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## Securities Regulation—Tenth Circuit Allows Lying Executives to Escape Section 10(b) Liability, Leaving Investors Remediless

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**SECURITIES REGULATION—TENTH CIRCUIT ALLOWS  
LYING EXECUTIVES TO ESCAPE SECTION 10(B)  
LIABILITY, LEAVING INVESTORS REMEDILESS**

ROBERT C. UHL\*

**I**N *ANDERSON V. SPIRIT AEROSYSTEMS HOLDINGS, INC.*,<sup>1</sup> the Tenth Circuit incorrectly held that investors failed to establish a cogent, compelling inference of scienter sufficient to prove that Spirit AeroSystems (Spirit) violated Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission’s Rule 10b-5.<sup>2</sup> The majority opinion focuses on four Spirit executives’ forward-looking statements about the company’s projected ability to meet cost targets,<sup>3</sup> but the majority seems to ignore the falsity of those same executives’ statements about then-present facts, arbitrarily eliminating part of the plaintiff investors’ claim. Although Section 10(b) analysis concerns two categories of statements, “those projecting *future* performance, and those reflecting *past* performance,”<sup>4</sup> the Tenth Circuit’s decision drastically narrows the scope of this inquiry, allowing company executives to escape 10(b) liability for inaccurately depicting a project’s factual past performance.<sup>5</sup> The two categories “differ markedly for purposes of a securities fraud claim,”<sup>6</sup> so the court should have preserved the investors’ remedy and concluded that the investors did establish a cogent and compelling inference of scienter for the false statements about the then-current status of a project, as these independently pass the test.<sup>7</sup>

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<sup>1</sup> 827 F.3d 1229 (10th Cir. 2016).

<sup>2</sup> 5 U.S.C. § 78j(b) (2016); 17 C.F.R. § 240.10b-5 (2016).

<sup>3</sup> *Anderson*, 827 F.3d at 1251.

<sup>4</sup> *Id.* at 1252 (Lucero, J., concurring in part and dissenting in part).

<sup>5</sup> *Id.* at 1253.

<sup>6</sup> *Id.* at 1252.

<sup>7</sup> *Id.* at 1256.

A class of investors of Spirit AeroSystems Holdings sued the company and four executive officers for misrepresenting and failing to disclose cost overruns and production delays for three important projects after the company lost nearly a half-billion dollars.<sup>8</sup> Spirit, which produces commercial aerostructures, agreed to supply parts for the Gulfstream Aerospace Corporation's G280 and G650 aircraft and the Boeing Company's 787 "Dreamliner" aircraft.<sup>9</sup> Spirit used a program accounting method for the 787 project to report a profit rate based on actual historical costs of this, and similar type projects, plus future estimated costs.<sup>10</sup> These factors created a "cost curve" that described the average cost per unit over the course of the contract, and because Spirit expected to benefit from a "learning curve" as the project progressed, the cost curve was downward sloping, such that the average cost per unit would decrease as Spirit produced more units.<sup>11</sup> According to Confidential Witness Ten, individual project leaders updated estimates for the project's cost curve quarterly, allowing upper management to see whether the project was "on the curve" (meeting expectations), "above the curve" (over budget), or "below the curve" (under budget).<sup>12</sup>

Confidential Witness Ten, who prepared these projections, also explained that the data showed that the 787 project "costs were much higher than expected," so the project was above its cost curve.<sup>13</sup> Moreover, the witness stated that two of the executives named in the suit actually received the quarterly reports indicating that the 787 project was not properly tracking its forecasted cost curve.<sup>14</sup> However, these executives instead informed investors that the project was on schedule, "tracking per plan to

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<sup>8</sup> *Id.* at 1236, 1251 (majority opinion).

<sup>9</sup> *Id.* at 1235.

<sup>10</sup> *Id.* at 1253 (Lucero, J., concurring in part and dissenting in part); see also Jon Ostrower, *Boeing's Unique Accounting Method Helps Improve Profit Picture*, WALL ST. J. (Oct. 4, 2016), <http://www.wsj.com/articles/boeings-unique-accounting-method-helps-improve-profit-picture-1475522362> [<https://perma.cc/N2DS-PKDR>].

<sup>11</sup> *Anderson*, 827 F.3d at 1253 (Lucero, J., concurring in part and dissenting in part).

