

Bofl Ruling May Erode Cos.' Securities Class Action Defenses

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On Oct. 8, the U.S. Court of Appeals for the Ninth Circuit reversed the dismissal of a securities fraud class action against San Diego-based Bofl Holding Inc., now known as Axos Bank, in *In re: Bofl Holding Inc. Securities Litigation*.

A majority of the appellate panel held that a former employee's fraud allegations in a whistleblower lawsuit may qualify as a corrective disclosure and may be used in the securities class action to plead loss causation under the Private Securities Litigation Reform Act, as long as the whistleblower allegations are plausible, and even if there are no additional disclosures or evidence corroborating the allegations.

In so holding, the Ninth Circuit joined the U.S. Court of Appeals for the Sixth Circuit in rejecting the "categorical rule that allegations in a lawsuit, standing alone, can never qualify as a corrective disclosure."

In a dissenting opinion, one panelist expressed his preference for a bright-line rule that requires an external disclosure or evidence that confirms the allegations in a whistleblower lawsuit over the majority's approach, which he fears opens the door for meritless securities fraud suits that impose exorbitant costs on companies.

The Ninth Circuit's holding threatens to erode some of the protections Congress intended the PSLRA to provide to publicly traded companies and their officers and directors facing shareholder class actions. Specifically, Bofl Holding may give shareholder plaintiffs a road map to new strategies for pleading two elements of a Section 10(b) claim: loss causation and scienter.

Where share price declines untethered to an actual revelation of fraud make pleading loss causation more challenging, Bofl Holding gives plaintiffs another potential event that they may label a corrective disclosure.

In addition, while Bofl Holding focuses on the loss causation element, its holding also seemingly gives additional weight to mere allegations in nonsecurities litigation, from which shareholder plaintiffs may attempt to plead particularized facts giving rise to a strong inference of scienter.

It remains to be seen how district courts will grapple with the Ninth Circuit's analysis and holding in Bofl Holding when evaluating the plausibility of allegations in a whistleblower complaint. More concerning,



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there are few proactive steps issuers can take to avoid being subjected to costly securities litigation grounded in mere allegations made by a whistleblower in a separate suit.

Background

In *Bofl Holding*, the U.S. District Court for the Southern District of California dismissed the operative complaint on the grounds that the plaintiffs failed to adequately plead loss causation, one of six elements a plaintiff must plead to state a securities fraud claim.

To plead loss causation, the complaint relied on two corrective disclosures, one of which was a whistleblower lawsuit filed in August 2015 by a former midlevel auditor at the company, alleging rampant and egregious wrongdoing at the company.

In dismissing the complaint, the district court reasoned that because the whistleblower lawsuit contained only "unconfirmed accusations of fraud," it could not have disclosed to the market that Bofl's alleged misstatements were actually false. To qualify as a corrective disclosure, the lawsuit had to be followed by a subsequent confirmation of the fraud, which the shareholders had not alleged.

That the district court dismissed the action with prejudice on these grounds is noteworthy, because a failure to plead loss causation is not typically fertile grounds for a motion to dismiss. Plaintiffs face a relatively low pleading bar to adequately allege loss causation. For example, where a company's stock suffers a substantial price decline, plaintiffs are often able to identify some public disclosure immediately preceding the price drop on which they can pin their loss causation allegations.

In *Bofl Holding*, because the plaintiffs could not identify any such revelatory disclosure, they were forced to rely on, in the district court's view, unsubstantiated allegations made in a whistleblower lawsuit shortly before the relevant stock price decline.

Whistleblower Lawsuit May Be Used to Plead Loss Causation if Insider Allegations Are Plausible

Reversing the district court's decision, the Ninth Circuit held that the plaintiffs alleged particularized facts plausibly suggesting that the market perceived the whistleblower's allegations as credible and acted upon them on the assumption that they were true. The whistleblower's descriptions of wrongdoing by the company were highly detailed, specific and based on firsthand knowledge that the whistleblower likely possessed by virtue of his position as a midlevel auditor at the company.

Additionally, the plaintiffs alleged that Bofl's stock price fell by more than 30% immediately after the market learned of the whistleblower's allegations. Thus, the Ninth Circuit joined the Sixth Circuit in rejecting the categorical rule that allegations in a lawsuit, standing alone, can never qualify as a corrective disclosure.

Bofl Holdings is another decision in the Ninth Circuit's rollercoaster ride of analyses that attempt to distinguish between loss causation arguments based on the announcement of an investigation, versus those based on the disclosure of insider allegations.

In a 2014 decision, the Ninth Circuit held that a plaintiff could not rest his theory of loss causation on the announcement of an internal investigation alone because it did not reveal to the market any facts that could call into question the veracity of the company's prior statements.

On the other hand, in a 2016 decision, the Ninth Circuit held that an announcement of a government investigation can qualify as a corrective disclosure for loss causation purposes if the inaccuracy of the misstatement at issue is subsequently confirmed.

Then, in a 2017 decision, the Ninth Circuit rejected as inadequate a loss causation theory based on some 2,000 complaints the Federal Trade Commission had released to the public, because the complaints came from outsiders who lacked firsthand knowledge of the defendant's practices.

Bofl Holding seemingly indicates that plaintiffs may root their theory of loss causation in the disclosure of investigations or other complaints, where they are based both on plausible insider knowledge and where the disclosure allegedly suggests that a prior company disclosure was false or misleading.

Further, while the Ninth Circuit's holding is limited to the loss causation element, shareholder plaintiffs will likely use the Ninth Circuit's analysis as a springboard in some cases to attempt to plead scienter based on allegations made in whistleblower complaints.

