

Daily Journal

www.dailyjournal.com

FRIDAY, MAY 19, 2017

Ruling extends heightened securities fraud pleading standard

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In *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology Inc.*, 2017 DJDAR 4267 (May 5, 2017), the 9th U.S. Circuit Court of Appeals affirmed the dismissal of a pension fund's securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, holding that the plaintiff failed to satisfy the pleading requirements established by *Omnicare, Inc. v. Laborers District Counsel Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), for allegedly false opinion statements. The ruling clarifies that *Omnicare*, a case addressing Section 11, applies to Section 10(b) and Rule 10b-5 claims as well.

The 9th Circuit expressly overruled *Reese v. Malone*, 747 F. 3d 557 (9th Cir. 2014), a Section 10(b) case decided prior to *Omnicare*, which had allowed plaintiffs to plead falsity of opinion statements by alleging that the speaker lacked a "reasonable basis" for the belief. Consistent with *Omnicare*, to state a claim under a material misrepresentation theory, plaintiffs in Section 10(b) cases must plead that the speaker actually did not believe the statement — not merely that the speaker had "no reasonable basis for the belief." Such allegations, however, may suffice to state a Section 10(b) claim under an omissions theory of liability.

Background

The City of Dearborn Heights Act 345 Police & Fire Retirement System brought securities fraud claims against Align Technology, Inc. under Section 10(b) and Rule 10b-5, as well as a control person claim under Section 20(a) against the individual defendants. The complaint alleged that Align made several materially false and misleading statements regarding Align's goodwill valuation of its subsidiary, Cadent Holdings, Inc., which

management's opinion regarding fair value." The pension fund argued that the district court erred (1) by construing certain alleged misstatements as opinions rather than statements of fact and (2) by applying *Omnicare*'s heightened pleading standard to plaintiff's Section 10(b) claim.

9th Circuit Opinion

The 9th Circuit affirmed, first holding that the district court properly characterized one of Align's alleged misstatements

she professed" and that the belief is objectively untrue. Second, when relying on a theory that an opinion contained an embedded statement of fact, the plaintiff must allege that the supporting fact is untrue. Third, when relying on a theory of omission, the plaintiff must allege that the undisclosed facts make the opinion statement "misleading to a reasonable person reading the statement fairly and in context."

The 9th Circuit said its prior holding in *Reese* conflicted with *Omnicare* in one important respect. Under *Reese*, a plaintiff could plead falsity of an opinion statement under a material misrepresentation theory by alleging that "there is no reasonable basis for the belief." Because this would allow a plaintiff to plead falsity under a misrepresentation theory without alleging that the speaker actually believed that the statement was untrue, the 9th Circuit concluded that *Reese* was "clearly irreconcilable" with *Omnicare* and therefore overruled its prior decision.

The 9th Circuit agreed that the complaint failed to satisfy *Omnicare*'s pleading standards. Under *Omnicare*, plaintiff's allegations that Align had "no reasonable basis" for its expressed belief that Cadent's goodwill was such a high value were insufficient to plead falsity. The plaintiff failed to plead that Align did not actually believe that its opinion statements regarding Cadence's goodwill were true. The allegations fared no better when con-

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Align acquired in March 2011. The pension fund said that at the time of the acquisition, Align had derived the majority of that value from Cadent's goodwill even though it knew that Cadent had artificially inflated its value. According to the complaint, it was not until October 2012 that Align began evaluating Cadent's actual value. Thereafter, Align announced a series of impairment charges reducing the value of the goodwill.

The U.S. District Court for the Northern District of California dismissed the claims with prejudice for failure to adequately plead falsity and scienter. The court held that Align's alleged misstatements regarding goodwill valuations were opinion statements because they "are inherently subjective and involve

— a qualitative assessment of Cadent's fair value — as an opinion statement, as it could not be objectively verified. The court held that a different alleged misstatement — that there were no indications that the fair value may be less than the current carrying amount — was properly characterized as an opinion statement with an embedded statement of fact. Although *Omnicare* concerned Section 11 claims, the 9th Circuit concluded that the Supreme Court's reasoning was "equally applicable" to both 10(b) and 10b-5 claims.

Under *Omnicare*, plaintiffs can plead falsity of opinion statements in three ways. First, when relying on a theory of material misrepresentation, the plaintiff must allege both that the "the speaker did not hold the belief

strued under an omissions theory because none of the alleged omissions called into question the issuer's basis for offering the opinion.

The court went on to affirm the holding that the allegations of scienter were inadequate. Having held that plaintiff failed to plead the requisite elements of a primary securities violation, the court held that its Section 20(a) claim necessarily failed.

In a concurring opinion, Judge Andrew Kleinfeld stated that, while he "might well agree" that the *Omnicare* analysis applies to Section 10(b) cases, the district court should have avoided the issue and based its decision instead on the inadequate scienter allegations. In Judge Kleinfeld's view, whether *Omnicare* overrules *Reese* is an "important and debatable question" due to the "considerable differences" between Sections 11 and 10(b).

Takeaways

The 9th Circuit's ruling will likely make it more difficult to allege securities fraud claims based on allegedly false or misleading opinion statements. As the *Align* decision illustrates, it

can be more difficult to allege particularized facts showing that a speaker *subjectively* did not believe that its opinion statements were true than to allege that the speaker lacked a reasonable basis for the statement. The decision thus provides an additional tool to defendants in the 9th Circuit.

By clarifying that *Omnicare's* pleading standards apply to both Section 11 and Section 10(b) claims, the court's ruling brings a larger swath of cases within *Omnicare's* scope. Whereas Section 11 concerns statements and omissions made in registration statements, Section 10(b) applies to any public statements or omissions made in connection with the purchase or sale of a security. According to a recent study, more than two-thirds of securities filings in the last five years involved Rule 10b-5 claims, while less than 15 percent involved Section 11 claims during the same time period.

The 9th Circuit joins the 2nd Circuit in holding that *Omnicare's* pleading standards apply to claims under Section 10(b). In other circuits, the issue remains unsettled, with at least one district court expressing doubt as to

Omnicare's application outside of the Section 11 context. See *Firefighters Pension & Relief Fund v. Bulmahn*, 147 F. Supp. 3d 493, 528 (E.D. La. 2015) ("That *Omnicare* concerned a strict liability statute suggests that the Supreme Court's reasoning — which contemplates liability for statements of opinions that are genuinely held but misleading to a reasonable investor — does not directly apply to the statute at issue here."). It remains to be seen how other circuits will come out on this issue.

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