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

<sup>13</sup> *Id.*; see also Benjamin Zhang, *Boeing's Most Turbulent Saga of the Past Decade is Finally Over*, BUS. INSIDER (July 27, 2016), <http://www.businessinsider.com/boeing-787-dreamliner-terrible-teens-2016-7> [<https://perma.cc/8LJJ-YS95>] (while *Anderson* does not offer specifics on why the Boeing 787 project was so over budget, Zhang's article may provide an explanation).

<sup>14</sup> *Anderson*, 827 F.3d at 1253 (Lucero, J., concurring in part and dissenting in part).

identify and implement cost improvements,” and that the project was “very much on plan and where we expected to be.”<sup>15</sup> A few quarters later, these executives reiterated their position, emphasizing that “we continue to improve our unit cost performance, as planned,” that the company expected to “continue to track [the 787 project] curve,” and that the 787 project was “going to *keep* coming down the curve.”<sup>16</sup>

Spirit did caution investors to the risks of these projects in its public SEC filings.<sup>17</sup> Spirit’s 10-Q near the beginning of the class period stated that these projects “continue to pose a risk of additional charges and/or forward-loss” based on cost pressures, a 10-K reiterated this sentiment, and even toward the end of the class period, multiple 10-Qs highlighted this serious risk of forward-losses.<sup>18</sup> Despite the seemingly standard “risk of loss” language issued throughout the project, Spirit publicly maintained its ability to meet production deadlines and break even (or even gain) on these projects.<sup>19</sup> Yet to the investors’ surprise, the company announced that it expected to lose “hundreds of millions of dollars on the three projects,” causing the company’s stock price to plummet roughly thirty percent.<sup>20</sup> The plaintiff investors brought this suit alleging that the executives’ statements misled investors and artificially inflated the company’s stock price before Spirit recorded the forward-loss charge.<sup>21</sup>

A claim under Section 10(b) and Rule 10b-5 requires pleading scienter, “a mental state embracing intent to deceive, manipulate, or defraud, or recklessness.”<sup>22</sup> The court weighs the plaintiff’s inference of scienter against “competing inferences rationally drawn from the facts alleged,” and a complaint only satisfies the pleading standard if the inference of fraudulent intent is “cogent and compelling.”<sup>23</sup> Thus, the issue before the

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<sup>15</sup> *Id.*

<sup>16</sup> *Id.* (emphasis added).

<sup>17</sup> *Id.* at 1250 (majority opinion).

<sup>18</sup> *Id.* at 1249–50; Spirit AeroSystems Holdings, Inc., Quarterly Report (Form 10-Q), at 40 (Nov. 4, 2011); Spirit AeroSystems Holdings, Inc., Annual Report (Form 10-K), at 53 (Feb. 14, 2012); Spirit AeroSystems Holdings, Inc., Quarterly Report (Form 10-Q), at 40 (May 4, 2012); Spirit AeroSystems Holdings, Inc., Quarterly Report (Form 10-Q), at 43 (Aug. 7, 2012).

<sup>19</sup> *Anderson*, 827 F.3d at 1235–36.

<sup>20</sup> *Id.* at 1236.

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

<sup>22</sup> *Id.* at 1236–37 (internal quotations omitted) (quoting *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003)).

<sup>23</sup> *Anderson*, 827 F.3d at 1237 (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 310 (2007)).

Tenth Circuit in this case was whether the investors' allegation of the executives' scienter was cogent and compelling.<sup>24</sup> The Tenth Circuit determined that even though Spirit's executives knew the projects had cost problems and might not meet production deadlines, they most likely did not communicate these issues because they were merely "overly optimistic" about the project's potential for success, not because they intentionally misrepresented facts or recklessly ignored financial red flags.<sup>25</sup>

The court began its analysis by weighing the lack of proof of any executive's particular motive to falsify information against an inference of scienter.<sup>26</sup> Even a "general motive[ ] for management to further the interests of the corporation fail[s] to raise an inference of scienter" the court opined.<sup>27</sup> And while plaintiffs do not necessarily need to show a particular motive to prove scienter,<sup>28</sup> "[t]he absence of a motive allegation . . . is relevant."<sup>29</sup> The Tenth Circuit decided that it was not just relevant—a lack of particular motive for securities fraud actually mitigated an inference of scienter.<sup>30</sup>

Next, the court summarily dismissed the importance of the confidential witnesses' testimony, criticizing their positions at Spirit as too far down the hierarchal chain to have specific knowledge of the executives' "mental states," what the executives actually knew or might have known, or what the final cost calculations were.<sup>31</sup> The court even determined that a witness who worked directly with one of the executives was unable to prove anything beyond that executive's extreme optimism because the testimony could not be definitively placed on a timeline of events and did not suggest that the executive wished to intentionally mislead investors.<sup>32</sup>

The investors also alleged that because these top executives were personally in charge of the three projects, they must have

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<sup>24</sup> *Id.* at 1238.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 1238–39.

