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Rombach v. Chang: To 9(b) or not to 9(b)

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ROMBACH V. CHANG: TO 9(b) OR NOT TO 9(b)

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I. INTRODUCTION

In *Rombach v. Chang*,[1] the Second Circuit held that the heightened pleading requirements of Rule 9(b)[2] of the Federal Rules of Civil Procedure applies to claims brought under section 11[3] and section 12(a)(2)[4] of the Securities Act of 1933 (the "Securities Act") when the claim "sounds in fraud."[5] Although this was an issue of first impression for the Second Circuit,[6] several district courts within the Second Circuit had split on the issue.[7] In addition, the decision was consistent with several other circuits that have held

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1. 355 F.3d 164 (2d Cir. 2004).

2. FED. R. CIV. P. 9(b). The rule states, in pertinent part, that in "all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." *Id.* The Second Circuit has interpreted this to require a plaintiff alleging a securities law violation based on a false or misleading statement to "(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." Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir. 1993).

3. 15 U.S.C. § 77k (1998). Section 11 imposes civil liability against an issuer of securities and those classes of persons named in the statute. *Id.* Liability under Section 11 arises if a registration statement filed with the SEC, at the time the registration statement becomes effective, "contained an untrue statement of material fact or omitted to state a material fact . . . necessary to make the statements therein not misleading." *Id.*

4. 15 U.S.C. § 77*l*(*a*)(2) (2000). Section 12(a)(2) imposes civil liability on anyone who sells a security pursuant to a prospectus or any other communication that is false or misleading. *Id.*

5. *Rombach*, 355 F.3d at 167.

6. *Id.*

7. *See* Griffin v. PaineWebber Inc., 84 F. Supp. 2d 508, 513-14; *In re* Ultrafem Inc. Sec. Litig., 91 F. Supp. 2d 678, 690 (S.D.N.Y. 2000) (holding that rule 9(b) applies to section 11 and section 12(a)(2) claims "where the complaint is grounded in fraud"); Ellison v. Am. Image Motor Co., 36 F. Supp. 2d 628, 639 (S.D.N.Y. 1999) (holding that rule 9(b) applies); *In re* In Store Advertising Sec. Litig., 878 F. Supp. 645, 647-49 (S.D.N.Y. 1995) (holding rule 9(b) inapplicable); Nelson v. Paramount Communications Inc., 872 F. Supp. 1242, 1246 (S.D.N.Y. 1994) (holding rule 9(b) inapplicable).

that the heightened pleading requirements of rule 9(b) are applicable to section 11 and section 12(a)(2) claims.[8] Those courts, as the Second Circuit did here, distinguished between allegations that sound in fraud rather than in negligence.[9]

This case comment will argue that the heightened pleading requirements of rule 9(b) should not apply to claims under section 11 of the Securities Act, whether or not those claims were grounded in fraud. Requiring the heightened standard of rule 9(b) undermines the purpose of the Securities Act and is inconsistent with the plain language of section 11. In addition, there is already ample protection for defendants from claims under section 11 of the Securities Act so that the protections of rule 9(b) are not necessary.

II. Background

In *Rombach*, the plaintiffs were a class of investors that purchased stock in Family Golf Centers, Inc. ("Family Golf") between May 1998 and August 1999 and a subclass that purchased Family Golf stock in the secondary public offering.[10] Family Golf, a publicly traded company, was a leading consolidator of golf centers.[11] In 1998, the company adopted a growth strategy of acquiring large golf course operators with multiple locations.[12] That same year, Family Golf made three such acquisitions.[13] To help finance these transactions, the company conducted a secondary public offering of securities on July 23, 1999.[14] During these three transactions, Family Golf and its underwriters made several optimistic public

8. *See* Shapiro v. UJB Financial Corp., 964 F.2d 272, 288 (3d Cir. 1992) (holding that "when § 11 and § 12(a)(2) claims are grounded in fraud rather than negligence, Rule 9(b) applies"); Melder v. Morris, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994) (holding that rule 9(b) applies when "Securities Act claims are grounded in fraud rather than negligence"); *In re* Stac Elecs. Sec. Litig., 89 F.3d 1399, 1404-05 (9th Cir. 1996) ("The particularity requirements of Rule 9(b) apply to claims brought under Section 11 when, as here, they are grounded in fraud."); Sears v. Likens, 912 F.2d 889, 893 (7th Cir. 1990) (holding that the plaintiff's Securities Act claims sounded in fraud and did not satisfy rule 9(b)).

9. *Id.*

10. *Rombach*, 355 F.3d at 167.

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

statements that claimed success in the integration of the newly acquired securities.[15]

In early 1999, Family Golf announced lower than expected earnings for the last quarter of 1998, and the stock price soon fell by more than 43%.[16] In August of 1999, the Company announced another loss for the second quarter of the year and that it was in default on a number of financial obligations.[17] On May 4, 2000, Family Golf filed for bankruptcy protection.[18]

The plaintiffs brought suit, filing their original complaint on February 16, 2000, and a consolidated amended class action complaint was filed on July 17, 2000.[19] Named as defendants were: Dominic Chang, chief executive officer and chairman of Family Golf; Krishnan Thampi, president, chief operating officer, assistant secretary, treasurer and director; and Jeffrey Key, chief financial officer (the "individual defendants").[20] Also named were Jefferies & Co., Inc. and Prudential Securities, Inc., the underwriters of the 1998 secondary public offering (together, the "underwriters").[21] The complaint alleged that the individual defendants and the underwriters made several misrepresentations and omissions about the Company's financial condition, especially that the newly acquired golf facilities would be profitable even though the defendants knew, or should have known, that the Company was in a liquidity crisis and having serious trouble integrating the new acquisitions.[22]

The complaint set forth five claims, two of which are relevant here.[23] First, the plaintiffs alleged that all defendants violated section 11 of the Securities Act by disseminating a registration statement containing false and misleading statements and omitting

15. *Rombach*, 355 F.3d at 167-68. For example, Family Golf issued "press releases indicating that the integration of the new acquisitions was progressing smoothly." *Id.* at 168.

