Oklahoma Law Review

Volume 71 | Number 3

2019

The Near Impossibility of Pleading Falsity of Opinion Statements Under Section 10(b) of the Securities Exchange Act and Rule 10b-5

J. Cooper Davis

NOTES

The Near Impossibility of Pleading Falsity of Opinion Statements Under Section 10(b) of the Securities Exchange Act and Rule 10b-5

I. Introduction

Imagine you have just invested in a company with expectations of making a sizeable return on your investment. News breaks, and the market responds positively to an acquisition. Because of the nature of the acquisition and positive future outlook of the assets acquired, a large portion of the purchase price is allocated to the goodwill account. This is even better than expected, the price of your shares of stock continue to rise during a period with a positive outlook and a high valuation of goodwill of the newly acquired assets of the subsidiary. Then, with little forewarning, the large goodwill account is suddenly depleted over a matter of a few quarters, and all the appreciation of the stock is wiped away.

Now there is concern regarding overvalued goodwill because there may have been inappropriate actions during this period that led to the improper valuation. You wish to bring a lawsuit against the company and management to recover losses resulting from potentially fraudulent actions. Because goodwill is considered an opinion statement, the pleading standard to allege fraud quickly becomes a minefield that is nearly impossible to traverse in order to get past the pleading stage, even if there is illegal conduct. At the pleading stage, the defendant has a toolbox full of defenses that make getting past the pleading stage to discovery a burdensome task. The recent Ninth Circuit decision in *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology, Inc.* adds yet another tool to the defendant's toolbox that makes getting beyond the pleading stage in such a case unlikely, which may ultimately allow illegal conduct to continue without penalty.

II. Overview and Background

The origins of the Securities Act of 1933 and the Exchange Act of 1934 can be traced back to concerns arising from the Panic of 1907.[1] The Panic of 1907 began when a group of banks failed to obtain control of a mining company, leading to significant losses on the New York Stock Exchange, a

1. Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 395-397 (1990).

decline in investor confidence, and a call for government intervention.[2] Congress formed committees in 1912 to investigate whether key industries had become so concentrated that a few people controlled the entire economy through their holdings on the New York Stock Exchange.[3] The committees concluded that the exchange operated to the benefit of a few of its members and to the detriment of its investors.[4] The committees likened the state of the New York Stock Exchange to manipulation-prone gambling; this was a grave concern.[5] The efforts of the committees proved fruitless, however, as Congress took no legislative action in response.[6] The Panic of 1907 faded from memory and twenty years of prosperity on the New York Stock Exchange discouraged further calls for regulation.[7]

But the stock market crash of 1929 and the Great Depression brought securities regulation back to the forefront of public discussion.[8] Congress first enacted the Securities Act of 1933 to achieve truth in securities relating to public offerings; it was designed to prevent the issuers from manipulating the offerees in a public offering.[9] Shortly thereafter, Congress enacted the Securities Exchange Act of 1934 to regulate brokers, dealers, the securities market, and the securities traded in certain markets.[10] The Securities Exchange Act of 1934 created a periodic disclosure system for securities traded on the market.[11] The purpose of enacting legislation to regulate exchange operation was "for the protection of investors, [] the safeguarding of values, and . . . the elimination of unnecessary, unwise, and destructive speculation."[12] The purpose of the Securities Act of 1933 and the Exchange Act of 1934, coupled with the context in which they were passed, demonstrate that the "fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy

---

2. *Id.* at 395.
3. *Id.* at 402-03.
4. *Id.* at 403.
5. *Id.*
6. *Id.* at 406.
7. *Id.* at 407-08.
8. *Id.* at 408.
9. Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1340, 1367-68 (1966).
10. *Id.* at 1340-41.
11. Shurkin v. Golden State Vintners, Inc., 303 F. App'x 431, 433 (9th Cir. 2008).
12. Thel, *supra* note 1, at 425 (quoting President's Message to Congress, 3 PUB. PAPERS 90, 91 (Feb. 9, 1934), *reprinted in* 78 CONG. REC. 2264 (1934)).

of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[13]

This is the context in which section 10(b) of the Securities Exchange Act operates to protect investors. Section 10(b) provides:

> It shall be unlawful . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate *in the public interest or for the protection of investors*."[14]

Congress enacted section 10(b) to authorize the Securities Exchange Commission (SEC) to issue rules and regulations "prohibit[ing] or regulat[ing] the use of any other manipulative or deceptive practices which it finds *detrimental to the interests of the investor*."[15] Pursuant to this power, and to clarify what it considers to be "manipulative or deceptive practices," the SEC devised rule 10b-5 which provides that:

> It shall be unlawful . . . (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit . . . a material fact necessary in order to make the statements . . . not misleading, (c) [t]o engage in any act . . . which operates . . . as a fraud or deceit upon any person . . . .[16]

A. Elements of a Section 10(b) Claim

The Supreme Court's interpretation of section 10(b) allows for private actions even though the text of the statute does not do so explicitly.[17] The Court has inferred this right to bring private actions in order to enforce the purpose of the statute and to effectuate the overall intent of the provision.[18]

---

13. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); *see also* Silver v. N.Y. Stock Exch., 373 U.S. 341, 366 (1963) ("The benefits which a guarantee of procedural safeguards brings about are, moreover, of particular importance here. It requires but little appreciation of the extent of the Exchange's economic power and of what happened in this country during the 1920's and 1930's to realize how essential it is that the *highest ethical standards* prevail as to every aspect of the Exchange's activities.") (emphasis added).

