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Supreme Court Clarifies Pleading Requirements for Claims Premised on Statements of Opinion Under Section 11 of the Securities Act of 1933

On March 24, 2013, the Supreme Court issued an opinion in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, which clarified the pleading requirements for claims based on statements of opinion under § 11 of the Securities Act of 1933. The Court held that an opinion can be "an untrue statement of a material fact" under the first clause of § 11 only if subjectively disbelieved at the time it is made. However, the Court also held that an opinion can form the basis for omissions liability under the second clause of § 11 if a plaintiff can plead particular material facts underlying the opinion, the omission of which made the opinion misleading "to a reasonable person reading the statement fairly and in context." While clarifying that sincerely held statements of opinion cannot be challenged as untrue statements of fact under the first clause of § 11, the Court's decision exposes defendants to potential liability under the second clause of § 11 with respect to omissions claims for certain statements of opinion.

Background

Omnicare concerned the pleading requirements under § 11, which provides a private right of action for any investor who purchases a security pursuant to a registration statement which "contained an untrue statement of a material fact or omitted to state a material fact … necessary to make the statements therein not misleading." 15 U.S.C. § 77k. The issue presented to the Court was whether a plaintiff must plead subjective falsity or only objective falsity of a statement of opinion to plead a cause of action under § 11.

Petitioners are Omnicare, Inc., the country's largest provider of pharmacy-related services for the elderly and other residents of long-term care facilities, and individuals who were officers or directors of Omnicare at the relevant time. Respondents are pension funds which purchased shares of Omnicare stock in Omnicare's December 2005 public stock offering. The pension funds originally brought suit in 2006, alleging that statements in the registration statement were materially false or misleading at the time they were made, entitling respondents to relief under § 11.

Specifically, Omnicare's registration statement included statements of opinion as to legal compliance, such as "[w]e believe our contract arrangements with other healthcare providers, our pharmaceutical suppliers and our pharmacy practices are in compliance with applicable federal and state laws." The pension funds alleged that because some of Omnicare's contractual arrangements amounted to illegal kick-backs, this statement and others like it were materially false or misleading in violation of § 11. In order to avoid the heightened pleading burden triggered by an allegation of intent, respondents specifically disclaimed any allegation of fraud or intentional wrongdoing.

The district court dismissed the complaint for failure to state a claim, following the lead of the Second, Third, and Ninth Circuits in holding that a pleading of subjective falsity is required to make out a § 11 claim based on a statement of opinion. The Sixth Circuit reversed, holding that it was inappropriate for the district court to require the pension fund respondents to plead subjective knowledge to make out a claim because § 11 is a strict liability statute that does not require any allegation of scienter. In so doing, the court recognized its disagreement with its fellow circuits. The Supreme Court granted certiorari and heard oral argument in November 2014.

Summary of the Decision

Justice Kagan wrote the majority opinion, which was joined in full by Chief Justice Roberts and Justices Alito, Breyer, Ginsburg, Kennedy, and Sotomayor. The Court first explained that while the lower courts had addressed the issue of false and misleading statements of opinion as one question, § 11 is properly read as two separate clauses—the first clause prohibits any "untrue statement of a material fact," and the second prohibits the omission of "a material fact … necessary to make the statements … not misleading." In addressing the first clause of § 11, the Court held that "every such statement [of opinion] explicitly affirms one fact: that the speaker actually holds the stated belief." Because the first clause of § 11 only prohibits untrue statements of material fact, Justice Kagan reasoned that a statement of opinion can generally be the basis for liability under this clause only if the speaker subjectively disbelieved the opinion at the time the statement was made. Justice Kagan flatly rejected the view of both the Sixth Circuit and the respondents that Omnicare could be held liable under § 11 merely because its opinion ultimately proved to be wrong, holding that "a sincere statement of pure opinion is not an 'untrue statement of material fact,' regardless whether an investor can ultimately prove the belief wrong."