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.* at 167-68.

20. *Rombach*, 355 F.3d at 167.

21. *Id.* at 167. Family Golf was originally named as a defendant but was dropped after it filed for bankruptcy protection. *Id.* at 168 n.1.

22. *Id.* at 168.

23. *Id.* The plaintiffs also brought claims under section 15 of the Securities Act, section 10(b) and rule 10(b)(5) of the Exchange Act of 1934, and section 20(a) of the Exchange Act of 1934.

material facts.[24] Second, the complaint stated that the underwriters violated section 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 failed to state material facts.[25] All the defendants moved to dismiss the complaint for, among other grounds, failure to plead fraud with sufficient particularity under rule 9(b).[26]

As to the section 11 claims against the Individual Defendants, the district court found them to be "classic fraud allegations."[27] The "fraud" language in the complaint identified by the district court alleged dissemination of an "inaccurate and misleading" registration statement and that the registration statement "contained false statements of material fact and omitted other facts necessary to make the statements not misleading."[28] Furthermore, the plaintiffs were found to have "relied on these statements to their detriment."[29] Thus, because the section 11 claims against the individual defendants sounded in fraud, the court held that they were subject to the heightened pleading requirements of rule 9(b).[30] The court then held that the plaintiffs' section 11 claims failed to meet that standard and dismissed the section 11 claims.[31]

As to the section 11 and section 12(a)(2) claims against the underwriters, the district court found them to be claims of negligence, rather than fraud. Therefore, rule 9(b) was not applicable. Nonetheless, these claims were dismissed because any optimistic remarks attributable to the underwriters were protected by the "bespeaks caution" doctrine and the safe harbor provision of the Private Securities Litigation Reform Act of 1995 ("PSLRA").[32] In addition, there was no showing that the underwriters knew, or should have known, of any facts that would make their statements

24. *Id.*
25. *Id.*
26. *Rombach*, 355 F.3d at 169.
27. Rombach v. Chang, 2002 WL 1396986, at *4 (E.D.N.Y. June 7, 2002).
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.* at *13.

or omissions false or misleading when made.[33] The plaintiffs appealed.

At issue on appeal was whether the heightened pleading requirement of rule 9(b) should be applied to claims brought under section 11 and section 12(a)(2).[34] The Second Circuit held that rule 9(b) applies to section 11 and section 12(a)(2) claims insofar as the claims are premised on allegations of fraud.[35] This holding is consistent with the majority of other circuits that have ruled on the issue.[36] Only the Eighth Circuit has held rule 9(b) inapplicable to claims under section 11 of the Securities Act even when the complaint sounds in fraud.[37]

III. Discussion

The Second Circuit held that rule 9(b) was applicable to claims that sound in fraud despite acknowledging that "[f]raud is not an element or a requisite to a claim under section 11 or section 12(a)(2)" and that "a plaintiff need allege no more than negligence to proceed under section 11 and section 12(a)(2) . . . ."[38] Instead of focusing on the plain language of sections 11 and 12 of the Securities Act, the court based its decision on other considerations. For example, the court stated that because "[f]raud allegations may damage a defendant's reputation," rule 9(b) served to "safeguard a defendant's reputation from improvident charges of wrongdoing."[39] Also, rule 9(b) "prohibit[s] plaintiffs from unilaterally imposing upon the court, the parties, and society enormous social and economic costs absent some factual basis."[40]

33. *Rombach*, 2002 WL 1396986, at *14.

34. *Rombach*, 355 F.3d at 167. For the purposes of this Comment, I will limit my discussion to section 11. For a discussion on whether rule 9(b) should apply to section 12(a)(2) and available defenses to claims under this section, see generally Thomas Lee Hazen, The Law of Securities Regulation 341–401 (4th ed. 2002) (analyzing both liability provisions and pointing out similarities and differences between liability under section 11 and section 12(a)(2)).

35. *Id.* at 171 (stating that although "a plaintiff need allege no more than negligence . . . claims that do rely on averments of fraud are subject to the test of Rule 9(b)").

36. *See supra* note 8 (citing cases).

37. *In re* NationsMart Corp. Sec. Litig., 130 F.3d 309, 314 (8th Cir. 1997).

38. *Rombach*, 355 F.3d at 171.

39. *Id.* (citations omitted).

40. *Id.* (citation omitted).

While these are important policy concerns, holding that claims under section 11 of the Securities Act must meet the heightened pleading requirements of rule 9(b) is inconsistent with the plain language of section 11 and the general purpose of the Securities Act. As will be discussed below, protection of the investing public was the primary goal of the Securities Act, whereas the protection of potential defendants was not a key concern. To ensure compliance with the Act, Congress purposely created liability sections that made it easy for investors to bring a claim under the Act. In addition, imposing a heightened pleading requirement is inconsistent with rule 8(a) of the Federal Rules of Civil Procedure. Finally, section 11 already contains sufficient procedural requirements and defenses that offer ample protection from liability under section 11. Thus, the concerns expressed by the Second Circuit in *Rombach* should not override the language and the intent of section 11.

