



UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re: PETROBRAS SECURITIES LITIGATION	: 14-cv-9662 (JSR) : : <u>MEMORANDUM ORDER</u> : : -----x
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JED S. RAKOFF, U.S.D.J.

This is a consolidated class action against Brazilian oil company Petr leo Brasileiro S.A. - Petrobras ("Petrobras") and related defendants, including Petrobras' independent auditor, PricewaterhouseCoopers Auditores Independentes ("PwC"). Plaintiffs allege that Petrobras was at the center of a multi-year, multi-billion dollar bribery and kickback scheme, in connection with which defendants made false and misleading statements in violation of the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). In particular, plaintiffs raise claims under   11 of the Securities Act and   10(b) of the Exchange Act against PwC. PwC now moves to dismiss these claims, arguing that the plaintiffs' Fourth Amended Complaint ("FAC") fails to adequately plead them. The Court grants PwC's motion with respect to the   10(b) claim and denies the motion with respect to the   11 claim.

The general details of this case are set forth in the Court's Opinion dated July 30, 2015, familiarity with which is

here presumed. See Opinion dated July 30, 2015, at 2-14, ECF No. 194. Plaintiffs' § 10(b) claim is primarily based on PwC's February 25, 2014, clean audit opinion on Petrobras's 2013 financial statements and its February 4, 2013, clean audit opinion on Petrobras's 2012 financial statements. See FAC ¶ 183. Plaintiffs also allege that, as part of its reviews of Petrobras's financial statements, PwC certified that Petrobras had effective internal controls. Id. ¶ 184. The FAC also details the incorporation of PwC's audit opinions or endorsements in Petrobras's 6-K and 20-F filings from March 31, 2012, through August 11, 2014. See FAC ¶¶ 273-353. Plaintiffs allege that PwC turned a blind eye to red flags of fraud at Petrobras throughout this period.

Plaintiffs' § 10(b) claim is also based on PwC's approval of the writedowns and consolidated financial statements for 2012, 2013, and 2014 that Petrobras published on its website on April 22, 2015. Id. ¶ 355. Plaintiffs allege that these were an attempt to "whitewash" the bribery scandal. Id. ¶ 169.

Plaintiffs' § 11 claims are based on the incorporation of PwC's clean audit opinions into the offering materials for the 2013 and 2014 Petrobras Notes. Id. see FAC ¶¶ 325, 524, 527, 624-31. PwC consented to this incorporation. Id.

First, PwC attacks plaintiffs' § 10(b) claim for failing to adequately plead scienter. "[A] plaintiff may satisfy [the

scienter] requirement by alleging facts (1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness." ATSI Communications, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 99 (2d Cir. 2007) The Private Securities Litigation Reform Act ("PSLRA") requires that an inference of scienter "must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).

The only motive alleged in the FAC for PwC to commit fraud was its desire for compensation. See FAC ¶ 53 (alleging Petrobras paid PwC \$26.3 million for its services). At oral argument, plaintiffs' counsel suggested that, beyond the bare desire for compensation, PwC also wanted to stay on Petrobras's good side because Petrobras was "the largest company in Latin America" and wielded considerable power and influence. See Transcript dated Feb. 10, 2016, at 14. Setting aside that these allegations do not appear within the four corners of the FAC, they are insufficient to establish a motive to commit fraud. "[M]ere receipt of compensation and the maintenance of a profitable professional business relationship for auditing services does not constitute a sufficient motive for purposes of pleading scienter." Zucker v. Sasaki, 963 F. Supp. 301, 308

(S.D.N.Y. 1997); see In re Doral, 563 F. Supp. 2d 461, 466 (S.D.N.Y. 2008). Auditing firms are compensated for providing opinions that are both expert and objective, and their financial success is at least partly a function of their reputation for honesty and accuracy. While they will ordinarily seek to stay in the good graces of a powerful client with strong connections, they have an at least equally strong motive to maintain their professional reputation.

If plaintiffs do not plead a motive for a defendant to commit fraud, "the strength of the circumstantial allegations [of conscious misbehavior or recklessness] must be correspondingly greater." In re Advanced Battery Technologies, Inc., 781 F.3d 638, 644 (2d Cir. 2015). "[F]or an independent auditor, the [alleged] conduct 'must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company,' as, for example, when a defendant . . . disregards signs of fraud so obvious that the defendant must have been aware of them." Id. (citation omitted).

Plaintiffs do allege that there were important indications of fraud at Petrobras throughout the period when PwC provided auditing services. See FAC ¶ 185-86. These indications included internal investigations into kickbacks and overpayments, id. ¶¶ 185-86, 372, news reports in the Brazilian press regarding corruption at Petrobras, id. ¶¶ 185, 371, reports that Brazilian

lawmakers had assembled a committee to investigate kickbacks paid to Petrobras by Dutch firm SBM Offshore, id. ¶ 186, and the arrest of a former Petrobras senior executive, Paulo Costa, for participation in a money laundering scheme, id. ¶ 186. Moreover, in connection with the audit of the purchase of a refinery in Pasadena, Texas, conducted by the Brazilian Federal Court of Accounts (the *Tribunal de Contas da União*), that Court found evidence of improper conduct on the part of Petrobras executives and ultimately fined them \$792 million. Id. ¶¶ 117, 392.