<sup>27</sup> *Id.* (quoting *In re Level 3 Commc'ns, Sec. Litig.*, 667 F.3d 1331, 1347 (10th Cir. 2001)); *see also* *City of Phila. v. Fleming Cos.*, 264 F.3d 1245, 1269 (10th Cir. 2001).

<sup>28</sup> *Nakkhumpun v. Taylor*, 782 F.3d 1142, 1152 (10th Cir. 2015).

<sup>29</sup> *In re Level 3*, 667 F.3d at 1347 (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 310 (2007)).

<sup>30</sup> *Anderson*, 827 F.3d at 1238.

<sup>31</sup> *Id.* at 1243–44; *see also* *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 998 (9th Cir. 2009).

<sup>32</sup> *Anderson*, 827 F.3d at 1245.

known the projects would not meet their cost forecasts.<sup>33</sup> But the court relied heavily on *City of Philadelphia v. Fleming Companies* to conclude that scienter could not be inferred solely from the executives' position in the company or involvement with the projects.<sup>34</sup> Again, the investors' alleged inference of scienter was deemed not cogent or compelling enough to outweigh the court's decision that executives were simply "overly optimistic," despite testimonial evidence of the executives' attendance at meetings where the projects were discussed.<sup>35</sup> And while precedent clearly establishes that this factor cannot be the *sole* reason for a cogent and compelling inference of scienter, the court seems to dismiss it completely without regard to its weight among all the other arguments that the investors put forth.<sup>36</sup>

Finally, the investors argued that the existence of a recovery plan for the 787 project, the CEO's admission of the company's failure to meet projections, and Spirit's disclosure of the risks of loss all indicated that the executives knew of the problems and failed to accurately communicate them.<sup>37</sup> The investors also argued that the magnitude of the forward loss was so large (\$434.6 million) that the executives must have known before they made public statements.<sup>38</sup> But, the court again swiftly side-stepped these points, dismissing them as "fraud by hindsight," too tenuous to establish a cogent and compelling inference.<sup>39</sup> Ultimately, the court dismissed every one of the investor's arguments as insufficient on its own to reach cogent and compelling, and apparently, they were not cogent and compelling collectively either.<sup>40</sup> The Tenth Circuit chalked the nearly half-billion dollar loss up to the executives' extreme over-optimism and the company not learning as fast as its cost curves predicted, not "a cogent and compelling inference of scienter."<sup>41</sup>

The court's decision appears to afford dangerous deference to company executives to say just about anything they want with no fear of liability to shareholders, enabling executives to hide

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<sup>33</sup> *Id.*

<sup>34</sup> *Id.*; see also *City of Phila. v. Fleming Cos.*, 264 F.3d 1245, 1264 (10th Cir. 2001).

<sup>35</sup> *Anderson*, 827 F.3d at 1246.

<sup>36</sup> *Id.*; see also *City of Phila.*, 264 F.3d at 1264.

<sup>37</sup> *Anderson*, 827 F.3d at 1247–50.

<sup>38</sup> *Id.* at 1251.

<sup>39</sup> *Id.* at 1250; see *City of Phila.*, 264 F.3d at 1261; see also *In re Zagg, Inc. Sec. Litig.*, 797 F.3d 1194, 1204–05 (10th Cir. 2015).

<sup>40</sup> *Anderson*, 827 F.3d at 1251.

<sup>41</sup> *Id.* at 1238, 1249.

behind a shield of corporate “optimism.”<sup>42</sup> The Tenth Circuit refused to equate scienter with “failing to give adequate weight to financial red flags” and telling investors the opposite of what updated cost projections predicted.<sup>43</sup> Evidently being “negligent in failing to put together the pieces” carries no liability.<sup>44</sup> But while reasonable minds may differ on the culpability of the executives’ forward-looking statements, the opinion’s more glaring issue is the court’s apparent failure to address the implications of the executives’ false and misleading statements about then-present facts.<sup>45</sup>

