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A Cloudy Prospectus: The Supreme Court's Problematic Reasoning in *Gustafson v. Alloyd Co.*

Krista R. Bowen*

I. Introduction

On February 28, 1995, the United States Supreme Court decided *Gustafson v. Alloyd Co.*¹ In a five-to-four decision, the Court held that the term "prospectus," as used in Section 12(2) of the Securities Act of 1933 (1933 Act),² applies only to initial public offerings of securities by issuers or controlling shareholders.³ The Court's holding greatly restricted the

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1. 115 S. Ct. 1061 (1995).

2. Securities Act of 1933 § 12, 15 U.S.C. § 77l (1994) (providing statutory remedy of rescission for material misrepresentations or omissions in prospectus). Section 77l states that any person who:

- (1) offers or sells a security in violation of section 77e of this title, or
- (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b) of this section, to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Id.

3. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1066 (1995).

availability of rescission remedies against sellers who make material misstatements or omissions by means of a prospectus or oral communication.⁴ With the erosion of Section 10(b) coverage in recent years,⁵ Section 12(2) of the 1933 Act has assumed greater prominence in securities litigation.⁶ At the same time, that litigation has spawned a vast and conflicting body of case law⁷ and commentary.⁸ This split of authority led the Supreme Court

4. See Richard A. Booth, *The Scope of Section 12(2) After Gustafson*, INSIGHTS, July 1995, at 8 (discussing potential implications of *Gustafson* decision). Booth suggests that the *Gustafson* decision has brought into question the availability of § 12(2) in connection with a wide variety of securities offerings to which most investors previously assumed that the section applied. *Id.*

5. See, e.g., *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1447-48 (1994) (refusing to imply private right of action for aiding and abetting liability under § 10(b) of Securities Exchange Act of 1934); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991) (establishing uniform federal statute of limitations requiring plaintiffs to bring § 10(b) claims within one year of discovery of facts establishing violation or within three years of occurrence of violation); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (imposing element of scienter for actions under § 10(b)).

6. See Louis Loss, Commentary, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 910 (1992) (noting that scienter requirement imposed on § 10(b) actions prompted increase in § 12(2) actions); Robert A. Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 ALB. L. REV. 97, 101-03 (1991) (suggesting that "pendulum has swung" towards § 12(2) actions because of relative disadvantages of § 10(b) actions).

7. See, e.g., *First Union Discount Brokerage Servs. v. Milos*, 997 F.2d 835, 843-44 (11th Cir. 1993) (holding § 12(2) inapplicable to secondary market transactions); *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 595 (7th Cir. 1993) (holding § 12(2) applicable to initial and secondary market transactions), *cert. dismissed*, 114 S. Ct. 1146 (1994); *Metrodmedia Co. v. Fugazy*, 983 F.2d 350, 360 (2d Cir. 1992) (stating that courts consistently have applied § 12(2) to private as well as to public offerings), *cert. denied*, 113 S. Ct. 2445 (1993); *Ryder Int'l Corp. v. First Am. Nat'l Bank*, 943 F.2d 1521, 1530 n.16 (11th Cir. 1991) (noting that Eleventh Circuit did not reach question of scope of § 12(2)); *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.) (concluding that § 12(2) applies only to initial stock offerings), *cert. denied*, 502 U.S. 820 (1991); see also Therese H. Maynard, *The Future of Securities Act Section 12(2)*, 45 ALA. L. REV. 817, 820 n.9 (1993) (listing courts that have examined § 12(2) issue); Prentice, *supra* note 6, at 97, 99 n.14 (1991) (noting cases that discuss applicability of § 12(2)).

8. See generally Louis Loss, *Securities Act Section 12(2): A Rebuttal*, 48 BUS. LAW. 47 (1992) (asserting that § 12(2) applies to secondary transactions); Loss, *supra* note 6 (arguing for broad application of § 12(2)); Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 WM. & MARY L. REV. 847 (1991) (proposing availability of § 12(2) for any defrauded buyer); Prentice, *supra* note 6 (discussing limitation of § 12(2) remedy to initial distributions); Robert N. Rapp, *The Proper Role of Securities Act Section 12(2) as an Aftermarket Remedy for Disclosure Violations*, 47 BUS. LAW. 711 (1992) (asserting that confining § 12(2) to initial distributions undermines effectiveness of entire statutory scheme of 1933 Act);

to attempt to clarify the scope of Section 12(2) and the right of rescission that the Section creates.⁹ Using *Gustafson* as its vehicle, the Court followed the lead of the Third Circuit and narrowed the definition of prospectus as it applies to Section 12(2) of the 1933 Act.¹⁰

This Note undertakes a critical analysis of *Gustafson* and evaluates the potential future effects and consequences resulting from the *Gustafson* decision. Through an analysis of the principal cases, Part II of this Note examines the split among the circuits and the reasoning that both sides of the controversy employ.¹¹ Part III turns to a detailed examination of the text of Section 12(2), the contextual role of Section 12(2), and the accompanying legislative history.¹² Part IV analyzes the reasoning of the Justices in the *Gustafson* majority and in the dissents.¹³ This analysis includes a critique of the majority's analysis and the result reached.¹⁴ Part V discusses the potentially far-reaching implications of the *Gustafson* decision.¹⁵ Finally, Part VI suggests the need for future remedial action either by Congress¹⁶ or by the Securities and Exchange Commission (SEC).¹⁷

Elliott J. Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 BUS. LAW. 1 (1992) (arguing that § 12(2) applies only to initial public offerings).

9. See *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 595 (7th Cir. 1993) (holding § 12(2) applicable to both initial stock offerings and secondary transactions), *cert. dismissed*, 114 S. Ct. 1146 (1994). The Supreme Court voluntarily dismissed the *Pacific Dunlop* case after the parties settled, but subsequently granted a writ of certiorari in *Gustafson*. See also Therese H. Maynard, *Gustafson v. Alloyd Co.: The Supreme Court to Decide a Section 12(2) Case*, INSIGHTS, Aug. 1994, at 33 (suggesting apparent Supreme Court interest in deciding scope of § 12(2) rescission remedy).

10. See *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.) (holding that § 12(2) applies only to initial stock offerings), *cert. denied*, 502 U.S. 820 (1991).

11. See *infra* notes 18-75 and accompanying text (discussing split between Third and Seventh Circuits concerning scope of § 12(2) applicability).

12. See *infra* notes 86-184 and accompanying text (analyzing legislative history of 1933 Act and construing text of § 12(2)).

13. See *infra* notes 185-248 and accompanying text (summarizing facts and reasoning of *Gustafson* opinion).

14. See *infra* notes 249-303 and accompanying text (performing critical analysis of *Gustafson* reasoning).

15. See *infra* notes 304-78 and accompanying text (suggesting potential implications and interpretations of *Gustafson* decision).

16. See *infra* notes 379-89 and accompanying text (suggesting possible corrective actions of Congress in response to *Gustafson* decision).

17. See *infra* notes 390-94 and accompanying text (providing proposal for responsive measures by SEC).

II. Contrasting Approaches Among the Circuits

In determining the parameters of liability under Section 12(2) of the 1933 Act, the Third and Seventh Circuits have reached diametrically opposed results.¹⁸ However, both courts have examined the statutory text, context, and legislative history of Section 12(2) in arriving at their respective outcomes.¹⁹ These conflicting holdings led the *Gustafson* Court to attempt to resolve the issue of Section 12(2)'s availability as a rescissory remedy.

A. The Rule of Ballay

In *Ballay v. Legg Mason Wood Walker, Inc.*,²⁰ the Court of Appeals for the Third Circuit became the first circuit court to decide squarely the issue of whether Section 12(2) of the 1933 Act creates a cause of action for secondary market transactions.²¹ In *Ballay*, investors sued their brokerage firm, Legg Mason, alleging oral and written misrepresentations about the book value calculation of shares of the Wickes Company, Inc. (Wickes).²²

18. Compare *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 595 (7th Cir. 1993) (holding that § 12(2) liability extends to cover secondary market transactions), *cert. dismissed*, 114 S. Ct. 1146 (1994) with *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.) (holding that § 12(2) liability extends only to initial public offerings of securities), *cert. denied*, 502 U.S. 820 (1991).

19. See *infra* part II.A-B (providing summaries of Third and Seventh Circuit analyses).

20. 925 F.2d 682 (3d Cir.), *cert. denied*, 502 U.S. 820 (1991).

21. *Ballay*, 925 F.2d at 693 (holding that § 12(2) claims apply only to initial stock offerings). The SEC provides definitions of terms at issue in *Ballay* and used throughout this Note. Brief for the Securities and Exchange Commission as Amicus Curiae Supporting Respondents at 5 n.5, *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995) (No. 93-404). The SEC states the relevant definitions as follows:

The [1933] Act does not contain definitions that explicitly distinguish among the various types of securities transactions that Section 12(2) covers. It is generally understood, however, that an "initial offering" of securities is a sale of securities by the issuer and a "secondary" sale is a subsequent transaction. Initial offerings are, generally speaking, of two types — public and private. An "initial distribution" is understood to be a public offering of securities by the issuer; a "private placement" is an issuer's sale of its securities not involving a public offering. Secondary sales are generally either public resales of stock on organized securities markets or private resales.