A. *The Heightened Pleading Requirement of Rule 9(b) is Inconsistent with the Plain Language of Section 11 and Congressional Intent*

Neither the plain language of the statute nor the intention of Congress indicates any requirement that a plaintiff prove fraud to recover on a section 11 claim. The Supreme Court has stated that "[w]here . . . resolution of a question of federal law turns on a statute and the intention of Congress, we look first to the statutory language and then to the legislative history if the statutory language is unclear."[41] Here, neither the language of section 11 nor the intent of Congress is unclear.

To make out a prima facie claim under section 11, a plaintiff need only show that he purchased the security and that the registration statement contained a material misstatement of fact or an omission of a material fact.[42] There is no requirement in the statute that a plaintiff prove scienter, or the intent to defraud or deceive, to succeed on a section 11 claim.[43] Also absent from the

41. Blum v. Stenson, 465 U.S. 886, 896 (1984).

42. 15 U.S.C. § 77k. *See also* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) ("If a plaintiff purchased a security pursuant to a registration statement, he need only show a material misstatement or omission to establish his prima facie case.").

43. 15 U.S.C. § 77k. *See also Herman & MacLean*, 459 U.S. at 382 (discussing the differences between a claim under section 11 and one under section 10(b) of the Ex-

language of section 11 is the requirement that a plaintiff prove he relied on the misstatement or omission when making the decision to buy the security and that such reliance actually caused him to buy.[44] Requiring proof of loss causation is also absent from the statute. In fact, the burden is on the defendant to prove, as an affirmative defense if he so chooses, that the plaintiff's loss was caused by something other than the misstatement or omission.[45] Fraud, by its very definition, requires intent, reliance, and causation.[46] By not requiring proof of these necessary elements of fraud, section 11 is not an anti-fraud statute. By eliminating the requirement of proving fraud, the Securities Act gave investors additional protections and made recovery in securities claims easier.[47]

The intent of Congress is also clear. Congress enacted the Securities Act and the Exchange Act of 1934 in response to the col-

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change Act, the court stated: "[A] section 10(b) plaintiff carries a heavier burden than a section 11 plaintiff. Most significantly, he must prove that the defendant acted with scienter, i.e., with intent to deceive, manipulate or defraud."); *In re NationsMart Corp.*, 130 F.3d at 315 (holding that "[s]cienter is not required for establishing liability under [section 11]").

44. William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE. L. J. 171, 174 (1933) ("In the second place the Act requires no proof of reliance by plaintiff on the untruth or omission. Neither the plaintiff nor anyone else need to have known of it.").

45. 15 U.S.C. § 77k(e). When stating how damages are computed, the statute continues "[p]rovided, [t]hat if the *defendant proves* that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which liability is asserted . . . such portion of or all such damages shall not be recoverable." *Id.*

46. Fraud is defined as "a knowing misrepresentation of the truth (intent) or concealment of a material fact to induce another (reliance) to act to his or her detriment (loss causation)." BLACK'S LAW DICTIONARY 670 (7th ed. 1999). *See also* Bastian v. Petren, 892 F.2d 680 (7th Cir. 1990) (holding that a plaintiff alleging a violation of section 10(b) and rule 10b-5 of the Exchange Act must prove that the alleged fraud actually caused the loss to the plaintiff). In its discussion, the court stated that "what securities lawyers call 'loss causation' *is* the standard common law fraud rule, merely borrowed for use in federal securities fraud cases." *Id.* at 683.

47. "Nevertheless it is true that [section 11] gives to investors additional protection long needed. Satisfaction of the common law requirements of fraud raised almost insurmountable barriers to recovery. The road of investors has not been an easy one owing to the common law insistence on scienter, reliance, and causation." Douglas & Bates, *supra* note 44, at 174.

lapse of the financial markets in 1929.[48] One of the major purposes of these new laws was to protect investors by encouraging the disclosure of accurate information by the issuer of securities to the investing public.[49] In the context of the Securities Act, which governs the issuance of new securities into the market, the protections are especially important. To encourage compliance with the Securities Act, "Congress made it easy for buyers to bring a claim under section 11."[50] The liabilities were "set high to guarantee the risk of their invocation will be effective in assuring that 'the truth about securities' will be told."[51]

Requiring a plaintiff to plead with particularity the circumstances that constitute fraud adds an additional burden upon the plaintiff that was not intended by Congress and that is clearly contrary to the language of section 11. "In each instance that Congress created express civil liability in favor of purchasers or sellers of securities it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake."[52] Section 11, however, does not contain any language requiring proof of knowing or intentional conduct, and "[w]ithin the limits specified in [section] 11(e), the issuer of the securities is held absolutely liable" for damages resulting from misstatements or omissions contained in the registration statement that cause losses to purchasers.[53] The statute clearly places the burden on the defen-

48. Billions of dollars worth of securities were brought to market in the 1920s, of which more than half had become completely worthless by 1933. J. Hicks, CIVIL LIABILITIES: ENFORCEMENT LITIGATION UNDER THE 1933 ACT § 4.01[1], 4-6 (1994).