14. 15 U.S.C. § 78j(b) (2012) (emphasis added).

15. SEC v. Clark, 915 F.2d 439, 450 (9th Cir. 1990) (quoting S. REP. NO. 73-792, at 18 (1934)).

16. 17 C.F.R. § 240.10b-5 (2018).

17. Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2407 (2014).

18. *See id.*

The elements of a section 10(b) claim require the plaintiff to prove "(1) a material misrepresentation or omission by the defendant[19]; (2) scienter; (3) a connection between the misrepresentation or omission; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[20]

B. Pleading Standards Generally

In claiming securities fraud, plaintiffs bringing a private action face heightened pleading requirements that present large hurdles when alleging a violation of section 10(b) and rule 10b-5.[21] Claims of fraud under section 10(b) and rule 10b-5 must satisfy dual pleading requirements under both the Federal Rule of Civil Procedure 9(b)[22] and the Private Securities Litigation Reform Act of 1995.[23] Under the FRCP 9(b), the complaint must "state with particularity the circumstances constituting fraud or mistake." [24] Therefore, a plaintiff alleging fraud in violation of section 10(b) must plead the particular circumstances of the fraud instead of only the typical pleading requirements under Federal Rules of Civil Procedure 8(a)(2).[25]

In addition to the increased pleading standards imposed by FRCP 9(b), the Private Securities Litigation Reform Act of 1995 (PLSRA) mandates that "the complaint shall specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading."[26] Additionally, the PLSRA requires the complaint to "state with particularity facts giving rise to a strong inference that the defendant acted with the required [scienter]."[27] The scienter requirement poses a particularly high bar because "to adequately plead scienter, the complaint must now 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'"[28] To plead a "strong inference" of scienter, the inference "must be cogent and at least as compelling as any

19. While this Note will discuss other factors, this is the main element of a 10(b) claim that will be discussed.

20. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008).

21. *In re* Verifone Holdings, Inc. Sec. Litig., 704 F.3d 694, 701 (9th Cir. 2012).

22. *See* FED. R. CIV. P. 9(b).

23. 15 U.S.C. § 78u-4 (2012).

24. FED. R. CIV. P. 9(b).

25. FED. R. CIV. P. 8(a)(2).

26. 15 U.S.C. § 78u-4(b)(1)(B); *see also Verifone Holdings*, 704 F.3d at 701.

27. 15 U.S.C. § 78u-4(b)(2)(A).

28. Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 991 (9th Cir. 2009) (quoting 15 U.S.C. § 78u-4(b)(2)(A)).

opposing inference of nonfraudulent intent."[29] Pleading scienter presents a significant hurdle for a securities fraud plaintiff, but that topic is not the focus of this Note.[30]

This Note examines section 10(b) and rule 10b-5's requirements that a plaintiff plead the falsity component, which requires the plaintiff 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 . . . state with particularity all facts on which that belief is formed."[31]

It is worth noting the rationale and legal setting in which the PSLRA requirements were passed and implemented. Congress was dissatisfied with the manner in which courts of appeals were applying FRCP rule 9(b) in their application of stating fraud with "particularity."[32] Congress recognized and considered the serious nature of being named a party to a suit for fraud, and the fact that, if the fraud claims prove unwarranted, serious damage to reputation will have nevertheless been done.[33] Congress was concerned with the abuse it perceived in class actions filings in private securities litigation alleging fraud.[34] Congress believed parties were filing frivolous suits, driven by lawyers, to target deep-pocket defendants with little merit for the claim in order to then make extreme discovery requests.[35] The concern was that such practices were leading to extortionate type settlements, which harmed companies and deterred involvement in management positions of companies.[36]

With these issues in mind, Congress passed the PSLRA with the "intent[ion] to strengthen existing pleading requirements"[37] and balance the two goals of the PSLRA "to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."[38] Thus, although the PSLRA increases plaintiffs' pleading requirements under section 10(b) and rule 10b-5, the requirements have a justification—the

29. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).

30. *See generally* Michael D. Moritz, *The Advent of Scienterless Fraud? Applying Omnicare to Section 10(b) and Rule 10b-5 Claims*, 13 N.Y.U. J.L. & BUS. 595 (2017).

31. 15 U.S.C. § 78u-4(b)(1)(B).