Id. This Note also uses the term "aftermarket" to refer to secondary transactions. This Note refers to these definitions throughout, but with the understanding that distinctions between the terms may not always be clear. See *infra* notes 354-61 and accompanying text (describing difficulty of distinguishing between private and public offerings of securities).

22. See *Ballay*, 925 F.2d at 684-85 (alleging misrepresentations about valuation of

Legg Mason operates as a full-service brokerage house that promotes investment in undervalued securities.²³ Through written and oral communications, Legg Mason estimated the book value of Wickes stock and recommended investment in Wickes based on its alleged future growth potential.²⁴ However, Legg Mason erred in its valuation estimates by stating that the figures excluded any value for goodwill.²⁵ Subsequently, the plaintiffs claimed violations of Section 12(2) based on these misrepresentations of value.²⁶

In deciding whether these misrepresentations fell within the parameters of Section 12(2) coverage, the Third Circuit focused on the plain meaning of the terms "prospectus" and "oral communication."²⁷ The court determined the plain meanings of these terms through *noscitur a sociis*, the canon of construction that instructs courts to interpret words in accordance with the surrounding text.²⁸ Based on this analysis, the court decided to read the two words together as related terms and thus to restrict the definition of "oral communication" to an oral communication relating to a prospectus.²⁹ The *Ballay* court concluded that Congress used the term "prospectus" as a "term of art which describes the transmittal of information concerning the sale of a security in an initial distribution."³⁰ The court explained that the use of the term "prospectus" in various provisions of the

Wickes stock). According to 41 investors, Legg Mason stated that its analysis of the value of Wickes stock excluded the value of goodwill. *Id.* at 685. In fact, Legg Mason's report of book value, \$23.70, did include goodwill. *Id.* at 686. Legg Mason later acknowledged its error and corrected its valuation report, but asserted that it had merely made typographical errors in suggesting that goodwill was excluded from its book value calculations. *Id.*

23. *Id.* at 685.

24. *Id.*

25. *Id.* at 685-86.

26. *Id.* at 686.

27. *Id.* at 688.

28. See *id.* (explaining that phrase "*noscitur a sociis*" means that words are known by company that they keep (quoting *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307 (1961))); see also *Massachusetts v. Morash*, 490 U.S. 107, 114-15 (1989) (instructing that courts should view provisions in light of words that accompany them). The *Jarecki* Court explained that courts should apply the canon to avoid giving unintended breadth to acts of Congress. *Jarecki*, 367 U.S. at 307. The *Ballay* court used the canon to decide that Congress did not intend a broad reading of the term "oral communication." See *Ballay*, 925 F.2d at 688 (explaining that courts must construe prospectus and oral communication as related terms).

29. *Ballay*, 925 F.2d at 688.

30. *Id.*

1933 Act supported the idea that Congress intended to confine the definition of the term to documents used in initial offerings of securities.³¹

The *Ballay* court then briefly examined the legislative history and organizational structure of the 1933 Act.³² The court found that, in enacting the 1933 Act, Congress intended to regulate initial offerings.³³ The Third Circuit turned to House Report 85 of the 1933 Act to support its conclusion regarding congressional intent.³⁴ The court relied on the following portion of that report:

The bill affects only new offerings of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering.³⁵

The final section of the *Ballay* court's analysis focused on the relationship between Sections 12(2) and 17(a)³⁶ of the 1933 Act.³⁷ Section 17(a) makes fraudulent conduct a crime during the offer or sale of securities "by the use of any means," as opposed to Section 12(2)'s language "by means

31. *Id.*

32. *Id.* at 689-90.

33. *Id.* at 690.

34. *Id.*

35. HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT SECURITIES IN INTERSTATE COMMERCE, H.R. REP. NO. 85, 73d Cong., 1st Sess. 7 (1933), *reprinted in* 2 J.S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 item 18, at 5 (1973) [hereinafter H.R. REP. NO. 85].

36. Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1994) (providing criminal sanctions for fraud violations of 1933 Act). Section 77q(a) states:

It shall be unlawful for any person in the offer or sale of securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Id.

37. See *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 690-92 (3d Cir.) (comparing and contrasting §§ 12(2) and 17(a) of 1933 Act), *cert. denied*, 502 U.S. 820 (1991).

of a prospectus."³⁸ The investors in *Ballay* urged the court to analogize Section 12(2) to Section 17(a) and consequently, to extend Section 12(2) to cover both secondary and initial stock distributions.³⁹ However, the court of appeals refused to analogize the application of Section 17(a) to Section 12(2).⁴⁰ The Third Circuit explained that Section 17(a) contains broader language than Section 12(2) and thus the reading of Section 17(a) failed to support a broad interpretation of the parameters of Section 12(2).⁴¹ The *Ballay* court summarized its decision by stating that the language of the 1933 Act, the legislative history, and the dissimilar language of Sections 12(2) and 17(a) convinced the court that Section 12(2) applies only to initial offerings.⁴²

Another court of appeals recently followed the *Ballay* court's reasoning⁴³ in *First Union Discount Brokerage Services v. Milos*.⁴⁴ In *First Union*, the Eleventh Circuit decided that Section 12(2) does not apply to aftermarket transactions.⁴⁵ Prior to the *Ballay* decision, the Eleventh Circuit had

38. Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1994); see *Ballay*, 925 F.2d at 690 (describing operation of § 17(a)); cf. Securities Act of 1933 § 12(2), 15 U.S.C. § 77l(2) (1994).

39. See *Ballay*, 925 F.2d at 691 (stating that §§ 12(2) and 17(a) exist as civil and criminal analogues and that Third Circuit should interpret § 12(2) expansively by analogy to interpretation of § 17(a)); see also *United States v. Naftalin*, 441 U.S. 768, 778-79 (1979) (expanding scope of § 17(a) to reach secondary market transactions); *infra* notes 71-73 and accompanying text (discussing *Naftalin* decision).

40. See *Ballay*, 925 F.2d at 691 (explaining that language of § 17(a) differs from text of § 12(2)). The *Ballay* court pointed out that § 17(a) proscribes fraudulent conduct by the use of any means, either direct or indirect. *Id.* However, the court concluded that the term "prospectus or oral communication," found in § 12(2), serves as a limitation on the means used to commit the fraud for § 12(2) purposes. *Id.* Thus, the *Ballay* court refused to expand § 12(2) to cover trading in secondary markets. *Id.* at 691-92.

41. See *Ballay*, 925 F.2d at 691-92 (refusing to extend reasoning that Supreme Court used in determining scope of § 17(a) to support broad reading of § 12(2)); see also *United States v. Naftalin*, 441 U.S. 768, 778-79 (1979) (holding that § 17(a) proscribes fraud during all parts of selling process). Compare Securities Act of 1933 § 17(a) (stating "by the use of any means") with Securities Act of 1933 § 12(2) (stating "by means of a prospectus or oral communication"). But see *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 593 (7th Cir. 1993) (asserting that *Naftalin* does not preclude broad interpretation of § 12(2) liability), *cert. dismissed*, 114 S. Ct. 1146 (1994).

42. *Ballay*, 925 F.2d at 693.

43. See *supra* notes 20-42 and accompanying text (summarizing *Ballay* approach to interpreting parameters of § 12(2)).

44. 997 F.2d 835 (11th Cir. 1993).

45. See *First Union Discount Brokerage Servs. v. Milos*, 997 F.2d 835, 843-44 (11th Cir. 1993) (holding § 12(2) inapplicable to secondary market transactions). In *First Union*, a discount broker sued its customers, Nick and Catherine Milos, to recover a post-liquida-

refused to decide the scope of applicability of Section 12(2) actions.⁴⁶ In reaching its later decision regarding Section 12(2)'s scope, the *First Union* court relied exclusively on the reasoning of the *Ballay* court and adopted the Third Circuit's rationale in formulating its holding.⁴⁷

B. The Seventh Circuit's Textual Analysis

*Pacific Dunlop Holdings, Inc. v. Allen & Co.*⁴⁸ provides an opposing approach to the issue of the scope of Section 12(2)'s applicability.⁴⁹ In *Pacific Dunlop*, the United States Court of Appeals for the Seventh Circuit held that Section 12(2) applies both to initial offerings and to secondary market transactions.⁵⁰ In *Pacific Dunlop*, the plaintiff, Pacific Dunlop, entered into a stock purchase agreement with GNB Holdings (GNB) and its shareholders, including Allen & Co.⁵¹ The stock purchase agreement represented that GNB and its subsidiaries had complied with environmental regulations and did not face any governmental investigations as to environmental compliance.⁵² In fact, the government had environmental claims pending against

tion debit balance in the Miloses' account following the stock market crash of October 1987. *Id.* at 835. The Miloses refused to pay the debt and subsequently filed seven counterclaims against the broker. *Id.* at 837. One of their counterclaims alleged that the discount broker had made material false representations about the status of the Miloses' account. *Id.* at 840. The Miloses claimed that the broker overstated the equity percentage in the Miloses' account and that, as a result, they failed to deposit additional funds into their account. *Id.* In dismissing this counterclaim, the Eleventh Circuit relied on the reasoning of the Third Circuit in *Ballay*. *Id.* at 842-43. First, the *First Union* court adopted the *Ballay* court's conclusion that § 12(2)'s language limits its scope to initial distributions of securities. *Id.* at 843. Next, the Eleventh Circuit decided that the placement of § 12(2) among sections of the 1933 Act dealing exclusively with initial distributions leads to the conclusion that Congress intended § 12(2) to be similarly limited in its scope. *Id.* The court of appeals then rejected the idea that the *Naftalin* Court's interpretation of § 17(a) requires an expansive reading of § 12(2). *Id.* Based on these factors, the *First Union* court concluded that § 12(2) does not apply to aftermarket transactions. *Id.* at 843-44.