However, the FAC is notably silent in alleging particular facts connecting these "red flags" to PwC and its auditing services. Without specific allegations regarding PwC's awareness of, and reaction to, information regarding the over-budget construction projects, newspaper reports, internal investigations, and the like, such events do not give rise to a strong inference of PwC's fraudulent intent. See FAC ¶¶ 185. Moreover, some of the most significant of these negative events were, so far as the FAC indicates, either unrelated to Petrobras or concerned activities that predated the beginning of PwC's relationship with Petrobras on January 16, 2012. Id. ¶ 49. For example, Costa was arrested in connection with his acquisition of a luxury car; he had left Petrobras in April 2012. Id. ¶ 33. Petrobras purchased the Pasadena refinery, the subject of the TCU report, in 2006. Id. ¶ 97, 185.

Furthermore, under the PSLRA, the scienter inquiry is “inherently comparative,” and “the court must take into account plausible opposing inferences.” Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 323 (2007). Accordingly, the Court considers the implications of the FAC’s own allegation, confirmed by PwC’s counsel at oral argument, that PwC did take action when it was confronted with direct indications of fraud. See Transcript dated Feb. 10, 2016, at 3-4. Specifically, PwC’s last alleged approval of Petrobras’s financials in 2014 occurred on August 11, 2014, when Petrobras filed its Form 6-K with the SEC containing its financial statements for the second quarter of 2014. FAC ¶¶ 351, 353. On October 9, 2014, a Brazilian federal court released Costa’s testimony regarding bribery and corruption at Petrobras. Id. ¶ 401. In response, PwC, by no later than November 1, 2014, refused to sign off on Petrobras’s third quarter financial statements in light of the money-laundering and bribery investigations. Id. ¶ 414. A highly plausible inference to be drawn from this timeline is that PwC, instead of “disregard[ing] signs of fraud so obvious that [PwC] must have been aware of them,” took appropriate action upon learning evidence of fraud directly linked with Petrobras itself. In re Advanced Battery Technologies, Inc., 781 F.3d 638, 644 (2d Cir. 2015). In light of this “nonculpable explanation” for PwC’s actions, plaintiffs have failed to adequately plead

scienter with respect to the events of 2014. Tellabs, Inc., 551 U.S. at 314.

Plaintiffs also argue that their § 10(b) claim rests on PwC's actions in 2015, when it allegedly approved Petrobras's release of writedowns and consolidated financial statements for 2012, 2013, and 2014. FAC ¶ 355. Plaintiffs allege these statements were a "whitewash" of the bribery and kickback scheme. Id. ¶ 169. However, the FAC is devoid of scienter allegations with respect to PwC concerning this alleged whitewash. The FAC does not allege that PwC had any motive to participate in a whitewash of the scandal or that it consciously or recklessly approved incorrect figures to diminish the magnitude of the scandal. In the absence of any allegations of scienter on PwC's part in 2015, plaintiffs' § 10(b) claim against PwC fails with respect to the events of 2015.

It should be noted, however, that PwC's alternative ground for dismissing the § 10(b) claim, namely, the alleged failure to adequately plead loss causation, is not persuasive. "To plead loss causation, [a] complaint[] must allege facts that support an inference that [a defendant]'s misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud." Lentell v. Merrill Lynch & Co., Inc., 396 F.3d 161, 175 (2d Cir. 2005). PwC

argues that plaintiffs have failed to meet this standard because they have not alleged specific losses caused by PwC's actions as distinct from the wider bribery revelations. In this respect, PwC relies heavily on Amorosa v. Ernst & Young LLP, 682 F. Supp. 2d 351 (S.D.N.Y. 2010). However, in Amorosa and related cases, the plaintiffs failed to "allege . . . that the truth of [the auditor's opinion] was called into question . . . during the . . . stock decline that caused their losses." Amorosa v. Ernst & Young LLP, 682 F. Supp. 2d 351, 363 (S.D.N.Y. 2010) (quoting In re AOL Time Warner, Inc. Sec. Litig., 503 F. Supp. 2d 666, 678 (S.D.N.Y. 2007)). In contrast, the plaintiffs here have alleged that the financial statements reviewed by PwC were incorrect and that Petrobras acknowledged as much through the writedowns and consolidated reports published on April 22, 2015, in the midst of plaintiffs' losses. FAC ¶ 355; see, e.g., FAC ¶¶ 611-13; 617-18.

Although the losses allegedly caused by PwC's opinions coincide with the alleged losses from the wider corruption allegations, this is not necessarily fatal to a pleading of loss causation against PwC. The allegations in the FAC give rise to a plausible inference that, had PwC discovered the alleged fraud at Petrobras earlier and withheld its clean audit opinions and endorsements, plaintiffs would have been spared at least some ascertainable portion of their losses. See Lentell v. Merrill

Lynch & Co., Inc., 396 F.3d 161, 175 (2d Cir. 2005).