32. H.R. REP. NO. 104-369, at 41 (1995) (Conf. Rep.).

33. *Id.*

34. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 81 (2006).

35. *See id.*; H.R. REP. NO. 104-369, at 28.

36. *Merrill Lynch*, 547 U.S. at 81; H.R. REP. NO. 104-369, at 28.

37. H.R. REP. NO. 104-369, at 41; *see also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 321-22 (2007).

38. *Tellabs, Inc.*, 551 U.S. at 322.

regulations were passed in response to abuse and unintended consequences of having relaxed rules for pleading securities fraud. The remaining concern is the balance between avoiding non-meritorious, harmful allegations while allowing merited claims to proceed. The recent decision in *City of Dearborn Heights* shifts the balance further in favor of preventing fraud allegations from proceeding beyond the pleading stage.

III. Law Prior to City of Dearborn Heights*: Pleading the First Prong of a Section 10(b) Claim Under the Securities Exchange Act of 1934*

A. Falsity and Materiality Under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934

Prior to *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology, Inc.*, in order to satisfy the first prong of pleading fraud there first had to be a material misstatement.[39] For a statement to be material, there had to be "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[40] Further, the allegations had to "raise a reasonable expectation that discovery will reveal evidence satisfying the materiality requirement, and to allow the court to draw the reasonable inference that the defendant is liable."[41]

In addition to being material, the statement alleged to be misleading had to be a factual misstatement to be actionable under section 10(b).[42] Statements of reasons, opinions, or beliefs were considered factual under the securities laws, and therefore actionable as material factual misstatements by the speaker if "(1) the statement [was] not actually believed, (2) there [was] *no reasonable basis for the belief*, or (3) the speaker [was] aware of undisclosed facts tending seriously to undermine the statements accuracy."[43]

---

39. Reese v. Malone, 747 F.3d 557, 568 (9th Cir. 2014), *overruled by* Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc., 856 F.3d 605 (9th Cir. 2017).

40. *Id.* (quoting Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988)).

41. *Id.*

42. *Id.* at 579.

43. *Id; see also In re* Wells Fargo Sec. Litig., 12 F.3d 922, 930 (9th Cir. 1993) (emphasis added).

B. Pleading Falsity of Opinion Statements Under Section 11 of the Securities Act of 1933

The Securities Act of 1933 sought to protect investors by requiring that issuers disclose information through a registration statement in connection with a public offering.[44] Liability would be imposed on certain individuals if the registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[45]

In its landmark decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, the Supreme Court addressed pleading standards for plaintiffs alleging violation of section 11 of the Securities Act of 1933 based on material misstatements or omissions contained in the registration statement filed with the SEC.[46] In *Omnicare*, the registration statement Omnicare filed with the SEC contained statements regarding Omnicare's belief it had complied with legal requirements, for example: "[w]e believe our contract arrangements . . . are in compliance with . . . federal and state laws" and "[w]e believe that our contracts . . . are legally and economically valid . . . ."[47] The plaintiffs purchased shares pursuant to the registration statement, and at a later date the Federal Government pressed charges against Omnicare alleging the contracts discussed in the registration statement violated anti-kickback laws.[48] Thereafter, the plaintiffs claimed a violation of section 11 of the Securities Act of 1933 because the registration statement contained materially false representations that misled investors.[49] The Court established three standards that apply under different circumstances. First, liability under Section 11's false statement clause will follow if the plaintiff establishes that the speaker did not subjectively believe the statement and the statement is objectively untrue.[50] Second, if alleging an opinion statement with an embedded fact that is materially misleading, the plaintiff must demonstrate the fact supporting the opinion is untrue.[51] Third, when alleging a theory of material omission in the registration statement, the

---

44. Omnicare v. Laborers Dist. Council Const. Ind. Pension Fund, 135 S. Ct. 1318, 1323 (2015); Cohen, *supra* note 9.

45. 15 U.S.C. § 77k(a) (2012).

46. *Omnicare*, 135 S. Ct. at 1323-25.

47. *Id.* at 1323.

48. *Id.* at 1324.

49. *Id.*

50. *Id.* at 1327.

51. *Id.*

plaintiff must show "facts going to the basis for the issuer's opinion . . . whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context."[52]

The Supreme Court formulated these guidelines to guide the section 11 analysis of material misstatements of opinions or beliefs contained in a registration statement, and focused on the importance of proving falsity.[53] By holding it insufficient to simply allege that the belief is wrong and requiring the plaintiff to allege that the belief was not subjectively held, the decision prevented investors from "second-guess[ing] inherently subjective and uncertain assessments" and protected honest opinions.[54] Additionally, when the Court required a plaintiff to allege the falsity of the factual basis of the opinion to establish liability for an omission, the Court did not believe its requirement would prevent "valuable information [from] flowing," but instead felt that it would enhance the information for investors.[55]

