as a warning to companies making statements about their environmental impact, and more generally, to companies whose activities have an impact on the environment. Specifically, the ruling is useful and cautionary for companies who have a knowledgeable, on-the-ground manager or executive charged with making statements to the public concerning operations and policy. However, perhaps the most consequential portion of the Ninth Circuit's holding concerns the statements made in BP's annual report ("Management believes that the Group's activities are in compliance with in all material respects with applicable environmental laws and regulations"). This statement was most likely simple boilerplate language, and yet the court held it was actionably deceptive, notwithstanding the veil of qualifiers like "management believes" and "all material respects." Companies must now be very careful when making such broad, standardized statements to investors as such provisions may still be actionable. On the other side of the issue, ideally, investors can have more confidence with their investments. Specifically, investors and the rest of the public should now be able to have more faith in the assertions of publicly traded companies.

One can see how such qualifying language could have made the statement in BP's annual report not actionable with regards to scienter; or how Johnson's statements distinguishing the WOA and EOA lines were not misleading because the lines' similarities were a matter of public knowledge, as the defense argued. However, the court held otherwise. One can also see how the defense's other arguments could also be plausible: it is possible Johnson and other BP executives did not have full access to the relevant or most recent data, or misinterpreted that data, and it is possible that some of the statements at issue were based only on preliminary assessments or were otherwise incomplete. However, the appellate court was correct in remanding the case so that a trial court may determine the facts of the matter.

VI. CONCLUSION

Through its holding in *Reese,* that BP's statements to the public and shareholders are actionable as securities fraud, the Ninth Circuit won an indirect victory for the environment. This decision means BP's attempts to cover up its fault in harming the environment are now a potential source of liability for BP. Based on the court's analysis of the issues, it is likely a trial court will find BP liable in this case.[156] One can only hope this will deter other companies from similar conduct in the future.

[156]At the time of publication, this case has not yet gone to trial.