46. See *Ryder Int'l v. First Am. Nat'l Bank*, 943 F.2d 1521, 1530 n.16 (11th Cir. 1991) (stating that Eleventh Circuit did not address issue of availability of § 12(2) relief for aftermarket buyers).

47. *First Union*, 997 F.2d at 843.

48. 993 F.2d 578 (7th Cir. 1993), *cert. dismissed*, 114 S. Ct. 1146 (1994).

49. See *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 582 (7th Cir. 1993) (announcing departure from *Ballay* in deciding scope of § 12(2) rescission remedy), *cert. dismissed*, 114 S. Ct. 1146 (1994).

50. See *id.* at 594 (holding § 12(2) applicable to both initial and secondary market transactions).

51. *Id.* at 578.

52. *Id.*

GNB and its subsidiaries.⁵³ Consequently, Pacific Dunlop sought rescission of the stock purchase agreement to avoid GNB's environmental liabilities.⁵⁴ Pacific Dunlop based its rescission claim on the assertion that GNB violated Section 12(2) of the 1933 Act when the company omitted material facts about its environmental liability from the stock purchase agreement.⁵⁵

In evaluating Pacific Dunlop's claim, the Seventh Circuit began its analysis with an examination of the conflicting authority on the issue.⁵⁶ However, the court looked beyond prior case law in formulating its decision. First, the Seventh Circuit focused on the definition of prospectus in Section 2(10) of the 1933 Act.⁵⁷ Based on the broad definition in Section 2(10),

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*; see, e.g., *Rodriguez De Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 486 (1989) (avoiding § 12(2) issue by deciding that parties must submit question to arbitration under prior agreement); *Wilko v. Swan*, 346 U.S. 427, 438 (1953) (remanding to district court which rejected argument that Congress did not intend 1933 Act to apply to secondary transactions); *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.) (holding § 12(2) applicable only to initial offerings), *cert. denied*, 502 U.S. 820 (1991); *Woodward v. Wright*, 266 F.2d 108, 116 (10th Cir. 1959) (implying availability of § 12(2) claim for case involving unregistered sale of securities); Loss, *supra* note 6, at 908 (supporting broad interpretation of prospectus for § 12(2) purposes); see also *supra* notes 20-42 and accompanying text (discussing Third Circuit approach to deciding scope of § 12(2) action).

57. *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 582-84 (7th Cir. 1993), *cert. dismissed*, 114 S. Ct. 1146 (1994); see Securities Act of 1933 § 2(10), 15 U.S.C. § 77b(10) (1994) (providing 1933 Act definition of prospectus). Section 77b defines prospectus as follows:

(10) The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that

(a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 77j of this title) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 77j of this title at the time of such communication was sent or given to the person to whom the communication was made, and

(b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of section 77j of this title may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

the *Pacific Dunlop* court interpreted the term "prospectus" to include a contract of sale or any other kind of written communication that disposes of a security.⁵⁸ Accordingly, the court found that the stock purchase agreement at issue in the case fell within the broad definition of prospectus offered in Section 2(10).⁵⁹ Thus, the *Pacific Dunlop* court's approach directly contravened the *Ballay* court's analysis of Section 12(2)'s text.⁶⁰

The *Pacific Dunlop* court next turned to an analysis of the statutory context in defining prospectus as used in Section 12(2).⁶¹ Rejecting the Third Circuit's view of the context as the overall structure of the 1933 Act,⁶² the *Pacific Dunlop* court focused its inquiry of context on the language of Section 12 alone.⁶³ The court noted that the key to defining prospectus consisted of looking at the substance of the communication rather than at whether the particular form of communication could be found on the list of media provided in Section 2(10).⁶⁴ The court also found that the context of the word "prospectus" failed to indicate the need for any definition of prospectus narrower than the one offered in Section 2(10).⁶⁵

Next, the Seventh Circuit examined the legislative history of the 1933 Act and concentrated on the history of Section 12.⁶⁶ However, the *Pacific Dunlop* court stated that it could rest its decision on its analysis conducted

58. See *Pacific Dunlop*, 993 F.2d at 583-84 (advancing idea that prospectus includes any written communication disposing of securities (citing *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1225 (7th Cir. 1980))), *cert. denied*, 450 U.S. 1005 (1981); see also *Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385, 1390 (7th Cir. 1990) (interpreting "prospectus" to include "materially incorrect or misleading selling literature"), *cert. denied*, 501 U.S. 1250 (1991).

59. *Pacific Dunlop*, 993 F.2d at 583-84.

60. See *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 688 (3d Cir.) (construing text of § 12(2)), *cert. denied*, 502 U.S. 820 (1991); see also *supra* notes 27-31 and accompanying text (discussing *Ballay* analysis of text of § 12(2)).

61. See *Pacific Dunlop*, 993 F.2d at 584 (noting that definitional section, § 2, begins with phrase "when used in this title, unless the context otherwise requires . . .").

62. Cf. *Ballay*, 925 F.2d at 689 (analyzing structure of 1933 Act as context of § 12(2)).

63. See *Pacific Dunlop*, 993 F.2d at 584-86 (explaining that structure of 1933 Act cannot qualify as context for definition of prospectus, but noting that structure inquiry would not require definition narrower than one offered by § 2(10)).

64. *Id.* at 588.

65. See *id.* (stating that "we cannot say that the structure of the 1933 Act, the text of section 12, and in particular the context of the word 'prospectus' in section 12(2), require a definition of prospectus contrary to the broad definition of section 2(10)").

66. *Id.* at 588-92.

up to this point and addressed the issue merely as a means of refuting the *Ballay* court's interpretation of the legislative history.⁶⁷ The Seventh Circuit pointed out the sparseness of Section 12(2)'s legislative history⁶⁸ and, after a lengthy discussion, concluded that the legislative history of the 1933 Act does not require a narrower definition of prospectus than the definition that Section 2(10) provides.⁶⁹

In concluding its analysis, the *Pacific Dunlop* court examined the relationship between Sections 12(2) and 17(a) of the 1933 Act and Section 10(b) of the 1934 Act.⁷⁰ The Seventh Circuit found that *United States v. Naftalin*⁷¹ served as an instructive guide to the statutory construction of Section 12(2).⁷² In *Naftalin*, the Supreme Court held that Section 17(a) applies broadly to brokers and investors and that, in fact, the Section applies to every component of the selling process.⁷³ In its analysis, the *Pacific Dun-*

67. See *id.* at 589 (rejecting *Ballay*'s legislative history analysis and noting that *Rowland v. California Men's Colony*, 113 S. Ct. 716, 721 (1993), rejects any reliance on legislative history for context purposes); see also *supra* notes 32-35 and accompanying text (providing *Ballay* court's interpretation of legislative history of § 12(2)).

68. See *Pacific Dunlop*, 993 F.2d at 591 (citing *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986)).

69. *Id.* at 592.

70. See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994) (providing basis for implied private right of action against fraud); *infra* note 152 (providing full text of § 10(b)); *infra* note 153 (providing text of Rule 10b-5); see also Maynard, *supra* note 7, at 844 (discussing § 12(2)'s relationship with § 10(b) of 1934 Act and § 17(a) of 1933 Act).

71. 441 U.S. 768 (1979).

72. See *Pacific Dunlop*, 993 F.2d at 593 (examining *Naftalin* reasoning as means of determining proper scope of § 12(2)). But see *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 691-92 (3d Cir.) (finding that language of § 12(2) differs materially from that of § 17(a) and thus rejecting line of reasoning utilized by Supreme Court in *United States v. Naftalin*, 441 U.S. 768 (1979)), *cert. denied*, 502 U.S. 820 (1991).

73. *United States v. Naftalin*, 441 U.S. 768, 778-79 (1979) (holding that § 17(a) applies to entire selling process). In *Naftalin*, the defendant investor engaged in a short selling scheme by placing orders with brokers to sell stock that he did not own. *Id.* at 769. The defendant gambled that the price of the stock would decline before the buyers required him to deliver the stock. *Id.* The government prosecuted the defendant under § 17(a) of the 1933 Act. *Id.* at 770. The *Naftalin* Court considered the applicability of § 17(a) when brokers, rather than investors, suffered harm from the defendant's fraudulent actions. *Id.* The Supreme Court reasoned that Congress intended to interpret the statutory terms broadly to encompass the entire selling process. *Id.* at 773. In examining the legislative history, the Court concluded that Congress did not intend to make investor protection the sole purpose of the 1933 Act. *Id.* at 774. The Court explained that achieving a high standard of business ethics also concerned Congress. *Id.* at 775. Thus, the *Naftalin* Court concluded that Congress was concerned with the welfare of both investors and financial intermediaries in formulating the 1933 Act. *Id.* Additionally, the Court pointed out that the defendant's

lop court concluded that nothing in the relationships among these various antifraud sections requires a narrower interpretation of prospectus than the one that Section 2(10) provides.⁷⁴ Thus, the Seventh Circuit held that Section 12(2) applies to any communication that offers any security for sale or that confirms the sale of any security whether within an initial or secondary market transaction.⁷⁵

C. Confusion Abounds: Questions Left Unanswered by the United States Courts of Appeals

Although the conflicting body of case law failed to yield a definitive answer to the question of the scope of Section 12(2),⁷⁶ it raised several interesting questions. First, the courts in *Pacific Dunlop* and *Ballay*, the two leading cases in the lower courts, formulated their holdings around the distinction between initial stock offerings and secondary market transactions.⁷⁷ However, the *Gustafson* Court framed the issue and its holding in terms of public versus private agreements.⁷⁸ In deciding the future implica-

actions could have harmed other investors if the brokers had suffered insolvency. *Id.* at 777. Finally, the *Naftalin* Court explained that although the 1933 Act mainly concerned the regulation of initial public offerings, Congress intended for § 17(a) to depart from that primary purpose. *Id.* at 777-78. To support this assertion, the Court cited the language of the statutory provision and the Senate report of the 1933 Act. *Id.* at 778. Consequently, the *Naftalin* Court upheld the defendant's conviction under § 17(a) of the 1933 Act. *Id.* at 778-79.

