

**SECOND CIRCUIT COURT OF APPEALS APPLIES HEIGHTENED PLEADING
REQUIREMENT TO CLAIMS UNDER SECTIONS 11 AND 12(a)(2)
OF THE SECURITIES ACT OF 1933 THAT SOUND IN FRAUD**

In a recent decision, the United States Court of Appeals for the Second Circuit held that claims under Sections 11 and 12(a)(2) of the Securities Act of 1933 (the “Securities Act”) that sound in fraud must satisfy the heightened pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure requiring allegations of fraud to be stated with particularity. Rombach v. Chang, No. 02-7907 (2d Cir. Jan. 20, 2004). This was an issue of first impression for the Second Circuit.

Background

Plaintiffs, shareholders in Family Golf Centers, Inc. (“Family Golf”), filed a putative securities class action against certain directors and officers of the company and its underwriters. Family Golf is a Delaware corporation that acquired and operated a chain of driving ranges and golf courses in the United States and Canada. In May 2000, Family Golf filed for protection under the bankruptcy laws. The plaintiffs alleged that the defendants made materially false and misleading statements and omissions in violation of Sections 11 (liability for materially false statements or omissions in a registration statement) and 12(a)(2) (liability for materially false statements or omissions in a prospectus) of the Securities Act and Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934 (the “Exchange Act”) (liability for knowingly or recklessly issuing materially false and misleading statements).

The defendants moved to dismiss the complaint on the ground, *inter alia*, that plaintiffs’ claims under the Securities Act and the Exchange Act failed to plead fraud with particularity as required by Rule 9(b) of the Federal Rules of Civil Procedure. In a decision dated June 7, 2002, the United States District Court for the Eastern District of New York (Johnson, J.) held that the plaintiffs’ claims under Sections 11 and 12(a)(2) against the individual defendants sounded in fraud and dismissed them because they were not pled with the particularity required by Rule 9(b). Rombach v. Chang, 00 CV 0958, 2002 U.S. Dist. LEXIS 15754 (E.D.N.Y. June 7, 2002). An appeal ensued.

The Second Circuit Decision

The Second Circuit affirmed the dismissal and for the first time in this Circuit addressed the issue of whether the heightened pleading standard of Rule 9(b) of the Federal Rules of Civil Procedure, which requires that in all averments of fraud, the circumstances of the fraud shall be stated with particularity, applies to claims brought under Sections 11 and 12(a)(2) of the Securities Act.

The Second Circuit noted that Section 11 and 12(a)(2) claims may be rooted in fraud or negligence. Where rooted in fraud, courts have split over whether Rule 9(b) applies. Courts in the Third, Fifth, Seventh and Ninth Circuits have found that Rule 9(b) applies to Section 11 and 12(a)(2) claims that sound in fraud. The Eighth Circuit, on the other hand, has held that Rule 9(b) does not apply to a Section 11 claim irrespective of whether it sounds in fraud because proof of fraud is not an element of such a claim.

The Second Circuit held that although a plaintiff need not plead more than negligence to support a Section 11 or 12(a)(2) claim, if a plaintiff is relying on allegations of fraud to support such a claim, the particularity requirements of Rule 9(b) apply. The Second Circuit found that the particularity requirement “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.’” The Second Circuit agreed with the District Court’s determination that the Section 11 and 12(a)(2) claims against the individual defendants were predicated on allegations of fraudulent behavior and that the allegations in support of those claims were not stated with the requisite particularity.

The Rombach decision establishes that complaints filed in the Second Circuit alleging Section 11 and 12(a)(2) violations that sound in fraud (rather than negligence) must meet the heightened pleading requirements of Rule 9(b) to survive a motion to dismiss.

* * * * *

If you have any questions about the Rombach decision, or to obtain a copy of the opinion, please call Stephen W. Greiner (212-728-8224) or Stacey E. Paradise (212-728-8621).

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

February 2, 2004

Copyright © 2004 by Willkie Farr & Gallagher LLP

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information.