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SECOND CIRCUIT REVIEW

BY MARTIN FLUMENBAUM AND BRAD S. KARP

Pleading Under §§11 and 12(A)(2) of the Securities Act of 1933

IN THIS MONTH'S column, we report on a recent decision by the U.S. Court of Appeals for the Second Circuit in which the court determined, as a matter of first impression, that the heightened pleading standard of Rule 9(b) of the Federal Rules of Civil Procedure applies to claims premised on allegations of fraud brought under §11 and §12(a)(2) of the Securities Act of 1933. In *Rombach v. Chang*,[1] the Second Circuit, in an opinion written by Judge Dennis Jacobs and joined by Judges Guido Calabresi and Sonia Sotomayor, affirmed the district court's dismissal of plaintiffs' securities fraud claims with prejudice and remanded the matter to the district court to determine whether any party or lawyer violated Rule 11 of the Federal Rules of Civil Procedure, as required by the Private Securities Litigation Reform Act (PSLRA).

Background

Plaintiffs, purchasers of stock in Family Golf Centers Inc. (Family Golf) between May 12, 1998 and Aug. 12, 1999, brought a putative securities fraud class action against certain officers of Family Golf and the underwriters of a secondary offering used to finance acquisitions of certain golf courses. Before it went bankrupt, Family Golf was a publicly traded company that owned and operated more than one hundred golf facilities throughout the United States. In 1998, Family Golf acquired three large golf course operators with multiple locations. In connection with these acquisitions, Family Golf hired Defendants Jeffries & Company, Inc. and Prudential Securities to underwrite a secondary public offering that took place on July 23, 1998.


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In February and March 1999, Family Golf announced lower-than-expected earnings and revenue for the fourth quarter of 1998, and its stock price plummeted over 43 percent. On Aug. 12, 1999, it announced a net loss of six cents per share for the second quarter of 1999, and disclosed that it was in default of a number of financial obligations. Family Golf filed for bankruptcy protection on May 4, 2000.

Plaintiffs filed a complaint in February 2000 and an amended complaint in July 2000, alleging that Family Golf, the individual defendants and the underwriters had misrepresented Family Golf's financial performance and projected income while knowing — or recklessly disregarding — that Family Golf was having liquidity difficulties as well as trouble incorporating its latest large acquisitions. Specifically, plaintiffs alleged that (1) defendants violated §11 of the Securities Act of 1933 by disseminating a registration statement for the secondary public offering that contained false and misleading statements and omitted material facts; (2) the underwriters violated §12(a)(2) of the Securities Act by soliciting the sale of shares in the secondary public offering based on a prospectus that contained false and misleading statements and omitted material facts; (3) the individual defendants violated §15 of the Securities Act by signing the registration statement or otherwise participating in the process that allowed the secondary offering to be completed; (4) the individual defendants violated §10(b) of the Exchange Act of 1934 and Rule 10b-5 by making false statements or omitting material facts; and (5) the individual defendants violated §20(a) of the Exchange Act, which imposes joint and several liability on persons who are "control persons of the Company."

Defendants moved to dismiss the amended complaint for failure to state a claim under Rule 12(b)(6), failure to plead fraud with particularity as required by Rule 9(b) and failure to state a claim

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under the PSLRA. The district court, Judge Sterling Johnson Jr., granted defendants' motions and dismissed the amended complaint with prejudice. With respect to the claims asserted against the individual defendants, the district court ruled that plaintiffs failed to plead fraud with particularity with regard to their claims under §10(b) and §11 because they did "not sufficiently explain how any of the statements attributed to Defendants are false or misleading."[2] The district court also ruled that plaintiffs failed to plead scienter as required by the PSLRA. Because these claims failed, the district court also dismissed the "control person" claims under §15 and §20(a). With respect to the claims against the underwriters, the district court found that the optimistic remarks about Family Golf's acquisitions in the prospectus were accompanied by meaningful cautionary language and therefore were protected by the bespeaks caution doctrine and the safe harbor provision of the PSLRA.[3]

The Second Circuit

Plaintiffs appealed to the Second Circuit. Defendant Jeffries & Company cross-appealed on the ground that the district court failed to make findings under Rule 11 of the Federal Rules of Civil Procedure, as required by the PSLRA, and failed to find that the claims against the underwriter defendants were not time-barred.

