Helwig v. Vencor, Inc.

251 F.3d 540 (6th Cir. 2001)

Merritt, Judge.

* * *

The complaint in this securities class action features allegations of insider trading, fraudulent omissions, and inflated stock prices punctured by bad news in the health care industry. The principal issues on appeal arise under the new pleadings standard created by the Private Securities Litigation Reform Act of 1995. As often is the case in suits for securities fraud, we must deal with controverted inferences of knowledge and intent to defraud from facts that give rise to more than one interpretation. How to steer a course between indulging strike suits and predatory allegations on the one hand and deterring meritorious claims on the other: This has been the work of Congress and a number of our sister circuits. The fruit of their efforts has been a statute containing general language at a high level of abstraction, an ambiguous legislative history, and a tri-parted split among the circuit courts. We conclude that plaintiffs here have stated a claim for securities fraud by creating—in the words of the statute—a "strong inference" that defendants projected financial well-being at a time when they had actual knowledge that their statements were false or misleading, while knowingly omitting material facts that would have tempered their optimism. . . .

At the time of the events in suit, defendant Vencor, a company then traded on the New York Stock Exchange, was said to be the largest full-service long-term health care provider in the United States, focusing on hospital and nursing services. Six of its directors are also named as defendants. Plaintiffs are a class of investors in Vencor. They allege a number of misstatements and material omissions by Vencor calculated to artificially balloon stock prices and defraud purchasers. A divided panel of this court concluded that plaintiffs failed to state a claim. . . .

. . . On February 6, 1997, President Clinton proposed the Balanced Budget Act (the "Budget Act"), which featured several Medicare provisions that would substantially affect the health care industry. . . . During this half-year of legislative deliberation, the proposed act alarmed sectors of the health care industry because it changed Medicare reimbursement and reduced incentive payments for hospitals that kept actual costs below federal targets. Because Vencor derived significant revenue from Medicare, it too was concerned about several aspects of the proposed act and received regular updates from its lobbyists in Washington, D.C. Plaintiffs claim that the company undertook an analysis of the proposed act as early as April 1997. According to plaintiffs, these cost analyses culminated in July 1997 when Thomas Schumann, vice president and director of Vencor's reimbursement department, circulated an internal memorandum detailing the potential impact of the legislation.

In the meantime—from at least February 10, 1997, until October 21, 1997—defendants maintained that they were "comfortable" with projections of fourth-quarter earnings of $0.59 to $0.64 per share and yearly returns between $2.10 to $2.20 for 1997 and $2.60 to $2.65 for 1998. Such sanguine statements led market analysts to recommend Vencor's stock as a "buy." In its 1996 Form 10 K, filed March 27, 1997, the company did acknowledge the looming Budget Act:

> [T]he Company cannot predict the content of any healthcare or budget reform legislation which may be proposed in Congress or in state legislatures in the future, and whether such legislation, if any, will be adopted. Accordingly, the Company is unable to assess the effect of any such legislation on its business. There can be no assurance that any such legislation will not have a material adverse impact on the Company's future growth, revenues and income.

Other more cursory warnings later appeared in Vencor's first- and second- quarter 10-Q forms, filed April 23 and July 25 respectively.

On October 22, 1997, Vencor lowered its estimates of fourth-quarter earnings due to "management's recently completed analysis of the Balanced Budget Act of 1997." The stock price dropped from $42-5/8 per share to $30 per share, a nearly thirty percent decline. Soon after, the company announced that an anticipated sale of one of its divisions would not be completed. The stock price fell further to $23 per share. Plaintiffs allege that Vencor knew about the likely adverse impact of the Budget Act before its October announcement but nonetheless made false and misleading earnings statements to boost stock prices.

In late June 1997, four months before Vencor publicly revealed how the Budget Act would affect its earnings, defendants Michael Barr, executive vice president and chief operating officer of Vencor, and James Gillenwater, senior vice president, met with employees of the newly acquired Transitional Hospitals Corporation. During this presentation, Barr gave the employees notice that they would be laid off in sixty days. Barr's explanation, according to plaintiffs, was that "there were tough times coming in the industry because of the likely cutbacks in Medicare" and that they "would have been laid off anyway because the proposed Medicare regulations were going to make it difficult for Vencor to make money and stay profitable."

