SECURITIES LAW — RULE 10B-5 — NINTH CIRCUIT EFFECTIVELY ELIMINATES ADVERSE-INTEREST EXCEPTION AS A DEFENSE TO FRAUD-ON-THE-MARKET CLAIMS. — *In re ChinaCast Education Corp. Securities Litigation*, 809 F.3d 471 (9th Cir. 2015).

Because corporations cannot act or think on their own, courts apply common law agency principles[1] to impute employees' knowing conduct to their corporate employers when the employees act within the scope of their employment. However, under the adverse-interest exception, courts do not impute agents' knowledge to their principals when agents act adversely to their principals' interests. Recently, in *In re ChinaCast Education Corp. Securities Litigation*,[2] the Ninth Circuit held that a CEO's scienter to commit securities fraud can be imputed to his corporate employer even when the CEO's underlying conduct — looting the company coffers and concealing his theft from the board and shareholders — was adverse to the corporation's interests.[3] The Ninth Circuit refused to apply the adverse-interest exception because it found that the plaintiff shareholders were innocent third parties who relied on the CEO's apparent authority.[4] By doing so, the court effectively removed the adverse-interest exception as a defense to fraud-on-the-market claims — claims regarding the disclosure of misleading information that impacts the market price of a security[5] — at the pleading stage.[6] The court's formulaic application of traditional agency principles to attribute liability to corporations looted by their managers conflicts with the restrained approach of both Congress and the Supreme Court to liability arising from suits filed by private investors.[7] Furthermore, the court ignored important nuances associated with fraud-on-the-market securities claims that undercut the traditional policy justifications for the common law's innocent-third-party ex-

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[1] "Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or ot[h]erwise consents so to act." RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. LAW INST. 2006).

[2] 809 F.3d 471 (9th Cir. 2015).

[3] *Id.* at 472–73.

[4] *Id.* at 477–78.

[5] The Supreme Court has noted that fraud-on-the-market claims are based on "the hypothesis that, in an open and developed securities market, [a company's stock price] is determined by the available material information regarding the company and its business," and "[m]isleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements." Basic Inc. v. Levinson, 485 U.S. 224, 241–42 (1988) (quoting Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986)).

[6] *In re ChinaCast*, 809 F.3d at 479.

[7] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-664, SECURITIES FRAUD LIABILITY OF SECONDARY ACTORS 3–4 (2011) (describing the private cause of action for securities fraud).

ception. Ultimately, the court's decision might be detrimental to the very class it was seeking to protect — innocent shareholders.

ChinaCast Education Corporation (ChinaCast), formerly listed on NASDAQ,[8] provides college-level education — in both physical and online formats — to students in China.[9] In March 2011, ChinaCast disclosed in its annual report filed with the Securities and Exchange Commission (SEC) that its outside auditor, Deloitte, had "identified 'serious internal control weaknesses' with respect to [the company's] financial oversight."[10] ChinaCast and its board allegedly "turned a blind eye" to Deloitte's warning.[11] Shortly after the disclosure, ChinaCast's founder and CEO, Ron Chan Tze Ngon (Chan), committed massive misappropriations — including siphoning $120 million in company funds into outside accounts — that brought the company "to financial ruin."[12] At the same time, Chan and Antonio Sena, the company's CFO, concealed the fraud from investors; Chan even emphasized ChinaCast's "financial health and stability" in conference calls and other communications to investors.[13]

After learning that Chan had attempted to interfere with an annual audit, ChinaCast's board dismissed him as CEO and chairman in March 2012.[14] Sena stepped down the following day.[15] Soon thereafter, ChinaCast announced that it had discovered illegal behavior by its senior executives.[16] In September 2012, shareholders who had purchased ChinaCast stock between February 2011 and April 2012 sued Chan, Sena, ChinaCast, and ChinaCast's independent directors in district court for violating Rule 10b-5 under section 10(b) of the Securities Exchange Act of 1934[17] (1934 Act).[18]

The district court dismissed the shareholders' complaint for failure to state a claim, holding that the shareholders failed to plead that

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[8] NASDAQ decided to delist ChinaCast in May 2012. *ChinaCast Education Received NASDAQ Notification Letter Regarding Delisting Determination*, PR NEWSWIRE (May 8, 2012, 4:30 PM), http://www.prnewswire.com/news-releases/chinacast-education-received-nasdaq-notification-letter-regarding-delisting-determination-150662565.html [http://perma.cc/FQC2-SJK6].