Accordingly, plaintiffs' § 10(b) claim need not be independently dismissed on loss causation grounds.

Turning to the § 11 claim, PwC argues that this claim must be dismissed, pursuant to Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund, 135 S. Ct. 1318 (2015), because PwC's audit opinions were statements of opinion rather than fact. While an auditor's "opinion" is a term of art, the meaning of which may not be entirely synonymous with the more everyday use of the word discussed in Omnicare, the Court need not grapple with this distinction, because, even assuming an auditor's opinion is to be treated the same as the opinions described in Omnicare, that case sets out three avenues of liability for statements of opinion under § 11, two of which are adequately alleged here.

One such avenue is that a defendant is liable under § 11 if its opinions contained "embedded statements of fact" that are untrue. Id. at 1327. Omnicare offered the simple example of a CEO stating, "I believe our TVs have the highest resolution available because we use a patented technology to which our competitors do not have access." Id. The conclusion of the CEO rested on an "underlying fact" of use of specific technology. In much the same way, PwC's audit opinions that "the accompanying consolidated [financial] statement[s] . . . present fairly, in

all material respects, the financial position of [Petrobras]" rested on the underlying facts contained in the financial statements. FAC ¶¶ 524, 527, 626-29. Similarly, PwC stated that its audit opinions were based on "examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements." Id. The facts of the financial statements were embedded in PwC's audit opinions.

One measure of how embedded these underlying facts were within PwC's opinions is the de minimis value investors would place on PwC's opinions were the facts excluded. To invoke Omnicare's example: a saavy consumer will roll her eyes when she hears from a CEO that he believes his TVs have the highest resolution available if he does not base this assessment on any facts. Likewise, PwC's audit opinions would be of no use to anyone if they announced, without any basis in the content of the financial statements or other evidence, that a company's presentation of its financial health was sound.

Moreover, even if these facts were not considered embedded in PwC's audit opinions, plaintiffs still state another of Omnicare's avenues of § 11 liability for opinion statements, namely, omissions liability. To establish omissions liability under Omnicare, a plaintiff must "identify particular (and material) facts going to the basis for the issuer's opinion . . . whose omission makes the opinion statement at issue misleading

to a reasonable person reading the statement fairly and in context." Omnicare, Inc., 135 S. Ct. at 1332. A reasonable person reading PwC's audit opinions fairly and in context would conclude that the financial statements and evidence reviewed by PwC were the bases of its opinions. If these facts were missing from PwC's audit opinions, the opinions would be misleading. Thus, to the extent PwC argues that its audit opinions are pure opinion by severing them from their underlying factual basis, PwC opens itself to omissions liability under Omnicare.

PwC also argues that plaintiffs' § 11 claim fails regardless of whether the underlying financial statements are considered embedded or omitted, because the financial statements are themselves statements of opinion. Specifically, PwC claims that the proper values of Petrobras's assets in use were estimates, based on "uncertain assumptions." See Supplemental Declaration of James J. Capra, Jr. in Support of Defendant PricewaterhouseCoopers Auditores Independentes' Motion to Dismiss Ex. A at 103, ECF No. 412. But a fact-based estimate is different from a subjective opinion. Issuers like Petrobras are required to submit financial statements under the Securities Act, and the Act does not call for an issuer to submit its opinion of what it thinks an asset might be worth. See 17 C.F.R. Pt. 210. Instead, it requires issuers to make factual statements about their financial health and imposes strict liability with

respect to errors and omissions in such statements to "promot[e] 'full and fair disclosure' of material information." Omnicare, Inc., 135 S. Ct. at 1331 (quoting Pinter v. Dahl, 486 U.S. 622, 646 (1988)). The supposition that financial statements are nonactionable opinions flies in the face of the statutory language of § 11, which imposes liability expressly on auditors for portions of registration statements that they certify, see 15 U.S.C. § 77k(a)(4), and long-standing precedent applying the same. See In re Lehman Bro. Sec. and ERISA Litig., 2015 WL 5514692 at *11, *11 n.108 (S.D.N.Y. Sept. 18, 2015) (collecting cases). Accordingly, the financial statements embedded within PwC's audit opinions are actionable under § 11 as facts.

Plaintiffs have alleged that PwC's audit opinion was incorporated, with PwC's consent, into the offering documents for the 2013 and 2014 Note, see FAC ¶¶ 524, 527, 624-29, and that the facts contained in the financial statements reviewed by PwC were untrue, see FAC ¶¶ 611-13; 617-18. An additional inference to be drawn from these allegations is that the supporting evidence PwC relied on when forming its opinion was insufficient or untrue. Accordingly, the FAC adequately "call[s] into question [PwC's] basis for offering the opinion." Omnicare, Inc., 135 S. Ct. at 1332. Therefore, plaintiffs have stated a § 11 claim under Omnicare.

For the foregoing reasons, PwC's motion to dismiss is granted with respect to plaintiffs' § 10(b) claim and denied with respect to plaintiffs' § 11 claim.

The Clerk of Court is directed to close document number 376 on the docket of this case.

SO ORDERED.

Dated: New York, NY
February 18, 2016



JED S. RAKOFF, U.S.D.J.