49. President Roosevelt said that Congress was putting the "burden of telling the whole truth on the seller" in order to "give impetus to honest dealing in securities and thereby bring back public confidence." Brian Murray & Donald J. Wallace, *You Shouldn't be Required to Plead More than you Have to Prove*, 53 BAYLOR L. REV. 783, 784 (2001), *citing* 77 Cong. Rec. 937 (1933).

50. Krista L. Turnquist, Note, *Pleading Under Section 11 of the Securities Act of 1933*, 98 MICH. L. REV. 2395, 2401 (2000). *See also* Douglas & Bates, *supra* note 44, at 173 ("The civil liabilities imposed by the Act are not only compensatory in nature but also *in terrorem*.").

51. *Id. See also Herman & MacLean*, 459 U.S. at 381-82 ("[Section 11] was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering.").

52. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 207 (1976).

53. *Id.* at 208 (stating that "section 11 of the 1933 Act unambiguously creates a private action for damages when a registration statement includes untrue statements of material facts or fails to state material facts. . . ."). *See also Herman & MacLean*, 459 U.S.

dant to prove that the plaintiff knew of the misstatement or omission at the time the plaintiff acquired the stock.[54] Congress expressly intended the burden to be on the defendants, stating that for the statute to have any meaning, "it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements for the public's reliance."[55]

It is clear then that section 11 was not intended to, nor does it, predicate liability on a showing of fraud. Accordingly, a plaintiff should not be required to satisfy the heightened pleading requirements of rule 9(b), even when his or her section 11 claim "sound[s] in fraud." A section 11 claim will usually sound in fraud when the plaintiff pleads claims under the Securities Act and the Exchange Act in one complaint and incorporates by reference all factual allegations pleaded for one claim into the other claims.[56] Claims pursuant to section 10b(b) and rule 10b-5 under the Exchange Act are predicated on fraud,[57] and the pleading requirement for those claims must meet the heightened standard of rule 9(b) and of the

at 382 ("Liability against the issuer of a security is virtually absolute, even for innocent misstatements.").

54. 15 U.S.C. § 77k(a). The statute states, in pertinent part, "any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either in law or in equity, in any court of competent jurisdiction, sue—." *Id.*

55. MATHEW BENDER, FEDERAL SECURITIES ACT OF 1933 § 9.02[12][a], *citing* H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

56. This was the case in *Rombach*. *See Rombach*, 355 F.3d at 168-69 (listing the five different claims pleaded by the plaintiffs, including claims under section 11 and section 12(a) of the Securities Act, and under section 10(b) and rule 10b-5 of the Exchange Act). *See also Shapiro*, 964 F.2d at 287 ("[The section 11 and section 12 claims] incorporate by reference all preceding factual allegations, including those delineating defendant's 'intent'."). It is possible to plead both Securities Act and Exchange Act claims because, as the Supreme Court held, claims under section 11 and under section 10(b) are separate causes of action to address different kinds of wrongdoing. *Herman & MacLean*, 459 U.S. at 381-84 (discussing the difference between the two sections, namely that section 10(b) addresses fraudulent conduct while section 11 does not).

57. *See* 15 U.S.C. § 78j(b) (2000) (stating in pertinent part that "[i]t shall be unlawful . . . [t]o use or employ . . . any manipulative or deceptive device. . . ."); 17 C.F.R § 240.10b-5 (2005), promulgated under section 10(b) (holding it unlawful to "(a). . .employ any devise, scheme, or artifice to defraud . . . (c) To engage in any act, practice, or course of business which operates . . . as fraud or deceit . . ."). *See also Hochfelder*, 425 U.S. at 207 (holding that scienter is a requirement for claims under section10(b) and rule10b-5).

PSLRA.[58] Incorporating multiple claims into a single complaint is encouraged because it conserves judicial resources.[59] Thus, to avoid rule 9(b) requirements in a section 11 claim, a plaintiff would need to allege that the defendants acted fraudulently in one part of the complaint, but allege that the defendants did not act fraudulently in another.[60] Of course, a plaintiff could separate the factual allegations of fraud from the factual allegations used to plead a section 11 claim. Some courts have also held that a plaintiff can avoid pleading fraud for a Securities Act claim by expressly disavowing any allegations of fraud when incorporating factual allegations.[61] Such end result, however, should be avoided.

B. *Applying Rule 9(b) to Section 11 Claims is Inconsistent with the Liberal Pleading Requirements Of Rule 8(a)*

In a pleading setting forth a claim for relief, rule 8(a) of the Federal Rules of Civil Procedure requires only "a short and plain statement of the claim showing that the pleader is entitled to relief."[62] The purpose of this rule is to give the defendant "fair notice of what the plaintiff's claim is and the ground upon which it rests."[63] In *Leatherman v. Tarrant County*, the Supreme Court reversed the Fifth Circuit's requirement that plaintiffs bringing Sec-

58. 15 U.S.C. § 78u-4(b)(1)(B) (1998). The PSLRA requires that a plaintiff specify in the complaint "each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading. . . ." In addition, much like rule 9(b), a plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *Id.* at § 78*u*-4(b)(1)-(2).

59. Murray & Wallace, *supra* note 49, at 789.

60. *Id.* Although, such alternative pleadings are expressly permitted by the Federal Rules of Civil Procedure. FED. R. CIV. P. 8(e)(2).