The dissent correctly highlighted this oversight, concluding that while the investors may not have properly proved scienter regarding the forward-looking statements, they did in fact prove scienter for two executives’ statements about the then-current performance of Spirit’s 787 program.<sup>46</sup> First, the dissent separated the two categories of statements before the court: “those projecting *future* performance, and those reflecting *past* performance;” then, it admitted that the majority was correct in its analysis of the future statements.<sup>47</sup> But the majority stopped its analysis there, so the dissent argued that even though part of the statements were opinions about the future (and thus not actionable), the executives still inaccurately described the 787 project’s current status, and those false statements *are* actionable.<sup>48</sup> Two Spirit executives knew that the project was above its cost curve (over budget) because Confidential Witness Ten testified to giving them copies of the quarterly report indicating as such, yet these executives still “repeatedly informed investors that 787 program costs were declining as planned.”<sup>49</sup>

While the majority discredited the witness’s ability to testify directly to the executives’ scienter, a court must accept the complaint’s factual allegations as true in a *de novo* review,<sup>50</sup> so the witness *can* at least establish that the executives received these

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<sup>42</sup> See *id.* at 1238.

<sup>43</sup> *Id.* at 1238.

<sup>44</sup> *Id.* (quoting *In re Level 3 Commc’ns, Sec. Litig.*, 667 F.3d 1331, 1345 (10th Cir. 2001)).

<sup>45</sup> See *Anderson*, 827 F.3d at 1251.

<sup>46</sup> *Id.* at 1251.

<sup>47</sup> *Id.* at 1252 (Lucero, J., concurring in part and dissenting in part).

<sup>48</sup> *Id.* at 1251–52.

<sup>49</sup> *Id.* at 1253.

<sup>50</sup> See *id.* at 1237 (majority opinion); see also *Dronsejko v. Thornton*, 632 F.3d 658, 666 (10th Cir. 2011).

quarterly reports.<sup>51</sup> The majority quoted *City of Philadelphia* to define recklessness,<sup>52</sup> which the dissent also reproduced, as “conduct that is an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”<sup>53</sup> The dissent correctly indicates, then, that after the executives read the reports, telling investors that the project’s costs were declining when they were not would certainly “present[ ] a danger of misleading buyers,” and is in fact an outright intentional lie.<sup>54</sup> Even if the executives had not actually read the reports, that too would be an “extreme departure from the standards of ordinary care,” repeatedly informing investors based on zero information.<sup>55</sup>

Taken together with all the other arguments the majority jointly dismisses as not strong enough to create a cogent and compelling inference—that the 787 project was key to Spirit’s bottom line as part of its core business (twenty percent of total revenue),<sup>56</sup> that the magnitude of the falsity (the 787 project alone resulted in \$184 million in forward-losses, one quarter of reported earnings two years prior) was so large executives had to have known,<sup>57</sup> and that the executives had a general desire to protect their own position<sup>58</sup>—the dissent concludes that the investors did in fact prove scienter as to the statements made by two executives regarding the status and progress of the 787 project.<sup>59</sup>

In this case, innocent investors were left completely cheated, bearing the entire cost of the executives’ risk-loving “over optimism.” By refusing to consider liability for misleading the investors and even intentionally lying to them about then-present facts, the majority sends a dangerous message to corporate of-

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<sup>51</sup> See *Anderson*, 827 F.3d. at 1255 (Lucero, J., concurring in part and dissenting in part); see also *id.* at 1245 (majority opinion).

<sup>52</sup> *Id.* at 1237 (majority opinion).

<sup>53</sup> *Id.* at 1255 (Lucero, J., concurring in part and dissenting in part) (quoting *City of Phila. v. Fleming Cos.*, 264 F.3d 1245, 1260 (10th Cir. 2001)).

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*; see also *Reese v. Malone*, 747 F.3d 557, 575 (9th Cir. 2014).

<sup>57</sup> *Anderson*, 827 F.3d at 1255 (Lucero, J., concurring in part and dissenting in part); see also *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1106 (10th Cir. 2003).

<sup>58</sup> *Anderson*, 827 F.3d at 1255–56 (Lucero, J., concurring in part and dissenting in part); see also *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1191 (10th Cir. 2003).