[9] *In re* ChinaCast Educ. Corp. Sec. Litig., No. CV 12-4621-JFW (PLAx), 2012 WL 6136746, at *1 (C.D. Cal. Dec. 7, 2012).

[10] *In re ChinaCast*, 809 F.3d at 473 (quoting Consolidated Class Action Complaint at 14, *In re ChinaCast*, 2012 WL 6136746) (No. CV 12-4621-JFW (PLAx)).

[11] *Id.* (quoting Consolidated Class Action Complaint, *supra* note 10, at 14).

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] 15 U.S.C. § 78j (b) (2012).

[18] *In re ChinaCast*, 809 F.3d at 474. Rule 10b-5 is an antifraud provision that makes it "unlawful for any person, directly or indirectly, . . . [t]o make any untrue statement of a material fact . . . in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (2015).

ChinaCast acted with scienter as required under Rule 10b-5.[19] Applying the adverse-interest exception, the court reasoned that Chan's fraudulent intent could not be imputed to ChinaCast because his looting was adverse to the corporation's interests.[20]

The Ninth Circuit reversed.[21] Writing for the panel, Judge McKeown[22] first recognized that, to balance the "competing forces" of fraud deterrence and the costs of "abusive litigation," the Private Securities Litigation Reform Act of 1995[23] (PSLRA) sets strict pleading requirements that require plaintiffs to "show a 'strong inference'" of scienter to survive a motion to dismiss.[24] Judge McKeown noted that under the rule of imputation — an agency principle used in the context of Rule 10b-5 claims — a corporation is liable for an executive's fraud committed within the scope of employment and for misleading statements made by employees with actual or apparent authority.[25] Judge McKeown also explained that, under the common law adverse-interest exception, an agent's acts or intent are not imputed to his corporate employer if the agent acts adversely to his principal and entirely for his own benefit.[26]

However, drawing support from academic literature,[27] the Restatement (Third) of Agency,[28] case law in other circuits and districts,[29] and a Supreme Court antitrust decision,[30] Judge McKeown held that the adverse-interest exception was unavailable to ChinaCast and that imputation was therefore proper because the plaintiffs were innocent third parties that relied in good faith on Chan's statements — statements made under Chan's apparent authority as ChinaCast's CEO.[31] Judge McKeown also noted that imputing Chan's intent to ChinaCast

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[19] *In re* ChinaCast Educ. Corp. Sec. Litig., No. CV 12-4621-JFW (PLAx), 2012 WL 6136746, at *8–10 (C.D. Cal. Dec. 7, 2012). Plaintiffs bringing private securities fraud claims must show that the defendant acted with scienter — a mental state that in this context embraces the "intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

[20] *In re ChinaCast*, 2012 WL 6136746, at *8–10.

[21] *In re ChinaCast*, 809 F.3d at 473.

[22] Judge McKeown was joined by Judges Reinhardt and Milan Smith.

[23] Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

[24] *In re ChinaCast*, 809 F.3d at 474 (quoting 15 U.S.C. § 78u-4(b)(2)(A) (2012)).

[25] *Id.* at 476.

[26] *Id.*

[27] *See id.* at 477 (quoting Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1214 (2003)).

[28] *See id.* (citing RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b (AM. LAW INST. 2006)).

[29] *See, e.g.*, *id.* (citing Belmont v. MB Inv. Partners, Inc., 708 F.3d 470 (3d Cir. 2013)); *id.* at 478 (citing *In re* Tyco Int'l, Ltd., Nos. MDL 02-1335-B, 02-266-B, 2004 WL 2348315, at *6 (D.N.H. Oct. 14, 2004)); *id.* (citing Puskala v. Koss Corp., 799 F. Supp. 2d 941, 944, 947 (E.D. Wis. 2011)).

[30] *Id.* at 477–78 (citing Am. Soc'y of Mech. Eng'rs, Inc. v. Hydrolevel Corp., 456 U.S. 556 (1982)).

[31] *Id.* at 478–79.

served the related policy goals of "fair risk allocation and ensuring close and careful oversight of high-ranking corporate officials to deter securities fraud."[32] Finally, Judge McKeown recognized that, "as a practical matter," the court's decision eliminated the adverse-interest exception as a defense to fraud-on-the-market claims at the pleading stage because "a bona fide plaintiff will always be an innocent third party."[33]

Recognizing the dangers of expanding private liability under the 1934 Act, the Supreme Court has cautioned against the unconstrained application of common law principles to fraud-on-the-market claims and has anchored its application of such principles to congressional intent and statutory purposes. The Ninth Circuit's unrestrictive application of agency principles to decide *ChinaCast* stands in stark contrast to the Supreme Court's cautious approach and is at odds with Congress's desire to curb abusive litigation and to match liability with culpability. Furthermore, the Ninth Circuit's recitation of broad policy goals to support its decision overlooks the nuances associated with fraud-on-the-market claims that undercut the traditional rationales for applying the innocent-third-party exception to circumvent the adverse-interest exception.