61. *In re NationsMart*, 130 F.3d at 315 (refusing to apply rule 9(b) even though the complaint alleged both Securities Act and Exchange Act claims because the complaint "expressly disavow[ed] any claim of fraud in connection with the § 11 and § 12(2) counts"). *See also In re* Number Nine Visual Tech. Corp. Sec. Lit., 51 F. Supp. 2d 1,12-25 (D. Mass. 1999) (approving the use of a disclaimer in the section 11 claim that disavowed all allegations of fraud in the section 11 complaint). *But see In re Ultrafem Inc. Sec. Lit.*, 91 F. Supp. 2d at 690-91 (refusing to hold that a disclaimer incorporating all factual allegations "except to the extent they . . . sound in fraud" disavowed the fraud allegations).

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

63. Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit, 507 U.S. 163, 168 (1993) (citation omitted).

tion 1983 claims must meet a heightened pleading requirement.[64] The Court held that "it is impossible to square the 'heightened pleading standard' applied by the Fifth Circuit . . . with the liberal system of 'notice pleading' set up by the Federal Rules."[65]

The Court recognized that rule 9(b) addresses the need for greater particularity in pleading certain actions, specifically "in all averments of fraud or mistake."[66] However, as stated above, section 11 is not an anti-fraud statute and "proof of fraud or mistake is not a prerequisite to establishing liability under section 11."[67] Even if a plaintiff alleges fraud in a section 11 claim, "any such allegation would be mere surplusage."[68] "The only consequence of a holding that rule 9(b) is violated with respect to a section 11 claim would be that any allegations of fraud would be stripped from the claim. The allegations of innocent or negligent conduct, which are at the heart of a section 11 claim, would survive."[69]

In addition, a primary purpose of rule 9(b)'s particularity requirement is to "apprise a defendant of the claim against him and of the acts relied upon as constituting the fraud charged."[70] However, a plaintiff makes out a prima facie case under section 11 simply by showing that he or she bought the security and that the registration statement contained a material misstatement or omission of fact.[71] Thus, once a plaintiff alleges that he bought the security and that the registration statement contained a material misstatement or omission, he has satisfied rule 8(a) and given the defendant "fair notice of what [his] claim is and the grounds upon which it rests."[72] Further, no single individual defendant needs to be put on notice of a particular statement because a registration

64. *Id.* at 164.

65. *Id.* at 168.

66. *Id.*, *citing* FED. R. CIV. P. 9(b) (alteration omitted).

67. *In re NationsMart*, 130 F.3d at 314.

68. *Id.* at 315.

69. *Id. See also* Lone Star Ladies Inv. Club v. Schlotzky's, 238 F.3d 363, 368 (5th Cir. 2001) ("Where averments of fraud are made in a claim in which fraud is not an element, an inadequate averment of fraud does not mean that no claim has been stated. The proper route is to disregard averments of fraud not meeting rule 9(b)'s standard and then ask whether a claim has been stated.").

70. Felton v. Walston & Co., 508 F.2d 577, 581 (2d Cir. 1974), *citing* 5 C. WRIGHT & A. MILLER, FEDERAL PRACTICE & PROCEDURE § 1297, 404 (1969).

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

72. *Leatherman*, 507 U.S. at 168 (citation omitted).

statement is a collective work, and every person named in a section 11 claim is liable for any misstatement in the registration statement.[73] Therefore, requiring a heightened pleading standard for section 11 claims cannot be squared with the "liberal system of notice pleading set up by the Federal Rules."[74]

C. Procedural Safeguards of Section 11 and Available Affirmative Defenses Warrant Sufficient Protection for Defendants from Frivolous Claims

A plaintiff must meet the numerous procedural requirements of section 11 before proceeding with a section 11 claim. First, a plaintiff must have standing to bring a section 11 claim. To have standing, the plaintiff must trace the purchased securities to the registration statement containing the alleged misstatements or omissions.[75] This task should be relatively rudimentary if the purchaser acquired the securities in the initial offering or if the issuing company has undertaken one stock offering only. The task however may become thorny in a situation where the purchaser acquired the security in the secondary markets, especially when the issuing corporation has made more than one registered offering and not every registration statement is defective. Next, the alleged misstatement or omission must be present at the time the registration statement becomes effective.[76] A registration statement that

73. 15 U.S.C. § 77k(a)(1)-(5). *See also* Murray & Wallace, *supra* note 49, at 800 ("The prospectus is a group effort . . . It is impossible for an outsider to identify who is responsible for a particular statement in a prospectus.").

74. *Leatherman*, 507 U.S. at 168 (internal quotation marks omitted).

75. *See* Demaria v. Anderson, 318 F.3d 170, 176 (2d Cir. 2003) ("[The] understanding of the statutory text conforms with the long-standing practice in this circuit of permitting suit under § 11 by those who can 'trace' their shares to the allegedly defective registration statement."). *See also* Lee v. Ernst & Young, 294 F.3d 969, 978 (8th Cir. 2002) (holding that a plaintiff will have standing to sue under section 11 by making a prima facie showing that the stock he or she purchased "can be traced to the registration statement alleged to be false and misleading").

