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Second Circuit Establishes More Stringent Pleading Standard for Securities Act Claims Based on Statements of Opinion

Earlier this week, the Second Circuit decided *Fait* v. *Regions Financial Corp.*, No. 10-2311-cv (2d Cir. Aug. 23, 2011), in which the Court affirmed the dismissal of a putative class action alleging violations of Sections 11(a), 12(a)(2), and 15 of the Securities Act of 1933 (the "Securities Act"). The Second Circuit held that defendants' alleged failures to write down goodwill in a timely manner and to increase loan loss reserves sufficiently during the financial crisis were not actionable, because defendants' challenged statements were matters of opinion rather than fact. Thus, plaintiffs had to allege that defendants did not believe the statements were true at the time they were made, something the complaint failed to do. *Fait* promises to be a useful tool in defending claims under the Securities Act, as well as claims that a defendant otherwise misstated financial figures, when those figures depend on the judgment of management rather than strictly objective criteria. The decision may be particularly important with respect to claims against accounting firms, whose conclusions based on their audits of financial statements and internal control regularly take the form of an expression of opinion.

The allegations in *Fait* centered on the 2007 10-K (later incorporated into a registration statement and prospectus) of defendant Regions Financial Corp. ("Regions"). Regions reported that it held $11.5 billion in goodwill, a measure of the excess purchase price paid by Regions in prior acquisitions over the net fair value of the assets acquired. *Fait*, op. at 3. Regions also reported $555 million in loan loss reserves, a balance set aside to cover expected losses in its loan portfolio. *Id.* Regions disclosed dramatic changes in these figures a year later: in its results for the fourth quarter of 2008, Regions reported a $6-billion goodwill impairment and an increase in loan loss provisions to $1.15 billion. *Id.* at 4. In the following months, Regions' stock price fell and plaintiff filed suit, alleging that despite adverse trends in the mortgage and housing markets, Regions had "overstated goodwill and falsely stated that it was not impaired, and 'vastly underestimated' Regions' loan loss reserves and failed to disclose that they were inadequate." *Id.* at 4-5.

The Court addressed each set of allegations in turn. With respect to goodwill, it noted that one component of goodwill, the "fair value" of assets previously acquired, is not a matter of objective fact. *Id.* at 9. The Court recognized that there is no "universally infallible" index of fair market value. *Id.* (citing *Henry* v. *Champlain Enters., Inc.*, 445 F.3d 610, 619 (2d Cir. 2006)). Moreover, plaintiff did not point to "any objective standard such as market price" that Regions should have used. *Id.* at 9. Instead, Regions' goodwill estimates were subjective, and defendants' statements about goodwill would be actionable only if "defendants did not believe the[m] . . . at the time they made them." *Id.* at 12-13.

Similarly, with respect to Regions' loan loss reserves, the Court held that the adequacy of such reserves is "not a matter of objective fact." *Id.* at 14. Rather, loan loss reserves are an estimate that "reflect[s] management's opinion or judgment about what, if any, portion of

amounts due on the loans ultimately might not be collectible," a determination that is "inherently subjective, and like goodwill, . . . will vary depending on a variety of predictable and unpredictable circumstances." *Id.* "Thus, . . . plaintiff must allege that defendant's opinions were both false and not honestly believed when they were made. Because the complaint does not plausibly allege subjective falsity, it fails to state a claim." *Id.* at 15 (citation omitted).

The Second Circuit analogized the case before it to *Virginia Bankshares* v. *Sandberg*, 501 U.S. 1083 (1991). Defendants in that matter allegedly violated Section 14 of the Securities Exchange Act of 1934 when they stated that minority shareholders were receiving "high" value and a "fair" price in a freeze-out merger, even though defendants supposedly did not believe these statements and made them for ulterior reasons. *See Fait*, op. at 10-11. The Supreme Court held that these statements could be actionable only if they misrepresented defendants' opinions or beliefs, in addition to being false or misleading with respect to the underlying subject matter. *See id.* at 11. Applying this precedent to Fait's Securities Act claims, the Second Circuit held that where challenged statements are based not on fact, but on opinion, plaintiff must plead either that the defendant did not believe the statements or that the statements were worded as guarantees. *Id.* at 10 n.3, 12-13, 15 n.6. Because Fait did neither, dismissal was proper.

To be sure, the Second Circuit clarified that it was not requiring plaintiff to plead scienter. *See id.* at 13 n.5 ("We do not view a requirement that a plaintiff plausibly allege that defendant misstated his truly held belief and an allegation that defendant did so with fraudulent intent as one and the same."). Nevertheless, the Court did require plaintiff to plead subjective falsity with respect to certain types of financial estimates, and further held that "allegations about adverse market conditions" did not suffice. *Id.* at 12. In cases involving expressions of opinion, *Fait* can thus be viewed to raise plaintiffs' "relatively minimal burden" in pleading claims under the Securities Act, *see*, *e.g.*, *Litwin* v. *Blackstone Group, L.P.*, 634 F.3d 706, 716 (2d Cir. 2011) ("'Although limited in scope, Section 11 places a relatively minimal burden on a plaintiff.'" (quoting *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 381-82 (1983))). Under *Fait*, where a plaintiff is unable to point to an objective indicator of falsity, he will have to allege that the speaker did not genuinely believe his own statement.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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