This was nearly a month before Vencor filed its second-quarter 10-Q, in which defendants stated they could not predict whether Medicare reform proposals would be adopted by Congress "or if adopted, what effect, if any, such proposals would have on its business." Also during this time, from July to September 1997, defendant executives sold nearly $9.5 million in stock holdings. Defendant Earl Reed, executive vice president and chief financial officer of Vencor, alone realized more than $3 million in stock sales in September, a sum large enough to elicit inquiries from the financial media.

On February 10, 1997, Vencor announced a "definitive merger agreement" with TheraTx, another provider specializing in rehabilitation care and occupational health. In a press release, Vencor's chief executive officer, Bruce Lunsford, explained that the acquisition would "be accretive to earnings based on projected synergies." As part of the stock purchase, however, plaintiffs allege that Vencor also acquired $25 million in bad debt and 26 poorly performing nursing homes. Though Lunsford stated that by July 24, 1997, "we successfully integrated the operations of TheraTx," computing incompatibilities prevented full consolidation until March 1998. Plaintiffs claim that these statements were false and misleading.

On May 7, 1997, Vencor announced another acquisition. Through a $500 million senior subordinated debt private placement, the company planned to purchase Transitional Hospitals Corporation and its 58 long-term acute care hospitals. Nearly a month later, Vencor announced that it had sold $750 million of senior notes, scheduled to mature in 2007. The senior notes required that Vencor exchange them for publicly traded notes and file a registration statement effective November 18, 1997, or face additional interest. On October 8, 1997, Vencor initiated this exchange. According to plaintiffs, the company would not have been able to complete the bond offering had investors known the truth about how the Balanced Budget Act would affect Vencor.

On September 16, 1997, Vencor announced a "definitive agreement" to sell Behavioral Healthcare Corporation to Charter Behavioral Health Systems. The press release detailing the sale explained that the "transaction, which is subject to acceptable financing, due diligence . . . and certain regulatory approvals, is expected to close during the fourth quarter of 1997." The deal collapsed, however, sagging Vencor stock further. On November 3, 1997, Vencor explained that the sale would not be consummated due to a dispute over final payment terms. Plaintiffs claim that they were misled as to the certainty of this transaction.

II. The Private Securities Litigation Reform Act [PSLRA]

Plaintiffs claim that Vencor made misleading statements and omissions in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C/ §§ 78j(b) and 78t(a) respectively, and Rule 10b-5 promulgated thereunder by the Securities Exchange Commission . . . Plaintiffs' case turns on the discrepancy between what defendants said and what they knew prior to their announcement of revised earnings projections.

A. The Safe Harbor

[In 1995] Congress created a "safe harbor" for "forward-looking statements." Based on the judicial "bespeaks caution" doctrine, this provision excuses liability for defendants' projections, statements of plans and objectives, and estimates of future economic performance. A plaintiff may overcome this protection only if the statement was material; if defendants had actual knowledge that it was false or misleading; and if the statement was not identified as "forward-looking" or lacked meaningful cautionary statements.

B. The Pleading Standard

Second, Congress heightened the pleading standard for securities fraud. Before 1995, a plaintiff had to allege fraud "with particularity." Under the PSLRA, a plaintiff must now "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." . . . It is clear that some form of fraudulent intent is required. . . . When we first interpreted how the PSLRA modified securities litigation, we explained that Congress "did not change the scienter that a plaintiff must prove to prevail in a securities fraud case but instead changed what a plaintiff must plead in his complaint in order to survive a motion to dismiss." In this case, then, we confront not what constitutes scienter but rather what produces a "strong inference that the defendant acted with the required state of mind."

. . . .