76. 15 U.S.C. § 77k(a) (stating that a purchaser of securities may sue if "any part of the registration statement, when such part became effective, contained an untrue statement of material fact or omitted to state a material fact . . .").

becomes misleading due to events that occur *after* the effective date does not provide a basis for liability.[77]

The plaintiff must also commence his action within the statute of limitations.[78] Actual knowledge of the misleading statements or omissions is not required, and the statute will begin to run even if the plaintiff was put on "inquiry notice" of the section 11 violations.[79] The standard of inquiry notice is an objective one, and the question is whether there was enough information so that a person of ordinary intelligence would have investigated further.[80] Compliance with the statute of limitations is a pleading requirement for section 11 claims and not an affirmative defense.[81] Finally, a plaintiff may also be required to post a bond for costs, including reasonable attorney's fees and expenses, incurred in defense of a suit later found to be without merit.[82]

These requirements, which are built into the statute, alleviate the fear that plaintiffs would bypass the pleading requirements of rule (9)(b) and the PSLRA by bringing their securities fraud claims

77. BENDER, *supra* note 55, at § 9.02[6][c] ("Section 11 provides no liability unless the misrepresentations and omissions were present when the registration statement became effective.").

78. 15 U.S.C. § 77m (1978). The statute states, in pertinent part, "No action shall be maintained to enforce any liability created under section 11 or section 12(a)(2) unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . In no event shall any such action be brought . . . more than three years after the security was bona fide offered to the public . . . ."

79. Cantor Fitzgerald, Inc. v. Lutnick, 2001 U.S. Dist. LEXIS 999, at *6 (2002) ("Under federal law, to be placed on inquiry notice, 'a plaintiff need not be aware of all aspects of the alleged fraud . . . Rather, a plaintiff is on inquiry notice at the time at which the plaintiff should have discovered the general fraudulent scheme,'" *citing In re* Merrill Lynch Ltd. P'shps Litig., 7 F. Supp. 2d 256, 265 (S.D.N.Y. 1997) (internal quotation marks omitted)).

80. Armstrong v. McAlpin, 699 F.2d 79, 88 (2d Cir. 1983) ("Where the circumstances are such as to suggest to a person of ordinary intelligence the probability that he has been defrauded, a duty of inquiry arises, and if he omits that inquiry when it would have developed the truth, and shuts his eyes to the facts which call for investigation, knowledge of the fraud will be imputed to him." *citing* Higgins v. Crouse, 147 N.Y. 411, 416 (1895)).

81. *In re* Complete Mgmt. Sec. Litig., 153 F. Supp. 2d 314, 335 n.15 (2001).

82. 17 U.S.C. § 77k(e). *See also Hochfelder*, 425 U.S. at 209-10 ("Section 11(e) of the 1933 Act, for example, authorizes the court to require a plaintiff bringing a suit under section 11. . . to post a bond for costs, including attorney's fees, and in specified circumstances to assess costs at the conclusion of the litigation.").

under section 11, rather than under section 10(b) and rule 10b-5 of the Exchange Act. Claims under section 11, unlike claims under section 10(b) and rule 10b-5, may only be brought in limited circumstances. As just stated, liability under section 11 occurs only when the misstatements and omissions are contained in a registration statement and only at the time the registration statement became effective.[83] In contrast, a claim can be brought under section 10(b) and rule 10b-5 for any misstatement or omission made by anyone with authority to speak for a public corporation, at any time, in any medium.[84] Rule 10b-5 liability has been extended to cover a number of situations, including traditional insider trading transactions,[85] insider trading based on the "misappropriation" theory,[86] and "tipper" liability.[87] In addition, a plaintiff pleading a claim under rule 10b-5 has the burden of proving loss causation, unlike claims under section 11.[88] Therefore, the heightened pleading requirements are necessary for section 10(b) and rule 10b-5 to protect defendants and to prevent an overflow of frivolous lawsuits. Such added protection is not necessary for section 11 defendants.

83. The title to section 11 is "Civil Liabilities on Account of False Registration Statement." 15 U.S.C. § 77(k); *see supra* note 76 and accompanying text.

84. 15 U.S.C. § 77k(a). *See also Herman & MacLean*, 459 U.S. at 382 ("§ 10(b) is a 'catchall' antifraud provision."). While a section 11 action must be brought by a purchaser of a registered security, must be based on misstatements or omissions in a registration statement, and can only be brought against certain parties, a section 10(b) action can be brought by a purchaser or seller of "*any* security" against "*any* person" who has used "*any* manipulative or deceptive devise or contrivance." *Id.*, *citing* 15 U.S.C. § 78j (emphasis added by the Court).

85. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (holding that rule 10b-5 applied to the stock transactions made by various corporate insiders who were in possession of material, non-public information); United States v. O'Hagan, 521 U.S. 642, (1997) (stating that "[u]nder the 'traditional' or 'classical theory' of insider trading liability, section 10(b) and rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information.").

86. *See O'Hagan*, 521 U.S. 642 (approving the misappropriation theory as a basis for liability under section 10(b) and rule 10b-5). Under this theory, a non-corporate insider commits fraud "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *Id.* at 652. Unlike a corporate insider who violates his duties of trust to the shareholders of the corporation for which he works, liability is premised on "a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." *Id.*

87. *Id.*

88. *See Bastian*, 892 F.2d 680; *see also supra* note 45 and accompanying text.

Furthermore, a defendant in a section 11 suit also has a number of affirmative defenses available to defend against a section 11 claim. As noted above, a plaintiff must not have known about the alleged misstatement or omission at the time the plaintiff purchased the securities.[89] Accordingly, if a defendant can prove that the plaintiff in fact knew of the misstatement or omission, the defendant may avoid liability. In addition, a defendant may reduce or even entirely eliminate liability if the defendant can prove that something other than the misstatement or omission, outside market forces for instance, caused the decline in the security's value.[90]

The so-called due diligence defense is probably the most significant defense available to a section 11 defendant.[91] Each individual defendant[92] can avoid liability by demonstrating that, after a reasonable investigation, he or she had reasonable grounds to believe, and did believe, that at the time the registration statement became effective the statements contained therein were true and without omission of any material facts.[93] When determining what constitutes a reasonable investigation, the "standard of reasonableness is that of a prudent man in the management of his own property."[94]

This general due diligence defense applies only to portions of the registration statement "not purporting to be made on the authority of an expert."[95] Section 11 distinguishes between portions of the registration statement that were made under the authority of

89. 15 U.S.C. § 77k(a).