IV. Statement of the Case: City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology, Inc.

A. Facts

This case arose from alleged misstatements in Align Technology's communications and filings with the SEC under the Securities Exchange Act of 1934.[56] Align Technology Inc. (Align)—a public company subject to the reporting requirements of the Securities Exchange Act of 1934—"designs, manufactures, and markets" Invisalign, a system designed to treat misaligned teeth.[57] In March of 2011, Align announced the acquisition of Cadent; Align intended to integrate Cadent's design and manufacturing of 3D digital services and other oral scanners used by dentists and orthodontists into their business.[58] Upon acquiring Cadent for $187.6 million, "Align allocated $135.5 million of the purchase price [to its] 'goodwill'" account.[59] $76.9 million of the goodwill was allocated to the

52. *Id.* at 1332.
53. *Id.*
54. *Id.* at 1327.
55. *Id.* at 1332.
56. City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc., 856 F.3d 605, 609-10 (9th Cir. 2017).
57. *Id.* at 610.
58. *Id.*
59. *Id.*

goodwill account for "the acquired computer-aided design and manufacturing (CAD/CAM) and scanner unit (together with CAD/CAM, the SCCS unit)."[60]

Goodwill represents "an intangible asset that [is] 'the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed'"—it represents value of the company that is difficult to quantify and includes items such as reputation, brand recognition, and synergy.[61] Plaintiff alleged that these goodwill allocation numbers were based on 2010 inflated revenue numbers due to channel stuffing activities[62] that Cadent participated in prior to the acquisition.[63] The Generally Accepted Accounting Principles (GAAP) require a company to conduct annual tests for goodwill impairment.[64]

Plaintiff alleged multiple instances and factors that occurred between the time of acquisition and the time Align impaired the goodwill; these allegations included: goodwill overstatement based on inflated numbers, integration issues with the SCCS unit, struggles in productivity of the SCCS unit during the acquisition and implementation periods, increases in competition, change in international sales, and other factors that pointed to potential issues with goodwill.[65] Plaintiff further alleged that there were seven false and misleading statements concerning Align's goodwill valuation of Cadent, and that Align intentionally overvalued goodwill, all of which injected falsity into statements of the goodwill estimates.[66] The statements all dealt with the analysis of goodwill and indications of goodwill impairment.[67]

---

60. *Id.*

61. *See In re* REMEC Inc. Sec. Litig., 702 F. Supp. 2d 1202, 1212 (S.D. Cal. 2010) (citation omitted).

62. *Align Tech., Inc.*, 856 F.3d at 610. "'Channel stuffing' means inducing purchasers to increase substantially their purchases before they would . . . otherwise . . . . It has the result of shifting earnings into earlier quarters, quite likely to the detriment of earnings in later quarters." Greebel v. FTP Software, Inc., 194 F.3d 185, 202 (1st Cir. 1999) (inflating an earlier quarter's earnings could have the appearance of higher sales and thus be more appealing to a potential acquiring corporation).

63. *Align Tech., Inc.*, 856 F.3d at 610.

64. *Id.* at 611 (defining impairment as occurring "when the carrying amount of goodwill exceeds" the fair value of the goodwill (quoting FIN'L ACCOUNTING STANDARDS BD., ACCOUNTING STANDARDS CODIFICATION Topic 350-20-35-28)).

65. *Id.*

66. *Id.* at 612-13.

67. *Id.*

From the time of acquisition until the third quarter of 2012, Align made various statements in filings to the SEC and issued various press releases disavowing any goodwill impairment.[68] In October of 2012, however, Align announced they were conducting impairment tests because of SCCS performance issues that sparked a 20% decrease in Align's stock price; Align eventually noted a goodwill impairment of $52.6 million in November of 2012.[69] Align then made an additional goodwill impairment charge for $36.6 million in January of 2013, followed by yet another goodwill impairment charge for the remainder of the goodwill account, so that the original $76.9 million of goodwill allocated to SCCS totaled $0 in April of 2013.[70] Plaintiff alleged that failure to impair goodwill inserted falsity into their financial statements—thus leading to materially false and misleading statements— because of Align's integration issues and business struggles.[71]

B. Issue

The Ninth Circuit reviewed the district court's holding that the plaintiff failed to state a claim and the dismissal of the case pursuant to FRCP 12(b)(6).[72] Because the court was reviewing whether the plaintiff failed to state a claim, it was required to determine the appropriate pleading standards for section 10(b) and rule 10b-5, particularly for pleading falsity of opinion statements.[73]

C. Holding

The court held that although *Omnicare* addressed section 11 claims under the Securities Act of 1933, the reasoning in *Omnicare* applies to section 10(b) and rule 10b-5 claims.[74] When the court applied the *Omnicare* standards to the plaintiff's allegations, it held that the plaintiff pled insufficient allegations to state a claim for securities fraud because the plaintiff failed to adequately plead subjective falsity.[75]

---

68. *Id.* at 611-12.
69. *Id.*
70. *Id.* at 612, 613.
71. *Id.* at 612.
72. *Id.*
73. *Id.* at 612.
74. *Id.* at 616.
75. *Id.* at 617.

