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## *Omnicare Extended: The Ninth Circuit Adopts a Heightened Falsity Pleading Standard for Section 10(b) and Rule 10b-5 Material Misstatement Claims*

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In *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Technology, Inc.*,<sup>1</sup> the Ninth Circuit held that the standards for pleading falsity of opinion statements articulated by the Supreme Court in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund* apply to claims brought under Section 10(b) of the Securities Exchange Act of 1934 and Securities Exchange Commission (“SEC”) Rule 10b-5.<sup>2</sup> Rule 10b-5, which was promulgated pursuant to Section 10(b), prohibits any act or omission resulting in fraud in connection with the purchase or sale of any security.<sup>3</sup>

The Ninth Circuit, after upholding the district court’s dismissal of a securities fraud suit arising out of one company’s (the “acquiring company”) acquisition of another company (the “target company”), found that *Omnicare* required plaintiffs pleading falsity under the material misrepresentation theory of liability to allege that a speaker’s statement of opinion was objectively false and that the speaker actually knew the opinion to be false. But the Ninth Circuit still allows plaintiffs pursuing a material omissions theory of liability to allege that the speaker had no reasonable basis for his or her beliefs.

The Ninth Circuit now joins the Second Circuit in applying *Omnicare*’s heightened falsity pleading standards to Section 10(b) and Rule 10b-5 fraud claims about opinion statements.<sup>4</sup> Prior to *City of Dearborn Heights*, the Ninth Circuit allowed plaintiffs to plead falsity by merely alleging that “there is no reasonable basis” for the speaker’s beliefs.<sup>5</sup>

### **The Acquisition, Disclosures, and Resulting Lawsuit**

In 2011, the acquiring company announced that it was purchasing a target company that designs, manufactures, and markets 3D digital services for orthodontists and dentists for \$187.6 million. The acquiring company allocated \$135.5 million of the purchase price as “goodwill,” or the amount of the purchase price exceeding the fair value of the net assets of the target company. In 2012, the acquiring company stated that, with regards to its acquisition of the target company, “there were no facts and circumstances that indicated that the fair value of the reporting units may be less than their current carrying amount” and “based on the goodwill impairment analysis . . . we determined that no impairment needed to be recorded as the fair value of our reporting units were significantly in excess



of the carrying value.” But from 2012 to 2013, the acquiring company announced a series of goodwill impairment charges, reducing the goodwill of its target company.

In 2013, an investor of the acquiring company filed a class action alleging that the company and its directors made materially false and misleading statements concerning the company’s goodwill valuation of the target company. These alleged misstatements appeared in the acquiring company’s public filings with the SEC. The plaintiff claimed that these misstatements violated Section 10(b) and Rule 10b-5. The district court dismissed the plaintiff’s complaint for failing to plead falsity and scienter. The plaintiff appealed the dismissal, arguing that the district court misinterpreted the company’s fact-based statements as statements of opinion, imposed the wrong standard for pleading falsity of opinion statements, and wrongly determined that the plaintiff failed to plead scienter.

## **The Ninth Circuit Adopts *Omnicare’s* Falsity Pleading Standards to Section 10(b) and Rule 10b-5 Claims**

The Ninth Circuit upheld the district court’s dismissal, finding the plaintiff’s complaint failed to adequately plead falsity under any of the three standards articulated in *Omnicare* and failed to plead scienter. While *Omnicare* was decided in the context of Section 11 of the Securities Act of 1933, which prohibits registration statements from containing false statements of material facts, the Ninth Circuit found that the Supreme Court’s reasoning was applicable to Section 10(b) and Rule 10b-5 claims.<sup>6</sup>

*Omnicare* established three different standards for pleading falsity of opinion statements.<sup>7</sup> First, if a plaintiff claims that the speaker made material misrepresentations, the plaintiff must allege that the speaker did not hold the belief he or she professed and that the belief is objectively false. Second, if the plaintiff claims that the speaker’s opinion statement contained embedded facts that were materially misleading, the plaintiff must also allege that the speaker did not hold the belief he or she professed and the embedded fact was false. Third, if a plaintiff claims that the speaker omitted a material fact, the plaintiff must allege some material facts that formed the basis for the speaker’s opinion, whose omission makes the opinion statement misleading to a reasonable investor.