74. *Pacific Dunlop*, 993 F.2d at 594; *cf. Naftalin*, 441 U.S. at 777-78 (stating that § 17(a) "was meant as a major departure" from general limitation of 1933 Act to new stock offerings and pointing out that Congress intended § 17(a) to cover any fraudulent scheme). *But see* *First Union Discount Brokerage Servs. v. Milos*, 997 F.2d 835, 843 (11th Cir. 1993) (pointing out that, unlike *Naftalin* decision, Eleventh Circuit's proposed application of § 12(2) did not depart drastically from general idea that 1933 Act would regulate new stock offerings).

75. *See Pacific Dunlop*, 993 F.2d at 595 (explaining that neither prior case law, structure of 1933 Act, context of § 12, nor legislative history of 1933 Act defeats or alters textual clarity of § 2(10)).

76. *Compare supra* notes 48-75 and accompanying text (discussing *Pacific Dunlop* court's reasoning) *with supra* notes 20-42 and accompanying text (providing analysis of *Ballay* court).

77. *Compare Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 595 (7th Cir. 1993) (holding that § 12(2) applies to initial offerings and to secondary market transactions), *cert. dismissed*, 114 S. Ct. 1146 (1994) *with Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.) (holding that § 12(2) remedy is limited to initial distributions), *cert. denied*, 502 U.S. 820 (1991).

78. *See Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1073 (1995) (holding that § 12(2) applies only to initial public offerings of securities by issuers or controlling shareholders).

tions of the *Gustafson* holding, an investigation of the scope of what the Court decided becomes important.⁷⁹ Thus, the precise nature of the *Gustafson* holding is critical in Part IV.D and Part V, which criticize the decision and discuss the potential far-reaching implications of the *Gustafson* holding.⁸⁰

Second, these lower court decisions raise issues concerning the proper approach to and focus of statutory construction.⁸¹ Both the Third and Seventh Circuits acknowledged that courts first must examine the statutory language when engaging in statutory construction,⁸² but these courts disagreed over the proper meaning of the statutory text of Section 12(2).⁸³ Both lower courts looked to the context and structure of the 1933 Act, but each court defined the context differently.⁸⁴ Finally, both courts examined

In reviewing the decisions of the lower courts, the *Gustafson* Court found that the district court had concluded that a private sale agreement "cannot be compared to an initial offering." *Id.* at 1065; *see also* Petitioner's Brief at 5, *Gustafson v. Alloyd Co.*, 115 S. Ct. 106 (1995) (No. 93-404) (stating question presented as "whether Section 12(2) of the Securities Act of 1933 extends to a privately negotiated sale of stock").

79. *See* Booth, *supra* note 4, at 33 (discussing possibility of courts applying *Gustafson* holding broadly as consequence of Court's reasoning). Booth suggests that the *Gustafson* decision may preclude the use of the § 12(2) cause of action for offerings that do not require registration statements, such as certain types of offshore offerings. *Id.* Prior to the *Gustafson* holding, one scholar speculated as to how the Court would approach the issue. *See* Maynard, *supra* note 9, at 1 (suggesting that Supreme Court could adopt either narrow or broad focus in tailoring its decision). Maynard explains that the Court could choose to base its decision solely on the specific facts of *Gustafson* by limiting its holding to the application of § 12(2) for a controlling shareholder's secondary distribution. *Id.* On the other hand, Maynard comments that the Court could focus on the larger question of secondary brokerage transactions, the question the Third Circuit addressed in *Ballay*. *Id.*

80. *See infra* parts IV.D, V (pointing out problems with, and potential implications of, *Gustafson* holding).

81. *See Ballay*, 925 F.2d at 687-93 (discussing importance of text, context, and legislative history in construing applicability of § 12(2)); *see also* First Union Discount Brokerage Servs. v. Milos, 997 F.2d 835, 843-44 (11th Cir. 1993) (following statutory construction analysis of *Ballay* court). *But see Pacific Dunlop*, 993 F.2d at 582-92 (considering interpretive role of context and legislative history of § 12(2), but focusing on text as key to statutory construction).

82. *See Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 687 (3d. Cir.) (stating that starting point in every case of statutory construction is language of statute (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976))), *cert. denied*, 502 U.S. 820 (1991); *see also Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 582 (7th Cir. 1993) (same (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975))), *cert. dismissed*, 114 S. Ct. 1146 (1994)).

83. *See supra* notes 27-31 (discussing *Ballay* court's interpretation of text). *But see supra* notes 57-60 (explaining *Pacific Dunlop* court's textual analysis).

84. *Compare Pacific Dunlop*, 993 F.2d at 584-85 (stating that "context" means text

the legislative history of the 1933 Act and of Section 12(2) in particular, but each court interpreted and weighed the significance of the legislative history differently.⁸⁵ Deciding the proper roles of the statutory structure and legislative history in construing Section 12(2) becomes important in evaluating the reasoning and result of the *Gustafson* Court's decision.

III. Statutory Language, Context, and Legislative History: Conclusive Guides to Interpretation?

Some securities scholars regard the text of Section 12(2) as a clear and definitive answer to the question regarding the scope of its applicability.⁸⁶ Other courts and commentators have pointed out that courts must go beyond the text of Section 12(2) and examine the provision in light of its context.⁸⁷ However, those who advocate analyzing the context disagree about the parameters of the context that courts should consider in determining the availability of Section 12(2).⁸⁸ Finally, although most agree with the Supreme

of act of Congress surrounding word at issue, and thus is confined here to § 12 of 1933 Act) with *Ballay*, 925 F.2d at 690-91 (suggesting review of legislative purpose and structure of entire 1933 Act as means of putting provision in context).

85. Compare *Pacific Dunlop*, 993 F.2d at 585 (rejecting use of legislative history in context analysis) with *Ballay*, 925 F.2d at 690 (quoting H. REP. NO. 85, 73d Cong., 1st Sess. 7 (1933), as conclusive evidence of congressional intent in creating 1933 Act).

86. See, e.g., 17 J. WILLIAM HICKS, CIVIL LIABILITIES: ENFORCEMENT AND LITIGATION UNDER THE 1933 ACT § 6.01[3][C], at 6-26 (1990) (relying on "plain meaning" argument for defining prospectus broadly). Hicks states that "[i]n the absence of a conflict between reasonably plain meaning and legislative history, the words of the statute must prevail." *Id.* (quoting *Aaron v. SEC*, 446 U.S. 680, 700 (1980)); *Loss*, *supra* note 6, at 917 (explaining importance of text in construing scope of § 12(2)); *Loss*, *supra* note 8, at 54 (stating that available legislative history is not determinative and that face of statute provides greater insight to meaning of § 12(2)); *Maynard*, *supra* note 8, at 870 (noting that nothing in statute's text limits § 12(2) rescission remedy to initial distribution transactions). *But see Weiss*, *supra* note 8, at 6 (asserting that analysis of statute's language and grammatical structure fails to allow conclusive determination of which sales of securities are within scope of § 12(2)).

87. See *First Union Discount Brokerage Servs. v. Milos*, 997 F.2d 835, 843 (11th Cir. 1993) (examining relationship of § 12(2) to other sections of 1933 Act); *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 689-90 (3d Cir.) (using overall object and structure of 1933 Act as context), *cert. denied*, 502 U.S. 820 (1991); see also *Prentice*, *supra* note 6, at 112-14 (examining scope of § 12(2) in light of overall legislative scheme); *Weiss*, *supra* note 8, at 7 (asserting that Supreme Court has relied principally on statutory context of provision in question to answer interpretive issues in federal securities laws).

88. See *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 584-85 (7th Cir. 1993) (limiting context analysis to § 12 of 1933 Act only), *cert. dismissed*, 114 S. Ct. 1146 (1994); *Ballay*, 925 F.2d at 690-91 (defining context as entire 1933 Act); *Weiss*, *supra* note 8, at 9-14 (viewing context as general regulatory scheme of 1933 Act). *Weiss* examines the

Court's conclusion that little legislative history of Section 12(2) and the 1933 Act exists,⁸⁹ courts and commentators have accorded the existing legislative history different weights when using it to interpret Section 12(2).⁹⁰

A. Analyzing the Text

Section 12(2)'s text states that any person who offers or sells a security "by means of a prospectus or oral communication" that includes a misstatement or omission of a material fact shall be subject to an action for rescission or damages.⁹¹ The textual issue focuses on the meaning of the phrase "by means of a prospectus."⁹² The *Pacific Dunlop* court found the text to be dispositive in its determination of the parameters of Section 12(2).⁹³

context of § 12(2) by evaluating how it fits with other provisions of the Act to form a comprehensive regulatory scheme. Weiss, *supra* note 8, at 9-14.