V. Decision

The court, analyzing the applicability of *Omnicare* to section 10(b) and rule 10b-5 claims, compared language in section 11 of the Securities Act and rule 10b-5, pointing out that both contain "identical limitation of liability to 'untrue statement[s]' and omissions of 'fact.'"[76] The court reasoned that because of this common language, *Omnicare* standards of pleading falsity of opinion statements apply to section 10(b) and rule 10b-5.[77] Therefore, when pleading falsity of opinion statements, the court concluded the plaintiff must allege that "'the speaker did not hold the belief she professed' and that the belief is objectively untrue" when relying on a theory of material misrepresentation.[78] When the plaintiff relies on a theory that the statement contained an embedded fact that is misleading, it must be alleged that "the supporting fact [the speaker] supplied [is] untrue."[79] And when the plaintiff relies on omissions theory, then it must be alleged that "facts going to the basis for the issuer's opinion . . . whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context."[80]

The significance of applying *Omnicare* to section 10(b) and rule 10b-5 claims is that under the prior standard, a plaintiff could rely on pleading falsity by alleging that "there is no reasonable basis for the belief" under a material misrepresentation theory.[81] But that is irreconcilable with the *Omnicare* standard that requires a plaintiff to allege under a material misrepresentation theory that "'the speaker did not hold the belief she possessed' and that the belief is objectively untrue."[82]

This shift in the pleading standard made it more difficult for the plaintiff to claim material misrepresentations that would survive a 12(b)(6) motion to dismiss. The plaintiff alleged Align had no reasonable basis for the goodwill evaluations because they were based on inflated numbers, poor performance of the SCCS unit, internal struggles in integrating the two companies, and significant decreases in foreign sales relating to the SCCS

76. *Id.* at 616 (quoting 17 C.F.R. § 240.10b-5(b) (2018)).

77. *Id.*

78. *Id.* (quoting Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1327 (2015)).

79. *Id.* (quoting *Omnicare, Inc.*, 135 S. Ct. at 1327).

80. *Id.* (quoting *Omnicare, Inc.*, 135 S. Ct. at 1332).

81. Reese v. Malone, 747 F.3d 557, 579 (9th Cir. 2014), *overruled by* Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc., 856 F.3d 605 (9th Cir. 2017).

82. *Align Tech., Inc.*, 856 F.3d at 616 (quoting *Omnicare, Inc.*, 135 S. Ct. at 1327).

unit.[83] Even when there may have been a basis to doubt the goodwill evaluations under all these factors, however, the plaintiff could no longer rely solely on "no reasonable basis for belief," but, rather, the only way the plaintiff could state a claim was to allege that Align did not subjectively hold the belief and the belief was untrue—all without the opportunity for any discovery.[84] The plaintiff was unable to allege with particularity the actual assumptions that Align relied upon when Align conducted the goodwill analysis, meaning it could not show that Align subjectively believed it misstated the goodwill account.[85] Therefore, the court concluded the plaintiff failed to allege subjective falsity, and thus its claims under a material misstatement theory of liability regarding the statements of goodwill were properly dismissed under FRCP 12(b)(6).[86]

The court also evaluated one of Align's statements that had an embedded fact within an opinion statement.[87] The statement at issue stated as a fact that "there were 'no facts and circumstances'" showing that goodwill was impaired,[88] and, thus, to properly allege the misstatement of the fact, the plaintiff must allege that "the supporting fact [the speaker] supplies [is] untrue."[89] The court held that because the plaintiff was unable to allege additional facts showing Align did not consider negative factors or that the assumptions Align used in evaluation were untrue or that it did not have a basis for the evaluation, the plaintiff failed to properly allege falsity of the statement.[90]

VI. Analysis

The standard set forth in *Omnicare*, which was decided by the Supreme Court in the context of a cause of action under section 11 of the Securities Act of 1933, should not be applied to a section 10(b) and rule 10b-5 cause of action in the strict sense that the Ninth Circuit applied it in *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align*

83. *See id.* at 611.

84. *See id.* at 617; 15 U.S.C. § 78u-4(b)(3)(B) (2012) ("[A]ll discovery and other proceedings shall be stayed during the pendency of any motion to dismiss . . . .").

85. *Align Tech., Inc.*, 856 F.3d at 618.

86. *Id.; see also* 15 U.S.C. § 78u-4(b)(3)(A) (2012).

87. *Id.* at 613-14 ("Statement 2: (Form 10-K, filed February 29, 2012): '[D]uring the fiscal year ended December 31, 2011, there were no facts and circumstances that indicated that the fair value of the reporting units may be less than their current carrying amount.'").

