Adverse Interest Exception Not Applied in Securities Class Action

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On Oct. 23, the U.S. Court of Appeals for the Ninth Circuit decided the following issue of first impression: Whether, when assessing the pleading adequacy of a securities class action complaint's scienter (fraudulent intent) allegations, a court may impute a corporate officer's scienter to the corporation under the "adverse interest exception" even where the officer allegedly acted out of his or her own interests and contrary to the interests of the company. In its opinion, *In re ChinaCast Education Securities Litigation*, No. 12-57232,

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2015 U.S. App. LEXIS 18462 (9th Cir. Oct. 23, 2015), the Ninth Circuit answered this question in the affirmative, holding that, where a complaint alleges that a corporate officer acted with apparent authority, the court should impute the officer's scienter to the defendant corporation—regardless of whether the officer's fraudulent conduct was adverse to the corporation's interest. The Ninth Circuit's decision in *ChinaCast* is particularly noteworthy for parties litigating securities class actions in the Third Circuit because it expands the application of the Third Circuit's recent decision in *Belmont v. MB Investment Partners*, 708 F.3d 470 (3d Cir. 2013), which was not a class action, to the securities class action context where plaintiffs are not required to plead and prove direct reliance on a defendant's representations.

Factual and Procedural Background

According to the Ninth Circuit's opinion, which draws the facts from the plaintiffs' complaint, ChinaCast Education Corp. is a for-profit post-secondary education and e-learning services provider based in China. From June 2011 through April 2012, ChinaCast's founder and CEO, Ron Chan Tze Ngon, allegedly "looted the company's coffers, including proceeds from the U.S. stock offerings." Specifically, Chan allegedly transferred $120 million from the company to outside accounts controlled by him and his allies; permitted a company vice president to move $5.6 million of ChinaCast funds to his son; shifted control of two of ChinaCast's private colleges to outside the company; and pledged $37 million in company assets to secure third-party loans unrelated to ChinaCast's business. According to the court, these actions brought the company to "financial ruin."

In September 2012, a group of ChinaCast shareholders brought a securities class action against Chan, ChinaCast, and the company's chief financial officer and independent directors for alleged violation of Section 10(b) of Securities Exchange Act of 1934 and the U.S. Securities and Exchange Commission Rule 10b-5. The defendants filed a motion to dismiss the complaint on grounds, inter alia, that the complaint failed to meet the heightened requirements of the Private Securities Litigation Reform Act of 1995 (PSLRA) for pleading the element of scienter as to ChinaCast. The district court agreed, holding that, under the adverse interest exception, Chan's scienter could not be imputed to ChinaCast because Chan acted adversely to the company's interest.

The Ninth Circuit's Decision

In reversing the district court's decision, the Ninth Circuit focused on an "apparent authority" exception to the adverse interest exception. As the court explained: "The starting point is that all information known by the agent, at least when received within the scope of authority, is deemed known by the principal. But this is not so if the agent is acting

contrary to the principal's interests—the so-called 'adverse interest' exception. In turn, the adverse interest exception itself has an exception: the principal is charged with even the faithless agent's knowledge when an innocent third-party relies on representations made with apparent authority," quoting Donald C. Langevoort's "Agency Law Inside the Corporation: Problems of Candor and Knowledge." The rationale for the apparent authority exception is that, as between the principal whose agent is acting against the principal's interest and the innocent third party who is relying on the misstatements of the agent with apparent authority, the risk of loss should fall on the principal. The principal is presumptively better able to monitor the conduct of the agent than is the innocent third party.

The Ninth Circuit analyzed cases, including the Third Circuit's decision in *Belmont*, where courts had applied this apparent authority exception to the adverse interest exception in the non-securities class action context. In *Belmont*, according to the Third Circuit's opinion, Mark Bloom allegedly perpetrated a Ponzi scheme while he was employed as a senior executive of a registered investment adviser, MB Investment Partners Inc. Bloom allegedly diverted at least $20 million in client funds to finance his lavish lifestyle, and several of his clients sued MB and others, asserting Rule 10b-5 and other claims. Citing the adverse interest exception to imputation, the district court granted summary judgment in favor of MB on the plaintiffs' Rule 10b-5 claim. The Third Circuit reversed, explaining that, under the apparent authority exception to the adverse interest exception, "imputation may be appropriate in this case, if the investors can prove that the manner in which Bloom marketed North Hills [the alleged Ponzi scheme] to them while he was working for MB, and the apparent benefit to MB, made it appear that he marketed North Hills within the scope of his authority as a senior executive of MB."

In applying the apparent authority exception in *ChinaCast*, the Ninth Circuit pointed out that "the complaint alleges that third-party shareholders understandably relied on Chan's representations, which were made with the imprimatur of the corporation that selected him to speak on its behalf and sign SEC filings." In addition, the complaint alleged that Chan knowingly misrepresented ChinaCast's financial condition. Accordingly, the court held that the plaintiffs "pled sufficient allegations to support imputation and survive the pleading requirements of the PSLRA."

Implications of 'ChinaCast'

Although the Ninth Circuit relied on the complaint's allegations of shareholders' direct reliance on Chan's representations in reaching its decision in *ChinaCast*, plaintiffs in securities class actions need not plead or prove direct reliance on a company's representations in making their investment decisions. Instead, under the fraud-on-the-market

theory adopted by the Supreme Court in *Basic v. Levinson*, 485 U.S. 224 (1988), courts presume that all material representations made by a company's officers are incorporated into the company's stock price, so long as the stock traded in an efficient market, and, therefore, all class members' reliance is presumed, regardless of whether the officers acted within their authority. Just last year, the U.S. Supreme Court reaffirmed in *Halliburton v. Erica P. John Fund*, 134 S. Ct. 2398, 2408 (2014), that this presumption of reliance, while rebuttable, relieves class action plaintiffs of the burden of proving direct reliance. Accordingly, the Ninth Circuit's application of an apparent authority exception (which is premised on an innocent third party's reliance on representations made with apparent authority) to the adverse interest exception seems inapposite in the context of securities class actions brought under the fraud-on-the-market theory (where actual reliance is not required). Whether or not courts in the Third Circuit decide to follow the Ninth Circuit's decision in *ChinaCast*, it serves as another wake-up call to corporate boards of directors that they must exercise vigilant and careful oversight of their corporate officers if they are to avoid the financial loss that rogue executives can bring to both the company and its shareholders.