Second Circuit Finds Alleged Reckless Failure to Disclose Loan Used to Pay Rent to Lender Was Sufficient to Give Rise to Strong Inference of Scienter

On August 3, 2020, the United States Court of Appeals for the Second Circuit reversed the dismissal of a securities fraud claim brought pursuant to Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"). *Setzer* v. *Omega Healthcare Inv'rs, Inc.*, 2020 WL 4431902, at *1 (2d Cir. Aug. 3, 2020) (hereinafter, *Setzer* v. *Omega*).[1] The Second Circuit analyzed both the factors giving rise to a duty of disclosure and how to assess scienter in the context of an allegedly reckless (as opposed to intentional) non-disclosure and held that allegations about the allegedly reckless failure to disclose a loan used to pay rent to the lender were sufficient to give rise to a strong inference of scienter.

I. Background

Omega Healthcare Investors, Inc. ("Omega") is a publicly traded, self-administered real estate investment trust that invests in healthcare facilities. Omega earns money by collecting rent payments from the operators of those facilities. *In re Omega Healthcare Inv'rs, Inc. Securities Litig.*, 375 F. Supp. 3d 496, 502 (S.D.N.Y. 2019) (hereinafter, *In re Omega*). By late 2016 and early 2017, Orianna Health Systems ("Orianna"), Omega's second largest operator, experienced severe financial difficulties and became delinquent on its rent payments. *In re Omega*, at 502.

On May 2, 2017, Omega provided a $15 million working capital loan to Orianna (the "Loan"). *Id.* The next day, Omega issued a press release that included funds from operations ("FFO") estimates of $3.40 to $3.44 per share (diluted). *Id.* On May 4, Omega stated on its first quarter earnings call that, "[o]ne private top 10 operator, of note, however, felt the performance pressure more than most," which "was exacerbated in 2016 by complete replacement of senior management early in the year." *Id.* In response to an analyst who questioned why Omega's guidance did not reflect that the tenant [i.e., Orianna] was no longer paying rent, Taylor Pickett, Omega's Chief Executive Officer, stated "… at 45 days past due, to start fiddling around with guidance, just doesn't make any sense, we feel pretty comfortable that they're going to come back with coverages at their previous level …" *Id.* at 502-03. Following the earnings call, on May 5, Omega filed its Quarterly Report on Form 10-Q for the quarter ended March 31, 2017, which stated, among other matters, that there were no material changes to previously disclosed risk factors. *Id.*

On July 27, 2017, Daniel Booth, Omega's Chief Operating Officer, stated during its second quarter earnings call that Orianna's rent payments were ninety days past due, and that any further such issues would result in Orianna being placed in cash basis accounting. *Id.* Omega's Quarterly Report on Form10-Q for the quarter ended June 30, 2017 stated that Orianna was making partial monthly rent payments. *Id.*

By the end of the third quarter of 2017, Orianna had not achieved its recovery goals. Omega placed Orianna on a cash basis, recognizing no revenue for Orianna for the quarter. *Id.* at 504. On October 30, 2017, Omega issued a press release, disclosing impairments of $194.7 million on direct financing leases and $9.5 million in provisions for uncollectible accounts related to Orianna, contributing to an overall $46.8 million loss of FFO. *Id.* Omega did not disclose to investors the existence of the Loan in any of the above-referenced Securities and Exchange Commission filings or earnings calls.

[1] Unless otherwise noted, all quotations in this memorandum are taken from this decision.

Omega shareholders brought suit in the United States District Court for the Southern District of New York, arguing that Omega and its chief executives violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. *Id.* at 501. The shareholders also brought a Section 20(a) claim against Omega's chief executives. *Id.*

Plaintiffs argued a two-pronged theory of liability under Section 10(b) of the Exchange Act. *Id.* at 506. First, plaintiffs asserted that Omega used both the fact and the non-disclosure of the Loan to make various material misrepresentations of its FFO and adjusted funds from operations ("AFFO"). *Id.* Second, plaintiffs argued that defendants' failure to disclose the Loan was a material omission that independently establishes liability under Section 10(b). *Id.*

The district court found that the Loan was material, as the inability of one of Omega's top operators to pay its rent in the absence of the Loan "can be construed as playing a 'significant role' in Omega's business, such that the issuance of the loan 'significantly altered the total mix of information made available.'" *Id.* at 509.

Focusing on the allegations that Omega was reckless in not disclosing the Loan, the district court observed that the plaintiff was required to "present facts indicating a clear duty to disclose." *Id.* at 510. The court explained that "[s]uch a clear duty can arise 'from the need to correct or update prior statements, and that, where a duty is 'not so clear,' failure to disclose is insufficient to establish conscious misbehavior or recklessness." *Id.* (internal citations omitted).