. . . While it is true that motive and opportunity are not substitutes for a showing of recklessness, they can be catalysts to fraud and so serve as external markers to the required state of mind. . . . We reaffirm that plaintiffs cannot simply plead "motive and opportunity" as a mantra for recovery under the Reform Act. The Act requires plaintiffs to "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which the belief is formed." In this wash of allegations, "motive" and "opportunity" are simply recurring patterns of evidence. We decide cases on facts, not labels. Whether the facts can be said to establish motive, opportunity, or neither, we are directed only to consider whether they produce a strong inference that the defendant acted at least recklessly. This necessarily involves a sifting of allegations in the complaint. [F]acts presenting motive and opportunity may be of enough weight to state a claim under the PSLRA, whereas pleading conclusory labels of motive and opportunity will not suffice.

In Greebel, the First Circuit indicated several factors usually relevant to scienter. These have been enumerated as follows:

(1) insider trading at a suspicious time or in an unusual amount;
(2) divergence between internal reports and external statements on the same subject;
(3) closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information;
(4) evidence of bribery by a top company official;
(5) existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit;
(6) disregard of the most current factual information before making statements;
(7) disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication;
(8) the personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and
(9) the self-interested motivation of defendants in the form of saving their salaries or jobs.

. . . We find this list, while not exhaustive, at least helpful in guiding securities fraud pleading.

III. Plaintiffs' Allegations Concerning the Effect of the Balanced Budget Act

. . . .

. . . [W]e must decide whether defendants can claim safe harbor protection for their forward-looking statements. For those statements that are not forward-looking or do not fit within the statutory shelter, we must determine whether plaintiffs have stated a claim under the PSLRA. As we apply the pleading standards of the Reform Act, we keep in mind the substantive elements of a claim for securities fraud. To prevail on a § 10(b)(5)/Rule 10b- 5 claim, a plaintiff must establish (1) a misrepresentation or omission, (2) of a material fact, (3) made with scienter, (4) justifiably relied on by plaintiffs, and (5) proximately causing them injury.

A. Vencor's Forward Looking Statements

. . . [D]efendants made numerous statements concerning the Balanced Budget Act and its effect on Vencor's business. In its quarterly and annual reports filed with the Securities and Exchange Commission, Vencor stated that it could not gauge the impact of the legislation as it progressed through Congress. At the same time, the company projected fourth-quarter earnings of $0.59 to $0.64 per share and yearly returns between $2.10 to $2.20 for 1997 and $2.60 to $2.65 for 1998. According to plaintiffs, Vencor told analysts that it was "comfortable" with these figures as late as September 25, 1997, nearly seven weeks after the Balanced Budget Act was signed into law. These statements were "forward-looking" within the meaning of the PSLRA in that they reflected predictions about earnings, revenue, and future economic performance. Plaintiffs urge that Vencor's professed inability to assess the impact of the Budget Act was a statement of then-present fact. Even as a statement of existing condition, however, these statements were forward-looking in that they concerned "assumptions underlying or relating to" economic predictions. Therefore, all of defendants' earnings projections and statements about the Balanced Budget Act qualify as "forward-looking."

Defendants would dismiss their optimistic projections and internal estimates as "soft, puffing statements" that are immaterial as a matter of law. . . . Yet we do not agree that Vencor's estimates of strong earnings were so uncertain or casually disregarded by the marketplace. In the context of the Budget Act—whose form and effect the company denied knowing until seven weeks after its passage—the projections were framed as material reassurances of continued good fortune. . . .

The Supreme Court has endorsed a fact-intensive test of materiality in securities fraud cases. Specifically, "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information." . . .

In this case, it cannot be said that Vencor's preliminary appraisals and internal assessments of the Balanced Budget Act were material solely by virtue of their omission. As discussed infra, plaintiffs have alleged facts to produce a strong inference that defendants knew that the Budget Act could adversely affect their operations. Yet defendants simply rested on their disavowals of knowledge while continuing to make favorable earnings predictions.

. . . Defendants claim that the Balanced Budget Act was a "moving target" until it was signed, subject to committee compromise and negotiation, and that its complexity and impact were impossible to assess until long after it was enacted.

Vencor's claimed inability to assess the adverse impact of the Budget Act is plausible—but only to a point. . . . [B]y August 5, if not before, the form of the legislation had become fixed and its impact measurable.

. . . When defendants disclaimed any ability to predict health care legislation, while persisting in favorable earnings estimates even seven weeks after enactment of the Budget Act, Vencor was representing that it knew of no way the Budget Act could adversely affect its operations. . . .

