

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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| IN RE PENN WEST PETROLEUM | : | |
| LTD. SECURITIES LITIGATION | : | No. 14-cv-6046 (JGK) |
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**DEFENDANTS' MEMORANDUM OF LAW IN SUPPORT OF THEIR MOTION
TO DISMISS THE CONSOLIDATED AMENDED CLASS ACTION COMPLAINT**

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March 6, 2015

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PRELIMINARY STATEMENT

Reflexively suing on the announcement of a financial restatement, Plaintiffs have brought a putative “stock drop” class action against Defendants Penn West Petroleum Ltd. (“Penn West”), its President and CEO, David E. Roberts, two former Presidents and CEOs, William E. Andrew and Murray R. Nunns, and two former CFOs, Todd H. Takeyasu and Jeffery Curran (collectively, the “Individual Defendants”). Plaintiffs claim that, from February 18, 2010 through July 29, 2014 (the “putative class period”), Defendants made misstatements about Penn West’s costs and accounting practices in order to hide Penn West’s high operating expenses. Plaintiffs contend that they were harmed (i) when Penn West’s stock price dropped 14% on July 29, 2014, after the Company voluntarily disclosed its intention to reclassify certain expenses and to restate its financials, and (ii) by an unrelated stock drop of 15.7% nearly nine months earlier on November 6, 2013, when Penn West announced its quarterly earnings and a strategic review (but said nothing about any accounting errors or possible restatement).

As required by the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 (“Reform Act”), 15 U.S.C. § 78u-4, and Rule 9(b) of the Federal Rules of Civil Procedure, this Court should dismiss the Consolidated Amended Class Action Complaint (“Amended Complaint” or “AC”) with prejudice.

First, Plaintiffs do not allege, as required by the Reform Act, facts giving rise to a “strong inference” that Defendants acted with fraudulent intent. Penn West’s restatement mainly involved reclassifying certain expenses as operating, capital, or royalty expenses, and there is no allegation that any Defendant misstated Penn West’s financials for any personal, concrete benefit, such as to profit on insider trading. Accordingly, Plaintiffs are left to claim conclusorily that Defendants were driven to commit fraud to maintain the appearance of profitability. But the Second Circuit has repeatedly held that this generalized motive, possessed by all corporate

executives, is legally insufficient to establish the required strong inference of scienter. *See* cases cited *infra* at 17 to 18.

Because Plaintiffs do not plead motive, they must allege facts raising an even “stronger inference,” *Kalnit v. Eichler*, 264 F.3d 131, 143 (2d Cir. 2001), that Defendants acted knowingly or with conscious recklessness, *i.e.*, with “an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it,” *ECA, Loc. 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 198 (2d Cir. 2009) (citation omitted). Tellingly, Plaintiffs do not cite a single internal Penn West document or confidential witness—even one—showing that any Defendant acted knowingly or with conscious recklessness in stating the Company’s expenses.

Instead, Plaintiffs rely exclusively on Penn West’s own voluntary disclosures filed with the Securities and Exchange Commission (“SEC”) about its internal accounting review and restatement to contend that a fraud occurred, even though none of Penn West’s disclosures suggested that any Defendant engaged in fraud. Specifically, the Amended Complaint conclusorily—and erroneously—alleges that Penn West “*admitted that the fraud was designed and executed at the highest levels of Penn West,*” citing the Company’s July 29, 2014 and September 18, 2014 press releases, which stated that the improper accounting practices corrected by the restatement “occurred at the corporate level,” and that “senior finance and accounting personnel” and “senior accounting management” were responsible for those practices. (AC ¶¶ 11, 52 (emphasis added); *see* AC ¶¶ 44, 113, 116, 118, 119, 122, 123.) But, by their terms, these references do not include the Individual Defendants (all CEOs and CFOs), or anyone else who made the challenged disclosures.

Moreover, courts have rejected the other allegations that Plaintiffs rely on to plead scienter—the general importance of the financial metrics restated, the size and nature of the restatement, and the timing of the resignation of Penn West’s CFO and the discovery of the errors. *See* cases cited *infra* at 19 to 29. The deficient accounting practices that led to Penn West’s restatement were not the type of obvious or dramatic errors about which the Company’s most senior executives necessarily would have known. Once corrected, these errors had a limited effect on Penn West’s reported operating expenses (only between 16% and 20%) and an even more limited effect on reported profitability metrics that Plaintiffs contend were key for the Company and investors (only between 3% and 7%). In fact, certain of the accounting errors resulted from Penn West accounting personnel misclassifying capital expenses as operating expenses, something that would have made *no sense* for Defendants to do if their goal was to hide high operating expenses. And, Penn West’s outside auditor, KPMG, provided clean audit opinions for the Company’s financial statements and internal controls throughout the putative class period. Thus, the “opposing inference of nonfraudulent intent”—that Defendants reasonably relied on Penn West’s accounting department and outside auditor to follow proper accounting procedures and then sought to fix the accounting errors as soon as the Company’s senior executives learned of those errors—is the far more compelling inference than the speculative allegations of fraud in the Amended Complaint. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007).

Second, the Individual Defendants’ statements about their beliefs, aims, or goals for reducing Penn West’s operating costs constitute opinions not actionable as a matter of law, because Plaintiffs do not allege with the required particularity that those opinions were both false and not honestly believed. *See* cases cited *infra* at 33 to 34.

Third, the Amended Complaint does not plead adequately that the 15.7% decline in Penn West's stock price on November 6, 2013 had anything to do with the accounting restatement on which Plaintiffs rest their claims. Indeed, Penn West's November 6, 2013 disclosure simply stated that the Company was experiencing higher than expected operating costs and was looking to reduce those costs; this disclosure said nothing about any accounting errors. Therefore, Plaintiffs fail as a matter of law to plead loss causation as to the November 6 stock drop. *See* cases cited *infra* at 34 to 35.

BACKGROUND¹

A. Defendants

Penn West “is one of the largest conventional oil and natural gas producers in Canada.” (AC ¶ 21.) Throughout the putative class period, Penn West had more than \$12 billion in total assets. In 2013, the last full year of the putative class period, Penn West had gross revenues of more than \$2.8 billion.² (Exhibit (“Ex.”) 1 (Form 6-K, Ex. 99.1 at 1, 13 (Mar. 7, 2014)) at 13.)³ Since June 2013, Mr. Roberts has served as Penn West's President and CEO.

¹ The following facts are drawn from (i) the Amended Complaint; (ii) “statements or documents incorporated into the complaint by reference” *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007); (iii) “legally required public disclosure documents filed with the SEC” (*id.*); and (iv) judicially noticeable matters, including published stock prices *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 166 n.8 (2d Cir. 2000).

² Except for stock and oil prices, which are expressed in U.S. Dollars, dollar figures referenced herein are expressed in Canadian Dollars, as reported by Penn West in its SEC filings.

³ Unless otherwise specified, all exhibits cited are contained in the March 6, 2015

(footnote continued...)

(AC ¶ 24.) Mr. Nunns was Penn West’s CEO from August 2011 until June 2013 (AC ¶ 23), and before him Mr. Andrew was CEO from May 2005 until August 2011 (AC ¶ 22). Mr. Takeyasu served as Penn West’s CFO from May 2005 through March 24, 2014, and Mr. Curran was interim CFO from March 24, 2014 until May 1, 2014. (AC ¶¶ 25-26.)

B. Accounting Rules for Capital Expenses, Operating Expenses and Royalties

Penn West’s September 18, 2014 restatement corrected accounting errors that misclassified (i) certain operating expenses as either capital or royalty expenses (AC ¶ 5), and (ii) certain capital expenses as operating expenses (Ex. 2 (Sept. 18, 2014 Press Release) at 2). Plaintiffs claim that these errors were designed primarily to conceal Penn West’s true operating costs. (AC ¶¶ 5-6.)

From February 18, 2010, the start of the putative class period, through December 2010, Penn West applied Canadian Generally Accepted Accounting Principles (“Canadian GAAP”) to its financial statements. Thereafter, Penn West applied International Financial Reporting Standards (“IFRS”) and International Accounting Standards (“IAS”). (AC ¶ 279.)