Thus, to plead a violation of the first clause of § 11, plaintiffs must plead that the defendant subjectively disbelieved the opinion at the time it was made. The Court also recognized that opinion statements may give rise to liability under the first clause of § 11 where they contain "embedded statements of [untrue] fact."

The greater portion of the Court's opinion, however, is devoted to parsing the application of the omissions clause of § 11 to statements of opinion. The Court rejected Omnicare's contention that "no reasonable person, in any context, can understand a pure statement of opinion to convey anything more than the speaker's own mindset," holding instead that a reasonable investor may understand a statement of opinion to convey more than that, depending on the context. Specifically, a reasonable investor could understand a statement of opinion to convey "facts about how the speaker has formed the opinion" or "about the speaker's basis for holding that view." The Court went on to explain that "if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then § 11's omissions clause creates liability." The Court cautioned that the facts which can be inferred are inherently contextual, and the reasonable inferences that can be made are dependent on the type of opinion being

given, the specificity of the statement, and the context of the opinion in the registration statement as a whole.

Justice Kagan looked to the common law for guidance on how a reasonable person understands statements of opinion. The common law tort of misrepresentation provided for liability for the omission of facts known to the speaker where those facts rebut the recipient's predictable inference based on a statement of opinion. Justice Kagan further expounded that the common law provided for greater liability for those who were understood "as having special knowledge of the matter which is not available" to the listener, which, in the case of the securities laws, applies to issuers, which are understood to have special knowledge about the information in their registration statements. Moreover, Justice Kagan found support for imposing liability for misleading opinions under § 11's second clause in the Congressional purpose in enacting the statute, which was meant to ensure that issuers tell the whole truth to investors: "An issuer must as well desist from misleading investors by saying one thing and holding back another" in addition to achieving literal accuracy in registration statements.

Finally, the Court rejected concerns about unpredictable standards for issuers, maintaining that such policy arguments are properly addressed to Congress and would be mitigated by the heightened pleading standard under *Iqbal v. Ashcroft*. Indeed, Justice Kagan cast doubt on the sufficiency of the instant complaint, describing respondents' "recitation of the statutory language" as "not sufficient" and "conclusory," and asserting that respondents "cannot proceed without identifying one or more facts left out of Omnicare's registration statement." The Court also rejected Omnicare's policy arguments about chilling the flow of information to investors, indicating that "market-based forces push back against any inclination to under disclose" and that "Congress worked to ensure better, not just more, information." The Court vacated the decision below and remanded the case for application of this new standard to the facts of the matter.

Justice Scalia concurred in part and in the judgment, agreeing with the majority's analysis of the first clause of § 11 but disagreeing with its analysis of the second clause. Justice Scalia disputed the majority's account of the common law, arguing that the "effect of the Court's rule is to adopt a presumption of expertise on all topics volunteered within a registration statement," which Justice Scalia argued was appropriate only for those disclosures specifically required by law to be set forth in the statement. Justice Scalia further opined that even if that presumption was appropriate, the common law standard would focus not on the expectations of the listener but rather on the adequacy of the basis of the statement from the expert speaker's point of view, because a person receiving an expert opinion does not assess the adequacy of the basis of that opinion, but rather relies on the expertise of the speaker.

Justice Thomas concurred only in the judgment, agreeing only that the statements of opinion at issue in the case do not constitute an untrue statement of material fact. Unlike the majority, however, Justice Thomas opined that the issue of whether the statements constitute an actionable omission was not properly before the Court, having not been squarely addressed by the courts below.

Implications

While the Court's opinion clarifies that sincerely held statements of opinion cannot be challenged as untrue statements of fact under the first clause of § 11, this decision nevertheless exposes defendants to potential liability under the second clause of § 11 with respect to omissions claims for certain statements of opinion. While this risk is mitigated by the Court's requirement that any alleged omissions be pled with specificity, issuers should be aware that phrasing a statement as one of opinion rather than of fact does not immunize the statement from potential § 11 liability. Such statements of opinion should be included only when there is underlying support both for making the statement and concluding that the opinion is not misleading to investors. The *Omnicare* decision creates a context and fact-specific test that, depending on the application by lower courts, could make it more difficult to obtain dismissal of § 11 claims at the pleading stage in certain cases.