88. *Id.* at 616 (quoting Omnicare, Inc., 135 S. Ct. at 1327).

89. *Id.* at 614.

90. *Id.* at 619.

Technology, Inc. In determining the applicability of *Omnicare* to section 10(b) and rule 10b-5, the court overlooked many differences between the two causes of action, and seemed to consider the standard applicable based on similar language between the two provisions—they both share a material misstatement or omission element—while ignoring the many differences between the claims.[91] The court also relied on the Second Circuit's decision in *Tongue v. Sanofi*,[92] which determined that *Omnicare*'s pleading standards applied to a section 10(b) cause of action because *Omnicare* "refined the standard for analyzing whether a statement of opinion is materially misleading."[93] The Second Circuit in *Tongue* pointed out that section 10(b) claims require a showing of scienter whereas claims under section 11 do not, but did not inquire into whether or not the differences between the two sections should lead to a determination that *Omnicare*'s section 11 analysis should be applied to section 10(b) claims.[94] This concern was expressed by Judge Kleinfeld in *City of Dearborn Heights* in a concurring opinion.[95] Judge Kleinfeld cautioned that there are material differences between section 11 and section 10(b), and a further inquiry, debate, and deliberation over the applicability of *Omnicare* to section 10(b) and overturning precedent should have waited until the issue needed to be determined.[96]

A. Differences Between Section 11 and Section 10(b)

1. Location of the Misstatement or Omission

Examination of section 11, section 10(b), and rule 10b-5 raises some concerns regarding the need for different pleading standards for pleading falsity under the two provisions. Section 11 imposes civil liability "[i]n case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated [in the registration statement]."[97] Section 11 is intended to ensure compliance with the registration and disclosure provisions by imposing liability on the actors

91. *See id.* at 616.
92. *Id.*; Tongue v. Sanofi, 816 F.3d 199 (2d Cir. 2016).
93. *Tongue*, 816 F.3d at 209.
94. *Id.*
95. *Align Tech., Inc.*, 856 F.3d at 623-24 (Kleinfeld, J., concurring) (explaining he would uphold the decision based on the scienter requirement alone, and leave the application of Omnicare to section 10(b) claims for further debate).
96. *Id.*
97. 15 U.S.C. § 77k(a) (2012).

and participants in the registration process.[98] Section 10(b) has no such requirement that the falsity be contained in a certain document or filing. Instead, a cause of action arises under section 10(b) "by the use of any means or instrumentality of interstate commerce . . . [t]o use or employ . . . any manipulative or deceptive device or contrivance."[99] Rule 10b-5 elaborates "by the use of any means or instrumentality of interstate commerce . . . [t]o make any untrue statement of a material fact or to omit to state a material fact."[100] Whereas section 11 was intended to ensure compliance with the registration requirements, section 10(b) serves as a "catch-all antifraud provision."[101]

Because section 11 claims are limited to the registration statement instead of the broader section 10(b) claim, the plaintiff will be able to allege more specifics. The registration statement will be carefully crafted with any opinion statements contained therein being mulled over by the speaker. A plaintiff will be able to allege with more details regarding the carefully crafted registration statement instead of the wide array of statements that could fall under a section 10b claim that may not have the sufficient detailed factual background required to allege subjective belief particularities.

2. Who Can Be Held Liable and By Whom?

Section 11 limits which actors can be held liable for the material misstatement or omission. Liability is limited to certain enumerated parties that include: all those who signed the registration statement, directors of the issuer, experts who certified parts of the registration statement, and every underwriter of the offering.[102] In addition, section 11 expressly exempts parties that resign from participating in the offering or parties who are not experts of the particular provisions in question from liability for misstatements or omissions in the registration statement.[103] Section 10(b) and rule 10b-5 contain no such restrictions on who can be liable, rather,

98. Herman & MacLean v. Huddleston, 459 U.S. 375, 381 (1983) (quoting H.R. REP. NO. 73-85, at 9 (1933)) ("Section 11 creates 'correspondingly heavier legal liability' in line with responsibility to the public.").

99. 15 U.S.C. § 78j(b) (2012).

100. 17 C.F.R. § 240.10b-5 (2018).

101. *Herman & MacLean*, 459 U.S. at 382.

102. *See* 15 U.S.C. § 77k(a).

103. *Id.* § 77k(b).