Under Canadian GAAP, IFRS and IAS, certain expenses incurred in the production of oil and gas are treated as “operating expenses,” *i.e.*, expenses charged against the Company’s revenues in arriving at net income, while other expenses are “capitalized,” *i.e.*, included as an asset on the Company’s balance sheet and amortized over time. (Ex. 3 (IAS §§ 1.54, 1.99).) In general, an expense may be capitalized if: “(a) it is probable that future economic benefits associated with the item will flow to the entity; and (b) the cost can be

(...continued footnote)

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measured reliably.” (*Id.*, IAS § 16.7; *see also* Ex. 4 (Canadian GAAP § 16.7); AC ¶ 282.) Deciding whether an expenditure is an operating or a capital expense requires “*the application of professional judgment*” based on the “*specific circumstances*” surrounding each item. (Ex. 4 (Canadian GAAP § 1000.43) (emphasis added); *see also* Ex. 3 (IAS § 16.9) (“*judgement is required*” based on the “*specific circumstances*” in deciding whether to capitalize an expenditure) (emphasis added).) Plaintiffs do not allege that any Individual Defendant determined how to classify Penn West’s operating or capital expenses for specific items.

Royalties represent “the government’s share of the natural resources exploited and are a share of production free of cost.” (AC ¶ 284.) For Penn West, “[r]oyalties from production on [government] lands are determined by governmental regulation and are generally calculated as a percentage of the value of gross production. The rates of royalties payable generally depend in part on prescribed reference prices, well productivity, geographical location, field discovery date, method of recovery and the type or quality of the petroleum product produced.” (AC ¶ 284.) Once accrued, “[r]oyalties should be excluded from the revenue recognised by the entity” on its income statement. (Ex. 5 (PwC, *Financial Reporting in the Oil and Gas Industry* at 29 (2011) (citing IAS 18.8)).) Plaintiffs do not allege that any Individual Defendant determined how to allocate any particular royalty expense.

C. Funds Flow and Netback

Penn West’s September 18, 2014 restatement also impacted the Company’s previously reported “funds flow” and “netback”—financial metrics not defined under IFRS, IAS or Canadian GAAP, but that Plaintiffs allege were important to Penn West and its investors. (*E.g.*, AC ¶¶ 3, 6-7, 34-39, 46, 66, 86.) Funds flow is “cash flow from operating activities before changes in non-cash working capital and decommissioning expenditures.” Penn West used that

metric “to assess [its] ability to fund dividend and planned capital programs.” (Ex. 6 (Form 40-F, Ex. 99.2 (Mar. 15, 2013)) at 1.) Netback is “the per unit of production amount of revenue less royalties, operating costs, transportation and realized risk management.” (*Id.*) Penn West used the netback metric “in capital allocation decisions and to economically rank projects.” (*Id.*)

D. KPMG’s Clean Audits of Penn West’s Financial Statements and Internal Controls

Throughout the putative class period, KPMG audited Penn West’s annual financial statements and reviewed its internal controls. Plaintiffs do not allege that KPMG ever questioned Penn West’s financial reporting, accounting methodologies, or internal controls. Indeed, the Amended Complaint conspicuously ignores that each annual report Penn West filed during the putative class period contained unqualified opinions from KPMG that the Company’s consolidated financial statements “present fairly, in all material respects, the financial position of Penn West . . . and its consolidated financial performance and its consolidated cash flows,” and that Penn West “maintained, in all material respects, effective internal control over financial reporting” during those years. (Ex. 7 (Form 40-F, Ex. 99.3 (Mar. 22, 2010)) at 3; Ex. 27 (Form 40-F, Ex. 99.3 (Mar. 22, 2011)); Ex. 8 (Form 40-F, Ex. 99.3 (Mar. 16, 2012)) at 3; Ex. 6 (Form 40-F, Ex. 99.3 (Mar. 15, 2013)) at 3; Ex. 22 (Form 40-F, Ex. 99.3 (Mar. 7, 2014).)

E. Penn West’s 2013 Strategic Review

During the putative class period, “Penn West struggled to keep its operating costs under control.” (AC ¶ 3.) By May 1, 2013, Penn West’s stock had fallen more than 53% from its \$19.38 share price on February 18, 2010 (the start of the putative class period) to \$9.07. (Ex. 9 (Table of Penn West Stock Prices) at 1-2.) The Amended Complaint does not allege that any misstatements or deficient accounting practices caused this decline.

In response to business setbacks, on May 2, 2013, Penn West disclosed that its Board of Directors had “commenced a renewal process” with the appointment of a new chairman. (Ex. 10 (Form 6-K, Ex. 99.2 (May 3, 2013)) at 1.) On June 4, 2013, as part of that process, Penn West announced Mr. Roberts’ appointment as President and CEO, replacing Mr. Nunns (AC ¶¶ 23-24), and that “[t]he Company . . . will focus on operating the business in a more efficient manner, significantly reducing General and Administrative expenses as well as field operating costs” (Ex. 11 (June 5, 2013 Press Release) at 1). Penn West also announced that its Board had reduced the Company’s dividend, and formed a Special Committee to “consider all alternatives to increase shareholder value, including strategic financing alternatives, asset divestments, joint ventures and/or other business combinations,” with the review to “be completed by year end.” (*Id.* at 2.) By August 22, Penn West disclosed a 25% reduction in its workforce during 2013 “as part of the ongoing process to improve competitive performance.” (Ex. 12 (Aug. 23, 2013 Press Release) at 1.)

On November 6, 2013, Penn West announced its results for the third quarter of 2013 and the Board’s strategic review, including that the Board had approved the disposition of between \$1.5 and \$2.0 billion in assets “to reduce Penn West’s leverage . . . and to focus its operational teams on fewer, more concentrated plays.” (Ex. 13 (Form 6-K, Ex. 99.2 (Nov. 7, 2013)) at 2.) Recognizing that the Company had “cut costs, improved capital performance, [and] demonstrated [its] focus on value added production,” Penn West further disclosed that it would “continue development, operating and administrative costs reduction actions.” (*Id.* at 1-2.) The November 6 press release made no mention of Penn West’s accounting practices or of a potential restatement of the Company’s financials. (*Id.*) That day, Penn West’s stock price declined from \$11.09 to close at \$9.35 per share. (AC ¶ 88.)

On March 24, 2014, Penn West announced that its then-CFO, Mr. Takeyasu, was stepping down, and that David Dyck would replace him as of May 1, 2014. (AC ¶ 97.) Mr. Curran, then-Vice President of Accounting and Reporting, was appointed to “fulfill the responsibilities of CFO in the interim period ensuring an orderly transition.” (Ex. 14 (Mar. 24, 2014 Press Release) at 1.)

F. Penn West’s 2014 Voluntary Accounting Practices Review and Restatement

On July 29, 2014, Penn West announced that its Audit Committee was “conducting a voluntary, internal review of certain of the Company’s accounting practices,” including “the capitalization of certain operating costs as property, plant and equipment, the income statement classification of certain costs and credits, and the timing of certain accruals relating to production, operating costs and capital.” (Ex. 15 (July 30, 2014 Press Release) at 1-2.) Penn West stated that these practices “came to the attention of” Mr. Dyck after joining the Company in May 2014, and that “[t]he Company’s management then recommended to the Board of Directors that the Audit Committee conduct an independent review of these practices.” (*Id.* at 1.) To assist in its review, “[t]he Audit Committee, comprised solely of independent directors, retained independent Canadian and U.S. legal counsel, and an independent forensic accounting firm.” (*Id.*) Penn West also “voluntarily informed the Alberta Securities Commission . . . and the [SEC] about its internal review.” (*Id.* at 3 (emphasis added).)

Penn West’s July 29 announcement stated that the Audit Committee and its advisors were “examining certain entries which *appear* to have been made to reduce operating costs and increase the Company’s reported capital expenditures and royalty expense, and that *appear* to have been made without adequate supporting documentation.” (*Id.* at 1 (emphasis added).) Penn West also announced that its Board “ha[d] made a decision to restate the

Company's audited financial statements" for fiscal years 2012 and 2013, "its unaudited interim financial statements" for the first quarter of 2014, as well as "all related [management discussion and analysis]," and "expect[ed] . . . the effect . . . will be to reduce historical reported capital expenditures, property, plant and equipment balances, royalty expenses and depletion expense and increase operating expenses," among other things. (*Id.* at 3.) Penn West explained that the accounting practices did "*not affect previously disclosed cash and debt balances or previously released 2014 production guidance,*" or the Company's "operations, strategy and anticipated growth going forward." (*Id.* at 1 (emphasis added).)