Fourth Circuit Finds District Court Erred by Taking Judicial Notice of SEC Filings That Were Not "Integral" to the Complaint at the Motion to Dismiss Stage

On March 16, 2015, the Fourth Circuit found that the district court had "erred in taking judicial notice" of SEC filings submitted in support of defendants' motion to dismiss a securities fraud action because the SEC filings "did not relate to the contents of the complaint." *Zak v. Chelsea Therapeutics International*, 2015 WL 1137142 (4th Cir. 2015) (Keenan, J.). The Fourth Circuit further held that the district court's "error was not harmless, because the court [had] incorrectly construed these [SEC filings] as supporting its holding that the plaintiffs' allegations of scienter were legally insufficient." The Fourth Circuit therefore reversed dismissal of plaintiffs' suit.

Background

Plaintiffs contended that Chelsea Therapeutics International ("Chelsea") and several of its corporate officers had made "dozens of allegedly misleading statements or material omissions" concerning the likelihood of FDA approval for Northera, a pharmaceutical treatment for a certain type of hypertension. The complaint stated "in general terms that, in investigating the case, plaintiffs' counsel had reviewed the public filings submitted [by Chelsea] to the SEC." Beyond this assertion, "the complaint did not otherwise refer to any SEC filings, or the contents of such filings, to support [ ] plaintiffs' allegations."

Defendants moved to dismiss plaintiffs' complaint under Rule 12(b)(6). Defendants asked the court to take judicial notice of several exhibits, including SEC filings, attached to their motion. According to defendants, the company's SEC filings demonstrated that "none of the Chelsea officers had sold any shares of Chelsea stock during the class period." Defendants asserted "that the absence of such sales undermined any inference of scienter."

The district court "took judicial notice of the SEC documents, and granted [ ] defendants' motion to dismiss." In "weighing the competing inferences regarding scienter," the court relied on Chelsea's SEC filings to find that "*none* of the individual defendants [had] sold stock during the class period." The court determined that "the lack of stock sales 'tip[ped] the scales in favor of defendant[s'] motion' to dismiss." Plaintiffs appealed.

Fourth Circuit Holds That the District Court Should Not Have Considered Defendants' SEC Filings in Evaluating Plaintiffs' Allegations Because the Complaint Did Not Explicitly Reference Those Filings

On appeal, the Fourth Circuit stated that "when a defendant moves to dismiss a complaint under Rule 12(b)(6), courts are limited to considering the sufficiency of allegations set forth in the complaint and the documents attached or incorporated into the complaint." The Fourth Circuit stated that "[c]onsideration of a document attached to a motion to dismiss ordinarily is permitted only when the document is integral to and explicitly relied on in the complaint and when the plaintiffs do not challenge [the document's] authenticity."

Here, the Fourth Circuit found that defendants' SEC filings "were not explicitly referenced in, or an integral part of, [ ] plaintiffs' complaint." Moreover, "the complaint did not contain any allegation suggesting that the individual defendants [had] made any sales or purchases of Chelsea stock during the class period," nor were "such allegations … required to demonstrate a strong inference of scienter." The Fourth Circuit therefore ruled that "the district court should not have considered [Chelsea's SEC filings] in reviewing the sufficiency of … plaintiffs' allegations."

Fourth Circuit Finds That Even If It Had Been Proper for the District Court to Take Judicial Notice of Defendants' SEC Filings, the District Court Had "Incorrectly Construed" Those Filings

The Fourth Circuit stated that there is a "narrow exception" pursuant to which courts may, at the motion to dismiss stage, consider "facts and documents" that are not "integral to" or "explicitly relied on" in the complaint.

Pursuant to Federal Rule of Evidence 201, "courts at any stage of a proceeding may 'judicially notice a fact that is not subject to reasonable dispute,' provided that the fact is 'generally known within the court's territorial jurisdiction' or 'can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned'" (quoting F.R.E. 201). The Fourth Circuit stated that "when a court considers relevant facts from the public record at the pleading stage" under Rule 201, "the court must construe such facts in the light most favorable to the plaintiffs."