89. See *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986) (remarking on sparseness of legislative history of 1933 Act); see also *Pacific Dunlop*, 993 F.2d at 591 (recognizing sparseness of legislative history in analyzing scope of § 12(2) availability); Prentice, *supra* note 6, at 107 (noting that § 12(2) "has no clear lineage" and stating that Congress never separately analyzed § 12(2) in legislative history of 1933 Act); Joseph E. Reece, *Would Someone Please Tell Me the Definition of the Term 'Seller': The Confusion Surrounding Section 12(2) of the Securities Act of 1933*, 14 DEL. J. CORP. L. 35, 41 (1989) (pointing out "lack of enlightenment" in legislative history of § 12(2)).

90. See, e.g., *Pacific Dunlop*, 993 F.2d at 591 (concluding that legislative history is not dispositive in limiting scope of § 12(2) actions); *Ballay*, 925 F.2d at 690 (noting clear intent of Congress to limit 1933 Act to regulation of initial public offerings); Maynard, *supra* note 7, at 842 (stating that courts should resolve interpretive issue by tools of statutory construction rather than by reliance on sparse legislative history). Maynard also points out that the overall role of legislative history in statutory interpretation continues to be a controversial subject. Maynard, *supra* note 7, at 842 n.115 (citing Jerry L. Marshaw, *Textualism, Constitutionalism, and the Interpretation of Federal Statutes*, 32 WM. & MARY L. REV. 827, 833 (1991)); see also Kevin N. Peter, Comment, *Section 12(2) of the Securities Act of 1933: Does it Apply to the Secondary Market? The Circuits are Fighting*, 31 HOUS. L. REV. 1205, 1229 (1994) (stating that ultimate answer to question of scope of § 12(2) must lie somewhere outside of legislative history). Peter asserts that the incredibly vague legislative history of § 12(2) fails to provide a clear answer to discerning congressional intent. Peter, *supra*, at 1229.

91. Securities Act of 1933 § 12(2), 15 U.S.C. § 771(2) (1994) (providing rescission remedy for material misstatements or omissions in prospectus); see *supra* note 2 (providing full text of § 12(2)).

92. See *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1066 (1995) (framing issue as whether private sale agreement constitutes prospectus for § 12(2) purposes). The Court stated that the parties and courts of appeals had all agreed that the text restricts the definition of "oral communication" to an oral communication that relates to a prospectus and thus the real issue involved defining prospectus for purpose of a § 12(2) remedy. *Id.*

93. See *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 582-84 (7th Cir.

Some scholars also have concluded that the text of Section 12(2) answers the question about the Section's scope of potential liability.⁹⁴

For example, Professor Louis Loss, a former professor of law at Harvard Law School and a securities expert,⁹⁵ asserts that at least the text, if not the "plain meaning," holds the key to resolving the interpretive issue surrounding the scope of the Section 12(2) rescission remedy.⁹⁶ Loss states that "all one needs to do here is to read the words" to know what Section 12(2) means.⁹⁷ However, Loss explains that "language, policy, and style" all support his broad, literal reading of the text.⁹⁸ Loss apparently derives his answer to the question of the scope of Section 12(2) from the text⁹⁹ and argues that policy and other factors do not detract from his conclusion that Section 12(2) applies to both initial and secondary market transactions.¹⁰⁰

In a recent article, Elliott J. Weiss, a law professor at the University of Arizona,¹⁰¹ criticizes the literal approach to defining the scope of prospectus.¹⁰² Weiss summarizes the literalist view as follows:

- (i) Section 12(2) applies to every person who sells a security "by means of a prospectus or oral communication;"
- (ii) Section 2(10) defines *prospectus* to include every "[written] communication . . . which offers any security for sale;"
- (iii) Every sale of securities involves some written or oral communication, so every sale of securities is covered by section 12(2).¹⁰³

1993) (emphasizing textual clarity of § 12(2) when read in conjunction with broad definition of prospectus in § 2(10)), *cert. dismissed*, 114 S. Ct. 1146 (1994).

94. See *infra* note 107 (noting advocates of literal approach to interpreting § 12(2)).

95. See Loss, *supra* note 8, at 47 n.* (identifying Professor Louis Loss).

96. See Loss, *supra* note 8, at 54 (seeking answer to availability of § 12(2) remedy for secondary market transactions on face of statute rather than in legislative history).

97. Loss, *supra* note 6, at 917.

98. *Id.*

99. See *id.* at 918 (arguing that text requires broad availability of § 12(2)); see also Loss, *supra* note 8, at 54-56 (concluding that statutory text demands application of § 12(2) to aftermarket trading).

100. See Loss, *supra* note 8, at 58 (arguing that public policy supports his view). Loss criticizes the *Ballay* opinion and the Weiss article for failing to consider the policy implications of limiting the availability of § 12(2). *Id.*; see *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.) (limiting § 12(2) actions to initial distributions), *cert. denied*, 502 U.S. 820 (1991); Weiss, *supra* note 8, at 3 (arguing for narrow construction of § 12(2) right of action).

101. See Weiss, *supra* note 8, at n.* (identifying Professor Elliott J. Weiss).

102. See *id.* at 2, nn.7-9 (summarizing literal approach to defining scope of § 12(2) rescission remedy).

103. *Id.*

Although acknowledging that many courts and scholars have accepted and continue to accept the literal approach,¹⁰⁴ Weiss refutes this approach and adopts what he describes as a functional approach.¹⁰⁵ Weiss bases his rejection of the literal approach on the premise that the text fails to provide a conclusive answer, and a need thus exists for examining other factors, such as the legislative history and the context of the 1933 Act and Section 12(2).¹⁰⁶ Advocates of the literal approach argue that a plain reading of the text indicates that Section 12(2)'s availability extends beyond initial distributions of securities.¹⁰⁷ However, scholars and courts that believe the text

104. *See id.* at 1-2 (acknowledging support of literal approach).

105. *See id.* at 2-3 (adopting functional approach). Weiss suggests that many scholars and courts have recently begun to question the literal approach. *Id.* at 2. Weiss states his functional point of view as follows: "The Securities Act primarily regulates public offerings of securities and the phrase 'by means of a prospectus or oral communication' limits the application of section 12(2) to public offerings." *Id.* As Weiss points out, this functional approach focuses on the structure and legislative history of the 1933 Act rather than emphasizing the text of § 12(2). *Id.* at 3. Thus, the functional approach examines § 12(2)'s role in the context of the overall statutory scheme. *Id.* Weiss endorses this approach and the result of the *Ballay* court. *Id.*; *see also* *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.) (holding § 12(2) applicable only to initial public offerings), *cert. denied*, 502 U.S. 820 (1991).

106. Weiss, *supra* note 8, at 3.

107. *See* Adam D. Hirsh, Comment, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. CHI. L. REV. 955, 962 (1990) (asserting that nothing in statutory language suggests that liability is restricted to initial distributions). Hirsh's approach differs somewhat from the approach taken by other literalists. Hirsh says that a prospectus is associated only with initial offerings, but then goes on to argue that "oral communication" must add scope to the phrase, or else the term is superfluous. *Id.* Hirsh argues that Congress would have drafted the provision as "by means of a prospectus or related oral communication" if it intended to limit Section 12(2) only to initial offerings. *Id.* at 963. However, this approach is not indicative of most literal approaches. *Cf.* Loss, *supra* note 6, at 916 (arguing that Congress expressly stated its intention to limit prospectus to document meeting formal statutory requirements whenever Congress desired such limitation); Loss, *supra* note 8, at 51 (same). Loss asserts that even a confirmation (a slip of paper telling the customer what security has been bought or sold) becomes a prospectus under the broad definition of prospectus offered in § 2(10). Loss, *supra* note 6, at 917; *see also* Maynard, *supra* note 8, at 868-69 (noting that nothing in statute's text limits § 12(2) remedy to initial distributions only); Rapp, *supra* note 8, at 715 (arguing that language of § 12(2) allows application to secondary market transactions). Rapp concedes that several provisions of the 1933 Act involving registration statements contain the term "prospectus" but concludes that the meaning is not so limited for the entire Act. Rapp, *supra* note 8, at 715. Rapp argues that the broad definition of "sale" in the 1933 Act supports the view that the term "prospectus" applies to secondary market transactions. *Id.*; *see* Securities Act of 1933 § 2, 15 U.S.C. § 77b (1994) (defining "sale" to include every contract for sale or disposition of security or interest in security for value). Section 2 of the 1933 Act states: "The term 'offer to sell,' 'offer for sale,' or 'offer' shall include every attempt or offer to dispose of, or

fails to provide a conclusive answer to the question of Section 12(2)'s scope instead turn to an examination of context as a means of attempting to resolve the issue.¹⁰⁸