The July 29 announcement further stated that "[t]he senior finance and accounting personnel believed responsible for the adoption and use of these practices have ceased to be employed by the Company," but never suggested that any Individual Defendant was involved in, or previously aware of, those practices. (*Id.* at 3.) This disclosure did not accuse anyone of fraud. Penn West's stock price dropped 14%, from \$9.15 at the close of trading on July 29, 2014 to \$7.85 at the close on July 30, 2014. (AC ¶ 107.)

On September 18, 2014, Penn West announced the results of its internal review, and restated its financials for 2012, 2013, and the first quarter of 2014. (Ex. 2 (Sept. 18, 2014 Press Release); AC ¶ 111.) This restatement resulted primarily from two accounting practices:

First, the review found "that certain operating expenses were reclassified to property, plant and equipment [*i.e.*, capital expenses] without adequate support and were determined to be incorrectly recorded as property, plant and equipment," and conversely—and contrary to Plaintiffs' theory that Defendants were trying to hide Penn West's high operating expenses—that certain capital expenditures "were incorrectly classified as operating expenses." (Ex. 2 (Sept. 18, 2014 Press Release) at 2.)

Second, the review found that Penn West had classified a portion of operating expenses as royalties in its income statement to account for “the fact that the Company incurs certain expenses producing royalty holders’ share of production.” (*Id.* at 3.) The review “determined that this practice was not appropriate” and reversed those classifications. (*Id.*) This portion of the restatement had no effect on Penn West’s net income, or its previously reported funds flow or netback.⁴ (*Id.*)

Penn West disclosed the effects of the restatement on several key financial metrics, which resulted in an *improvement* of net income in 2013 and the first quarter of 2014, as well as limited changes in operating expenses, funds flow and netback:

| Net Change in Financial Metric | 2012 | Change (%) | 2013 | Change (%) | Q1 2014 | Change (%) |
|---------------------------------------|-----------------------------|-------------------|-----------------------------|-------------------|----------------------------|-------------------|
| Operating Expenses | <i>Increased</i> \$167MM | 16% | <i>Increased</i> \$172MM | 20% | <i>Increased</i> \$28MM | 16% |
| Net Income | <i>Decreased</i> \$24MM | (16%) | <i>Increased</i> \$29MM | 3% | <i>Increased</i> \$7MM | 7% |
| Net Change in Financial Metric | 2012 | Change (%) | 2013 | Change (%) | Q1 2014 | Change (%) |

⁴ The review also found certain improper capital expenditure accruals, but “[t]hese adjustments [did] not have an impact on net income or retained earnings,” and that certain oil and natural gas sales and associated volumes were not recorded on a timely basis, but “were not material in volumes or dollars.” (*Id.*) Plaintiffs do not allege that these accounting errors were material and do not tie any alleged misstatements to them.

| | | | | | | |
|--------------------|----------------------------|------|----------------------------|------|----------------------------|------|
| Funds Flow | <i>Decreased</i> \$66MM | (5%) | <i>Decreased</i> \$69MM | (7%) | <i>Decreased</i> \$10MM | (4%) |
| Netback/boe | <i>Decreased</i> \$1.13 | (4%) | <i>Decreased</i> \$1.45 | (5%) | <i>Decreased</i> \$1.15 | (3%) |

(*Id.*; AC ¶¶ 188, 248, 262.)⁵ Even after the restatement’s overall corrections, Penn West had successfully reduced its operating costs over the restated periods. Specifically, operating expenses declined from \$1.186 billion in 2012 to \$1.025 billion in 2013 (more than 13.5%), and declined from \$272 million in the first quarter of 2013 to \$204 million in the first quarter of 2014 (25%). (Ex. 16 (Restated Form 40-F, Ex. 99.2 (Sept. 18, 2014)) at 11; Ex. 17 (Restated Form 6-K, Ex. 99.1 (Sept. 18, 2014)) at 2.)

Penn West’s review also found that “the accounting practices identified . . . *went undetected*” in part because of “several material weaknesses and a significant deficiency in Penn West’s internal control over financial reporting and control systems.” (Ex. 2 (Sept. 18, 2014 Press Release) at 4 (emphasis added).) These weaknesses included that “senior *accounting* management did not adequately establish and enforce a strong culture of compliance and

⁵ The improvement in net income in 2013 and the first quarter of 2014 occurred because (i) by reversing improperly capitalized expenses, Penn West’s depletion and depreciation expenses and losses on dispositions of assets *decreased*, which in turn *increased* the Company’s reported net income, and (ii) the remaining adjustments to operating expenses came from reclassification of royalty expenses to operating expenses (\$101 million in 2013 and \$18 million in the first quarter of 2014), which had no effect on net income. (Ex. 16 (Restated Form 40-F, Ex. 99.2 (Sept. 18, 2014)) at 11; Ex. 17 (Restated Form 6-K, Ex. 99.1 (Sept. 18, 2014)) at 2.)

controls.” (*Id.* (emphasis added).) Without identifying any particular persons, the Company reported in its restatement that: (1) “[t]here was a *lack of awareness or willingness of some staff with knowledge of improper accounting practices* to utilize the Company’s independently administered whistle blower hotline or to take other actions that could have identified the improper accounting practices *to the appropriate persons on a more timely basis*” (Ex. 17 (Restated Form 6-K, Ex. 99.3 (Sept. 18, 2014)) at 19 (emphasis added)); and (2) “*reviewers* in some instances approv[ed] journal entries without appropriate documentation” (*id.* (emphasis added)).⁶ Penn West further disclosed that “the senior finance and accounting personnel who were at the Company and involved in the adoption and use of the accounting practices that led to the restatement of our financial statements” had left after the “*unrelated restructuring* of [Penn West’s] accounting and finance departments” that began before Mr. Dyck discovered the deficient accounting practices. (Ex. 2 (Sept. 18, 2014 Press Release) at 4.)

On this announcement, Penn West stock rose more than 8%, from \$7.01 at close the day before to \$7.62. (Ex. 9 (Table of Penn West Stock Prices) at 3.)

G. The Alleged Misstatements

Plaintiffs contend that Defendants made the following misstatements about Penn West’s expenses and internal controls during the putative class period.

⁶ The review also found that, in regards to Penn West’s capital accruals, “senior *accounting* management overrode the outcomes from such processes and did not record the correct amounts in the appropriate period.” (*Id.* (emphasis added).) Again, Plaintiffs do not allege that these overrides were material or tie any alleged misstatements to them.

Financial Statements: The Amended Complaint alleges that Penn West’s quarterly and annual reports misstated Penn West’s operating expenses, capital expenses, and royalties and, as a result, misstated funds flow and netbacks from February 18, 2010 to May 1, 2014. (AC ¶¶ 1, 5.) Plaintiffs allege that “investors were extremely focused” on funds flow and netbacks, “because they were a critical driver of the Company’s financial performance.” (AC ¶ 28.)

Certifications by Penn West’s CEOs and CFOs: Plaintiffs also allege that the Individual Defendants’ certifications of Penn West’s financial statements and internal controls were false or misleading, because Penn West “in fact, lacked adequate internal controls over its financial reporting, and its financial results were materially misstated as a result of the accounting fraud.” (AC ¶ 166; *see also* AC ¶¶ 180, 199, 214, 229, 241, 258, 271.) Those certifications stated that, based on the CEO and/or CFO’s “knowledge, having exercised reasonable diligence,” Penn West’s quarterly and annual financials “fairly present[ed]” the Company’s financial condition and results of operations, and that Penn West had established a system of “internal control[s]” designed to provide “reasonable assurance” that the financials were accurate.⁷

⁷ See Ex. 18 (Form 52-109F2, Ex. 99.3 (May 6, 2010)) at 1 (Andrew); Ex. 19 (Form 52-109F2, Exs. 99.2 & 99.3 (May 4, 2012)) at 1 (Nunns, Takeyasu); Ex. 20 (Form 52-109F2, Ex. 99.6 (Aug. 9, 2013)) at 1 (Roberts); Ex. 21 (Form 52-109F2, Ex. 99.5 (May 1, 2014)) at 1 (Curran); Ex. 7 (Form 40-F, Exs. 99.5 & 99.6 (Mar. 22, 2010)) at 1 (Andrew, Takeyasu); Ex. 8 (Form 40-F, Ex. 99.5 (Mar. 16, 2012)) at 1 (Nunns); Ex. 22 (Form 40-F, Ex. 99.5 (Mar. 7, 2014)) at 1 (Roberts).