The Supreme Court generally applies common law agency principles only when doing so furthers congressional intent.[34] Congress has observed that the basic aims of the 1934 Act include "assur[ing] that dealing in securities is fair and without undue preferences or advantages among investors[] [and] . . . ensur[ing] that securities can be purchased and sold at economically efficient transaction costs."[35] Recognizing that the undisciplined expansion of private securities fraud liability might be contrary to the 1934 Act's purposes, the Court has taken a cautious approach to secondary liability — the liability of actors who do not expressly violate a statute but who either have a relationship with or provide assistance to the primary statutory violator[36] — under the 1934 Act. In *Central Bank of Denver, N.A. v.*

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[32] *Id.* at 478.

[33] *Id.* at 479. However, Judge McKeown noted that the plaintiff's innocence is an open question that might be answered differently at later stages of litigation. *Id.*

[34] *See, e.g.*, *Hydrolevel Corp.*, 456 U.S. at 570 (applying the agency theory of apparent authority in the antitrust context on grounds that doing so was "consistent with the congressional intent [behind the antitrust laws] to encourage competition"); *see also* Langevoort, *supra* note 27, at 1226 & n.152 (noting that courts are amenable to applying agency law in statutory interpretation where there is ambiguous statutory intent, "either because agency principles are persuasive authority, or because Congress [is] deemed to have enacted the law with the common law in mind," *id.* at 1226 n.152).

[35] H.R. REP. NO. 94-299, at 91 (1975) (Conf. Rep.), *as reprinted in* 1975 U.S.C.C.A.N. 321, 323.

[36] William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws — Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory*

First Interstate Bank of Denver, N.A,[37] the Court held that "a private plaintiff may not maintain an aiding and abetting suit under § 10(b),"[38] despite an established practice in lower courts of allowing such claims.[39] The Court expressly rejected the SEC's policy arguments in favor of aiding and abetting liability, including fraud deterrence and just compensation, noting that "[s]econdary liability for aiders and abettors exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets."[40] The Court was especially concerned that an overly broad interpretation of Rule 10b-5 would trigger excessive litigation that would impose substantial costs on the intended beneficiaries of the 1934 Act: investors.[41] In 2007, the Supreme Court reiterated these concerns in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[42] noting that "[p]rivate securities fraud actions, . . . if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals."[43]

Along with displaying a concern for litigation costs, the Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*[44] and Congress's approach to control-person liability under section 20(a) of the 1934 Act[45] evince a related concern regarding the divorce of liability from control or influence over the underlying misconduct. In *Janus*, the Court held that only "the person or entity with ultimate authority over [an untrue] statement" can be liable under Rule 10b-5 for making that statement,[46] and explicitly refused to "read into Rule 10b-5 a theory of liability similar to — but broader in application than — what Congress . . . created expressly [in section 20(a)]."[47] Section 20(a) of the 1934 Act imposes liability on persons that "control" a primary violator of the Act but provides such persons with a good

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Scheme, 14 J. CORP. L. 313, 320 (1988). Secondary liability includes liability under agency principles. *See id.* at 348.

[37] 511 U.S. 164 (1994).

[38] *Id.* at 191.

[39] *Id.* at 169.

[40] *Id.* at 188. Before turning to policy arguments, the Court determined that there was no basis for aiding and abetting liability in the text of the 1934 Act, nor any congressional intent to create such liability. *Id.* at 177, 179.

[41] *Id.* at 189. The dissenters in *Central Bank* expressed concern that the majority's holding might erase from existence other established forms of secondary liability, such as section 10(b) actions based on common law agency principles. *Id.* at 200 & n.12 (Stevens, J., dissenting).

[42] 551 U.S. 308 (2007).

[43] *Id.* at 313.

[44] 131 S. Ct. 2296 (2011).

[45] 15 U.S.C. § 78t(a) (2012).

[46] *Janus*, 131 S. Ct. at 2302. The Court held that because the statements underlying the Rule 10b-5 claim were "made" by an investment fund, the investment adviser — a legally separate entity — could not be held liable in a private Rule 10b-5 action despite its operational control of the investment fund. *Id.* at 2304–05.