B. Examining and Defining Context

Courts can view context narrowly or broadly by examining Section 12 solely, the entire 1933 Act, or the relationship between various provisions of the 1933 Act.¹⁰⁹ In his functional approach, Professor Weiss suggests that in determining the scope of Section 12(2), courts must place the provision in the context of the entire regulatory scheme of the 1933 Act.¹¹⁰ Weiss contends that Section 5 of the 1933 Act,¹¹¹ which prohibits any sale of securities without the filing of an effective registration statement, applies only to initial public offerings of securities.¹¹² Weiss argues that the broad language of Section 2(10) provides the definition of prospectus that Section 5 uses in setting forth registration requirements for public offerings.¹¹³

solicitation of an offer to buy a security or interest in a security for value." 15 U.S.C. § 77(b). Rapp argues that this broad definition of sale supports the idea that Congress must have intended § 12(2) to apply to the entire selling process. Rapp, *supra* note 8, at 715. Rapp notes that even beyond this broad definition of sale, the disjunctive phrase "or oral communication" indicates that § 12(2) applies to secondary market transactions. *Id.*

108. See *Ballay*, 925 F.2d at 689-90 (noting importance of overall context and structure of regulatory scheme); see also *First Union Discount Brokerage Servs. v. Milos*, 997 F.2d 835, 843-44 (11th Cir. 1993) (following analysis of *Ballay* court in examination of § 12(2) issue); Hirsh, Comment, *supra* note 107, at 968 (stating that courts should examine § 12(2)'s relationship to other remedies in 1933 Act to determine whether provision applies to secondary transactions); Weiss, *supra* note 8, at 9 (evaluating statutory context in determining scope of § 12(2) action).

109. See *infra* notes 110-61 and accompanying text (discussing different views of context of § 12(2)).

110. See Weiss, *supra* note 8, at 7 (stating that key to interpretation requires finding § 12(2)'s place within entire regulatory scheme). Weiss adopts Justice Souter's position that the obligation of the courts is to interpret whole statutes rather than individual sections. *Id.* Weiss quotes Justice Souter's statement that "[w]e should not be interpreting a statutory section without looking at the entire statute We are trying to come up with statutory coherence, not with just a bunch of pinpoints in individual sections." *Id.* (quoting *Hearings on the Nomination of David H. Souter to Be Associate Justice of the Supreme Court of the United States Before the Senate Committee on the Judiciary*, 101st Cong., 2d Sess. 131 (1990)).

111. See Securities Act of 1933 § 5, 15 U.S.C. § 77e (1994) (stating registration requirements of 1933 Act); *infra* note 129 (providing relevant text of § 5).

112. See Weiss, *supra* note 8, at 9 (stating that § 4 indicates that § 5 registration requirements apply only to public offerings of securities, and not to private transactions).

113. See *id.* at 9-12 (explaining role of § 2(10) definition of prospectus as part of § 5 registration process).

Therefore, Weiss asserts that limiting the definition of prospectus to the context of initial public offerings fits within the regulatory scheme of the 1933 Act.¹¹⁴

Weiss also examines Section 12(2) in light of the other civil liability provisions of the 1933 Act.¹¹⁵ Specifically, Weiss views Section 12(2) as a supplement to Sections 12(1)¹¹⁶ and 11¹¹⁷ of the 1933 Act.¹¹⁸ He asserts that Section 12(2) complements Section 12(1) by creating a longer time period in which to bring suits against sellers who sold securities in unregistered public offerings.¹¹⁹ In addition, Weiss claims that Section 12(2) reaches further than Section 11 by creating a remedy against all sellers. Section 11 does not create any liability against dealers and creates only limited liability against issuers and underwriters.¹²⁰ Thus, Weiss concludes

114. *See id.* at 11-16 (explaining that § 2(10) gives content to § 5 requirements and that narrow definition of prospectus "fits like a glove" with § 5 registration provisions). Weiss summarizes the regulatory scheme as follows:

During the pre-filing period, all selling communications, whether written or oral, are barred. During the waiting period, a seller can transmit a preliminary prospectus to a prospective purchaser and can communicate orally with a prospective purchaser. Written selling material other than the preliminary prospectus, however, falls within the Securities Act's definition of prospectus, and, because such material does not meet the requirements of section 10, transmitting it to a prospective purchaser violates section 5(b)(1). Finally, during the post-effective period, a seller can continue to communicate orally with a prospective purchaser and also can engage in "free writing."

Id. Weiss concludes that § 2(10) implicitly limits the definition of prospectus to "written offer[s] to sell securities in a public offering." *Id.* at 16. He explains that Congress failed to make this limitation explicit because its main concern was with the use of "prospectus" in § 5, which was by definition already limited to initial offerings. *Id.*

115. *See id.* at 12-14 (describing role of § 12(2) in light of other civil liability provisions); *see also* Securities Act of 1933 § 11, 15 U.S.C. § 77k (1994) (imposing strict liability for material misstatements in registration statements); Securities Act of 1933 § 12(1), 15 U.S.C. § 77l(1) (1994) (providing liability for violations of § 5 registration requirements).

116. *See* Securities Act of 1933 § 12(1) (giving rescission remedy against sellers who violate § 5 registration requirements).

117. *See* Securities Act of 1933 § 11 (imposing strict liability on issuers that include false or misleading statement of material fact in registration statement).

118. *See* Weiss, *supra* note 8, at 12-14 (discussing relationship between § 12(2) and §§ 12(1) and 11 of 1933 Act); *see also* Prentice, *supra* note 6, at 113-14 (asserting that § 12(2) complements other civil liability provisions by "filling the gaps" to create "consistency and symmetry in the legislative scheme").

119. *See* Weiss, *supra* note 8, at 13 (noting that § 12(2), in conjunction with § 13, allows buyers longer period to discover fraud before statute of limitations bars claim).

120. *See id.* (discussing limitations on § 11 liability); *see also* Prentice, *supra* note 6,

that interpreting a Section 12(2) prospectus as one concerning only initial distributions maintains consistency with the other statutory provisions of the 1933 Act.¹²¹ Weiss views the context of Section 12(2) as the entire regulatory scheme of the 1933 Act and concludes that this context indicates that Section 12(2) regulates only initial public offerings.¹²²

A much narrower approach to analyzing context consists of solely examining the text of Section 12(2) surrounding the word "prospectus." The *Pacific Dunlop* decision exemplifies this narrow approach.¹²³ For example, the *Pacific Dunlop* decision suggests that the text of the act that surrounds the word at issue serves as the only relevant context for means of interpretation.¹²⁴ The Seventh Circuit derived its definition of context from the prologue to the definitional section, Section 2, which states, "when used in this title, unless the context otherwise requires."¹²⁵ The *Pacific Dunlop* court acknowledged that courts sometimes may give context a broader meaning, but explained that a broader definition is not appropriate in this case.¹²⁶ Thus, the court restricted its context inquiry to the language of Section 12 only and remained consistent with its conclusion that the text alone could resolve the issue of the scope of Section 12(2).¹²⁷

The *Pacific Dunlop* court also considered Section 12(2)'s relationship with Section 12(1)¹²⁸ and the related Section 5 registration provisions,¹²⁹ and

at 113-14 (explaining loopholes in § 11 coverage).

121. See Weiss, *supra* note 8, at 16 (noting that analysis of all operative provisions establishes that coherence of regulatory scheme is not distorted by interpreting prospectus as relating only to public offerings).

122. *Id.* at 7.

123. See *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 585 (7th Cir. 1993) (stating that context is limited to text of act of Congress surrounding word at issue), *cert. dismissed*, 114 S. Ct. 1146 (1994).

124. *Id.*

125. See *id.* (quoting Securities Act of 1933 § 2, 15 U.S.C. § 77b (1994) (defining important terms of 1933 Act)).

126. See *id.* (explaining that if Congress had intended to consider broader scope of context, then it would have used more expansive phrase in place of context).

127. *Id.* at 586.

128. See Securities Act of 1933 § 12(1), 15 U.S.C. § 77l(1) (1994) (providing rescission remedy against those who sell or offer to sell securities in violation of § 5 registration requirements).

129. See Securities Act of 1933 § 5, 15 U.S.C. § 77e (1994) (describing registration requirements). The relevant portion of § 77e states:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly —

(1) to make use of any means or instruments of transportation or communication

concluded that a person may not offer or sell a security by means of a prospectus without first filing a registration statement.¹³⁰ The seeming implication is that a prospectus cannot exist without a registration statement.¹³¹ However, the *Pacific Dunlop* court pointed out that the exempted classes of securities found in Sections 3¹³² and 4¹³³ of the 1933 Act refute this implication.¹³⁴ The *Pacific Dunlop* court concluded that Section 12(2) applies to a broader range of securities than do Sections 5 and 12(1).¹³⁵ The court explained that although Section 5 requires a registration statement prior to a prospectus, the Section provides no assistance in defining a pro-

in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly —

(1) to make use of any means . . . to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry . . . any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

(c) It shall be unlawful . . . to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security

Id.

130. See *Pacific Dunlop Holdings, Inc., v. Allen & Co.*, 993 F.2d 578, 586 (7th Cir. 1993) (examining relationship between §§ 12(1) and 5 of 1933 Act (citing *A.C. Frost & Co. v. Coeur D'Alene Mines Corp.*, 312 U.S. 38, 41-42 (1941))), *cert. dismissed*, 114 S. Ct. 1146 (1994).

131. *Id.*

132. Securities Act of 1933 § 3, 15 U.S.C. § 77c (1994) (listing classes of exempted securities).

133. Securities Act of 1933 § 4, 15 U.S.C. § 77d (1994) (providing list of transactions exempted from § 5 registration requirements).