Other Statements About Penn West's Costs: In addition to the financial statements and certifications, the Amended Complaint lists dozens of statements that Messrs. Andrew, Nunns, Roberts or other non-Defendant Penn West employees made in connection with the Company's quarterly or annual reports concerning the Company's costs.⁸ Plaintiffs allege that these statements were false or misleading because they "failed to disclose" the effects of the alleged "fraudulent accounting practices." (AC ¶ 165.)

Specifically, Plaintiffs allege that the following categories of statements were false or misleading: (1) general statements about Penn West's "cost structure" and "cost pressures" that the Company was facing (*e.g.*, AC ¶ 237 ("[o]ur cost structure is in control and moving downward, and we're having success in what has been termed a very soft market, and tightening up our portfolio with asset divestitures")); (2) statements explaining Penn West's reported results (*e.g.*, AC ¶ 252 ("[t]he reduction in operating costs in 2013 compared to 2012 is attributed to the asset dispositions that closed late in 2012 along with field staff reductions and other cost reduction initiatives in 2013 aimed at streamlining our operations")); and (3) statements expressing Defendants' beliefs, aims, and goals about future costs (*e.g.*, AC ¶ 164 ("[w]e believe we have the capacity internally" "[t]o meet our CapEx guidance")).

⁸ The Amended Complaint asserts that Messrs. Takeyasu and Curran are liable for "failing to correct" one or more of these statements, which were allegedly "made in [their] presence" (AC ¶¶ 310(b), 314), and that Mr. Takeyasu is responsible for a single misleading statement during a May 4, 2012 conference call when he said that "our aim is to provide the Company with funds flow certainty to fund our growth and dividend" (AC ¶ 160).

H. The Alleged Corrective Disclosures

Plaintiffs allege that “corrective” disclosures occurred (i) on November 6, 2013, when Penn West announced its third quarter results and strategic review, but said nothing about any accounting errors or proposed restatement, *and* (ii) on July 29, 2014, when Penn West announced its voluntarily review of accounting practices. (AC ¶¶ 273-77.)

ARGUMENT

I. PLAINTIFFS FAIL TO PLEAD PARTICULARIZED FACTS GIVING RISE TO A “STRONG INFERENCE” THAT DEFENDANTS ACTED WITH SCIENTER.

The Reform Act and Rule 9(b) require that securities fraud complaints plead “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81-82 (2006) (quoting 15 U.S.C. §§ 78u-4(b)(2)). In this Circuit, a plaintiff can establish a strong inference of scienter only by pleading particularized facts that “(1) show[] that the defendants had both motive and opportunity to commit the fraud or (2) constitut[e] strong circumstantial evidence of conscious misbehavior or recklessness.” *ATSI*, 493 F.3d at 90. For an inference of scienter to be “strong,” the inference must be “more than merely ‘reasonable’ or ‘permissible’—it must be cogent and . . . at least as compelling as any opposing inference one could draw from the facts alleged.” *Tellabs*, 551 U.S. at 324. In reviewing the sufficiency of a complaint, “a court must consider plausible, nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.” *Id.* at 323-24.

Here, relying exclusively on Penn West’s voluntary disclosure of accounting errors and a resulting stock drop, the Amended Complaint does not allege that any Defendant had a cognizable motive to commit securities fraud. And, Plaintiffs have not pled with

particularity that any Individual Defendant, or any other officer whose intent may be imputed to Penn West, made the purported misstatements knowingly or with conscious recklessness. Rather, the more compelling inference from the circumstances surrounding Penn West's voluntary restatement of its financials is that the Company's executive officers relied on its accounting personnel and outside auditors, and promptly investigated, disclosed, and corrected accounting errors when those errors came to management's attention.

A. Plaintiffs Do Not Plead that Defendants Possessed Any Cognizable Motive To Commit Fraud.

To establish a strong inference of scienter through “motive and opportunity” to defraud,” Plaintiffs must allege facts that Defendants “benefitted in some concrete and personal way from the purported fraud.” *ECA*, 553 F.3d at 198 (citation omitted).

Here, Plaintiffs make no allegations whatsoever that any Defendant used the accounting errors in order to benefit in any “concrete and personal way,” such as “unusual” or “suspicious” trading in Company stock. *In re Lululemon Sec. Litig.*, 14 F. Supp. 3d 553, 584-86 (S.D.N.Y. 2014) (Forrest, J.) (dismissing complaint because, *inter alia*, individual defendants' sales of company stock did not give rise to strong inference of scienter). In fact, Plaintiffs' only theory of motive—that “Penn West's senior management” committed fraud “to show improving cost control” at the Company (AC ¶¶ 41-43)—is precisely the type of generalized corporate motive to “maintain the appearance of corporate profitability” that the Second Circuit has repeatedly held to be insufficient as a matter of law. *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 268 (2d Cir. 1996) (affirming dismissal of securities fraud action based on restated financials, holding alleged desire to “justify” corporate acquisition and “have that investment appear profitable” insufficient to show motive); *see also In re OSG Sec. Litig.*, 971 F. Supp. 2d 387, 408

(S.D.N.Y. 2013) (Scheidlin, J.) (dismissing complaint alleging improper tax accounting driven by “the desire to maintain a high credit rating to raise money” and “to protect the very survival of a company,” holding these motivations were “too generalized . . . [to] plead securities fraud”).

B. Plaintiffs Fail To Plead that Defendants Made the Challenged Misstatements Knowingly or With Conscious Recklessness.

Having failed to plead any cognizable motive to commit fraud, Plaintiffs must plead facts showing a “stronger inference” that Defendants made the alleged misstatements knowingly or with conscious recklessness. *Kalnit*, 264 F.3d at 143. Such “conscious recklessness” requires “a state of mind *approximating actual intent*, and *not merely a heightened form of negligence*” *S. Cherry St., LLC v. Hennessee Grp. LLC*, 573 F.3d 98, 109 (2d Cir. 2009) (citation omitted), and can be shown only by specific allegations that “someone whose intent could be imputed to the corporation”: (1) “engaged in deliberately illegal behavior;” (2) “knew facts or had access to information suggesting that their public statements were not accurate;” or (3) “failed to check information they had a duty to monitor” *Teamsters Loc. 445 Freight Div. Pension Fund v. Dynex Capital, Inc.*, 531 F.3d 190, 194-95 (2d Cir. 2008) (citation omitted). “[W]here plaintiffs contend defendants had access to contrary facts,” or failed to check information they had a duty to monitor, “they must specifically identify the reports or statements containing this information.” *Id.* at 196 (quotation omitted).

Here, the Amended Complaint cites no internal Penn West documents or witness statements demonstrating that any Individual Defendant was aware of, or involved in, the accounting practices that led to the restatement. Instead, Plaintiffs offer a host of speculative

allegations, none of which—taken separately or together—pleads with the required particularity that any Individual Defendant acted knowingly or with conscious recklessness.⁹

1. Plaintiffs’ Speculation About Penn West’s “Senior Finance and Accounting Personnel” Referenced in the Company’s July and September 2014 Voluntary Disclosures

In voluntarily disclosing in July and September 2014 that “senior finance and accounting personnel” and “senior accounting management” were responsible for its deficient accounting practices (AC ¶¶ 122-23), Penn West certainly did not admit—as Plaintiffs impermissibly speculate—that any *Individual Defendant* knew about those practices, much less that Mr. Takeyasu was responsible for those practices. Rather, Penn West’s internal review found that because of “material weaknesses” in the Company’s internal controls, those practices went “*undetected*” until Mr. Dyck discovered them in 2014. *See supra* at 12.

