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KEY FEDERAL COURT RULES ON SECURITIES FRAUD PLEADING STANDARD

by

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In a unanimous decision written by Justice Dennis Jacobs, the United States Court of Appeals for the Second Circuit held that plaintiffs alleging knowingly false statements by securities issuers must comply with the pleading standards applied to fraud claims in the federal courts, even if their claims could have been based on negligent conduct. On April 13, 2004 the Second Circuit denied appellants' petition for panel rehearing and rehearing *en banc*. In *Rombach et al. v. Chang et al.*, 355 F.3d 164 (2d Cir. 2004),[1] the Second Circuit applied the heightened pleading standards imposed by Rule 9 of the Federal Rules of Civil Procedure to claims under Sections 11 and 12 of the Securities Act of 1933 (the "1933 Act") when those claims are premised on allegations of knowing or intentional misconduct by defendants. This decision, which resolved a split among the district courts within the Circuit and aligns the Second Circuit with the Third, Fifth, Seventh and Ninth Circuits on this issue (the First and Tenth Circuits have indicated agreement with this position, but have not yet ruled directly on the issue), and evidences a common-sense application of Rule 9(b)'s plain language.

In *Rombach*, plaintiffs asserted claims under various securities laws against the former officers of Family Golf Centers, Inc. ("Family Golf"), alleging that they knowingly made false or misleading statements in press releases, analyst calls and in a registration statement filed in connection with the secondary offering of shares of Family Golf. The plaintiffs made claims based on Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), which prohibits fraudulent (*i.e.*, knowingly false or misleading) conduct in connection with the purchase or sale

[1]For a more extensive discussion of the *Rombach* decision, see *Second Circuit Affirms Dismissal of Securities Class Action Claims and Applies Heightened Pleading Standard to Claims Under Sections 11 and 12 of Securities Act of 1933 Based on Fraud*, available at http://www.velaw.com/mcso/shared/litigation/sleg0122.htm.

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of stock of a publicly traded company. However plaintiffs also asserted claims under Sections 11 and 12 of the 1933 Act, which can be based on negligent acts by defendants. In dismissing plaintiffs' claims, the Second Circuit applied Rule 9(b)'s heightened pleading standards, which require plaintiffs to plead "averments of fraud" "with particularity" by identifying in their complaint (i) the statements they contend were fraudulent, (ii) the person(s) who made the statements, (iii) where and when the statements were made, and (iv) why the statements were fraudulent.

Federal courts have consistently applied Rule 9(b)'s heightened pleading standards to fraud claims under Section 10(b) of the 1934 Act. However the question whether plaintiffs asserting claims under Sections 11 and 12 of the 1933 Act must meet those standards when their claims are based on allegations of intentionally false or misleading statements (as opposed to negligent acts) was one of first impression in the Second Circuit, and has split the Federal Circuit Courts of Appeal, with the Third, Fifth, Seventh and Ninth Circuits ruling that Rule 9(b) applies and the Eighth Circuit reaching the opposite conclusion.

In a well reasoned opinion, the Second Circuit noted that Rule 9(b) applies, by its terms, to "all averments of fraud," regardless of the legal claims in support of which they are made, and is intended, among other things, to "provide a defendant with fair notice of a plaintiff's claim, [and] to safeguard a defendant's reputation from improvident charges of wrongdoing." It then held that "while a plaintiff need allege no more than negligence to proceed under Section 11 and Section 12(a)(2), claims that do rely upon averments of fraud are subject to the test of Rule 9(b)."

Moving on to the question whether the trial court's dismissal of the *Rombach* case was proper, the Second Circuit analyzed the complaint and found that despite plaintiffs' argument that their Section 11 and 12 claims did not "sound in fraud," the "wording and imputations of the complaint are classically associated with fraud." The court then found that while the complaint "cataloged" various statements alleged to be false or misleading, the plaintiffs had not explained with the specificity required by Rule 9(b) how or why they were actually false or misleading. Finally, the court held that because the statements upon which the plaintiffs based their claims fell within the securities laws' "safe harbor" rules protecting forward looking statements which are accompanied by appropriate cautionary language warning investors that future events might significantly impact the validity of projections, the statements identified by plaintiffs could not support claims under Sections 11 or 12 even if repleaded as negligence-based claims.

The Second Circuit's ruling in *Rombach* clarifies the pleading standard applicable to claims under Sections 11 and 12 of the 1933 Act in the Second Circuit and reaffirms that plaintiffs must support their claims with specific factual allegations, rather than merely reciting known facts and then making conclusory allegations that the acts were undertaken with an intent to defraud. Although the applicability of Rule 9(b) to claims under Sections 11 or 12 of the 1933 Act which sound in fraud has been debated for years, and is the subject of a split among the federal Circuit Courts of Appeal, the directness of the Second Circuit's reasoning can hardly be denied. By honoring the plain meaning of Rule 9(b), and applying a common-sense analysis to the allegations in the complaint, the Second Circuit was able to reach its well-supported decision in *Rombach* and to interject clarity into the often nuanced area of securities class action lawsuits.