<sup>59</sup> *Anderson*, 827 F.3d at 1256.

ficers that as long as they can make statements under the guise of opinions about the future that are not “demonstrably false,” they will escape liability.<sup>60</sup>

Moreover, *In re Zagg* requires the court to consider whether *all* of the facts alleged give rise to a strong inference of scienter, “not whether any individual allegation, scrutinized in isolation, meets that standard.”<sup>61</sup> Simply put, the majority failed to consider all of the facts holistically and prevented the investors from recovering from their loss.<sup>62</sup> The court also seems to ignore its own definition of scienter: “a mental state embracing intent to deceive, manipulate, or defraud, *or recklessness.*”<sup>63</sup> While the majority continues to harp on the “over-optimism” of the executives and emphasizes a lack of proof to their intent, only the dissent truly tests the facts against the recklessness standard—and it finds liability.<sup>64</sup> So the majority ignores a critical piece of the Section 10(b) puzzle.<sup>65</sup> Either the executives were incompetent enough in managing these projects that they did not comprehend the potential loss or they were so blindingly optimistic that they failed to temper investor expectations adequately. Regardless, the standard that the Tenth Circuit sets in this case appears extremely deferential toward executives at the cost of investors.

As it relates to the airline industry specifically, Spirit’s projects supplied parts for three very commonly manufactured planes, Gulfstream’s G280 and its “crown jewel,” the G650,<sup>66</sup> and Boeing’s state-of-the-art 787 “Dreamliner,” which continues to pervade the market.<sup>67</sup> As more and more companies like Spirit enter the marketplace to provide parts, and especially as these companies want to be part of the Dreamliner trend, they have learning curves. A company’s ability to predict, and more impor-

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<sup>60</sup> *Id.* at 1251–52.

<sup>61</sup> *Id.* at 1237 (majority opinion); see *In re Zagg, Inc. Sec. Litig.*, 797 F.3d 1194, 1201–02 (10th Cir. 2015).

<sup>62</sup> *Anderson*, 827 F.3d at 1251.

<sup>63</sup> *Id.* at 1236–37 (internal quotations omitted) (emphasis added).

<sup>64</sup> *Id.* at 1255–56 (Lucero, J., concurring in part and dissenting in part).

<sup>65</sup> *Id.*

<sup>66</sup> See *id.* at 1235 (majority opinion); Kerry Lynch, *Full Steam Ahead for Gulfstream’s G650, G280*, AVIATION WEEK (Sept. 10, 2012), <http://aviationweek.com/blog/full-steam-ahead-gulfstream-s-g650-g280>.

<sup>67</sup> *Anderson*, 827 F.3d at 1235; Dan Catchpole, *Boeing 787 Delays Coincided with Spike in Airbus A330 Leases*, HERALDNET (Sept. 28, 2016), <http://www.heraldnet.com/business/boeing-787-delays-coincided-with-spike-in-airbus-a330-leases>; see also Zhang, *supra* note 13.

tantly, stay on its curve certainly determines its likelihood of repeat business, but large project losses of any sort breed litigation against executives, whether information was hidden from investors or fully disclosed.<sup>68</sup> *Anderson v. Spirit AeroSystems Holdings Inc.* seems to say that as long as statements aren't completely ludicrous, the Tenth Circuit will allow executives to err on the side of sheer optimism in addressing investors' concerns, even when they end up losing nearly half of a billion dollars.<sup>69</sup>

The case cautions that extra attention must be paid to executives' statements to investors about the company's cost and learning curves. This rings particularly true for Boeing and its 787 project suppliers, given that the 787 project is a project that, on Boeing's end, has already been embroiled in delays and setbacks.<sup>70</sup> Boeing uses a similar accounting method to Spirit, called "program accounting," which calculates Dreamliner earnings and costs based on "10-year forecasts of supplier contracts, aircraft orders and options, productivity improvements, labor contracts and market conditions."<sup>71</sup> This requires Boeing to defend its cost curves tightly, and any projection into the long-term future always risks major loss due to uncertainty.<sup>72</sup> While Boeing executives "continue to believe [the 787] will be a significant contributor to Boeing's success for decades to come,"<sup>73</sup> any project loss is sure to spawn litigation similar to this case. The Tenth Circuit appears to provide some shelter for executives, but with Spirit moving off the chopping block, investors may be looking for a new big target. They may only need to move up the chain.

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<sup>68</sup> Robert C. Epstein, *How Construction Contracts Cause Litigation*, GP SOLO LAW TRENDS & NEWS, Feb. 2005, [http://www.americanbar.org/content/newsletter/publications/law\\_trends\\_news\\_practice\\_area\\_e\\_newsletter\\_home/construction\\_contracts.html](http://www.americanbar.org/content/newsletter/publications/law_trends_news_practice_area_e_newsletter_home/construction_contracts.html).

<sup>69</sup> See *Anderson*, 827 F.3d at 1235–51.

<sup>70</sup> See Zhang, *supra* note 13.

<sup>71</sup> Ostrower, *supra* note 10.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*