134. See *Pacific Dunlop*, 993 F.2d at 586-87 (explaining that when securities are exempted under §§ 3 or 4, persons will not face exposure to § 12(1) liability, but concluding that §§ 3 and 4 do not provide exemption from § 12(2) liability). The *Pacific Dunlop* court explained that the text of § 12(2) states that fraud in a prospectus is actionable, whether or not § 3 exempts the underlying security from registration. *Id.* at 587. The *Pacific Dunlop* court noted that lower courts have consistently held that § 4 exemptions do not apply to § 12(2). *Id.* Finally, the *Pacific Dunlop* court argued that to apply the exemptions of §§ 3 and 4 to § 12(2) would erase any distinction between the two different classes of exemptions and concluded that § 12(2) imposes a broader scope of liability than does § 12(1). *Id.*

135. *Id.*

spectus for means of Section 12(2), and that Sections 5 and 12(1) thus do not narrow the meaning of prospectus from the broad definition found in Section 2(10).¹³⁶ Accordingly, the court concluded that the relevant context, Sections 5 and 12(1), did not require a definition of prospectus for Section 12(2) purposes any different than the broad definition offered in Section 2(10) of the 1933 Act.¹³⁷

Another contextual approach to deciding the scope of Section 12(2) requires an examination of the relationship between Section 12(2) and other provisions of the 1933 Act and the Securities Exchange Act of 1934 (1934 Act).¹³⁸ For example, securities scholar Therese Maynard asserts that the relationship between Section 12(2) and Section 17(a)¹³⁹ offers additional support for concluding that Section 12(2) applies to secondary market transactions.¹⁴⁰ In *Naftalin*, the Supreme Court held that Section 17(a) applied to any fraudulent scheme and thus to the entire selling process.¹⁴¹ Although the *Naftalin* Court recognized that Congress intended the 1933 Act primarily to regulate new offerings through specific registration and disclosure requirements, the Court found that Section 17(a) significantly departed from these new offering requirements.¹⁴² In one of her articles, Maynard contends that one should not view Section 17(a) as the only intended departure.¹⁴³ Rather, she suggests that courts should read Section

136. See *id.* (providing explanation by analogous hypothetical). The *Pacific Dunlop* court hypothesized that § 5 states that persons could not carry handguns unless the state issued them a license. *Id.* The court then supposed that § 12(2) made it unlawful to kill a person with a handgun. *Id.* The court concluded that a person who killed someone using a handgun would violate § 12(2), regardless of whether that person had a license. *Id.* Thus, although § 5 supposes the filing of a registration statement before a prospectus, a person cannot escape § 12(2) liability merely because he or she has failed to file a registration statement. *Id.* In conclusion, the existence of § 5 does not alter the free-standing offense of § 12(2). *Id.* Thus, § 5 does not alter the definition of prospectus as used in § 12(2).

137. *Id.*

138. See Maynard, *supra* note 8, at 882-86 (examining relationship between §§ 12(2) and 17(a)).

139. Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1994) (criminalizing certain fraudulent conduct in sales of securities).

140. See Maynard, *supra* note 8, at 886 (concluding that *Naftalin* Court's finding § 17(a) applicable to postdistribution trading suggests that § 12(2) also covers secondary market transactions).

141. *United States v. Naftalin*, 441 U.S. 768, 778-79 (1979).

142. *Id.*

143. See Maynard, *supra* note 8, at 884 (explaining that it is consistent to read §§ 12(2) and 17(a) as imposing liability in secondary market transactions as long as other requirements of provisions are met). Professor Maynard supports this theory with the fact that

12(2) as analogous to Section 17(a).¹⁴⁴ Maynard concludes that creating a civil fraud remedy that applies to all securities transactions remains consistent with the overall statutory scheme in the same manner that the criminal penalty of Section 17(a) applies to all transactions.¹⁴⁵

Professor Louis Loss has endorsed a similar view.¹⁴⁶ First, Loss analogizes by stating that Section 12(2) is to Section 17(a) what Section 12(1) is to Section 5.¹⁴⁷ He considers Section 12(2) to exist as the private analogue of Section 17(a)'s publicly enforced criminal provision.¹⁴⁸ He explains that the fact that Congress failed to repeat either Section 17(a) or Section 12(2) in the Securities Act of 1934 provides another reason to extend Section 12(2) to secondary market transactions.¹⁴⁹

Another way of evaluating the relationship between Section 12(2) and Section 17(a) requires consideration of the alternative means of allowing private rights of actions for material misstatements or omissions within secondary transactions. The alternative to a reading of Section 12(2) that reaches secondary transactions consists of implying a private right of action under Section 17(a).¹⁵⁰ At least one commentator has suggested that reading Section 12(2) to apply to aftermarket transactions is consistent with the statutory scheme because this approach is preferable to implying a private right of action under Section 17(a).¹⁵¹

courts have denied civil remedies under § 17(a) based on the idea that Congress provided these remedies through § 12(2). *Id.* Thus, she concludes that to deny secondary civil remedies under § 12(2) would undermine the operation of § 17(a). *Id.*

144. *Id.*

145. *Id.* at 886.

146. *See* Loss, *supra* note 6, at 915-16 (discussing relationship between §§ 12(2) and 17(a)); Loss, *supra* note 8, at 50 (same).

147. Loss, *supra* note 6, at 915.

148. *Id.*

149. *See id.* (explaining that Congress had no need to repeat these provisions in 1934 Act). Loss states that the alleged dichotomy between the 1933 Act as regulating initial offerings and the 1934 Act as regulating secondary distributions is not completely accurate because some overlap exists between the two. *Id.*

150. *See* Hirsh, Comment, *supra* note 107, at 970 (noting trend against implied private action under § 17(a)). Hirsh suggests that if any issue remains in the 1933 Act that courts can categorically decide, it is that no implied cause of action exists under § 17(a). *Id.* (quoting 5 LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 896, 977 (1988)).

151. *See* Hirsh, Comment, *supra* note 107, at 972 (explaining that if courts implied cause of action under § 17(a), then courts would have to decide damage remedy, statute of limitations, any potential defenses, and possibility of punitive damages). Hirsh asserts that courts would look to other 1933 Act remedies to decide the contours of the new cause of action and would most probably look to § 12(2). *Id.* Thus, Hirsh suggests that it makes more sense to extend § 12(2) to secondary transactions. *Id.*

Continuing the contextual analysis, another method of evaluating the scope of Section 12(2) requires examining its relationship to Section 10(b) of the 1934 Act¹⁵² and the related Rule 10b-5.¹⁵³ Rule 10b-5's relevance arises from the fact that Section 10(b), standing alone, fails to self-execute.¹⁵⁴ In fact, the limits that courts recently have imposed on the availability of Section 10(b) actions have accelerated the use of the Section 12(2) remedy and have brought it to the forefront of litigation.¹⁵⁵ Professor Loss explains that the availability of a Section 10(b) action does not displace the need for Section 12(2) in the secondary market context.¹⁵⁶ Loss

152. See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994) (providing broad remedy against fraudulent schemes in securities transactions). Section 78j(b) provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

(b) To 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.

Id.

153. See Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (1994) (providing operative rule of § 10(b) of 1934 Act). Rule 10b-5 provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

154. See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 387 n.10 (1990) (explaining that § 10(b) fails to self-execute).

155. See, e.g., *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1444 (1994) (abolishing aiding and abetting liability under § 10(b) of Securities Act of 1934); *Santa Fe Indus. v. Green*, 430 U.S. 462, 477-78 (1977) (refusing to extend § 10(b) cause of action to breach of director fiduciary duty); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976) (imposing scienter requirement for § 10(b) causes of action); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 732 (1975) (limiting class of plaintiffs under § 10(b)). See generally Prentice, *supra* note 6 (summarizing reasons for plaintiffs to bring actions under § 12(2) rather than under § 10(b)).

156. See Loss, *supra* note 6, at 915-16 (noting inclusion of § 10(b) as "catch-all fraud

argues that when Congress enacted Section 10(b) in 1934, Congress could not have anticipated the future adoption of Rule 10b-5 or the recognition of an implied private right of action under this provision.¹⁵⁷ Loss asserts that even though some overlap exists between Sections 12(2) and 10(b), this overlap does not detract from the availability of either provision.¹⁵⁸ Another scholar accuses the *Ballay* court of falling into a "[R]ule 10b-5 trap."¹⁵⁹ He explains that courts should not use either section to eviscerate the availability of the other and that Section 12(2) provides a different remedy for different claimants than does Section 10(b).¹⁶⁰ Thus, many scholars and courts have concluded that interpreting Section 12(2) as applying to secondary market transactions can be viewed as entirely consistent with the context — regardless of whether that context is viewed as only the text of Section 12 or as Section 12(2)'s fit within the overall statutory regulatory scheme.¹⁶¹

C. Evaluating the Legislative History

A remaining approach to deciphering the appropriate scope of a Section 12(2) action consists of examining the legislative history of the 1933

prophylactic" to provide remedy to defrauded investors whenever more specific sections fail to provide adequate protection).

157. *Id.* at 916.

158. *See id.* (stating that implied remedy under § 10(b) should not stand in way of § 12(2)'s express remedy and concluding that neither remedy need "yield to the other" (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983))).