As previously noted in section I.2 above, plaintiffs have alleged that Executive Vice President Barr told Transitional Hospitals employees in June 1997 that they would be laid off because of the impact of the Budget Act and the "tough times coming" that "were going to make it difficult for Vencor to make money and stay profitable." Vencor now explains that Barr's reference to Medicare cutbacks was limited to Vencor's hospital operations, which defendants claim comprised only 20 percent of the company's revenues. What Barr intended by his warning is not an issue we are prepared to resolve at this stage. For now, we note only that Vencor knew of "tough times" ahead for at least some of its operations.

Also as noted above, plaintiffs state that defendants sold nearly a quarter million shares from July to September 1997, yielding proceeds of $9.5 million. Defendant Reed alone sold more than $3 million in stock in mid-September, after passage of the Budget Act but before Vencor released its revised earnings estimates. . . .

These allegations suggest that it was obvious that the impact of the Balanced Budget Act would be adverse to Vencor before October 22, 1997. A health care executive whose organization represented Vencor testified before Congress about his concerns in April. The timing of Vencor's estimates and purported myopia concerning the Budget Act, when compared against the progress of the legislation through Congress, indicates that defendants consciously disregarded the warning signs of health care cutbacks. Certain defendant executives even acknowledged that "tough times" were ahead for at least part of the company and sold millions of dollars in stock after the act was signed but before prices plummeted. . . .

Though defendants described their predictions as "forward-looking" in the 1996 10-K, other SEC filings and press releases during the class period lacked this designation. Moreover, the first-and second-quarter 10-Q filings contained only a generic disclaimer of knowledge about "whether such proposals will be adopted or if adopted, what effect, if any, such proposals would have on its business." The safe harbor provision, in contrast, requires that defendants identify "important factors that could cause actual results to differ materially from those in the forward-looking statements."

. . . .

Defendants maintain that their statements concerning the Balanced Budget Act are not actionable because they qualify as "soft information" under the non-disclosure rules of Starkman and Sofamor Danek. This conclusion is mistaken because these cases are inapposite. In Sofamor Danek, the information claimed as adverse to the company had already been disclosed and was publicly available to permit an independent assessment by investors and analysts. And Starkman was a case about non-disclosure. This case, in contrast, is about selective disclosure of information known exclusively to defendants and essential to complete a picture they had only partially revealed. . . .

. . . [I]t is true that defendants had no independent duty to divulge their internal appraisals of the Budget Act, a comprehensive study that plaintiffs allege began in April and was completed by July. Nor do we disagree that the non-disclosure cases survive the Reform Act. But the protections for soft information end where speech begins. Though forward-looking statements may contain soft information, they do not themselves constitute soft information. . . .

. . . [T]he question in this case is not whether Vencor had a duty to divulge its internal assessments of the Balanced Budget Act. Rather, the question is whether the company had a duty to complete the information already given concerning the Budget Act and earnings estimates. Though the Reform Act does not impose a "duty to update and we do not decide today whether such an obligation exists, we at least require an actor to "provide complete and non-misleading information with respect to the subjects on which he undertakes to speak." . . .

. . . [I]t appears that the need for information in the name of completeness can conflict with the need to incubate uncertain data and avoid liability. These competing interests are reconciled in the Reform Act. If a company chooses to speak on an uncertain subject-as here, when Vencor claimed an inability to assess the Budget Act while simultaneously issuing flush earnings estimates-it cannot duck liability by pointing to the "soft" nature of the information it volunteered. It may, however, find refuge in the safe harbor of the Reform Act, provided that the statutory requirements are met. Here, we find they were not.

B. Sufficiency of Plaintiffs' Complaint

Having concluded that defendants' statements concerning the Balanced Budget Act are outside the statutory safe harbor, we now ask whether plaintiffs have alleged sufficient facts to state a cause of action for securities fraud. Because we find plaintiffs to have produced a strong inference that defendants made projections and disavowed the impact of the Balanced Budget Act with actual knowledge that their statements were misleading, a fortiori plaintiffs have produced a strong inference that defendants acted recklessly in their statements and omissions concerning earnings estimates and the Budget Act. As to these allegations,

then, plaintiffs have met the pleadings standards of the Reform Act.