Reviewing the district court's dismissal de novo, the Second Circuit first examined whether the heightened pleading requirement of Rule 9(b) applies to claims under §11 and §12(a)(2). The Second Circuit noted that claims under §11 and §12(a)(2) may be premised on allegations of negligence or allegations of fraud. Many courts distinguish between allegations of fraud and allegations of negligence under these sections and only apply the heightened pleading requirement of Rule 9(b) to allegations of fraud.[4] The U.S. Court of Appeals for the Eighth Circuit, however, has refused to apply Rule 9(b) to claims asserted under §11, reasoning that "a pleading standard which requires a party to plead particular facts to support a cause of action that does not include fraud or mistake as an element comports neither with Supreme Court precedent nor with the liberal system of notice pleading embodied in [Federal Rule of Civil Procedure 8(b)]."[5]

The Second Circuit disagreed with the Eighth Circuit and aligned itself with the Third, Fifth, Seventh and Ninth circuits, holding that the heightened pleading standard of Rule 9(b) applies to claims based on allegations of fraud under §§11 and 12(a)(2). The court reasoned that Rule 9(b) by its terms applies to "all averments of fraud," and is "not limited to allegations styled or denominated as fraud or expressed in terms of the constituent elements of a fraud cause of action."[6] The court explained that the rationale behind Rule 9(b) applies with equal force to claims of fraud under §§11 and 12(a)(2). The court stated:

> The particularity requirement of Rule 9(b) serves to 'provide a defendant with fair notice of a plaintiff's claim, to safeguard a defendant's reputation from improvident charges of wrongdoing, and to protect a defendant against the institution of a strike suit.' … These considerations apply with equal force to 'averments' of fraud in aid of Section 11 and Section 12(a)(2) claims that are grounded in fraud.[7]

Claims Against Defendants

Plaintiffs' Claims Against the Individual Defendants. The Second Circuit then considered whether plaintiffs' claims against the individual defendants under §11 and §12(a)(2) sounded in negligence or fraud. The court noted that the language used in the complaint was classically associated with allegations of fraud: plaintiffs alleged that the registration statement was "inaccurate and misleading," that it contained "untrue statements of material facts," and that "materially false and misleading written statements" were issued.[8] Accordingly, the court found that plaintiffs were required to meet Rule 9(b)'s heightened pleading requirements and "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker; (3) state where and when the statements were made, and (4) explain why the statements were fraudulent."[9]

The Second Circuit examined the four categories of statements plaintiffs alleged were false or misleading: First, plaintiffs alleged that the press releases issued by Family Golf between May 1998 and March 1999 were misleading because they failed to disclose the problems Family Golf was experiencing in integrating the three large acquisitions it made in 1998 and the problems with Family Golf's liquidity. The court found that, although the complaint listed a number of allegedly false or misleading statements in the press releases, plaintiffs failed to allege with adequate specificity how these complained-of statements were actually false or misleading. Further, the statements in the press releases either were forward-looking statements protected by the bespeaks caution doctrine or the PSLRA's safe harbor or were expressions of puffery and corporate optimism that do not give rise to securities violations.

Second, plaintiffs alleged that a slide prepared for use in connection with the secondary offering, entitled "Facility Economics Comparison," falsely portrayed Family Golf's growth and profitability by materially overstating the economics of Family Golf's facilities. But the slide was undated and it was unclear whether it contained historical data or projections for future revenue. Accordingly, the court concluded that plaintiffs failed to plead fraud with the

requisite particularity.

Third Plaintiff Allegation

Third, plaintiffs alleged that defendants disseminated misleading earnings projections and statements about the integration of the three large acquisitions to a variety of analysts who then used the information in their reports about Family Golf. The court noted that there are two ways to state a claim against corporate officials for analysts' statements: "the complaint can allege that the officers either '(1) intentionally foster[ed] a mistaken belief concerning a material fact that was incorporated into reports; or (2) adopted or placed their imprimatur on the reports.' "[10] The court found that while plaintiffs met the first prong of the test by alleging that the analyst reports were "based on specific information from defendants" and "were derived from internal budget information furnished to the respective analysts by [the individual defendants]," plaintiffs failed to explain why the complained-of statements in the analysts' reports were false. The analysts' statements — like the press releases — contained financial projections and statements of guarded optimism that are considered puffery and are not actionable as fraud.

