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Second Circuit Clarifies Nature of Actionable Opinions Under Securities Laws

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The U.S. Court of Appeals for the Second Circuit held that a statement of opinion that reflects some subjective judgment can nevertheless be actionable under the securities laws if it misleads investors into thinking that the issuer had historical or factual support for the judgment made. But the court also held that corporate officers' certifications of financial statements are nonactionable opinions in the absence of allegations that the officers either did not believe their certifications or knew that the financial statements were false or misleading.

The decision in *New England Carpenters Guaranteed Annuity and Pension Funds v. DeCarlo* continues to develop Second Circuit case law on the extent to which statements of opinion are actionable, an issue the Supreme Court addressed in its 2015 decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*. The Second Circuit's new ruling underscores the need to examine whether a statement of opinion accurately conveys the extent to which it has (or does not have) factual support. The ruling also could provide additional protection for corporate officers' certifications of financial statements.

Background

The *DeCarlo* litigation arose from AmTrust Financial Services' restatement of five years of financial results to correct "significant errors in its annual and quarterly reports." The company – a property and casualty insurer – disclosed that it had improperly recognized most of the expected revenue from certain extended-warranty contracts at the beginning of the contract term (at time of sale), rather than over the contracts' duration. AmTrust also reported that it had improperly accounted for certain discretionary employee bonuses by treating them as expenses in the year they were paid, rather than in the year they were earned by the employees. AmTrust's stock price fell when the restatement was announced, and shareholder litigation ensued under §§ 11, 12, and 15 of the Securities Act and §§ 10(b) and 20(a) of the Securities Exchange Act.

The District Court dismissed all claims, holding that the alleged misrepresentations were nonactionable statements of opinion, rather than misstatements of fact. The Second Circuit reversed the dismissal of some of the Securities Act claims against the AmTrust defendants, but affirmed the dismissal of the Exchange Act claims for lack of scienter.

The Second Circuit's Decision

The Second Circuit began by focusing on the difference between facts and opinions, as articulated in the court's prior case law and in *Omnicare*: "a fact is 'a thing done or existing or an actual happening,' while an opinion is 'a belief, a view, or a sentiment which the mind forms of persons or things'" (quoting *Omnicare*). Opinions nevertheless can be actionable as false or misleading statements under the securities laws if "'the speaker did not hold the belief she professed'" or if "the statement of opinion contains embedded statements of fact that are untrue, or the statement omits information whose omission conveys false facts about the speaker's basis for holding that view and makes the opinion statement misleading to a reasonable investor."

Applying those principles, the court held that plaintiffs had pled actionable false or misleading statements as to AmTrust's accounting for extended-warranty revenue and discretionary employee bonuses even though generally accepted accounting principles governing those matters involved some exercises of judgment.

Extended-Warranty Revenue. AmTrust argued that accounting for extended-warranty revenue involved judgment calls because GAAP allows revenue recognition at time of sale, rather than on a straight-line basis over the contract life, in some circumstances. AmTrust therefore asserted that its opinion as to which revenue-recognition principles to apply was not an actionable misrepresentation or omission. But the Second Circuit held that "subjective judgments about the sufficiency of historical evidence to support a particular accounting treatment presuppose the existence of some historical evidence" for the chosen accounting treatment and that GAAP "permits time-of-sale recognition only if some historical evidence justified doing so." At the pleading stage, the court credited plaintiffs' allegations that no such historical evidence existed here. Accordingly, "AmTrust's representations about the warranty contract revenue reported in its historical consolidated financial statements misled investors to conclude that the company was aware of some historical evidence in support of recognizing the revenue on a non-straight-line basis, when in (alleged) fact it was not."

Discretionary Employee Bonuses. AmTrust contended that it had exercised judgment in expensing discretionary employee bonuses when the bonuses were paid rather than when they were earned because payment of bonuses was not "probable" until the time of actual payment. But the court, again for pleading-stage purposes, accepted plaintiffs' allegations that AmTrust had a practice of paying bonuses and that "there was no basis to conclude that continued payment of earned bonuses was not 'probable' and that such bonuses therefore could not be expensed when earned." Accordingly, the court held that, even if the accounting for discretionary bonuses was a statement of opinion on the theory that "determining whether it is 'probable' that the corporate officers would exercise their discretion to pay the bonuses at a future time is a matter of subjective judgment," the statements nevertheless were actionable "because the Complaint adequately alleges that it was improbable that the earned bonuses would not be paid." In other words, the company's (admittedly improper) accounting judgment, even if an opinion, had implied the allegedly erroneous *fact* that payment of the bonuses was not "probable."

But on another opinion issue – the officer defendants' Sarbanes-Oxley certifications of the accuracy of AmTrust's financial reporting and the adequacy of its internal controls – the Second Circuit sided with the defendants and affirmed the dismissal of the claims. The court held that the certifications "signal that they are opinions by stating that they are 'based on [the] knowledge' of the officer," and "there is no allegation that the opinion is actionable on the ground that it was not based on the officer's knowledge." The court rejected plaintiffs' contention that the officers had known that the financial reports were false, misleading, or noncompliant with GAAP; it also held that plaintiffs had not pled facts establishing "a lack of meaningful inquiry, other than the fact that the certification turned out to be wrong." Nor did AmTrust's change of its accounting opinion (through the restatement) "mean that the original certified opinions were disingenuous."

Implications

The *DeCarlo* decision confirms the availability of an "opinion" defense to certain charges of false or misleading statements, but it illustrates the limitations on that defense. If the appropriateness of an opinion or judgment depends on the existence of certain supporting facts or evidence, a defendant who contends that an alleged misrepresentation was merely a nonactionable opinion or judgment must have had some factual or evidentiary basis for making that judgment. Otherwise, a plaintiff might be able to plead that the expression of the opinion or judgment misled investors to believe that the underlying facts or evidence existed even though, in reality, they allegedly did not. Thus, even if the alleged misrepresentation itself was actually an opinion, it created a misleading impression about an underlying fact: the existence of a factual or historical basis for the opinion. The Second Circuit's decision should be good news for signers of Sarbanes-Oxley certifications attesting to the accuracy of an issuer's financial statements and the adequacy of its internal controls. Those certifications are expressions of opinion where they state they are based on the signer's knowledge. However, the opinion defense will not be available if the signer *knew* the certifications were incorrect. The *DeCarlo* court noted that the plaintiffs had not developed an argument that the certifications contained false or misleading statements of fact, so the court did not address that question. But if certifications do contain embedded false statements of fact, an opinion defense might not be available for that reason as well.

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