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Client Alert Commentary

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Ninth Circuit Applies *Omnicare* to Section 10(b) and Rule 10b-5 Claims

The Ninth Circuit follows the Second and Tenth Circuits in extending* Omnicare*'s requirements for pleading the falsity of opinion statements to claims under Section 10(b) and Rule 10b-5.

In recent years, courts have grappled with the question of whether statements of opinion are actionable as false or misleading statements under federal securities laws. In its highly anticipated 2015 opinion, *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, the U.S. Supreme Court set forth the standard for pleading falsity under Section 11 of the Securities Act of 1933 for statements of opinion.[1] Since then, the Ninth Circuit had not definitively pronounced whether these standards also apply to claims under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. In its May 5, 2017 decision in *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology, Inc.*, the Ninth Circuit joined the Second and Tenth Circuits[2] in applying the *Omnicare* standard to Section 10(b) and Rule 10b-5 claims.[3]

The *Align Technology* Litigation

The *Align Technology* litigation involved Align Technology, Inc.'s acquisition of Cadent Holdings, Inc. in April 2011 for US$187.6 million. In valuing the transaction, Align allocated more than 40% of the purchase price to the "goodwill" — or the amount exceeding the fair value of the assets of the acquired company — of a single Cadent division.

In late 2011, after the close of the transaction, Align conducted testing to determine whether the goodwill valuation was impaired, and represented to investors that the valuation remained accurate. However, further impairment testing conducted between October 2012 and April 2013 resulted in a steady decline in the goodwill valuation from US$77.3 million to US$52.6 million to US$36.6 million to *zero*.

The plaintiffs alleged that the original goodwill valuations in 2011 were misstated because they were based on revenue figures artificially inflated by improper "channel stuffing" — *i.e.*, offering substantial discounts to customers to make purchases to increase revenue figures in certain periods. The plaintiffs claimed that this practice masked a variety of factors negatively impacting Cadent, including issues with integrating its business with Align, market competition, and a degrading relationship with a distributor.

In 2013, the plaintiffs sued under Section 10(b) and Rule 10b-5, alleging, *inter alia*, that Align's reassuring statements regarding the accuracy of the goodwill valuation were fraudulent.

The District Court's Decision

Under Section 10(b) and Rule 10b-5, it is unlawful for an issuer "to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of circumstances under which they were made, not misleading" in connection with the purchase or sale of any security.[4] Investors have a private right of action for breach of that section and rule.

In August 2014, the district court ruled that Align's statements regarding goodwill valuation were opinions because they were inherently subjective and involved management's beliefs regarding fair value. With respect to the proper standard for pleading the falsity of those statements, the plaintiffs argued that the Ninth Circuit's prior holding in *Reese v. Malone* required the plaintiffs merely to allege facts that demonstrate that there was no ***objectively reasonable basis*** for the stated opinions.[5] In contrast, the defendants argued that the plaintiffs were required to allege facts establishing that the defendants did not subjectively believe in their statements concerning goodwill at the time that they made the statements.

The district court agreed with the defendants and dismissed the plaintiffs' claims. In doing so, the court extended a Ninth Circuit decision that concerned opinions in the context of a Section 11 claim, *Rubke v. Capitol Bancorp, Ltd.*, to the Section 10(b) and Rule 10b-5 claims at issue, and held that the plaintiffs' claims failed because the plaintiffs failed to adequately allege that the defendants did not honestly hold those opinions.[6]

The Ninth Circuit's Decision

On appeal, the Ninth Circuit considered two elements of the plaintiffs' Section 10(b) and Rule 10b-5 claim: falsity and scienter. With respect to falsity, the majority applied *Omnicare*, which was decided after the district court's ruling, and held that the plaintiffs were required to plead that the defendants did not believe their statements were true at the time that they were made. As they had failed to do so, the plaintiffs' claims failed as a matter of law. With respect to scienter, the panel unanimously held that the plaintiffs had failed sufficiently to plead it, and their claims failed on that alternative, independent basis.[7]

In the majority opinion, the Ninth Circuit construed *Omnicare* as establishing three different standards for pleading falsity of opinion statements under Section 10(b) and Rule 10b-5:

1. Where plaintiffs rely on a ***theory of material misrepresentation***, they must allege both that the speaker did not hold the belief the speaker professed and that the belief is objectively false. For example, for an opinion that "no impairment needs to be recorded to a goodwill valuation," plaintiffs must plead facts showing that the impairment was necessary and that the speaker did not believe that an impairment could be avoided, such as facts showing that the speaker knew that the assumptions utilized were inaccurate or unreliable.