Moreover, the Amended Complaint does not identify the “senior finance and accounting personnel” referred to in Penn West’s July and September 2014 press releases, let alone suggest that any of those individuals engaged in fraud. “Senior finance and accounting personnel” does not mean the CEO or CFO. Indeed, the only Individual Defendant even mentioned in those announcements was Mr. Roberts, who, along with Penn West’s CFO

⁹ In addition to the Individual Defendants, the Amended Complaint alleges that Penn West’s COO, an Executive Vice President of Operations Engineering, a Senior Vice President of Exploration, and an Investor Relations Manager made statements about the Company’s costs during several conference calls that were rendered misleading by the subsequent restatement. (AC ¶¶ 171, 181, 212, 269.) None of these individuals is named as a defendant, and the Amended Complaint does not allege that they made those statements with scienter.

Mr. Dyck, “recommended to the Board that the Audit Committee conduct an independent review of” the accounting practices at issue. (Ex. 2 (Sept. 18, 2014 Press Release) at 1.)¹⁰

Likewise, that certain accounting and financial personnel may have known about the accounting errors is insufficient to plead that the Defendants acted with scienter as a matter of law. “[I]n the absence of allegations of fact from which one could infer that the alleged accounting improprieties [were] either being committed by” a Defendant when he made misstatements, “or were reported to” that Defendant, knowledge of such improprieties cannot be imputed to any Defendant merely because they were “involved in the day-to-day operations of the [C]ompany.” *City of Brockton Ret. Sys. v. Shaw Grp. Inc.*, 540 F. Supp. 2d 464, 473 (S.D.N.Y. 2008) (McMahon, J.) (citations omitted).

In *Shaw*, for example, Judge McMahon dismissed securities fraud claims against an energy and chemical company and its former CEO and CFO after the company announced a restatement. 540 F. Supp. 2d at 466-67. There, unlike this case, plaintiffs relied on confidential witness statements alleging that “knowledge of weaknesses in the accounting department was ‘widespread’” to try to show that the company’s CEO and CFO knew of those weaknesses when making public disclosures. *Id.* at 473. But Judge McMahon rightly rejected those allegations as insufficient to establish scienter because “not a single informant offer[ed] any information from which one could infer that either of the individual defendants knew or had reason to know

¹⁰ Penn West’s September 2014 press release stating that reclassifications of expenses were carried out “at the corporate level” does not establish that any Individual Defendant was involved with, or aware of, the Company’s deficient accounting practices. (AC ¶ 122.) All this disclosure reflects is that the accounting errors occurred at Penn West, as opposed to one of its subsidiaries.

anything about the mistaken application of” the applicable accounting rules. *Id.* The same reasoning applies to the Individual Defendants here.

Similarly, in *Plumbers and Pipefitters Local Union No. 719 Pension Trust Fund v. Conseco Inc.*, this Court dismissed securities fraud claims against an insurer and several current and former senior executives after the company announced government investigations into certain insurance claims-handling practices, and later restated its financials. 2011 WL 1198712, at *2-5, 16-17 (S.D.N.Y. Mar. 30, 2011) (Koeltl, J.). Like Plaintiffs here, the *Conseco* plaintiffs claimed that the defendant executives who made purported misstatements knew about the improper company practices based on allegations that those practices were “discussed with senior Conseco employees,” that a non-defendant employee who reported to the CEO “was a key player in authorizing the improper” practices, and that “Conseco executives” were “very aware” of the practices. *Id.* at *23. In rejecting plaintiffs’ claims, this Court held that conscious recklessness is not established where, as here, “the [c]omplaint is wholly devoid of any particularized allegation connecting the individual defendants to information suggesting unlawful activity within the company.” *Id.*

2. Timing of Penn West’s Restatement

Plaintiffs conclusorily allege that Mr. Dyck “discovered the fraud within weeks of joining the Company as its new CFO” on May 1, 2014, and, therefore, that the deficient accounting practices must have been “obvious to anyone who cared to look.” (AC ¶ 128.) But Plaintiffs’ speculation that the Defendants knew about the accounting errors simply because Penn West’s new CFO “quickly unearthed the fraud . . . suffers from hindsight bias.” *Special Situations Fund III QP, L.P. v. Deloitte Touche Tohmatsu CPA, Ltd.*, 33 F. Supp. 3d 401, 434 (S.D.N.Y. 2014) (Ramos, J.) (dismissing complaint).

In fact, Penn West's SEC filings do not suggest that the Company discovered the accounting errors "within weeks" of Mr. Dyck's arrival. The Company first announced that its Audit Committee had initiated a voluntary review of accounting practices on July 29, 2014, nearly three months *after* Mr. Dyck became CFO. Moreover, the results of the Audit Committee's review and Penn West's restatement were not disclosed until September 18, 2014, more than four months *after* Mr. Dyck's arrival. And, the review did not find that the errors were obvious, as Plaintiffs contend, but rather that "the accounting practices identified . . . went *undetected*," because of "several material weaknesses and a significant deficiency in Penn West's internal control[s]." (Ex. 2 (Sept. 18, 2014 Press Release) at 4 (emphasis added).) As Judge Forrest held in *In re Magnum Hunter Resources Corp. Securities Litigation*, "an inference of potentially poor accounting management . . . does not support fraud." 26 F. Supp. 3d 278, 297-98 (S.D.N.Y. 2014) (granting motion to dismiss for, *inter alia*, failure to plead scienter).

Nor can Plaintiffs sustain their burden of pleading a strong inference that Defendants acted with scienter based on the timing of Mr. Takeyasu's departure as CFO in March 2014, four months before Penn West voluntarily announced its investigation into the potential accounting errors. (See AC ¶ 122.) In *In re Openwave Systems Securities Litigation*, Judge Cote rejected a similar allegation that a former CEO's departure around the time of a company's internal investigation and restatement demonstrated that the CEO was aware of the company's improper accounting practices because, as here, the "[c]omplaint [did] not include a single fact linking [the CEO's] resignation to the alleged fraud or his knowledge thereof." 528 F. Supp. 2d 236, 251 (S.D.N.Y. 2007). As in *Openwave*, Plaintiffs have pled no facts linking Mr. Takeyasu's departure to the alleged improper accounting practices. Indeed, the more compelling inference is that Mr. Takeyasu's departure simply was part of Penn West's broader

restructuring, which began with Mr. Roberts' hiring in June 2013 and continued with the November 6, 2013 announcement of the Company's strategic review. *See supra* at 7 to 9.

3. The "Nature of the Accounting Violations"

Plaintiffs' contention that intentional misconduct is suggested by the "nature of the accounting violations," which involved "reclassifying" expenses (AC ¶ 123), does not plead a strong inference that any Defendant made the challenged disclosures with at least conscious recklessness. Under the governing accounting standards here, the classification of expenses required the "the application of professional judgment." (Ex. 4 (Canadian GAAP § 1000.43); *see also* Ex. 3 (IAS § 16.9)); *Doré Energy Corp. v. Prospective Inv. & Trading Co.*, 2010 WL 4068802, at *7 (W.D. La. Oct. 14, 2010) (recognizing in oil drilling contract dispute that "the determination of operating expenses is often a fact-intensive inquiry . . . requir[ing] an assessment of the purpose of the expense," while "[g]enerally accepted accounting procedures . . . may lead to one determination . . . 'equally accepted accounting practices, using acceptable and alternate methods and practices, can result in an opposite result'"); *Cincinnati, New Orleans & Texas Pac. Ry. Co. v. United States*, 424 F.2d 563, 582 (Ct. Cl. 1970) ("[o]ne cannot rigidly and automatically allocate expenditures" and "the differentiation of capital expenditures and operating expense disbursements is largely a matter of sound discretion and experienced business judgment").

As courts have recognized, violations of accounting standards "do[] not support a strong, *or even a weak*, inference of scienter." *Shaw*, 540 F. Supp. 2d at 472-73 (emphasis added); *see also In re Turquoise Hill Res. Ltd. Sec. Litig.*, 2014 WL 7176187, at *7 (S.D.N.Y. Dec. 16, 2014) (Schofield, J.) ("The fact of an error, even a large error, does not suggest knowledge or intent to misstate when the financial results were originally published, particularly

when the error was a matter of judgment.”). This conclusion is especially true here, where “the Complaint does not allege that [Penn West’s] auditors disapproved of . . . accounting practices or found any lack of internal controls prior to the restatement.” *Id.* at *6.