In the case before it, the Fourth Circuit determined that even if it had been proper for the district court to take judicial notice of Chelsea's SEC filings pursuant to Rule 201, the district court had "incorrectly construed the information contained in [those] documents." The Fourth Circuit found that Chelsea's SEC filings "did not provide a factual basis for the [district] court's conclusion that no individual defendant [had] sold Chelsea stock during the class period." Moreover, the Fourth Circuit held that this error "was not harmless" because the court had placed great weight on "defendants' purported failure to sell Chelsea stock during the class period" when evaluating plaintiffs' scienter allegations.

Fourth Circuit Determines Plaintiffs Had Adequately Pled Scienter Based on Defendants' Alleged Failure to Disclose Adverse FDA Guidance

Following a "de novo review" of plaintiffs' scienter allegations, the Fourth Circuit found that "plaintiffs' allegations … permit[ted] a strong inference that … defendants [had] either knowingly or recklessly misled investors by failing to disclose critical information received from the FDA during the new drug application process, while releasing less damaging information that they knew was incomplete." The court concluded that plaintiffs had adequately pled scienter by alleging a "conflict[ ]" between the "material, non-public information known to [ ] defendants about the status of" the company's application for FDA approval of Northera and "defendants' public statements on those subjects."

The Fourth Circuit "emphasize[d] that [its] conclusion [did] not stand for the proposition that a strong inference of scienter can arise merely based on a defendant's failure to disclose information." The court recognized that "Chelsea and its corporate officers may have lacked an independent, affirmative duty to disclose" adverse information received from the FDA in connection with the company's application for FDA approval of Northera. However, the Fourth Circuit stated that "defendants' failure" to disclose "must be viewed … in the context of the statements that they affirmatively elected to make" regarding the likelihood that the FDA would approve Northera. The Fourth Circuit noted that under *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011), "companies can control what they have to disclose under [Section 10(b) and Rule 10b-5(b)] by controlling what they say to the market" (quoting *Matrixx*, 131 S. Ct. 1309).

Judge Thacker, Dissenting, Finds That the Majority Applied Too Lenient of a Standard to Plaintiffs' Scienter Allegations

Judge Thacker dissented from the Fourth Circuit's majority opinion, finding that the majority had applied an overly lenient standard in evaluating plaintiffs' scienter allegations. Judge Thacker stated that the Fourth Circuit's decision in *Cozzarelli v. Inspire Pharmaceuticals, Inc.*, 549 F.3d 618 (2008) "makes clear that pleading scienter—whether in the form of fraudulent intent or severe recklessness—requires a showing of 'wrongful intent.'" She explained that "[t]his understanding of scienter … necessarily entails a 'culpable state of mind.'" Judge Thacker emphasized that courts in the Fourth Circuit may "not infer scienter 'from every bullish statement by a pharmaceutical company … trying to raise funds'" (quoting *Cozzarelli*, 549 F.3d 618). Judge Thacker stated that she would have affirmed the district court's decision.

Southern District of New York Finds That "Maintaining or Furthering a Friendship" Can Constitute a "Personal Benefit" to the Tipper Notwithstanding the Second Circuit's Decision in *United States v. Newman*

To sustain an insider trading conviction against a tipper, the government must establish that the tipper "personally … benefit[ed], directly or indirectly, from his disclosure" of confidential information to an outsider. *Dirks v. S.E.C.*, 463 U.S. 646 (1983). In *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014) (Parker, J.), the Second Circuit held that the government may not "prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature."[1]

On March 3, 2015, the Southern District of New York ruled that a "personal benefit" could be found under *Newman* "[i]f a tip maintains or furthers a friendship, and is not simply incidental to the friendship" because this may be "circumstantial evidence that the friendship is a *quid pro quo* relationship." *United States v. Riley*, 2015 WL 891675 (S.D.N.Y. 2015) (Caproni, J.).