In *City of Dearborn Heights*, the plaintiff claimed that the acquiring company’s statements in 2012 were material misstatements of fact because the company must have known that its target’s goodwill was impaired and that its goodwill valuation of the target was false. The plaintiff alleged that the acquiring company knew that the target had improperly inflated its 2010 annual revenue numbers prior to being acquired in 2011 and that the acquiring company conducted its goodwill valuation based on these inflated numbers.

First, the Ninth Circuit held the acquiring company’s statement, “that there were no facts and circumstances” indicating impairment of its target’s goodwill, was an opinion statement containing an embedded fact. The Ninth Circuit understood this statement to assert an objective fact identifying the acquiring company’s goodwill valuation methodology and an opinion on how that methodology was carried out. Similarly, the Ninth Circuit interpreted the acquiring company’s statement that based on its valuation the target company did not have any goodwill impairments, to reflect the company’s qualitative assessment of the target’s fair value. Because the acquiring company’s qualitative assessment of the target’s fair value was inherently subjective, the Ninth Circuit decided that the results of the company’s goodwill valuation could not be objectively verified.

Applying the *Omnicare* standards, the Ninth Circuit found that the plaintiff failed to plead any facts establishing that the acquiring company actually used its target’s allegedly inflated numbers, rather than relying upon its own valuation methods, in conducting its goodwill impairment testing.



Accordingly, because the plaintiff failed to allege the acquiring company's actual assumptions underlying its goodwill valuation, the Ninth Circuit concluded that the plaintiff did not sufficiently allege falsity. The plaintiff did not establish that the acquiring company relied upon information that it knew to be false.

The plaintiff also claimed that the acquiring company's statements in 2012 omitted material facts, including that its target inflated its 2010 revenues. Unmoved, the Ninth Circuit found that the plaintiff failed to plead facts establishing that the acquiring company actually used the allegedly inflated revenues to conduct its goodwill impairment testing. Thus, the court concluded that the plaintiff did not sufficiently demonstrate that the company knew it was relying upon objectively false assumptions. Relatedly, because plaintiff failed to allege the precise assumptions underlying the acquiring company's goodwill valuation of the target, the plaintiff also failed to plead that the company's directors acted with the required state of mind, or scienter.

## Conclusion and Key Takeaways

In upholding the district court's application of *Omnicare's* falsity pleading standards to Section 10(b) and Rule 10b-5 claims, the Ninth Circuit overturned prior Ninth Circuit precedent that allowed a plaintiff to plead falsity by alleging that "there was no reasonable basis for the defendant's belief," under a material misrepresentation theory of liability. But the court also noted that a plaintiff may allege falsity under an omissions theory of liability by alleging that the statement of opinion lacked a reasonable basis.

By extending *Omnicare's* standards for alleging falsity beyond the mere Section 11 case, the Ninth Circuit's decision in *City of Dearborn* has important implications for companies making disclosures or other public statements. Companies should pay attention to the *Omnicare* standards as applied to all of their public statements by:

- Emphasizing the subjective nature of their opinions regarding their business or financial outlook;
- Reiterating the inherently subjective nature of goodwill valuations;
- Clearly stating the bases for their business or financial opinions in order to better delineate the subjective and objective portions of their opinions; and
- Refrain from using overly conclusive language to avoid turning a statement of opinion into an objectively verifiable statement.

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1 --- F.3d ---, 2017 WL 1753276, at \*7 (9th Cir. May 5, 2017).

2 135 S. Ct. 1318 (2015).

3 15 U.S.C. § 78j.

4 See *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 110 (2d Cir. 2011) (“Estimates of goodwill depend on management’s determination of the ‘fair value’ of the assets acquired and liabilities assumed, which are not matters of objective fact.”).

5 See *Reese v. Malone*, 747 F.3d 557, 579 (9th Cir. 2014) (“A statement is a factual misstatement actionable under Section 10(b) if . . . there is no reasonable basis for the belief.”) (internal quotation marks omitted).

6 *Id.* at 1323.

7 135 S. Ct. at 1328-29.

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