4. Penn West’s and Investors’ Focus on Operating Expenses

Plaintiffs cannot plead scienter by conclusorily alleging that Defendants must have known about the accounting errors because the Individual Defendants and Penn West’s investors were “focus[ed]” on reducing Penn West’s operating expenses. (AC ¶¶ 124-25.) Tellingly, the Amended Complaint cites no instances where any Individual Defendant (a) received information contradicting their public disclosures, (b) did not review specific information they had a duty to monitor, or (c) otherwise ignored obvious signs of fraud. Moreover, Defendants’ focus on the Company’s operating expenses alone does not establish that any of them was aware that accounting and finance staff were improperly classifying some of those expenses. In fact, Penn West’s restated financials reflect that Penn West’s actual operating costs declined over the restated period, indicating that the Company was successful in its effort to reduce operating costs. *See supra* at 12.

In *Board of Trustees of City of Ft. Lauderdale General Employees’ Retirement System v. Mechel OAO*, plaintiffs brought federal securities fraud claims after Russian authorities cited the company for antitrust and tax code violations, alleging individual defendants “fail[ed] to disclose that a portion of the Company’s income and revenue during the Class Period derived from unlawful conduct.” 811 F. Supp. 2d 853, 859 (S.D.N.Y. 2011), *aff’d*, 475 F. App’x 353 (2d Cir. 2012). As here, the *Mechel* plaintiffs sought to plead a strong inference of scienter based on allegations of defendants’ “extensive experience” in the industry and “knowledge of” Russian competition and tax regulations. *Id.* at 873. Judge Sullivan dismissed the complaint, because,

like Plaintiffs here, the *Mechel* plaintiffs did not “provide specific instances in which Defendants received information that was contrary to their public declarations,” or “allege facts demonstrating that Defendants failed to review or check information that they had a duty to monitor or ignored obvious signs of fraud.” *Id.* at 870 (citations omitted).

5. The Magnitude of Penn West’s Restatement

Plaintiffs speculate that Defendants must have known about the accounting errors because the errors were “massive in scope.” (AC ¶ 126.) But it is settled that, “[a]lthough ‘the magnitude [of a restatement] can be relevant to the scienter inquiry[,] . . . it is clear that the size of the fraud alone does not create an inference of scienter.’” *Turquoise Hill*, 2014 WL 7176187, at *7 (citation omitted). Rather, to plead a strong inference of scienter based on the magnitude of a restatement, the misstatement must be “so dramatic” that a corporate officer must have been aware of it. *Dynex*, 531 F.3d at 195-96 (citing hypothetical example of General Motors announcing the sale of one million SUVs, when “the actual number was zero”).

By any measure, the magnitude of Penn West’s restatement was not so dramatic as to support a strong inference that any Individual Defendant knew of the Company’s deficient accounting. Specifically, the restatement impacted between 16% and 20% of the Company’s operating expenses on an annualized basis in 2012, 2013 and the first quarter of 2014. (Ex. 2 (Sept. 18, 2014 Press Release) at 6), and only modestly impacted the two profitability metrics—funds flow (between 5% and 7%) and netback (between 3% and 5%) (AC ¶¶ 188, 248, 262)—that Plaintiffs claim were key for investors.¹¹ In fact, Penn West’s restatement caused its annual

¹¹ Plaintiffs overstate the size and duration of Penn West’s misstated financials by erroneously claiming that the “fraud lasted for more than seven years.” (AC ¶ 126.) In fact, the

(footnote continued...)

net income to *improve* by 4% in 2013 and by 7% in the first quarter of 2014. (Ex. 2 (Sept. 18, 2014 Press Release) at 6.) This is because, among other things, the misclassifications of operating expenses to royalties did not change net income, and the improper capitalization of operating expenses had the effect of *increasing* depletion and depreciation expenses, thereby *reducing* the Company's reported net income for periods prior to the restatement.

In *Turquoise Hill*, plaintiffs asserted securities fraud claims against an oil and gas company and five of its current and former executives after the company announced that improper revenue recognition practices caused the company's reported revenues to be overstated for two years by 32% and 36%. 2014 WL 7176187, at *1, 3. Like Plaintiffs here, the *Turquoise Hill* plaintiffs sought to establish scienter through the supposedly "substantial" size of the restatement and the simplicity of the relevant accounting principles. *Id.* at *6-7. Judge Schofield dismissed the complaint, holding that "[t]he fact of an error, even a large error, does not suggest knowledge or intent to misstate when the financial results were originally published, particularly when the error was a matter of judgment." *Id.* at *7; *see also Shaw*, 540 F. Supp. 2d at 470

(...continued footnote)

Audit Committee determined that the Company needed to restate only its financial statements from 2012 through the first quarter of 2014, even though its review went back to 2007. (Ex. 2 (Sept. 18, 2014 Press Release) at 1-2, 5.) In disclosing certain "key impacts" that its restatement had on property, plant and equipment and net income in years prior to 2012 (Ex. 16 (Restated Form 40-F, Ex. 99.2 (Sept. 18, 2014)) at 14), Penn West did *not* "admit[]" in its Restatement that its senior executives [engaged] in the accounting fraud" during those periods, as the Amended Complaint impermissibly speculates. (AC ¶ 154.)

(dismissing complaint for failure to plead that company's executive officers were consciously reckless in issuing financial statements, even though the company overstated its revenues and improperly accounted for a minority interest in an asset, which had the effect of increasing net income by 14%); *Johnson v. NYFIX, Inc.*, 399 F. Supp. 2d 105, 111, 115-18 (D. Conn. 2005) (no strong inference of scienter from "combination of GAAP violations and the 'resulting, drastic overstatement of [five years of] financial results,' including annual overstatements of net income by as much as 335% and understatement of operating expense by as much as 69%, because the complaint did "not point to any specific source from which defendants received knowledge of [the accounting] flaws").

Similarly, in *In re DRDGOLD Ltd. Securities Litigation*, plaintiffs asserted securities fraud claims against a mining company and its chairman and CEO after the company disclosed that improper loss recognition practices caused net income to be overstated by 102% and losses understated by 11% over more than two years. 472 F. Supp. 2d 562, 566 (S.D.N.Y. 2007). Like Plaintiffs here, the *DRDGOLD* plaintiffs argued that a strong inference of scienter could be inferred based in part on the size of the restatement. Judge Marrero dismissed the complaint, holding that scienter could not be inferred from "[t]he nature and magnitude of the restatement." *Id.* at 573. In doing so, Judge Marrero contrasted the limited effect of the restatement in *DRDGOLD* with the transformative impact of the restatement in *In re Atlas Air Worldwide Holdings, Inc. Securities Litigation*, where the court found scienter in part because, unlike here, the company went bankrupt after a restatement of its retained earnings from a "\$185 million" surplus to "an accumulated deficit of approximately \$178 million." 324 F. Supp. 2d 474, 489 (S.D.N.Y. 2004) (Connor, J.).

6. Defendants’ Purported Desire To Use the Accounting Errors To Hide Penn West’s Purported Financial and Operating Difficulties

The Amended Complaint contends that Defendants’ scienter is shown by allegations that Defendants “increased the magnitude of [Penn West’s] accounting improprieties” (i) in 2009 (before the start of the putative class period) in response to the effect “plummet[ing]” oil prices had on Penn West’s financials (AC ¶¶ 59-60, 65), and (ii) in 2012 to mask Penn West’s “operational difficulties” (AC ¶¶ 66-67, 127). These allegations are not only speculative, but are directly contrary to facts alleged in the Amended Complaint or otherwise judicially noticeable.

