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## *Ninth Circuit Clarifies Application of 'Adverse Interest Exception' in Securities Class Actions*

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On October 23, 2015, the Ninth Circuit issued its decision in *In re ChinaCast Education Corporation Securities Litigation*, addressing a matter of first impression for the Ninth Circuit: whether a corporate officer's fraud may be imputed to the company in a securities fraud class action where the fraudulent actions of the officer were adverse to the company's interests?<sup>1</sup> In reversing the district court, the Ninth Circuit held that the plaintiff sufficiently alleged facts allowing for the imputation of the Chief Executive Officer's fraudulent misrepresentations and his scienter to the company.<sup>2</sup> The court rejected application of the adverse interest exception to the rule of imputation, concluding that the CEO was acting with apparent authority when making public statements and the corporation "controlled the level of oversight of [the CEO's] handling of the business."<sup>3</sup>

### **Imputation of Scienter Under Rule 10(b)(5)**

In order to establish a claim for fraud under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, a plaintiff must prove six elements: (1) material misrepresentation; (2) scienter; (3) connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation.<sup>4</sup> At issue in *ChinaCast* was whether the plaintiffs had made the requisite allegation of scienter against the company. Generally, scienter of senior officers of a corporation may be imputed to the corporation itself for the purposes of a securities fraud action when those officers are acting within the scope of their apparent authority.<sup>5</sup> Under the "adverse interest exception" to the rule of imputation, however, where a rogue agent "acts adversely to the principal in a transaction or matter, intending to act solely for the agent's own purposes or those of another person," a court need not impute knowledge of wrongdoing to the corporation.<sup>6</sup>

### ***ChinaCast*: Imputation and the Inapplicability of the "Adverse Interest Exception"**

The facts of *ChinaCast* are straightforward. In May of 2012, ChinaCast's shareholders filed a class action lawsuit against ChinaCast, the CEO, and other company directors, alleging securities fraud in violation of Rule 10b-5 of the Securities Act of 1934.<sup>7</sup> The complaint alleged that ChinaCast's founder and CEO looted ChinaCast of approximately \$120 million by fraudulently transferring corporate assets to privately-controlled accounts and the improper pledging of corporate assets to secure unrelated third-party loans.<sup>8</sup> While engaged in the scheme to defraud the company, the CEO consistently emphasized the company's financial health and security to investors via earnings calls and press releases.<sup>9</sup> The CEO reassured investors during a conference call in 2011 that "no questions or concern[s] had ever been raised by the company's auditors[.]"<sup>10</sup> When ChinaCast's board discovered that the CEO attempted to interfere with the company's annual audit in 2012, it removed him as chair



and disclosed in its SEC filings that it had uncovered questionable and illegal activities by its senior officers.<sup>11</sup> The district court dismissed the securities fraud complaint against ChinaCast without leave to amend.<sup>12</sup> The district court held that the plaintiffs had not pled scienter with respect to ChinaCast because imputation was improper under the adverse interest exception.<sup>13</sup>

The Ninth Circuit reversed, holding that the adverse interest exception did not foreclose the case from proceeding beyond the pleading stage. The court reasoned that the adverse interest exception does not apply when imputing an agent's actions is necessary to protect the rights of a third party, *i.e.* shareholders, who dealt with the principal in good faith.<sup>14</sup> When an agent acts with apparent authority on behalf of an entity, and third-party shareholders understandably rely on those representations because they are "made with the imprimatur of the corporation that selected" the agent to speak on its behalf, the entity cannot avoid liability simply because it, too, was harmed by the actions of its agent.<sup>15</sup>

The court emphasized that imputation exists in order to allocate risks fairly. In this case, the court determined that the risk should fall not on innocent third-party shareholders, but on the company, who must be responsible for those whom it placed in positions of trust and confidence.<sup>16</sup> The court concluded that imputation under these circumstances encourages corporations to engage in careful oversight of their executives.<sup>17</sup>

### ***ChinaCast*: Key Takeaways and Future of the Adverse Interest Exception**

*ChinaCast* is another reminder that companies and their directors must remain vigilant in their oversight of senior executives and continue to pay close attention to key indicia of possible wrongdoing. In *ChinaCast*, the court indicated that protecting innocent third-party shareholders from loss was a priority when allocating risk and responsibility.<sup>18</sup>

In dicta, the Ninth Circuit's decision considered whether the adverse interest exception would ever be applicable at the pleading stage in a securities fraud class action.<sup>19</sup> Instead of foreclosing future challenges, the court reiterated that the adverse interest exception may be applicable under certain limited facts not present in *ChinaCast*.<sup>20</sup> For instance, the court cited another district court decision suggesting that the exception may still apply at the pleading stage if the allegations in the complaint conclusively establish that the company received no benefit from the executive's conduct. The court also noted that the adverse interest exception could be applicable to rebut the presumption of indirect reliance and held open the exception as a possible affirmative defense to liability.<sup>21</sup> Thus, while companies invoking the adverse interest exception at the pleading stage are unlikely to be successful in the aftermath of *ChinaCast*, company counsel should be mindful of the doctrine's continued applicability in other stages of the litigation.

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<sup>1</sup> *In re ChinaCast Educ. Corp. Sec. Litig.*, No. 12-57232, ---F.3d ---, 2015 WL 6405680 (9th Cir. Oct. 23, 2015).

<sup>2</sup> *Id.* at \*1.

<sup>3</sup> *Id.*

<sup>4</sup> *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341 (2005).

<sup>5</sup> *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1106-07 (10th Cir. 2003).

<sup>6</sup> Restatement (Third) of Agency § 5.04 (2006); *Hecksher v. Fairwinds Baptist Church, Inc.*, 115 A.3d 1187, 1205 (Del. 2015).

<sup>7</sup> *Id.* at \*6.

<sup>8</sup> 2015 WL 6405680, at \*2.

<sup>9</sup> *Id.* at \*1.

<sup>10</sup> *Id.* at \*2.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at \*4-5.

<sup>15</sup> *Id.* at \*5.

<sup>16</sup> *Id.* at \*6.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at \*7.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

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