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Recent Favorable Case Law in the Ninth Circuit on the Core Operations Doctrine:

What it Means for Investors

Just a few months ago, the Court of Appeals for the Ninth Circuit issued a decision in *Reese v. Malone*, --- F.3d ---, 2014 WL 555911 (N.D. Cal. Feb. 13, 2014)[2] making a positive ruling for investors. The Court reinforced the viability of the "core operations doctrine" in bringing securities fraud cases – a legal concept valuable to overcoming the heightened pleading standards otherwise required in all securities fraud cases, but which has also been heavily questioned and sometimes rejected by many courts.

In *Reese v. Malone*, the Ninth Circuit analyzed BP's liability around a series of public statements made after two serious oil leaks from its Alaskan pipelines. BP's Prudhoe Bay site, at issue in the case, contains more than sixteen miles of oil transit lines grouped among three "similar" low-stress pipelines: the Western Operating Area, Eastern Operating Area, and the Lisburne Lines. On March 2, 2006, BP discovered an oil spill on the Western line that went undetected for an estimated five days, spilling 4,800 barrels (200,000 gallons) of oil. Five months later, BP discovered another spill, this time about 1,000 gallons, leaking out of its Eastern line. After the second spill, BP temporarily shut down the Prudhoe Bay site.

Plaintiffs in the case alleged that BP had notice of the state of the Prudhoe Bay site, and had for a long time ignored corrosion monitoring deficiencies. Indeed, when news of the first spill broke, there was significant publicity focused on the fact that BP had not tested the integrity of the Western line using the principal industry standard (called "smart pigging") since 1998. On March 15, 2006, two weeks after the first spill, the U.S. Department of Transportation Pipeline and Hazardous Materials Safety Administration issued a Corrective Action Order to BP-Alaska addressed to the Greater Prudhoe Bay Performance Unit Leader, Maureen Johnson, who had a Ph.D. in Chemical Engineering. The Order noted some additional safety concerns among the three pipelines but also discussed something the Ninth Circuit later focused on heavily: that all three pipelines in Prudhoe Bay were constructed around the same time and operated in similar environmental conditions, and so continued operation of them without corrective measures was hazardous. *Reese*, 2014 WL 555911, at *2. The Order required BP to "smart pig" the Eastern Line by a deadline of June 15, 2006. Yet not until July 22, 2006 did BP conduct an inspection of the Eastern line – discovering significant corrosion concerns – which shortly thereafter sprung a leak that BP discovered just two weeks after its inspection to the tune of 1,000 gallons spilled onto Alaska's tundra. After this second

[2] For brevity, all citations omit internal references and quotations.

spill, BP faced governmental investigations, two lawsuits, and agreed to settlement fees totaling $45 million with a promise to make an additional $60 million in improvements to its Alaskan pipelines.

Plaintiff shareholders in *Reese* launched their separate civil suit in 2008 in the U.S. District Court for the Western District of Washington, alleging securities fraud violations under the Exchange Act as amended by the stringent standards of the Private Securities Litigation Act of 1995 (the "PSLRA"). After some procedural developments involving an interlocutory appeal, the District Court dismissed plaintiff's claims. Plaintiffs appealed to the Ninth Circuit.

The Ninth Circuit's Decision

The Court analyzed several of BP's statements for their false or misleading nature. The first one was a statement on March 15th – two weeks after the first spill on the Prudhoe Bay lines and before the second spill – where Maureen Johnson reported that a 2005 BP inspection found corrosion in the Western line, but "at a low manageable rate." *Reese*, 2014 WL 555911, at *7. On or about that same day, Johnson told news reporters that "similar problems have not been found in other lines" and then on May 14, 2006, that of Prudhoe Bay's transit lines "none has the same combination of factors" that caused the corrosion and leak in the Western line. *Id.* at *10. The Court found the first statement false and misleading because it contradicted contemporaneous data that BP had showing objectively high corrosion rates on the Western line. The Court then held that the second and third statements were false due to plaintiffs' allegations that (1) BP was aware of the high corrosion rates on the Western Line, (2) the Eastern line had not been smart pigged since 1990, and (3) BP had failed to comply with the government Order to inspect the Eastern line by June 15, 2006.[3]