First, Plaintiffs provide no factual basis for their speculation that in 2009 Defendants intentionally decided to increase reclassifications of expenses to make up for declining oil prices. (AC ¶ 59.) Indeed, after collapsing in late 2008 to approximately \$33 U.S. Dollars per barrel during the financial crisis (AC ¶ 59), oil prices rebounded and more than *doubled* in 2009 to more than \$75 per barrel by December. (Ex. 23 (Chart of WTI Crude Prices).)¹²

Second, the only “operational difficulties” cited in the Amended Complaint as the purported reason for increasing the magnitude of reclassifications occurred *in the second quarter of 2011*, not in 2012, when Plaintiffs contend that the reclassifications increased. (AC ¶¶ 66-70, 127.) Thus, the Amended Complaint does not plead any facts establishing the necessary link between the purported increases in the magnitude of improper classifications of expenses and

¹² The Court may take judicial notice of oil prices on a motion to dismiss. *See Metro. Transp. Auth. v. F.E.R.C.*, 796 F.2d 584, 593 (2d Cir. 1986) (“tak[ing] judicial notice of the recent sharp decline in the price of oil”).

those operating difficulties, much less that any Individual Defendant was involved in or aware of that practice. *See Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1095 (2d Cir. 1995) (affirming dismissal of a complaint where conclusory allegations “are contradicted both by more specific allegations in the Complaint and by facts of which [the court] may take judicial notice”).¹³

C. Taken Together, the More Compelling Inference Is that Defendants Did Not Engage in Fraud.

Without any specific allegation that any Individual Defendant knowingly or with conscious recklessness made the challenged disclosures, Plaintiffs cannot establish scienter simply by listing the circumstances surrounding Penn West’s restatement in the hope that “zero

¹³ The fact that the Individual Defendants signed certifications that, based on their “knowledge [and] reasonable diligence,” Penn West had accurate financial statements and controls that gave “reasonable assurance” of the reliability of those statements does not support scienter. To premise a Section 10(b) claim on such certifications, a plaintiff must plead particularized facts demonstrating the “certifications . . . were not honestly and reasonably believed to be true *when made*.” *Turquoise Hill*, 2014 WL 7176187, at *6 (citation omitted) (emphasis added); *In re SAIC, Inc. Sec. Litig.*, 2013 WL 5462289, at *12 (S.D.N.Y. Sept. 30, 2013) (Batts, J.) (rejecting inference of scienter based on certification where “allegations do not specify which particular statements [in the certification] are false, why the statements were false, and the allegations do not plead facts giving an inference of scienter”). As shown *supra* at 19 to 29, the Amended Complaint makes no allegations that the Individual Defendants knew that their certifications were inaccurate.

plus zero plus zero plus zero plus zero adds up to something.” *Shaw*, 540 F. Supp. 2d at 475. At best, Plaintiffs’ allegations, taken together, support the inference that Defendants could have more diligently supervised Penn West’s accounting staff, but not that they committed fraud.

First, as shown *supra* at 17 to 18, Plaintiffs have failed to plead any cognizable motive for the Individual Defendants to commit securities fraud. *See Mechel*, 2011 WL 3502016, at *11.

Second, KPMG signed off each year on the accuracy of Penn West’s financials and the effectiveness of the Company’s internal accounting controls, which assured Defendants that Penn West’s accounting staff were appropriately reporting its operating expenses. *See Turquoise Hill*, 2014 WL 7176187, at *6 (rejecting scienter, in part, because “the Complaint does not allege that Turquoise Hill’s auditors disapproved of SouthGobi’s accounting practices or found any lack of internal controls prior to the restatement”) (citing *In re Bausch & Lomb, Inc. Sec. Litig.*, 592 F. Supp. 2d 323, 341 (W.D.N.Y. 2008) (no scienter where “outside auditor’s [sic] did not question [the company’s] accounting practices”)).

Third, the deficient accounting practices were far from the type of obvious or dramatic errors about which any senior executive would have known. Rather, the deficient accounting practices turned on “the application of professional judgment” to classify certain expenses based on the “specific circumstances” of each expense. *Supra* at 6; *see also In re Bristol-Myers Squibb Sec. Litig.*, 312 F. Supp. 2d 549, 567-68 (S.D.N.Y. 2004) (Preska, J.) (no scienter where accounting rules involved evaluating “a variety of factors” and “a number of complex judgments”). In addition, the impact of the restatement on Penn West’s alleged “key metrics” of between 3% and 7% (for funds flow and netback) and 16% to 20% (for operating expenses) was well below the magnitude that courts have found to be “dramatic.” *See Turquoise*

Hill, 2014 WL 7176187, at *3, 7 (alleged overstatement of revenue by 32% and 36% over two-year period not so dramatic as to support strong inference that current or former senior executives acted with scienter).

Fourth, Penn West’s review of its accounting practices found “instances where . . . capital costs were classified as operating expenses.” (Ex. 16 (Restated Form 40-F, Ex. 99.2 (Sept. 18, 2014)) at 27.) Classifying capital expenses as operating expenses *would have made no sense* if the purpose of the alleged fraud was to reduce operating expenses. *Kalnit*, 264 F.3d at 140-41 (“Where ‘plaintiff’s view of the facts defies economic reason, . . . [it] does not yield a reasonable inference of fraudulent intent.’”). Nor did the alleged improper practice of reclassifying certain operating expenses improve all measures of Penn West’s profitability. By increasing capital expenditures, for example, Penn West’s capital efficiency—a measure of output per dollar of capital—deteriorated. In addition, the restatement actually *increased* Penn West’s net income in 2013 and the first quarter of 2014 by 3% and 7%, respectively. (Ex. 2 (Sept. 18, 2014 Press Release) at 6.)

Fifth, that Penn West’s executive officers voluntarily initiated their own independent review of the Company’s accounting practices, restated its financial statements, and promptly reported to regulators and investors the review’s findings, undermines any inference of scienter. *See City of Brockton Ret. Sys. v. Avon Prods., Inc.*, 2014 WL 4832321, at *23 (S.D.N.Y. Sept. 29, 2014) (Gardephe, J.) (defendant’s voluntary investigation supported non-fraudulent inference).

Finally, none of the Individual Defendants held senior executive positions at Penn West throughout the putative class period, rendering implausible Plaintiffs’ contention that “the fraud was designed and executed at the highest levels of Penn West” by Defendants over more

than four-and-a-half years. (AC ¶ 122.) Specifically, Mr. Andrew retired from Penn West in August 2011, and Mr. Nunns acted as CEO and President from August 2011 until June 4, 2013, when Mr. Roberts was hired from outside the Company to replace him. (AC ¶¶ 22-24.) Likewise, Mr. Takeyasu retired as CFO on March 24, 2014, while Mr. Curran acted only as interim CFO for five weeks thereafter. (AC ¶¶ 25-26.) This revolving door of executives does not suggest any ongoing fraud on investors carried out by senior management, as Plaintiffs speculate.

* * *

Because Plaintiffs' allegations, taken together, do not support the required strong inference that Defendants acted with scienter in making the challenged disclosures, this Court should dismiss the Amended Complaint with prejudice.¹⁴

¹⁴ Because Plaintiffs have failed to state a Section 10(b) claim as to the Individual Defendants, the "control person" claims under Section 20(a) also should be dismissed. 15 U.S.C. § 78t(a). *See also Special Situations Fund*, 33 F. Supp. 3d at 437 ("It is axiomatic that liability for a Section 20(a) violation is derivative of liability for a Section 10(b) violation."). Plaintiffs' Section 20(a) claims also fail because, as demonstrated in Section I.(B), *supra*, the Amended Complaint does not allege that any Defendant "culpably participated" in any wrongdoing—*i.e.*, acted with at least conscious recklessness with respect to any misstatement. *Id.* at 438 (ruling that, to plead Section 20(a) liability, plaintiff must allege "particularized facts of the controlling person's conscious misbehavior or recklessness"). Nor does the Amended Complaint adequately allege that any Individual Defendant exercised "control" over any statement other than those that the executive actually made. *See In re Smith Barney Transfer Agent Litig.*, 884 F. Supp. 2d 152,

(footnote continued...)

II. UNDER SETTLED SECOND CIRCUIT LAW, PLAINTIFFS CANNOT CHALLENGE DEFENDANTS' STATEMENTS EXPRESSING THEIR "BELIEFS" ABOUT PENN WEST'S ABILITY TO CONTROL FUTURE COSTS.

In this Circuit, for statements of opinion or belief to be actionable, a plaintiff “must allege that [the] defendant’s opinions were both false and not honestly believed at the time they were made.” *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 113 (2d Cir. 2011); *see also City of Omaha, Neb. Civilian Emps.’ Ret. Sys. v. CBS Corp.*, 679 F.3d 64, 67-68 (2d Cir. 2012). As shown in Appendix A, the Amended Complaint quotes from numerous public statements made by certain Defendants about what they “believe we can achieve” with respect to costs, or their “aim[s] . . . to provide funds flow certainty,” or “goal to deliver best in class operating performance.” (AC ¶¶ 143, 160, 215.) Fatally, the Amended Complaint makes no attempt to allege with particularity why any of these statements of belief and goals for Penn West’s future performance was not an honestly held opinion at the time it was made. *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1127-28, 1131 (2d Cir. 1994) (management statements that company was “moving aggressively to overcome its problems,” and “was committed to delivering solid earnings in the third and fourth quarters,” and that “management believe[d] the current level of the [loan loss] allowance [wa]s adequate” inactionable where there was no allegation that management was aware of loan deficiencies).¹⁵

(...continued footnote)

166-67 (S.D.N.Y. 2012) (Pauley, J.) (dismissing Section 20(a) claim because alleged control person “must not only have control over the primary violator, but have control over the transaction in question”).