Securities class action plaintiffs often rely on confidential witness statements to establish scienter. This pleading tactic, however, has been an uphill battle. Federal courts' acceptance of confidential witnesses statements has been begrudging. Some circuits, including the Fifth and Seventh, steeply discount confidential witness allegations, and, in some instances, courts have determined that allegations attributed to confidential witnesses were misrepresented.

Shareholder plaintiffs seeking new strategies to plead scienter may thus seize on the Ninth Circuit's holding to transform unverified whistleblower claims in a separate suit to alleged facts indicative of scienter in a shareholder class action.

Partial Dissent Urging a Bright-Line Rule Whereby Whistleblower Allegations Must Be Corroborated

U.S. Circuit Judge Kenneth K. Lee dissented from the majority's holding that a whistleblower's lawsuit can qualify as a corrective disclosure for the purposes of pleading loss causation. Judge Lee feared that the majority's decision:

will have the unintended effect of giving the greenlight for securities fraud lawsuits based on unsubstantiated assertions that may turn out to be nothing more than wisps of innuendo and speculation.

And, as Judge Lee explained, "even meritless securities fraud lawsuits impose an exorbitant cost on companies."

First, Judge Lee disagreed with the majority's conclusion that the whistleblower's allegations against Bofl are plausible enough to constitute a corrective disclosure. Indeed, Bofl has not issued any financial disclosures that would confirm the whistleblower's allegations and in the five years that have passed since the whistleblower alleged misconduct at Bofl, investigations commenced by multiple government agencies into Bofl have adduced no evidence corroborating the allegations.

Second, Judge Lee disagreed with the majority's use of the plausibility standard under the U.S. Supreme Court's *Iqbal* and *Twombly* rulings to analyze the allegations in the whistleblower's lawsuit. An insider account will almost always have a "patina of plausibility" because it will likely be based on some non-public allegation that cannot be easily disputed or rebutted at the pleading stage. The plausibility

standard, therefore, provides little comfort to companies that may face securities fraud lawsuits based on unsubstantiated insider allegations.

Third, Judge Lee disagreed with the majority's analysis of the stock drop. The fact that Bofl's shares plummeted 30% after the whistleblower publicly accused his former employer of fraud did not demonstrate that the whistleblower's allegations revealed the truth and acted as corrective disclosure. Rather, the whistleblower's lawsuit is better construed as a disclosure of "an added risk of future corrective action."

Based on the foregoing, Judge Lee concluded that "if a securities fraud lawsuit turns on insider allegations of wrongdoing in a whistleblower lawsuit, I would prefer a bright-line rule that requires an external disclosure or evidence that confirms those allegations."

Key Takeaways

Congress passed the PSLRA because it expressly recognized that securities class actions, including meritless suits, threaten to impose unduly burdensome costs on publicly traded companies and their directors and officers. Accordingly, for 25 years, the PSLRA's heightened pleading standards have stood as a bulwark — although imperfect in some cases — against such meritless suits.

The Ninth Circuit's decision in *Bofl Holding* may erode some of the protections for securities class action defendants that Congress intended to provide in the PSLRA.

For instance, in cases where shareholders cannot identify clear revelations to establish loss causation, *Bofl Holding* provides an alternate route whereby shareholders might plead that an insider's allegations, even if there is no evidence or disclosure corroborating them, serve as a corrective disclosure for purposes of pleading loss causation.

In addition, although securities class action plaintiffs' confidential witness allegations have been met with increasing skepticism by courts over the past decade, *Bofl Holding* may portend a new trend in securities class actions, in which shareholder plaintiffs seize on unsubstantiated, and possibly meritless, whistleblower complaints as a foundation for pleading not just loss causation, but also scienter.

More aggressive plaintiffs may even attempt to marry their whistleblower practice with their securities class action practice by, for example, using the whistleblower practice to file complaints to drive loss causation events and supposed evidence of scienter, on which the securities class action practice can then piggyback.

It remains to be seen how district courts within the Ninth Circuit will apply *Bofl Holding* when evaluating the veracity of whistleblower allegations to determine if they bear the level of plausibility that the Ninth Circuit deemed to qualify as a corrective disclosure. Indeed, the dividing line between plausible and implausible whistleblower allegations that drive adequate indicia of loss causation is, as the *Bofl Holding* dissent suggested, likely to remain blurry for some time.

Notably, the Ninth Circuit placed great weight on the former employer's personal knowledge of the facts he alleged in his whistleblower complaint. But as the partial dissent questioned, what if the whistleblower, as a fairly junior-level former employee, was mistaken because he did not understand or have access to all the facts?

It will be worth monitoring how district courts apply this challenging analysis when presented with future securities class actions that piggyback off whistleblower complaints.

Perhaps most concerning, the Ninth Circuit's decision provides no guidance as to how public companies might take proactive steps to avoid the challenges that befell Bofl.

It goes without saying that a company has no say or control over the content or nature of mere allegations lodged in a whistleblower complaint. As such, even if mindful of the Ninth Circuit's Bofl Holding decision, there are no readily apparent measures companies can implement to avoid this sort of quagmire.

The uncertainty facing both district courts and publicly traded companies subject to securities class actions lends credence to Judge Lee's preference for a bright-line rule requiring an external disclosure or evidence confirming allegations contained in an insider's complaint

Such a bright-line rule would hew more closely to Congress' clear intent to shield companies from the burdens and expense of shareholder class actions premised on mere allegations and unsubstantiated innuendo.

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