"any person" who makes the misstatement can be subject to liability under these provisions.[104]

In order to have standing under section 11, "the pool . . . has been defined narrowly."[105] Because of the nature of the claim in alleging misstatement in the registration statement, the scope is limited to persons who purchased in the offering or shares that are traceable to the offering pursuant to the registration statement that contained the alleged misstatement.[106] However, section 10(b) is a relatively broad "catch-all" antifraud provision that contains a broader scope of potential plaintiffs with standing to bring suit and is limited to persons who have purchased or sold the security in connection with the fraud.[107]

3. Plaintiff's Burden

Section 11 provides a limited scope for liability in terms of what the misstatement must be, who can be liable, and how much liability may be imposed, whereas section 10(b) is much broader. Thus, while "[section] 11 places a relatively minimal burden on a plaintiff," section 10(b) claims place a higher burden on plaintiffs to restrict 10(b)'s applicability.[108]

For section 11, the plaintiff carries a lighter burden to allege it purchased "a security issued under a materially false registration statement."[109] The plaintiff must simply prove the registration statement contained a materially false statement or omission and that it purchased securities under such registration statement.[110] While a plaintiff need not purchase directly in the offering, one of the most challenging obstacles in a section 11 cause of action is tracing the shares back to the registration statement when the shares are purchased in the secondary market.[111] Unless the registration statement contains indicia of fraud, then there are no additional pleading requirements that must be met under section 11; therefore FRCP rule 8(a)(2) general pleading standards will apply, meaning section 11 itself

104. *See* 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5.

105. Todd R. David, *Heightened Pleading Requirements, Due Diligence, Reliance, Loss Causation, and Truth-on-the-Market-Available Defenses to Claims Under Sections 11 and 12 of the Securities Act of 1933*, 11 TRANSACTIONS: TENN. J. BUS. L. 53, 60 (2010).

106. *Id.*

107. *See* 15 U.S.C. § 78j; *Herman & MacLean*, 459 U.S. at 382.

108. *Herman & MacLean*, 459 U.S. at 382.

109. *See In re* Century Aluminum Co. Sec. Litig., 729 F.3d 1104, 1106 (9th Cir. 2013).

110. *See id.*

111. *See id.*

generally does not impose heightened pleading standards.[112] The imposition of the *Omnicare* standards adds an additional burden, but pleading a section 11 cause of action still faces fewer hurdles when compared to a section 10(b) cause of action. In *Omnicare*, the Supreme Court recognized the burden that would be placed on plaintiffs by stating that it will be "no small task for an investor" to meet the standard.[113] This shows that, even in a section 11 cause of action, *Omnicare* is considered to impose a stringent requirement.[114]

Section 11 requirements stand in stark contrast to the requirements for a cause of action under section 10(b). The section 10(b) requirements include "(1) a material misrepresentation or omission; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation."[115] In addition, because plaintiffs are alleging fraud they must meet the requirements to state with particularity their claims alleging fraud under FRCP 9(b) and the PSLRA.[116] The most significant requirement that often poses the most difficulty for plaintiffs is the requirement to plead particular facts leading to prove scienter,[117] whereas the most difficult task under section 11 is tracing the shares being sold pursuant to the registration statement in question.[118] Additionally, while the requirements at the pleading stage are heightened under FRCP 9(b) and PSLRA, a plaintiff's complaint must still fall in line with FRCP 8(a)(2) and avoid what has been termed "puzzle pleading." "Puzzle pleading" has been held to violate FRCP 8(a), and is present where the complaint contains, for example, large lists of challenged statements followed by various reasons why they are misleading without specifically allocating reasons to each statement.[119] To reach the level of "puzzle pleading" the complaint has to be fairly extreme and a complaint will not easily rise to that level; however, puzzle pleading

112. *See* City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc., 856 F.3d 605, 624 (9th Cir. 2017) (Kleinfeld, J., concurring); *see also* David, *supra* note 105, at 60.

113. Omnicare, Inc. v. Laborers Dist. Council Constr., 135 S. Ct. 1318, 1332 (2015).

114. *See id.*

115. Or. Pub. Emps. Ret. Fund v. Apollo Grp. Inc., 774 F.3d 598, 603 (9th Cir. 2014) (citing Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc., 552 U.S. 148, 157 (2008)).

116. *See supra* notes 22–28 and accompanying text.

117. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983).

118. *See In re* Century Aluminum Co. Sec. Litig., 729 F.3d 1104, 1106 (9th Cir. 2013).

119. *See, e.g.*, W. Pa. Elec. Emps. Pension Fund v. Mentor Graphics Corp., No. 316-CV-470-PK, 2017 WL 3668957, at *18-19 (D. Or. 2017); *In re* Splash Tech. Holdings, Inc. Sec. Litig., 160 F. Supp. 2d 1059, 1073 (N.D. Cal. 2001).

presents another balance for plaintiffs' complaints—to plead with enough particularity to satisfy PSLRA and FRCP 9(b) while avoiding "puzzle pleading."

