

CLIENT ALERT

Ninth Circuit Sends Warning on 10(b)(5) Consequences of Corporate Environmental Communication

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The Ninth Circuit Court of Appeals, in reinstating a securities fraud class action, *Reese v. Malone*, which stemmed from BP's statements describing and explaining two highly-publicized pipeline leaks in Prudhoe Bay in 2006, has clarified several significant rules of communication for publicly-held companies that are involved in high-profile environmental matters. While the Ninth Circuit remanded the case to the district court for a full trial on the merits, including the critical question of the causal relationship between BP's allegedly false statements and plaintiffs' damages, both the framework and the language of the Court's analysis provide a roadmap and important caution signs for companies that are in the public eye for the consequences of projects, the operations of a facility, or their corporate environmental conduct in general.

The triggering events for the suit were leaks in two areas of BP's Alaskan pipeline system, one of which spilled 200,000 gallons of oil in March of 2006 and the other, five months later, in a different transit line, which resulted in a much smaller spill. Both leaks were the product of pipeline corrosion that had been caused by several forces and exacerbated by what BP subsequently admitted were substandard corrosion detection protocols. The Court noted that BP's behavior had been called into question both by the Alaska Department of Environmental Conservation and by a BP workers' committee in a letter to BP's non-executive Board of Directors several years before the spills.

The first spill prompted an extensive investigation by the Pipeline and Hazardous Materials Safety Administration (PHMSA), which issued a Corrective Action Order that contained several findings and questions which, as events unfolded, contrasted markedly with certain of BP's public statements about the events, as well as with the company's corporate protocols.

The second spill, which resulted in a temporary shutdown of BP's Prudhoe Bay oil field, prompted investigations by both the Senate and the House. At these hearings, testimony both from regulatory authorities and private sector pipeline maintenance executives also contrasted unfavorably with BP's own public statements.

Finally, in resolving violations of the Clean Water Act, the Clean Air Act and the Federal Pipeline Safety Laws, in 2007 and 2011, BP made certain admissions about the nature of its pipeline safety practice and protocol which also differed from both BP's public statements and statements made to shareholders in its Annual Report leading up to the time of the spills and in the time between the first spill and the second.

In their securities fraud case, plaintiffs focused on three types of statements that they alleged to be false or misleading: (1) press statements by Maureen Johnson, BP's senior executive in charge of the Prudhoe Bay pipeline project, one of which was general in nature and two of which related specifically to the larger, March spill; (2) the general statement by BP's CEO to the press that the March spill had occurred notwithstanding "BP's world class corrosion monitoring and leak detection systems;" (3) statements in BP's annual reports, one concerning management's belief about BP's material compliance with applicable environmental laws and regulations and one touting BP's "environmental best practices."

In a succinctly-worded opinion that was nevertheless sweeping in its scope and pointedly critical in its conclusions, the Ninth Circuit found all but the CEO's general statement actionable under the federal securities laws. Employing an analysis that proceeded point-by-point to demonstrate the adequacy of plaintiffs' pleadings under federal "scienter" requirements as well as one that was broader in focus to comply with the so-called "holistic" analysis required under federal securities law, the Ninth Circuit found that plaintiffs had adequately pled knowing material falsity.

Specifically, Johnson's statements to the Associated Press that the pipeline corrosion that ultimately caused the March spill had been detected in a previous September inspection at a "low manageable rate" was false because it contradicted subsequently-discovered BP internal documents. The Ninth Circuit also rejected BP's argument that Johnson's statements were immaterial, because BP's knowledge of pipeline problems in advance of the spill were key questions raised both in the media and in the subsequent government investigations. While the public may have been skeptical about BP's pipeline maintenance practices following the spill, the Court reasoned, disclosure of the fact that BP may have ignored important warning signs would have altered the "total mix" of information made available to investors under the standard Supreme Court formulation in *Basic v. Levinson*, 485 U.S. at 231-232.

On the critical question of scienter, the Ninth Circuit relied heavily on the degree of knowledge that Johnson should have, or would be expected to have, both in light of her position with the company and the significance of the Prudhoe Bay development to BP. In short, the Court found that it was not plausible that Johnson either misunderstood the data, had no access to the data, did not understand its significance, or had made her statement to the press outside the ambit of what the data signified. The knowing falsity of these statements was the more likely inference, according to the Court, which accordingly remanded the elements of the claim based on those statements to the lower court for trial.

Similarly, the Court found a basis for plaintiffs' claims in two of Johnson's other statements to the press, in which she attempted to circumscribe the March spill by claiming both to the Associated Press and later to the Petroleum News that the conditions that gave rise to the corrosion were unique to that line. Here, the specificity of her comments about actual conditions, combined with the similarity between the two pipelines that had leaked, in particular the fact that flow velocity and susceptibility to corrosion were conditions that existed in both pipelines over the long term, made it likely that Johnson's statements were false.

More broadly, the Court noted a line of securities cases in which key personnel were deemed to have knowledge of "key operations" of their companies. In this case, according to the Court, circumstances strongly suggest both that Johnson had actual access to data that would have confirmed the inaccuracy or falsity of her statements and that the nature of her position was such that it would have been "absurd to think" that she did not know of the comparable condition of the two pipelines when she made public statements that they were distinguishable from each other.

While these aspects of the Court's analysis are useful and cautionary for all companies who have a knowledgeable point person who is both managing logistics on the ground and responsible for public statements concerning progress and policy, the final facet of the Court's opinion, which takes BP to task for what many would consider standard boilerplate disclosure in its Annual Report, may turn out to have the longest-lasting ramifications and the further-reaching consequences.

The language in BP's 2005 Annual Report, issued in June, 2006, states that "Management believes that [its] activities are in compliance in all material respects with applicable environmental laws and regulations." The district court had found that these statements were too "vague and ambiguous" to support an allegation of falsity. Similarly, the district court found the phrases "management believes" and the use of the qualifier "material," to be significant.

The Ninth Circuit took a sharply different view of these words in light of the circumstances of the case. The egregious nature of the violations, all of which had occurred before the annual report was formally issued, the ongoing discussions with PMHSA in the context of violations of the Corrective Action Order, and BP's comparatively poor performance compared to industry norms belied the assertion of "material compliance."

Even more striking is the Ninth Circuit's reasoning on scienter. Here, the Court applied the "absurdity" test under federal securities law and reasoned that, in light of the prominence of the violations and their magnitude, it would be absurd to suggest that top management was unaware of the compliance issues that rendered the annual report statement misleading. Not satisfied with simply tearing through the veil of these standard qualifiers, the Ninth Circuit also contrasted the specific statement with BP's broad boilerplate language concerning general environmental risks facing the company. Placed in the context of these broad risks, BP's statement concerning management's belief that there had been general compliance effectively misdirected shareholders from the very specific problems that BP was actually facing as a result of the corrosion of its Alaska pipelines and the resulting leaks. Rather than providing general cover, according to the Court, these two elements of the annual report compounded the falsity of the statements for purposes of analyzing the securities fraud pleadings.

While it is a long way from these damaging conclusions to actual damages, and a trial on causation awaits in the district court, the raw elements of what the Ninth Circuit found to be actionable language are already a far-reaching cautionary tale for any company with high profile environmental matters.

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