Background

The case before the Southern District of New York concerned the insider trading conviction of David Riley, Foundry Network's former Chief Information Officer. Riley had allegedly disclosed material, nonpublic information ("MNPI") with respect to Foundry's sales data and acquisition prospects to Matthew Teeple, a hedge fund analyst. The trial court's "charge permitted the jury to find that Riley had obtained a personal benefit in exchange for the MNPI … if he [had] provided the information for the purpose of 'maintaining or furthering a friendship.'" The jury convicted Riley on two counts of securities fraud and one count of conspiracy to commit securities fraud.

When the Second Circuit issued its decision in *Newman*, 774 F.3d 438, Riley moved for a new trial or, alternatively, a judgment of acquittal. Riley contended, *inter alia*, that the trial court's "instruction to the jury regarding the personal benefit element of securities fraud was erroneous in light of *Newman*."

Southern District of New York Finds That Information-Sharing to Maintain or Further a Friendship Suggests a *Quid Pro Quo* Relationship

The Southern District of New York acknowledged that under *Newman*, "'the mere fact of a friendship, particularly of a casual or social nature,' between the tipper and the tippee is not sufficient evidence that a personal benefit inured to the tipper" (quoting *Newman*, 774 F.3d 438). The court observed that here, however, the trial court's "instruction to the jury did not permit it to convict just because Teeple and Riley were friends." Rather, the trial court's charge "required that the tip be given to 'maintain[ ] or further[ ] a friendship." The Southern District of New York determined that "[i]f a tip maintains or furthers a friendship, and is not simply incidental to the friendship, that is circumstantial evidence that the friendship is a *quid pro quo* relationship." The court emphasized that "[t]he existence of some *quid pro quo* is the *sine qua non* of tipper liability for insider trading."

The court found that *Newman* does not preclude a finding of "personal benefit" based on the maintenance or furtherance of a friendship, as distinguished from the "mere" existence of a friendship. In *Newman*, the Second Circuit recognized that a "personal benefit" could be found if there was "proof of a meaningfully close personal relationship that generate[d] an exchange that [was] objective, consequential, and represent[ed] at least a potential gain of a pecuniary or similarly valuable nature" (quoting *Newman*, 773 F.3d 438). The court explained that under *Newman*, "[t]he tipper's gain does not have to be '*immediately* pecuniary,' but 'the personal benefit received in exchange for confidential information must be of some consequence'" (quoting *Newman*, 773 F.3d 438 (emphasis in original)). The *Newman* court "acknowledge[d] … that a tipper has received a personal benefit when there is 'a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the latter'" (quoting *Newman*, 773 F.3d 438).

1. Please click here to read our discussion of the *Newman* decision in the December 2014 edition of the Alert.

Based on this analysis, the Southern District of New York concluded that the trial court's jury instruction was not "plain error" under *Newman*. Although the Second Circuit might eventually "rule that merely maintaining or furthering a friendship is not a sufficient personal benefit" for purposes of an insider trading conviction, the court found that it was "not 'plain' that the Second Circuit ha[d] done so already" in *Newman*.

Southern District of New York Determines That Any Rational Jury Would Have Found That Riley Had Obtained a "Personal Benefit" from the Disclosure at Issue

The Southern District of New York found that even if the trial court's charge to the jury had been erroneous, the error had no impact on Riley's "substantial rights" because "any rational jury would have found, beyond a reasonable doubt, that Riley [had] obtained a personal benefit from providing MNPI to Teeple." The court determined that "[a]t a minimum, Riley [had] obtained three concrete personal benefits that were 'objective, consequential, and represent[ed] at least a potential gain of a pecuniary or similarly valuable nature'" (quoting *Newman*, 773 F.3d 438). First, "Teeple provided Riley with access to his many contacts," including in connection with Riley's "side business" and "his job search." Second, Teeple gave Riley "investment advice (which Teeple provided to others, but not for free)." And third, Teeple offered "insight into the companies with whom Riley was pursuing opportunities."