B. Implications of Applying Omnicare Standards to Section 10(b) Falsity of Opinion Statements

Because of the broad applicability of section 10(b), a broad range of possible parties could have standing to sue and liability can reach "any person." So it follows that there needs to be additional pleading requirements to narrow the cause of action, especially because of the seriousness of the allegations of fraud. But under *City of Dearborn Heights*, the task of pleading a cause of action for falsity of opinion statement for material misrepresentation under section 10(b) could be approaching a point where the cumulative effect of the requirements run contrary to the foundational purpose of the securities laws to protect investors, ensure accurate disclosure, and preserve the integrity of the markets.[120] In addition to alleging specific facts necessary to establish scienter, plaintiffs must also state with particularity that the assumptions relied on for the misstatement were not actually held by the speaker—all at the pleading stage.[121] In *Omnicare,* the Court recognized that it would be "no small task for an investor" to identify particular facts going to the basis for and subjective belief of the opinion statement.[122] While the Court recognized they were making it no small task for investors, this was in relation to a section 11 claim—which has much lighter pleading requirements and a more narrowly tailored cause of action to start with.[123] Conversely, even before the *Omnicare* standards were applied to section 10(b) pleading, it was already no small task for the investor to make it through the pleading stages because of the multiple elements to allege a 10(b) claim and the already heightened pleading standard.

The Ninth Circuit agreed with the Second Circuit in the justification for applying the *Omnicare* standards because it determined that *Omnicare* simply "refined the standard for analyzing whether a statement of opinion is

120. *See* Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971); 15 U.S.C. § 78j (2012) ("for the protection of investors"); *see also* Thel, *supra* note 1, at 425.

121. *See* City of Dearborn Heights Act 345 Police & Fire Ret. Sys., v. Align Tech., Inc., 856 F.3d 605, 612 (9th Cir. 2017).

122. Omnicare, Inc., v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1338, 1332 (2015).

123. *See id.*

materially misleading"; and sound statutory interpretation demands that section 11 impose the same requirements in the section 10(b) context.[124] However, there are reasons that terms or phrases, particularly within securities laws, should be interpreted differently—interpretations should fall in line with congressional intent.

VI. Conclusion

Courts need to undertake a more thorough analysis in their application of *Omnicare* standards to falsity of opinion statements under section 10(b). In *City of Dearborn Heights*, the Ninth Circuit applied the *Omnicare* standards to a case where, as pointed out in the concurrence, it was not needed. The court rushed through the analysis of applying *Omnicare*, did not consider the cumulative effect of such a move, and failed to analyze how the differences in a section 11 claim and section 10(b) claim might give rise to the need for different pleading standards. The type of misstatement, the context, the parties involved, and the existing pleading requirements are inherently different in the two claims, and thus necessitate different pleading requirements. Since a registration statement is narrowly tailored and a plaintiff has a low burden to allege a section 11 claim, the opinion statements in a registration statement deserve some level of added protection. After all, they are opinion statements, and liability should not flow simply because of an incorrect opinion.[125] However, in alleging a section 10(b) claim, there are already multiple levels of protection in place for opinion statements through the heightened pleading requirements and the multiplicity of elements that have to be alleged in comparison to section 11.[126] A thorough consideration and analysis of the differences and total effects is needed to ensure that the correct balance is struck between preventing meritless claims from proceeding to the discovery stage and allowing claims that have merit to continue. In striking this balance, the application of *Omnicare* to section 10(b) claims makes it even more difficult for a plaintiff claiming a falsity of opinion statement to survive a 12(b)(6) motion to dismiss because they now have to allege that the speaker did not subjectively believe the opinion statement. Further, the plaintiff must do so with particularity, while satisfying FRCP 9(b) and PSLRA, along with the other five elements of a section 10(b) claim—all without any

124. *Allign Tech., Inc.*, 856 F.3d at 616 (quoting Tongue v. Sanofi, 816 F.3d 199, 209 (2d Cir. 2016)).
125. *See Omnicare, Inc.*, 135 S. Ct. at 1327.
126. *See supra* Section V.A.

discovery. It can be argued that *City of Dearborn Heights* is in line with congressional intent under the PSLRA to curtail fraud claims without merit. And while that may be the case, the question needs to be raised, considered, and addressed: at what point does allowing defendants to have a case dismissed without much inquiry into the actual facts stray too far from protecting investors and ensuring market integrity by limiting fraud and manipulation? Because discovery is stayed and the defendant's toolbox is full of defenses during the motion to dismiss, they have a strong likelihood of having the case dismissed for a plaintiff's failure to successfully maneuver the minefield of alleging a section 10(b) violation even when illegal actions have taken place.

Thanks to *City of Dearborn Heights*, defendants now have another tool in their toolbox at the pleading stage when facing a section 10(b) claim, resulting in the increased likelihood of meritorious claims being dismissed on a 12(b)(6) motion. This development cuts against the foundational purpose of the Securities Act of 1933 and Securities Exchange Act of 1934. While the tremendous damage that can arise from fraud claims may be justification for the heightened pleading requirements, there remains a certain level of protection that must be preserved to safeguard investors. This issue calls for more thorough analysis by courts before a blind application of *Omnicare* to claims outside of section 11 context. The balance between investor protection and protection of the parties making the statements must be preserved.

J. Cooper Davis