IV. Other Claims

A. Vencor's Acquisition of TheraTx

When Vencor announced plans to merge with TheraTx, another provider specializing in rehabilitation care and occupational health, Vencor's chief executive officer, Bruce Lunsford, explained that the acquisition would "be accretive to earnings based on projected synergies." Plaintiffs maintain that this statement was false because Vencor also would be acquiring $25 million in bad debt and 26 poorly performing nursing homes from TheraTx. As a forward-looking statement, Lunsford's prediction falls within the safe harbor provisions of the PSLRA. Plaintiffs must plead facts giving rise to a strong inference that Vencor had actual knowledge of the false or misleading nature of the statement. The complaint is too conclusory in this regard to satisfy that standard. Naturally, Vencor's management would expect and publicly anticipate favorable results from its merger. We doubt that defendants would have completed the merger knowing that the deal would not "be accretive to earnings."

Plaintiffs also point to Lunsford's statement that "we successfully integrated the operations of TheraTx" as false because computing incompatibilities yet remained. However, plaintiffs fail to explain how computer problems precluded the successful integration of the companies. The allegations do not reveal Lunsford's statement to be false or misleading.

Plaintiffs have not stated a claim for securities fraud in connection with Vencor's acquisition of TheraTx.

B. Vencor's Acquisition of Transitional Hospitals Corporation

This claim appears to be an off-shoot of plaintiffs' charge that Vencor profited from failing to speak fully about the adverse impact of the Budget Act. We have already concluded that there is a strong inference that defendants knew more than they disclosed about the financial consequences of health care reform. In their allegations concerning stock prices, plaintiffs have shown that defendants had no reasonable basis for making earnings projections without discussing the potential effect of the Budget Act. Unlike the allegations concerning the earnings estimates, though, the complaint does not support its claim for fraud in the Transitional acquisition. Plaintiffs here allege only motive and opportunity to mislead without the factual basis for either. Vencor made no statements concerning the acquisition of Transitional that can be regarded as misleading or false.

C. Vencor's Proposed Sale of Behavioral Healthcare Corporation

. . . Plaintiffs allege that Vencor's announcement of a "definitive" deal was misleading, intended to reassure investors of the company's solvency following its acquisition of Transitional. We find this allegation of fraud unconvincing. The press release detailing the sale explained that the "transaction, which is subject to acceptable financing, due diligence . . . and certain regulatory approvals, is expected to close during the fourth quarter of 1997." Clearly, this language suggested that the sale was conditional and any agreement was tentative. Vencor's announcement was not false and is therefore not actionable.

V. Conclusion

As evidenced by the ambiguous legislative history and the split among the federal circuits, the import and application of the Private Securities Litigation Reform Act is an evolving issue. Perhaps the question would have been simpler had Congress drafted statutory language to reflect its apparent intention, such as the translation offered by one commentator:

> There are too many frivolous securities fraud class actions being filed. Such actions impose heavy costs on defendants as a result of the extensive discovery that is likely to ensue and often result in the defendants being forced to settle. There is no liability under Rule 10b 5 unless the defendant knew or recklessly disregarded that the representations were falseor misleading. A court should not allow discovery unless it determines the best it can from the pleadings whether the case is likely to have merit (defendant(s) made false representations and knew they were false) if discovery is allowed or whether it appears frivolous. Judges keeping all of this in mind

should exercise their discretion in determining whether the case should be allowed to proceed or be dismissed.

Congress has instead instructed us to dismiss complaints for securities fraud unless plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." With regard to defendants' earnings projections and disclaimers of knowledge about the Balanced Budget Act, plaintiffs have done so here. We would note that the district court, before granting summary judgment in error, arrived at the same conclusion concerning the sufficiency of the pleadings. Accordingly, we REVERSE the dismissal for failure to state a claim of securities fraud, except with respect to the claims referred to in section IV above, and REMAND the case for further discovery and proceedings on plaintiffs' claims under sections 10(b) and 20(a) of the Securities Exchange Act of 1934.

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