The court held that "[t]he relationship between Riley and Teeple was clearly a *quid pro quo* relationship in which each was trying to help the other; Riley's *quid* was Foundry's MNPI." The court therefore denied Riley's motion for both a new trial and for a judgment of acquittal.

Southern District of New York Declines to Exercise Section 1331 Jurisdiction Over a Derivative Suit Concerning FCPA Violations on the Grounds That Doing So Would Be Tantamount to Recognizing a Private Right of Action Under the FCPA

Pursuant to 28 U.S.C.A. § 1331, federal courts "have original jurisdiction of all civil actions *arising under* the … laws … of the United States" (emphasis added). On March 16, 2015, the Southern District of New York held that Section 1331's "arising under" requirement was not met in a shareholder derivative suit concerning Avon Products' alleged failure to comply with the Foreign Corrupt Practices Act ("FCPA"). *Pritika v. Moore*, 2015 WL 1190157 (S.D.N.Y. 2015) (Gardephe, J.). The court found that "exercising subject matter jurisdiction over [p]laintiff's state law claims would be tantamount to recognizing a private right of action under the FCPA."

Southern District of New York Explains that Section 1331 Confers Jurisdiction Over State Law Claims Only In "Exceptional" Cases

The Southern District of New York observed that "[f]ederal courts may exercise jurisdiction over state [law-based] claims" pursuant to Section 1331 "where it appears that some substantial, disputed question of federal law is a necessary element of one of the well-pleaded state [law] claims." In determining whether jurisdiction under Section 1331 is proper, courts must consider whether the state law claim "(1) necessarily raise[s] a stated federal issue" that is "(2) actually disputed and (3) substantial, which (4) a federal forum may entertain without disturbing any congressionally approved balance of federal and state judicial responsibilities" (quoting *Grable & Sons Metal Products, Inc. v. Darue Engineering & Manufacturing*, 545 U.S. 308 (2005)). The court underscored that state law-based claims that warrant Section 1331 jurisdiction are "extremely rare exceptions to the general rule that a suit arises under the law that creates the cause of action."

Southern District of New York Determines That Plaintiff's Derivative Suit Does Not Satisfy *Grable*'s Substantiality Requirement Because It Does Not Implicate the FCPA's Validity or Its Requirements

The court found that plaintiff's state law-based derivative action, brought on behalf of nominal defendant Avon, did not satisfy *Grable*'s substantiality requirement. While the court recognized that "Avon's compliance with the FCPA [would] be one of the critical issues in this litigation," the court determined that the "case [did] not implicate the validity of the FCPA or the requirements that the Act imposes." Rather, the case "involve[d], at best, the application of a federal legal standard to private litigants' state law claims."

The court rejected plaintiff's contention that it should exercise Section 1331 jurisdiction over plaintiff's claims because "a court may be required to interpret certain provisions of the [FCPA]" "in determining whether [d]efendants' conduct [violated] FCPA standards." The court explained that the same argument could be made "for every case that involves state law claims invoking a federal standard." The court also found meritless plaintiff's assertion that Section 1331 jurisdiction was warranted because "the FCPA is not commonly the subject of litigation." The court explained that in *Merrell Dow Pharmaceuticals, Inc. v. Thompson*, 478 U.S. 804 (1986), the Supreme Court "explicitly rejected the argument that the novelty of [an] issue" can justify the exercise of Section 1331 jurisdiction.

Southern District of New York Finds That Exercising Section 1331 Jurisdiction Over Plaintiff's Claims Would Disturb a "Congressionally Approved Balance of Federal and State Judicial Responsibilities" with Respect to FCPA Enforcement

The court further determined that it "could not exercise subject matter jurisdiction here 'without disturbing [the] congressionally approved balance of federal and state judicial responsibilities" with respect to FCPA enforcement (quoting *Grable*, 545 U.S. 308). The court explained that "Congress intended that federal court litigation under the FCPA would proceed by way of SEC and DOJ enforcement actions, … and not via private suit."