2. Where plaintiffs rely on a ***theory that a statement of fact embedded within an opinion statement is materially misleading***, they must allege that the speaker did not hold the belief professed and that the supporting fact the speaker supplied is untrue. For example, for an opinion that "there are no facts indicating that the goodwill valuation is inaccurate," plaintiffs must plead facts showing that the goodwill valuation was inaccurate and also that the speaker did not believe the opinion that there were no such facts.

3. Where plaintiffs rely on a ***theory of omission***, they must allege facts relating to the basis of the speaker's opinion, which omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context. For example, for an unqualified opinion that "we believe our goodwill valuation is in compliance with GAAP," plaintiffs must allege facts that were omitted from the opinion that made the opinion objectively misleading to a reasonable investor, such as facts suggesting that the speaker had information or reports from

accountants that the goodwill valuation was not in compliance with GAAP or that the assumptions utilized were inaccurate.

In other words, under the first two standards related to affirmative statements, plaintiffs must plead that the speaker did not honestly hold the opinion when it was said — regardless of whether there was any objectively reasonable basis for the speaker's belief. This decision reflects the Supreme Court's determination in *Omnicare* that expressions of opinion explicitly affirm only that the speaker actually holds the stated belief, and that liability follows only if the speaker does not honestly hold the stated belief and the belief is objectively incorrect.[8] In so holding, the Ninth Circuit overruled its prior guidance in *Reese* as "clearly irreconcilable" with *Omnicare.*[9]

Given this heightened standard applicable to affirmative misrepresentations, plaintiffs will likely rely more heavily in the future on the third standard applicable to theories of omission. Although the Ninth Circuit repeated the Supreme Court's warning that establishing such a theory is "no small task for an investor,"[10] there remains substantial uncertainty in how district courts will evaluate these cases in practice to determine whether the purportedly omission is misleading to a "reasonable person reading the statement fairly and in context."[11] As noted in the concurring opinions by Justice Antonin Scalia and Clarence Thomas in *Omnicare*, the omission theory of liability articulated by the Supreme Court is "highly fact-intensive" and creates substantial uncertainty for issuers that must now determine whether their opinions might be misconstrued by "reasonable" persons.[12] To provide the best chance that a court would grant a motion to dismiss, issuers should take care in articulating the foundation of their opinions, with all necessary "hedges, disclaimers, and apparently conflicting information."[13]

Circuit Split Avoided (For Now)

In Judge Kleinfeld's concurring opinion, he agreed with the decision to affirm the district court's order, but only on the grounds that plaintiffs had failed adequately to allege scienter as to any defendant. He disagreed with the majority's decision to overrule *Reese* and extend *Omnicare*'s falsity analysis to Section 10(b) and Rule 10b-5 claims. This hesitancy did not reflect Judge Kleinfeld's view of the merits of the majority decision, but instead reflected the view that under Ninth Circuit law, *Reese* should not be overruled unless it is "clearly irreconcilable" with *Omnicare*.[14] In his view, *Reese* was not "clearly irreconcilable" because it concerned different claims.

As the Supreme Court has noted, there are "considerable differences" between Section 11 and Section 10(b) claims, including, for example, the lack of any scienter requirement or any heightened pleading standard with respect to Section 11 claims.[15] Indeed, commentators have questioned the applicability of *Omnicare* to Section 10(b) claims on the basis that while Section 10(b) requires scienter, a sincerely held belief might nevertheless be actionable under *Omnicare* if it omits material facts going to the basis for that opinion and if that omission makes the opinion misleading to a reasonable investor.

Despite these concerns, the Ninth Circuit's decision will constitute controlling law in this circuit with respect to opinion statements challenged under Section 10(b) and Rule 10b-5. In addition, unless a circuit breaks with the emerging trend established by the courts of appeals to have considered this issue, the Supreme Court will not likely have reason to intervene and ultimately decide this issue of law in the future.

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1 135 S.Ct. 1318 (2015).

2 *See Tongue v. Sanofi*, 816 F.3d 199 (2d Cir. 2016); *Nakkhumpun v. Taylor*, 782 F.3d 1142 (10th Cir. 2015).

3 *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc.*, 2017 WL 1753276 (9th Cir. May 5, 2017).

4 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

5 747 F.3d 557, 579 (9th Cir. 2014).

6 551 F.3d 1156 (9th Cir. 2009).

7 As in the district court, the plaintiffs' control person liability claims were dismissed on the basis that there was no primary violation of federal securities law.

8 *Align Tech.*, 2017 WL 1753276, at *6.

9 *Id.* at *7

10 *Id.* at *6

11 *Id.*

12 135 S.Ct. at 1333-38.

13 *Id.* at 1330.

14 *Align. Tech.*, 2017 WL 1753276, at *7.

15 *Id.* at *13.