Finally, plaintiffs pleaded that the registration statement was false or misleading because it "failed to disclose that the [secondary] Offering was necessitated by pressure from the Company's lenders and its deteriorating cash position, and it failed to disclose that the integration of recently acquired sites was proceeding poorly and that the Company was experiencing operation problems associated with these acquired properties."[11] But the court noted that these allegations were belied by the language of the registration statement itself, which contained meaningful cautionary language and provided a "sobering picture of Family Golf's financial condition and future plans."

The court concluded that it would be futile to allow plaintiffs to replead their fraud claims as negligence claims, as any negligence claim would be "defeated in any event by the bespeaks caution doctrine."[12]

Scienter

Alternatively, the Second Circuit determined that plaintiffs' claims against the individual defendants should be dismissed for failure to plead scienter. The PSLRA requires that plaintiffs "state with particularity [the] facts giving rise to a strong inference that the defendant acted with the required state of mind." Plaintiffs can do so by "(1) alleg[ing] facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness, or (2) alleg[ing] facts to show that defendants had both motive and opportunity to commit fraud."[13] The Second Circuit found that plaintiffs failed to meet either prong. As to the first, the court noted that "a pleading technique that couples a factual statement with a conclusory allegation of fraudulent intent is insufficient to support the inference that the defendants acted recklessly or with fraudulent intent."[14] The individual defendants here disclosed Family Golf's low earnings and its problems with its acquisitions in a public filing well before the deadline for the filing of its 1998 Form 10-K, which undercut any allegation of recklessness or fraudulent intent. Moreover, plaintiffs failed to allege any personal interest that would be sufficient to plead motive and opportunity.

Plaintiffs' Claims Against the Underwriters. The Second Circuit found that plaintiffs' §§11 and 12(a)(2) claims against the underwriters sounded in negligence because plaintiffs alleged that the underwriters "owed to the purchasers of the shares of [Family Golf] … the duty to make a reasonable and diligent investigation of the statements contained in the Prospectus."[15] As such, the court did not require that plaintiffs meet the heightened pleading requirements of Rule 9(b). Nonetheless, the court agreed with the district court that the claims asserted against the underwriters should be dismissed because statements in the registration statement and prospectus were protected by the bespeaks caution doctrine.

Rule 11

The PSLRA mandates that, at the conclusion of any private securities action, the district court make specific findings regarding compliance with Rule 11 by each party and attorney. Accordingly, without commenting on the merits of any Rule 11 issue, the Second Circuit remanded the case for compliance with the PSLRA.

This decision resolves a long-standing split among the lower courts in the Second Circuit and is likely to become a central component of defense counsel's arsenal in seeking dismissal of fraud-styled claims under §11 and §12(a) of the Securities Act.

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(1) 355 F3d 164 (2d Cir. 2004).
(2) *Rombach*, 355 F3d at 169.
(3) Id.
(4) *In re Stac Elecs. Secs. Litig.*, 89 F3d 1399, 1404-05 (9th Cir. 1996); *Melder v. Morris*, 27 F3d 1097, 110 n.6 (5th Cir. 1994); *Shapiro v. UJB Fin. Corp.*, 964 F2d 272, 288 (3d Cir. 1992); *Sears v. Likens*, 912 F2d 889, 893 (7th Cir. 1990).
(5) *Rombach*, 355 F3d at 171 (quoting *In re NationsMart Corp. Secs. Litig.*, 130 F3d 309, 314 (8th Cir. 1997).
(6) Id.
(7) Id. (quoting *O'Brien v. Nat'l Property Analysts Partners*, 936 F2d 674, 676 (2d Cir. 1991)).
(8) Id. at 172.
(9) Id. at 170 (citing *Mills v. Polar Molecular Corp.*, 12 F3d 1170, 1175 (2d Cir. 1993)).
(10) Id. at 174-75 (quoting *Novak v. Kasaks*, 216 F3d 300, 314 (2d Cir. 1980) (internal quotation omitted)).
(11) Id.
(12) Id. at 176.
(13) Id. (quoting *Rothman v. Gregor*, 220 F3d 81, 90 (2d Cir. 2000)).
(14) Id. (quoting *Shields v. Citytrust Bancorp, Inc.*, 25 F3d 1124, 1129 (2d Cir. 1994) (internal alterations and quotation marks omitted)).
(15) Id. at 178.