Under the Exchange Act, once plaintiffs have sufficiently alleged falsity, they must also sufficiently allege scienter, "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at *6. With regard to Johnson's first statement, the Ninth Circuit found that plaintiffs had adequately pled scienter because (1) due to Johnson's position and educational background, she could not have misunderstand the data, (2) she had access to the data, and "had every reason to review" it, and (3) her public statements connoted that she had actually consulted the data. *Id.* at *8-10. With regard to her second and third statements, the Court held that plaintiffs had adequately pled scienter because the government's March 15, 2006 Order and other internal BP documents generated in response to the spills reaffirmed the similarity between the Western and Eastern lines and the likelihood the Eastern lines would corrode and leak, too. *Id.* at *11-12. The Court went on to hold that it would have been "absurd to think" that

[3] Finally, the Court also found misleading and false a statement in BP's 2005 Annual Report that "[m]anagement believes that the Group's activities are in compliance in all material respects with applicable environmental laws and regulations." *Id.* at *15. This last statement was ruled false and misleading, because in the face of all the corrosion data and lack of maintenance, "there was no reasonable basis" for a "belief that BP was in material compliance." *Id.* at *16.

Johnson, in her position was unaware of the relevant reports which were "fundamental to operations of her business over the tenure of her career." *Id.* at *14.

The Importance of the *Reese* Decision to Future Securities Fraud Cases

The second element of scienter can be very challenging in many cases because it requires that plaintiffs plead facts – and at a time well before they have any right to discovery from a defendant – to show that defendants had a state of mind making them responsible for the falsity of what they have told investors. Plaintiffs must show that, indeed, if defendants did not know directly of contemporaneous information contradicting the statements they made to investors, then they were at a minimum reckless in not informing themselves of information they should have known. Relatively recent law from the Supreme Court requires courts to analyze all the allegations "holistically," and so scienter can be shown in a variety of ways and when a single factor is not enough. Yet even where it might appear obvious to investors that that company executives failed in their responsibilities, courts dismiss many cases where plaintiffs cannot provide at the outset of their case particular factual evidence linking the negative information known within the company with the actual speaker's awareness of it. For instance, in *South Ferry LP, No. 2 v. Killinger*, 542 F.3d 776 (9th Cir. 2008), the Ninth Circuit discussed recent case law where it had "held that [plaintiffs'] allegations did not meet the PSLRA requirements because plaintiffs did not offer details that would bridge the gap between the existence of the [internal] reports and actual knowledge on the part of defendants." *Id.* at 783. In many cases, defendants prevail on just this theory.

There are several ways plaintiffs can bridge this gap. One commonly used way is to interview witnesses, namely former employees of a company, to investigate and gain eye-witness information of conditions at the company during the Class Period. The problem with this approach, however, is that witnesses can often be, for a variety of circumstances, unreachable or unwilling to speak. Another way to meet the heightened pleading standard to allege scienter is to describe in detail the nature of the company, its operations, and why particular executives – due to the company's operations, and the executives' positions – knew, or were reckless in not knowing, of contemporaneous conditions at the company contradicting those executives' assurances to investors. Nonetheless, numerous court decisions have questioned or even criticized the value of the "core operations" doctrine. As a recent example 2012, the Second Circuit – a magnet jurisdiction for securities fraud cases – ruled that "we have not yet expressly addressed whether, and in what form, the 'core operations' doctrine survives as a viable theory of scienter" after the enactment of the PSLRA in 1995. *Frederick v. Mechel OAO*, 475 Fed.Appx.353, 356 (2d Cir. 2012).

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Why the *Reese* Ruling is Matters to Investors

The *Reese* decision in a boon to plaintiffs in securities fraud cases because it provides a recent and strong decision in support of the value of the core operations doctrine, which holds companies liable for the responsibilities and roles of executives. The core operations doctrine is a valuable tool because it aligns with common-sense and can strengthen the probative value of other facts available to plaintiffs at such a preliminary pleading stage. Though the doctrine rarely can stand alone as a factor showing scienter, it can provide a means to "bridge the gap" to demonstrate scienter when other preliminary evidence, such as witness accounts or other factual information, are unavailable at the preliminary pleading stage.