Plaintiffs attempted to clear this hurdle by arguing that Omega was only able to report that Orianna was making partial rent payments by essentially paying itself with the Loan, and Omega knew that Orianna's financial condition was materially more dire than what they disclosed. *Id.* Plaintiffs also alleged that defendants were reckless in omitting the Loan because, once the defendants spoke about Orianna's financial health, there was a "duty to tell the whole truth." *Id.* at 511. The district court rejected plaintiffs' scienter argument, observing that:

> Of course, Omega would have acted with scienter had they chosen to discuss the positive aspects of Orianna's predicament (e.g., the replacement of senior management) while omitting negative aspects (e.g., Orianna's inability to pay rent). But that is not what happened here. In fact, Omega disclosed Orianna's financial predicament repeatedly to investors, first on the May conference call, and again in July, when they forewarned "any further deterioration and/or the failure of [Orianna] to achieve its budgeted plan may result in cash basis accounting." *Id.*

The district court explained, "At most, Omega's failure to disclose the working capital loan constitutes non-actionable fraud by hindsight." *Id.* The court concluded, "while omission of the working capital loan arguably became more significant once Orianna's financial situation deteriorated to the point Omega transitioned them to cash basis accounting, 'corporate managers are not obligated to portray their business'[s] performance and prospects in unduly cautious or gloomy terms in public pronouncements.'" *Id.* (internal citations omitted). Accordingly, the district court found that plaintiffs failed to allege scienter and dismissed plaintiffs' remaining Section 10(b) claims. *Id.*

II. Second Circuit Decision

The Second Circuit reversed the district court, holding both that Omega was required to disclose the Loan and that the allegations were sufficient to state a claim that Omega acted with scienter in connection with the non-disclosure. *Setzer* v. *Omega* at *1. The Second Circuit found that "Omega's duty to disclose the Loan arose directly from Rule 10b-5's requirement to disclose 'material fact[s] necessary in order to make the statements made, in the

light of the circumstances under which they were made, not misleading.'" (citing 17 C.F.R. § 240.10b–5(b)). The Court analyzed the situation as follows:

> By failing to disclose that the Loan accounted for all (or most) of Orianna's partial monthly rent payments, Defendants effectively communicated that, notwithstanding any disclosures regarding Orianna's performance issues, Orianna could pay more than half of its rent from its earnings. The omission concealed the extent of Orianna's solvency problems: Orianna could not pay rent without borrowing from its landlord. Under the facts as alleged, because in July 2017 Omega had stated that Orianna was making partial monthly payments, Omega was duty-bound to disclose that its loan was the source of Orianna's rent payments. *Id.* at *7.

Turning to the scienter analysis, the Second Circuit explained that plaintiffs typically state a securities fraud claim based on recklessness when they allege that the defendants knew or should have known of information contradicting their public statements. Thus, the Court observed that in determining whether the complaint adequately alleges facts giving rise to a strong inference that defendants acted recklessly, it focuses on the "defendants' degree of knowledge and the seriousness of the impact that results from their conduct."

Echoing the district court, the panel stated that the inability of one of Omega's top tenants to pay rent absent the Loan was clearly material. According to the Court, Orianna's performance clearly impacted Omega's overall financial health and Omega had to know that revealing the extent Orianna's financial problems would have been troubling to its investors. The Second Circuit continued, "Moreover, assuming most of the Loan proceeds were used to pay Orianna's rent during the second quarter—as the Complaint alleges—Omega knew that its money would be going directly back into its FFO and/or AFFO." Despite this, "Defendants chose to represent these numbers as 'partial monthly payments' indicating that Orianna was on the road to recovery" (internal citations omitted). The Second Circuit further observed in a footnote that Omega may not have violated U.S. generally accepted accounting principles ("GAAP"), but its alleged conduct remained "seriously misleading" because failing to disclose the Loan allowed Omega to express optimism about the financial performance of a key tenant.

Reaching the opposite conclusion from that of the district court, the Second Circuit highlighted that Omega's multiple disclosures regarding Orianna's financial difficulties actually *support* a finding of recklessness, as "they strongly suggest that Defendants sought to use Orianna's 'partial rental payments' to express optimism and underrepresent the extent of those very problems." (emphasis added). The Court concluded, "The facts alleged in the Complaint therefore support a strong inference that Defendants' failure to disclose the Loan constituted 'conscious misbehavior,' or, at the very least, 'highly unreasonable [conduct] ... [that] represents an extreme departure from the standards of ordinary care.'" Accordingly, the Court reversed the district court's decision.

III. Implications

The Second Circuit's decision in *Setzer* v. *Omega* clarifies that a violation of GAAP is not required to plead scienter under a recklessness theory regarding financial disclosure. Rather, courts within the Second Circuit will focus on "defendants' knowledge of facts or access to information contradicting their public statements." This is particularly important for companies accused of securities fraud based on transactions that may provide a non-disclosed benefit to one of the parties to the transaction. Companies should take care to consider carefully the scope of their disclosures when describing dependent business relationships that could give rise to claims of self-dealing or improper financial support.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email Joel Kurtzberg at 212.701.3120 or jkurtzberg@cahill.com; Peter J. Linken at 212.701.3715 or plinken@cahill.com; or G. Kevin Judy II at 212.701.3499 or kjudy@cahill.com; or email publications@cahill.com.