90. 15 U.S.C. § 77k(e); *see supra* note 45 and accompanying text.

91. *See* Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 682-83 (S.D.N.Y. 1968), which is the "leading section 11 decision." BENDER, *supra* note 55, at § 9.02[12][d].

92. The issuer itself cannot exercise due diligence and thus does not have a due diligence defense. 15 U.S.C. § 77k(b).

93. 15 U.S.C. § 77k(b)(3). *See also Barchris*, 283 F. Supp. at 683-97. The court sets forth the due diligence defense and goes on to discuss whether each individual defendant met his burden to show that he did in fact make some investigation into whether the registration statement was accurate.

94. 15 U.S.C. § 77k(c). To help clarify what constitutes a reasonable investigation, the SEC enacted rule 176 of the Securities Act. Rule 176 provides a non-exclusive list of circumstances that should be considered when determining whether there was a reasonable investigation. 17 C.F.R. § 230.176. Still, what constitutes a reasonable investigation is not entirely clear, but what is apparent is that more investigation is required when a defendant is in a higher position and was closely involved in the preparation of the registration statement. In addition, merely reading the registration statement or asking questions is not enough. *Barchris*, 283 F. Supp. at 683-97.

95. 15 U.S.C. § 77k(b)(3)(A).

an expert,[96] or the "expertised" portions,[97] and those that were not. As to those expertised portions of the registration statement, a non-expert defendant is not required to do any reasonable investigation. All the non-expert must demonstrate is that he or she simply "had no reasonable ground to believe, and did not believe . . . that the statements therein were untrue or that there was an omission to state a material fact . . . ."[98] The expert who prepared those expertised portions of the registration statement can only be held liable for the parts he prepared.[99] The same due diligence defense is available to the expert with respect to those expertised parts.[100] In determining whether such an expert engaged in a reasonable inves-

96. 15 U.S.C. § 77k(b)(3)(B) (stating, "as regards to any part of the registration statement purporting to be made upon his authority as an *expert* or purporting to be a copy of or extract from a report or valuation of *himself as an expert*. . . .") (emphasis added). "Typically, this includes only the certified financial statements." BENDER, *supra* note 55 , at § 9.02[12][d]. An expert is "any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any report or valuation which is used in connection with the registration statement. . . ." 15 U.S.C. § 77k(a)(4).

97. *See Barchris*, 283 F. Supp. at 683 (calling, for convenience, the parts of the registration statement made on the authority of an expert the 'expertised portion'). The court rejected the view that the entire registration was expertised merely because the lawyers for both the company and the underwriters were responsible for drafting the entire document. *Id.* However, it has been held that a legal opinion within a registration statement drafted by counsel is an expertised part of the statement. *See In re* Am. Cont'l Corp./Lincoln Sav. & Loan Sec. Litig., 794 F. Supp. 1424, 1453 (D. Ariz. 1992) (holding that an "attorney who provides a legal opinion used in connection with an SEC registration statement is an expert within the meaning of Section 11").

98. *Barchris*, 283 F. Supp. at 683.

99. *See In re* Software Toolworks, Inc. Sec. Litig., 789 F. Supp. 1489, 1510 (N.D. Cal. 1992) ("Section 11 limits an accountant's liability to a statement in a registration statement 'which purports to have been prepared or certified by him.' An accountant may therefore be held liable only for those statements 'expressly attributed to the accountant' on the face of the registration statement.") (*citing* 15 U.S.C. 77k(a)(4)); McFarland v. Memorex Corp., 493 F. Supp. 631, 643 (N.D. Cal. 1980).

100. Thus, such expert will not be liable if, with respect to those portions of the registration statement prepared by him or another similar expert, "he had, after reasonable investigation, reasonable ground to believe and did believe. . .that the statements [in the registration statement] were true and that there was no omission to state a material fact. . . ." 15 U.S.C. § 77k(b)(3)(B)(i). *See also Hochfelder*, 425 U.S. at 208 ("An expert may avoid civil liability with respect to the portions of the registration statement for which he was responsible by showing that 'after reasonable investigation' he had 'reasonable ground[s] to believe' that the statements for which he was responsible were true and there was no omission of a material fact," citing *Barchris*, 283 F. Supp. at 697-703).

tigation, the expert "should not be held to a standard higher that that recognized in their profession."[101]

Even if a defendant cannot rely on these affirmative defenses, the defendant can still seek to rely on the Securities Act's protection of certain forward looking statements. The first of these safe-harbor provisions for forward-looking statements is section 27A.[102] This section is the statutory codification of the "bespeaks caution" doctrine, created by the courts to protect defendants from statements that should bespeak caution upon a purchaser.[103] Under this section, any statement deemed to be "forward-looking" cannot be used by a plaintiff as the basis of liability for any suit under the Securities Act, not just section 11.[104] The safe-harbor applies to statements made by an issuer who is "subject to the reporting requirements of section 13(a) or section 15(d) of the Securities Ex-

101. *Barchris*, 283 F. Supp. at 703.