[47] *Id.* at 2304 (internal citation omitted).

faith defense if they "did not directly or indirectly induce" the actions that constituted the primary violations.[48] Thus, the express provisions of section 20(a) and the Court's *Janus* decision both restrict the attribution of liability to parties who lack immediate responsibility for the underlying proscribed conduct.[49] Given the Court's history of using other provisions of the 1934 Act to help define the contours of liability under Rule 10b-5,[50] the express limits on attribution provided by section 20(a) suggest limiting the use of traditional agency principles to attribute liability in 10b-5 claims.

The Ninth Circuit's decision in *ChinaCast* triggers the same concerns over litigation costs and attribution divorced from responsibility that animated the Court's reasoning in *Central Bank* and *Janus*. In 1995, Congress updated the 1934 Act with the PSLRA, which sought to enhance shareholder welfare by curbing abusive litigation.[51] The PSLRA requires plaintiffs to plead "with particularity facts giving rise to a strong inference that the defendant acted with [scienter],"[52] thereby making it easier for companies to dismiss meritless claims at an early stage in the litigation and avoid the substantial costs of trial.[53] To mitigate the unfairness of imposing a high proportion of damages on a less culpable party,[54] the PSLRA also created proportionate — rather than joint and several — liability for defendants who commit "nonknowing securities violations."[55] The Ninth Circuit's de facto elimination of the adverse-interest exception at the pleading stage is in direct tension with the PSLRA's goals because it deprives corporations of a tool that can be used to dismiss meritless claims early in a lawsuit and holds corporations (and indirectly their shareholders) liable even when they are *victims* of injuries caused by rogue managers.

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[48] 15 U.S.C. § 78t(a).

[49] *See also* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1581 (9th Cir. 1990) (Hall, J., dissenting) ("To hold an individual liable [under section 20(a)] for securities fraud committed by his employee without proof of fault, in addition to being contrary to . . . legislative history, would violate the express language of the [1934] Act.").

[50] *See* Musick, Peeler & Garrett v. Emp'rs Ins. of Wausau, 508 U.S. 286, 294–98 (1993) (finding an implied private right to contribution under Rule 10b-5 based on express rights to contribution found in sections 9 and 18 of the 1934 Act, 15 U.S.C. §§ 78i, 78r).

[51] *See* Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 550 (2011); Marilyn F. Johnson et al., In re Silicon Graphics Inc.*: Shareholder Wealth Effects Resulting from the Interpretation of the Private Securities Litigation Reform Act's Pleading Standard*, 73 S. CAL. L. REV. 773, 802 (2000).

[52] 15 U.S.C. § 78u-4(b)(2)(A).

[53] A failed motion to dismiss will incentivize defendants to settle regardless of the merits of the case because of the enormous expense associated with litigating scienter at trial, which often requires the "massive undertaking" of producing a large number of documents and a "seemingly endless series of depositions." Johnson et al., *supra* note 51, at 783.

[54] *See* H.R. REP. NO. 104-369, at 37 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 736.

[55] *Id.* at 38, *as reprinted in* 1995 U.S.C.C.A.N. at 737.

In the face of Supreme Court precedent and congressional intent that counsel against expansion of secondary liability, federal courts have been inconsistent in their application of the adverse-interest exception to Rule 10b-5 claims by shareholders against corporations like ChinaCast that are looted by their corporate officers.[56] Perhaps recognizing the lack of dispositive case law on the subject, the Ninth Circuit turned to the policy goals of "fair risk allocation" and fraud deterrence to justify imputation in *ChinaCast* through the innocent-third-party exception.[57] However, while the innocent-third-party exception might further these policy goals in traditional agency relationships, the underlying risk-allocation and deterrence considerations are more nuanced in fraud-on-the-market cases.[58] In particular, the court overlooked the fact that there might be multiple innocent parties in such cases.