The court found that "exercising subject matter jurisdiction over [p]laintiff's state law claims would be tantamount to recognizing a private right of action under the FCPA." Taking "[s]uch an approach would 'open the floodgates' to federal court litigation of private disputes raising issues under the FCPA, an outcome directly contrary to Congress's apparent intent." The court therefore dismissed plaintiff's derivative suit for lack of subject matter jurisdiction.

Southern District of New York Dismisses Securities Fraud Action Against Molycorp, Finding That the Case Was a "Classic Example of 'Fraud by Hindsight'"

On March 12, 2015, the Southern District of New York dismissed a securities fraud action against Molycorp Inc. for failure to allege scienter with respect to the progress of a mining project and the commercial potential of one of the company's products. *In re Molycorp, Inc. Sec. Litig.*, 2015 WL 1097355 (S.D.N.Y. 2015) (Crotty, J.). The court found that that the case was a "classic example of fraud by hindsight" in which plaintiffs attempted to plead scienter based on company statements that later turned out to be inaccurate.

Southern District of New York Determines That Defendants' Alleged Misstatements Concerning the Progress of Project Phoenix Were at Most Erroneous, Rather Than Reckless

The court found that plaintiffs had failed to allege scienter with respect to defendants' alleged misstatements concerning the progress and anticipated completion date of Phase 1 of Project Phoenix, an effort to modernize Molycorp's rare earths mine.

Plaintiffs attempted to plead scienter by demonstrating "circumstantial evidence of conscious misbehavior or recklessness," rather than "motive and opportunity to

commit the alleged fraud." The court explained that a "stricter standard" applies to scienter allegations based on "a conscious misbehavior or recklessness theory." Although a plaintiff can "plead scienter by identifying conscious misbehavior by the defendant, … the strength of circumstantial allegations must be correspondingly greater" than the allegations sufficient to plead scienter under a motive and opportunity theory. "A finding of recklessness requires a showing of conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care … to the extent that the danger was either known to the defendant or so obvious the defendant must have been aware of it." The court held that "[p]laintiffs' allegations fail[ed] to meet this high burden" for a number of reasons.

First, the court found that "a close analysis of the allegations of confidential witnesses" relied on by plaintiffs "reveal[ed] that the [c]omplaint d[id] not actually come close to alleging [d]efendants' knowledge of delays at the [Project Phoenix] mine until, at the earliest, June 2012." The court determined that "this dearth of scienter allegations mean[t] that a large portion of the statements which [p]laintiffs allege[d] [were] actionable, made during February and May [2012], [were] patently not actionable." The court found the remaining confidential witness allegations "devoid of facts demonstrating that [d]efendants knew they would fail to meet the announced schedule [for completing Phase 1 of Project Phoenix] when the statements were made." At best, the allegations "may show that [ ] defendants should have been more alert and more skeptical, but nothing alleged indicates that management was promoting a fraud."

Second, the court rejected plaintiffs' efforts to allege scienter based on defendants' knowledge of "serious problems in work performed by a [Project Phoenix] contractor, M & K Chemical Engineering." Even though "poor work was done and … the damages were significant enough for Molycorp to sue M & K," the court determined that this was not sufficient to establish "that Molycorp knew its proposed schedule [for completing Phase 1 of Project Phoenix] was no longer viable." The court found it "equally as likely, and indeed more compelling, that Molycorp believed it could remedy this damage within the existing time frame."

Third, the court determined that there was no basis for plaintiffs' assertion that defendants "must have known of the delay in completion of Phase 1 [of Project Phoenix] prior to the company's January 10, 2013 announcement that the project would take six months longer than expected. The court explained that "[m]anagers … are entitled to investigate for a reasonable time, until they have a full story to reveal." Moreover, even if defendants had relied on timelines that "were not realistic," the court emphasized that "recklessness and erroneousness are not equivalent" for purposes of alleging securities fraud. The court stated that "[j]ust because something is wrong or incorrect as a matter of fact does not mean it was reckless."