¹⁵ Under *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011),

(footnote continued...)

III. PLAINTIFFS CANNOT PLEAD LOSS CAUSATION BASED ON PENN WEST'S NOVEMBER 6, 2013 ANNOUNCEMENT.

Plaintiffs cannot increase their purported losses here by relying on a 15.7% drop in Penn West's stock price following the Company's November 6, 2013 quarterly earnings announcement. As shown *supra* at 8 to 9, that announcement occurred nearly nine months *before* Penn West disclosed that the Company was reviewing any accounting issues that led to its September 18, 2014 restatement.

“[T]o establish loss causation, ‘a plaintiff must allege . . . that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered,’ *i.e.*, that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security.” *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 173 (2d Cir. 2005) (affirming dismissal for failure to plead loss causation) (citation omitted). In *Police & Fire Retirement System of the City of Detroit v. SafeNet, Inc.*, plaintiffs alleged that defendants misstated a company's financial condition as a result of improper backdating and revenue recognition practices that later resulted in a restatement. 645 F. Supp. 2d 210, 217 (S.D.N.Y. 2009). Like Plaintiffs here, the *SafeNet* plaintiffs attempted to increase their purported damages

(...continued footnote)

Plaintiffs cannot seek to hold any Individual Defendant liable for failing to correct alleged misstatements made by others in his presence. (AC ¶¶ 310(b), 311(b), 312(b), 313(b), 314.) In *Janus*, the Supreme Court squarely held that liability under Section 10(b) is limited to each party's own misstatements. *Id.* at 2299, 2302-03 (investment advisor to mutual fund not liable for alleged misstatements in fund's prospectuses, because advisor “did not make the statements in the prospectuses”).

by alleging losses not only from a stock drop that occurred after the company's disclosure of those improper accounting practices, but also from two prior stock drops that occurred after the company announced separate and distinct accounting errors. *Id.* On a motion to dismiss, Judge Crotty dismissed plaintiffs' claims based on the two prior disclosures for failure to plead loss causation because those disclosures were "not tied to any fraud, omission, or misstatement, and [they] certainly made no reference to [accounting] irregularities." *Id.* at 228-29.¹⁶

Here too, nothing in Penn West's November 6, 2013 disclosure corrected or revealed anything about the improper classification of expenses that Plaintiffs contend made Defendants' statements prior to July 29, 2014 false or misleading. Rather, Penn West's November 6 announcement disclosed "poor third quarter results driven in part by higher than expected operating expenses," (AC ¶ 273), and the Company's new "long-term plan" focusing on "effective cost control and development," (Ex. 13 (Form 6-K, Ex. 99.2 (Nov. 7, 2013)) at 1).

¹⁶ See also *In re Gentiva Sec. Litig.*, 932 F. Supp. 2d 352, 385-89 (E.D.N.Y. 2013) (loss causation sufficiently pleaded with respect to company's announcements of two government investigations into improper billing practices, and results of one investigation, but not with respect to "negative earnings announcements" that did not "contain any disclosure of the alleged fraud," because "[s]peculation will not suffice to link the explanations actually given in the disclosures" for poor earnings "and Gentiva's allegedly fraudulent billing").

CONCLUSION

For the foregoing reasons, the Court should dismiss the Amended Complaint with prejudice.

Respectfully,

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March 6, 2015

APPENDIX A**Alleged Misstatements of Opinion or Belief**

| Alleged Misleading Statement | Plaintiffs Allegation as to Why the Statement was Misleading |
|---|--|
| <p>1. Defendant Nunns' statement during a 2010 first quarter earnings report conference call held on May 5, 2010 that "[t]he general pattern in anticipation as we scale up to a manufacturing model on these play in fundamentally that we generally tend to see a 30% to 40% cost reduction from initial tests of the plays, and we believe we can achieve that." (AC ¶ 143.)</p> | <p>Plaintiffs allege that this statement "was materially false and misleading" because Defendants omitted to disclose that "the Company's senior management was artificially decreasing its operating costs." (AC ¶ 144.)</p> |
| <p>2. Defendant Nunns' statement during a first quarter 2012 earnings report conference call held on May 4, 2012 that "[w]e believe we have the capacity internally" "[t]o meet our CapEx guidance." (AC ¶ 164.)</p> | <p>Plaintiffs allege that this statement "was materially false and misleading" because the Company omitted to disclose "that Penn West's reported capital expenditures were artificially inflated by the Company's fraudulent accounting practices." (AC ¶ 165.)</p> |
| <p>3. Defendant Takeyasu's statement during a first quarter 2012 earnings report conference call held on May 4, 2012 that "our aim is to provide the Company with funds flow certainty." (AC ¶ 160.)</p> | <p>Plaintiffs allege that this statement "was false and misleading" because Defendants omitted to disclose that "the Company was artificially inflating its reported funds flow through the fraudulent accounting scheme described above." (AC ¶ 161.)</p> |
| <p>4. Defendant Nunns' statement during a third quarter 2012 earnings report conference call held November 2, 2012 that "[w]e are committed to optimizing capital and operational efficiencies Over the last three years, we have taken appropriate measures to ensure that balance sheet integrity to support our endeavors." (AC ¶ 178.)</p> | <p>Plaintiffs allege that it was "materially false and misleading . . . to state that Penn West was 'committed to optimizing capital and operational efficiencies,' when Penn West was achieving its purported 'operational efficiencies' through the fraudulent accounting scheme described above." (AC ¶ 179.)</p> |

| Alleged Misleading Statement | Plaintiffs Allegation as to Why the Statement was Misleading |
|--|---|
| <p>5. Penn West’s statements in its second quarter 2013 Form 6-K filed on August 8, 2013 that Penn West would “continue to focus on cost saving initiatives and take further steps to allow us to achieve our goal to deliver best in class operating performance,” (AC ¶ 219);</p> | <p>Plaintiffs allege that it was “materially false and misleading for Penn West to represent that it was pursuing legitimate ‘cost saving initiatives’ by ‘actively streamlining’ its operations to deliver ‘best in class operating performance’ when, in reality, the Company was artificially reducing its operating costs through the fraudulent accounting scheme described herein.” (AC ¶ 220.)</p> |
| <p>6. Penn West’s statement in a November 6, 2013 press release that “[t]he Board and senior management believe that the Company’s new strategic focus and culture, improving corporate and operating cost structure and low-risk opportunities to increase oil-weighting will enable the company to deliver production and funds flow per share growth and largely fund its dividend and capital program from internally generated funds flow.” (AC ¶ 231.)</p> | <p>Plaintiffs do not make any particularized allegations as to why this statement was false or misleading.</p> |
| <p>7. Penn West’s statements in its fourth quarter and year end 2013 Form 6-K filed on March 7, 2014 that the Company’s “new vision” included “application of best-in-class operating practices,” “relentless cost control,” and “operat[ing] in a continuous and deliberate manner to drive cost efficiencies.” (AC ¶ 242.)</p> | <p>Plaintiffs allege that these statements were “materially false and misleading” because Penn West omitted to disclose that the Company “was artificially reducing its operating costs through the accounting fraud described above, and indeed, the Company’s actual operating costs had increased from the previous quarter, just before the announcement of the Company’s turnaround plan.” (AC ¶ 244.)</p> |
| <p>8. Penn West’s statements in its 2013 Annual Report Form 40-F that “[o]ne of the key strategies in [the Company’s] long-term plan is cost reduction to realize improvements in our netbacks, which in turn drives higher funds flow.” (AC ¶ 250.)</p> | <p>Plaintiffs allege that this statement “was materially false and misleading” because Penn West omitted to disclose that these metrics were impacted by “the fraudulent accounting scheme.” (AC ¶ 251.)</p> |