Proponents of the "circularity argument" posit that damages paid to plaintiff shareholders in private fraud-on-the-market suits ultimately come from the pockets of other shareholders, who are no more culpable than the plaintiffs for the underlying fraud.[59] In the typical fraud-on-the-market case involving a corporate manager who fraudulently conceals bad news about the firm, the only shareholders who benefit from the fraud are those who sell their shares before the fraud is revealed. Ironically, these shareholders avoid the costs of liability completely.[60] While the circularity argument applies generally to fraud-on-the-market cases, the argument has even greater force when

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[56] *Compare In re* Tyco Int'l, Ltd., Nos. MDL 02-1335-B, 02-266-B, 2004 WL 2348315, at *6 (D.N.H. Oct. 14, 2004), *and* Puskala v. Koss Corp., 799 F. Supp. 2d 941, 947–48 (E.D. Wis. 2011), *with* Nathanson v. Polycom, Inc., 87 F. Supp. 3d 966, 981–82 (N.D. Cal. 2015), *and In re* JPMorgan Chase & Co. Sec. Litig., C.A. No. 06 C 4675, 2007 WL 4531794, at *9 (N.D. Ill. Dec. 18, 2007). The Ninth Circuit placed significant weight on the Third Circuit's decision not to apply the adverse-interest exception in *Belmont v. MB Investment Partners, Inc.*, 708 F.3d 470, 496 (3d Cir. 2013). However, *Belmont* is not directly on point because the plaintiffs were not shareholders in the defendant company and because there was an issue of material fact as to whether the defendant company benefitted from the primary violator's conduct. *See id.* at 477–79, 496.

[57] *In re ChinaCast*, 809 F.3d at 478.

[58] The Ninth Circuit cited Professor Douglas Langevoort's article on agency law in the corporate context as support for its application of the innocent-third-party exception. *Id.* at 477 (citing Langevoort, *supra* note 27, at 1214). However, the passage cited by the court was part of Langevoort's exposition of *traditional* agency law principles; Langevoort mentions later in the same article that "[traditional agency] doctrines . . . operate with substantial breadth, perhaps proving too much if incorporated in their entirety [into 10b-5 cases]," such as in situations when an employee "engage[s] in an intricate scheme to defraud both customers and his employer." Langevoort, *supra* note 27, at 1228.

[59] *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 649 (1996); *see also* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 700 (noting also that "shareholders who bear the cost of liability [from damages] may themselves be victims of the fraud if they were dissuaded from selling their shares by false positive news").

[60] Arlen & Carney, *supra* note 59, at 699.

the underlying conduct is looting. Unlike the fraudulent concealment of bad news — which temporarily benefits shareholders due to its inflationary impact on the corporation's share price — looting is inherently damaging to corporations (and therefore to shareholders). Nonplaintiff shareholders face three sets of losses when they bear the cost of liability for corporate looting: losses stemming from the payment of damages, the market price impact of the fraud's revelation, and the corporate funds siphoned off by unscrupulous managers. Shifting losses from one innocent party to another innocent party who is already burdened with significant losses does not serve the same fairness interest that was at the root of the Ninth Circuit's reasoning.

It is also unclear how allocating liability to other innocent shareholders serves the goal of fraud deterrence. Shareholders elect directors to monitor corporate affairs because they face well-documented collective action problems that make it difficult for them to effectively police the conduct of corporate executives.[61] In *ChinaCast*, it was arguably the board's failure to respond to Deloitte's audit report that allowed Chan to loot the company.[62] To be effective, deterrence should be directed at the perpetrators of the fraud (senior managers) and those most directly tasked with monitoring managerial conduct (directors), rather than the company, and indirectly its shareholders.[63]

The Supreme Court has recognized that the application of agency principles to federal securities fraud cases should be anchored to statutory text and purposes. The Court's narrow construal of secondary liability under the 1934 Act, as well as Congress's concerns about excessive litigation and the mismatch between culpability and liability, counsel against the undisciplined importation of agency principles into fraud-on-the-market cases such as *ChinaCast*. Moving beyond the restraint embodied in the Supreme Court's approach to private securities fraud liability, the Ninth Circuit placed undue reliance on standard policy rationales to justify disabling corporations that have been looted by rogue executives from using the adverse-interest exception. As a result, the Ninth Circuit simply shifted the burden of losses to others within the very class that it sought to protect — innocent shareholders.

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[61] *See, e.g.*, *id.* at 693.

[62] The district court's dismissal of plaintiffs' claims against ChinaCast's independent directors was not challenged by the plaintiffs on appeal. *In re ChinaCast*, 809 F.3d at 474 n.1.

[63] The weight of empirical evidence indicates that shareholder class action lawsuits generally fail to deter managerial fraud because damages are ultimately paid by shareholders rather than culpable managers or directors. Lawrence E. Mitchell, *The "Innocent Shareholder": An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243, 247; *see also* Adam C. Pritchard, Stoneridge Investment Partners v. Scientific-Atlanta*: The Political Economy of Securities Class Action Reform*, 2007–2008 CATO SUP. CT. REV. 217, 225 (noting that "deterring fraud with enormous damages is weaker when the corporation does not benefit from the fraud").