102. 15 U.S.C. § 77z-2 (1998). Section 27A was added to the Securities Act as part of the PSLRA, Pub. L. No. 104-67, 109 Stat. 737 (1995). *See* BENDER, *supra* note 55, at § 9.02[6][b].

A forward looking statement is defined to include, in relevant part:

. . . .

> (A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;
>
> (B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
>
> (C) a statement of future economic performance . . . ;
>
> (D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C); . . .

Id. at § 77z-2(h)(I)(1).

103. *See* BENDER, *supra* note 55, at § 9.02[12][d] (discussing the enactment of the PSLRA and the bespeaks caution doctrine. It states that "[t]he safe harbor applies . . . as long as . . . (1) the statement is identified as a forward-looking statement and is accompanied by meaningful cautionary statements, *thereby codifying the 'bespeaks caution' doctrine*. . . .") (emphasis added); *In re* Donald Trump Casino Sec. Litig., 793 F. Supp. 543 (D.N.J. 1992), *aff'd* 7 F.3d 357 (3d Cir. 1993) (discussing the bespeaks caution doctrine).

104. 15 U.S.C. § 77z-2(c)(1) (stating in pertinent part that "in any private action arising under this title that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) *shall not be liable with respect to any forward-looking statement* . . . .") (emphasis added).

change Act of 1934."[105] In addition, the statement must be labeled as a forward-looking statement and must be accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement. . . ."[106] Similarly, the SEC has adopted rule 175 of the Securities Act, which protects certain forward-looking statements from being deemed fraudulent.[107] The definition of a forward-looking statement under this rule is fairly close to the definition of a forward-looking statement under section 27A.[108] There are, however, a few significant differences between section 27A and rule 175. First, section 27A covers any statement made by one of the specified people, whether written or oral, while rule 175 covers only written statements contained in documents actually filed with the SEC.[109] Second, rule 175 does not require that the statement

105. 15 U.S.C. § 77z-2(a)(1). Sections 13(a) and 15(d) of the Exchange Act, if applicable to a company, requires the company to file quarterly and annual reports about the financial health and performance of the company during the previous period with the SEC. They also require the company to file periodic reports to keep public information about the company current. The section also applies to "a person acting on behalf of such an issuer; an outside reviewer retained by such issuer making a statement on behalf of such issuer; or an underwriter . . ." *Id.* at § 77z-2(a)(2)-(4).

106. *Id.* at § 77z-2(c)(1)(A)(i). *See also In re Donald Trump Casino Sec. Litig.*, 793 F. Supp. at 371-72 (stating that "a vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation. To suffice, the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge."). Even if the statement is not labeled accordingly and accompanied by the cautionary language, the statement will not be the basis of liability if it is immaterial. *Id.* at § 77z-2(c)(1)(A)(ii).

107. 17 C.F.R. § 230.175(a) (2005). As defined in this rule, a "fraudulent statement" encompasses any statement "which is an untrue statement of a material fact, a statement false or misleading with respect to any material fact, an omission to state a material fact necessary to make a statement not misleading, *or* which constitutes the employment of a manipulative, deceptive, or fraudulent devise, contrivance, scheme, transaction, act practice, course of business, or an artifice to defraud. . . ." *Id.* at § 230.175(d) (emphasis added). It is clear that a "fraudulent statement" under this rule includes a statement that is false or misleading, even though made without the intent to defraud. *See NationsMart,* 130 F.3d at 316 ("'Fraudulent' for purposes of Rule 175 does not mean fraud in the traditional sense, but instead simply denotes any of the bases of liability under the Securities Act, including liability under § 11."); Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 513 (7th Cir. 1989) ("'[F]raudulent statement' in Rule 175(a) turns out to be shorthand for all of the bases of liability in the '33 Act and its implementing rules.").

108. *Id.* at § 230.175(c).

109. *Compare* 15 U.S.C. § 77z-2 *with* 17 C.F.R. § 230.175.

be labeled or accompanied by cautionary language. It only requires that the statement be made in good faith and with a reasonable basis.[110]

In *Rombach*, the court unambiguously stated that the plaintiffs' allegations were "undercut" because the registration statement "contained sufficient cautionary language to bespeak caution and trigger the safe harbor provision of the PSLRA."[111] Thus, the court stated that even if the section 11 claims did not sound in fraud and were pleaded in negligence, they "would be defeated in any event by the bespeaks caution doctrine . . . ."[112]

IV. Conclusion

Taking into account the arsenal of the stringent procedural requirements and the available affirmative defenses, as well as the protections afforded to forward-looking statements, it is beyond question that sufficient protection exists for defendants in a section 11 action. That section 11 can be used in limited circumstances is another factor weighing against requiring plaintiffs bringing suit under section 11 to meet the heightened pleading standards of rule 9(b). In addition, this heightened pleading requirement is contrary to the plain language of section 11, Congressional intent behind the Securities Act, and the liberal pleading requirements of Rule 8(a). Therefore, the Second Circuit's *Rombach* decision misses the mark.

110. 17 C.F.R. § 230.175(a).

111. *Rombach*, 355 F.3d at 175. The court referred to the district court's finding that the registration statement and prospectus contained sufficient cautionary language and information about the financial risks. For example, the offering documents stated "that some Family Golf facilities had 'experienced losses' and that "'no assurance' could be given that additional facilities would be 'readily integrated into the Company's operating structure.'" *Id.*

112. *Id.* at 176.