Fourth, the court found that plaintiffs had not alleged scienter based on "the facts that the financials were SOX-certified; that Project Phoenix was a 'core operation' of Molycorp; and that certain [i]ndividual [d]efendants were 'forced' to resign during the class period." The court explained that "in the absence of more particularized allegations of scienter," the fact "that certain [d]efendants signed or certified SEC disclosures is insufficient to support a finding of scienter." Moreover, "without factual allegations linking [d]efendants' resignations to the alleged fraud, the mere fact of the resignations provides no support for a finding of scienter." Finally, with respect to plaintiffs' attempt to rely on the "core operations" theory, the court explained that "the majority approach" in the Second Circuit "has been to consider such allegations as a supplementary but not independently sufficient means to plead scienter."

The court concluded that "[p]laintiffs' allegations regarding Project Phoenix read as a classic example of 'fraud by hindsight.'" Given that defendants "eventually disclosed the delay" in anticipated Phase 1 completion of Project Phoenix, the court found that permitting plaintiffs' claims to go forward "would impose too high a burden of clairvoyance and continuous disclosure on corporate officials."

Southern District of New York Holds Plaintiffs' Scienter Allegations Concerning the Commercial Viability of SorbX Inadequate Under the Heightened Scienter Standard Applicable to Forward-Looking Statements

The court determined that plaintiffs had also failed to allege scienter with respect to alleged misstatements concerning "Molycorp's progress in building commercial potential for SorbX, Molycorp's proprietary water filtration product." The court found that "[t]he majority of statements regarding SorbX identified in the complaint [were] classically forward-looking—they address[ed] what defendants expected to occur in the future." The court explained that "[t]he scienter requirement for forward-looking statements—actual knowledge—is stricter than [the standard applicable to] statements of current fact."

Here, the court found "[p]laintiffs' allegations of [d]efendants' knowledge … both speculative and conclusory." For example, plaintiffs cited a confidential witness who stated that "if anyone in management was 'paying attention,' they would [have] know[n] by late 2012 that SorbX had no short term commercial potential." The court explained that these types of allegations do "not meet th[e] [actual knowledge] standard" for forward-looking statements.

The court also found insufficient plaintiffs' attempt to allege scienter based on Molycorp's August 8, 2013 announcement that it would restate its financials for the first quarter of 2013, and therefore dismissed the complaint in its entirety.

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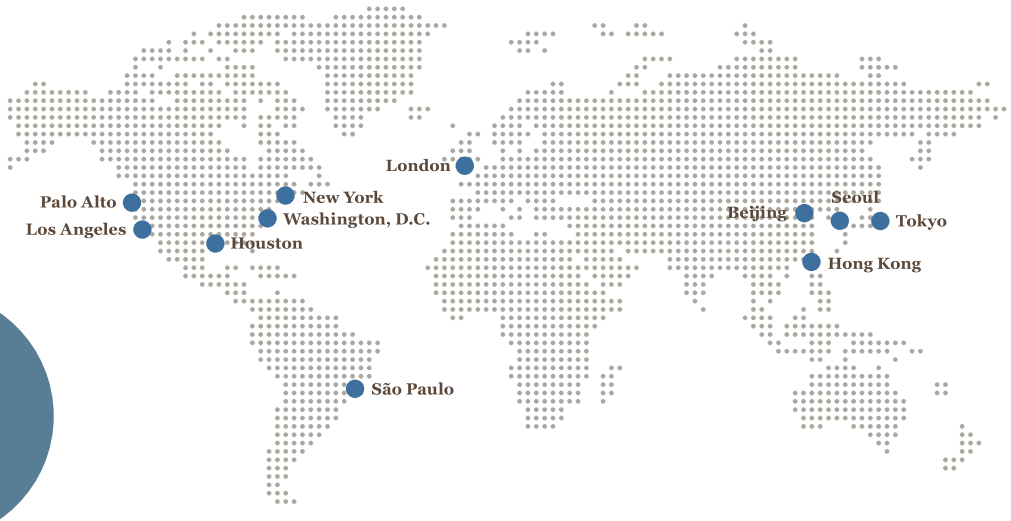

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