159. Rapp, *supra* note 8, at 725. Rapp explains that the *Ballay* court and others have made the mistake of confusing the common-law created § 10(b) action and the express § 12(2) action. *Id.* As judicially created private causes of action, § 10(b) actions differ from the statutorily prescribed § 12(2) actions. *Id.*

160. *See id.* at 726-27 (explaining importance of §-12(2) availability); *see also* Hirsh, Comment, *supra* note 107, at 974 (distinguishing between purposes of §§ 12(2) and 10(b)). Hirsh claims that Congress intended for § 10(b) to serve the purpose of deterring insiders from manipulating the market, and that the purpose of § 12(2) consisted of providing a remedy against sellers for making material misstatements in prospectuses. *Id.* Hirsh states that any overlap between the two is acceptable. *Id.* Hirsh alleges that it is preferable to extend § 12(2)'s express remedy rather than to continue to attempt to manage the "judicial oak" of § 10(b). *Id.* In conclusion, Hirsh asserts that applying § 12(2) to secondary transactions does not upset the overall statutory scheme. *Id.* at 975; *see also* Catherine Zucal, Comment, *Does Section 12(2) of the Securities Act of 1933 Apply to Secondary Trading?: Ballay v. Legg Mason Wood Walker, Inc.*, 65 ST. JOHN'S L. REV. 1179, 1184-85 (1991) (discussing different nature of remedies provided by § 12(2) and § 10(b)).

161. *See supra* notes 123-60 and accompanying text (providing arguments that application of § 12(2) to secondary transactions maintains consistency with context).

Act and Section 12(2) in particular. The Supreme Court has characterized the legislative history of Section 12(2) as sparse.¹⁶² Professor Loss proclaims the debate over the legislative history of the 1933 Act a "draw"¹⁶³ and admits that the legislative history does not yield a definitive answer to the proper scope of Section 12(2) actions.¹⁶⁴ Even James M. Landis, one of the participants in the original drafting of the 1933 Act, classified the documentation of the legislative history as "scanty."¹⁶⁵ At the other extreme, Professor Elliott Weiss claims that the legislative history of the 1933 Act demonstrates that Congress intended Section 12(2) to apply only to initial public offerings of securities.¹⁶⁶

President Franklin Roosevelt's administration spawned the Securities Acts of 1933 and 1934 as part of the reform legislation of the period.¹⁶⁷ In fact, Congress enacted the two acts in response to Roosevelt's message recommending federal supervision of securities in interstate commerce.¹⁶⁸

162. See *Randall v. Loftsgaarden*, 478 U.S. 647, 667 (1986) (describing sparseness of legislative history of § 12(2)).

163. See Loss, *supra* note 8, at 54 (finding potential points of debate for both sides in examination of legislative history).

164. See *id.* at 52 (noting that legislative history is not definitive). Loss asserts that the contemporaneous views of scholars yield more assistance to interpretation than do the historical legislative history documents. *Id.*

165. See James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 29 & n.1 (1959) (remarking on scantiness of documentation and pointing out unreliability of certain sources such as popular articles in contemporary magazines).

166. See Weiss, *supra* note 8, at 17 (arguing that legislative history supports theory that § 12(2) applies only to initial public offerings). Weiss explains that the legislative history indicates Congress's nearly exclusive concern with public offerings in adopting the 1933 Act. *Id.* He asserts that Congress intended § 12(2) to maintain consistency with the other civil liability provisions of the 1933 Act, which relate only to public offerings. *Id.* Finally, Weiss claims that the legislative history of the 1933 Act fails to offer any support for an interpretation of § 12(2) that includes secondary market transactions. *Id.*; cf. Prentice, *supra* note 6, at 105 (remarking that congressional motives for enacting § 12(2) "are as murky as the motives for enacting section 11 are clear," but agreeing with Weiss that § 12(2) applies only to initial public offerings).

167. See Prentice, *supra* note 6, at 115-17 (discussing reform of Roosevelt era).

168. See President's Message (March 29, 1933), in HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT SECURITIES IN INTERSTATE COMMERCE, H.R. REP. NO. 85, 73d Cong., 1st Sess. 1 (1933), reprinted in 2 J. S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 item 18, at 1-2 (1973) (recommending federal supervision of interstate commerce securities). The President pointed out that federal intervention should focus on mandating full disclosure of all important information rather than on evaluating the merit of individual securities. *Id.* at 2. President Roosevelt added

Most scholars agree that, at least initially, the 1933 and 1934 Acts had distinct purposes.¹⁶⁹ However, some scholars argue that even if Congress intended different purposes for the 1933 and 1934 Acts, this original intent does not foreclose the possibility of overlap between the two Acts.¹⁷⁰

Courts and commentators on both sides of the controversy about the parameters of Section 12(2) actions cite various parts of the legislative history as support for their positions.¹⁷¹ Those arguing for a restrictive reading of Section 12(2) most often point to House Report 85 as support for their position.¹⁷² These functionalists focus on a portion of House Report

that the overall purpose of new legislation consisted of protecting investors and that legislation should put the burden of telling the whole truth on the seller of securities. *Id.*; see also Weiss, *supra* note 8, at 17 (asserting that President Roosevelt's message establishes that Congress directed 1933 Act at problems associated with new issues of securities).

169. See, e.g., Landis, *supra* note 165, at 36 (asserting that "patent concern" of Congress in 1933 Act was regulation of initial offerings); Prentice, *supra* note 6, at 117-18 (noting that Congress originally intended 1933 Act to cover initial distributions and 1934 Act to cover secondary markets); Weiss, *supra* note 8, at 17 (arguing that Congress was mainly concerned with new, public issues of stock in 1933 Act); Peter, Comment, *supra* note 90, at 1223 (explaining that Congress believed that subsequent legislation, the 1934 Act, would cover secondary market transactions).

170. See Loss, *supra* note 8, at 56 (concluding that coexistence of overlapping actions between 1933 and 1934 Acts fails to demonstrate congressional intent to limit scope of § 12(2) action); see also Maynard, *supra* note 8, at 871-74 (discussing legislative history of 1933 Act). Maynard asserts that the 1933 Act reflected Congress's response to the collapse of the stock market on October 29, 1929 and to the preceding excesses of the bull market of the 1920s. *Id.* at 871-72. She argues that Congress intended to create a new regulatory structure to prevent future catastrophes and that this structure necessarily contemplated regulation of both the initial distribution and secondary markets. *Id.* at 872. Therefore, Maynard rejects the argument that Congress intended to limit the scope of § 12(2) actions because of potential future legislation it might enact. *Id.* at 872-73. Maynard advances the idea that Congress did intend to limit the registration statement requirements of § 5 to initial distributions, but did not intend to so limit every provision of the 1933 Act. *Id.* at 874-75.

171. See, e.g., *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 589-92 (7th Cir. 1993) (offering substantial discussion of legislative history documents), *cert. dismissed*, 114 S. Ct. 1146 (1994); *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 690 (3d Cir.) (relying on House report to support assertion that Congress clearly intended 1933 Act to regulate only initial offerings), *cert. denied*, 502 U.S. 820 (1991); Maynard, *supra* note 8, at 871-75 (looking at overall congressional intent); Rapp, *supra* note 8, at 720-21 (focusing on broad statements of purpose offered by Senate committee in its report); Weiss, *supra* note 8, at 17-27 (discussing House report and conference report); Peter, Comment, *supra* note 90, at 1224-29 (examining House report, Senate report, and committee report).

172. See *Ballay*, 925 F.2d at 690 (quoting House Report 85 as support of congressional intention to regulate only initial offerings via 1933 Act); Weiss, *supra* note 8, at 17-20 (asserting that House Report 85 focuses on new securities issue as 1933 Act area of con-

85 that states that the bill affects only new offerings and does not affect the ordinary redistribution of securities except in cases of offerings by a controlling shareholder.¹⁷³ Professor Weiss argues that the House Report's treatment of Section 12(2) demonstrates that Section 12(2) does not apply to secondary market transactions.¹⁷⁴ Weiss concludes that nothing in House Report 85 supports a more expansive view of the scope of Section 12(2) actions.¹⁷⁵ A review of the legislative history also requires an evaluation of Senate Report 47.¹⁷⁶ The *Naftalin* Court relied on a portion of Senate Report 47 in deciding that Section 17(a) extends to fraudulent trading activity in the secondary markets.¹⁷⁷ Although no similar language exists

cern). According to Weiss, the House committee indicated that the overall purpose of the 1933 Act was regulation of initial stock offerings, and consequently the committee had no need to specify the scope of individual provisions. Weiss, *supra* note 8, at 18. Weiss explains that the committee would have then specified any provisions which were designed to regulate private or secondary offerings. *Id.* Because the committee made no such specifications, Weiss concludes that the committee did not intend to expand the range of regulation of the 1933 Act outside the initial offerings context. *Id.*; *see also supra* notes 32-35 and accompanying text (discussing *Ballay* court's treatment of legislative history and providing supporting text from House Report 85).

173. *See* H.R. REP. NO. 85, *supra* note 35, at 7; *see also supra* note 35 and accompanying text (providing full quote from relevant portion of House Report 85).

174. *See* Weiss, *supra* note 8, at 19-20 (analyzing legislative history of §§ 11 and 12 of 1933 Act). The relevant text of House Report 85 reads as follows: "The committee emphasizes that these liabilities attach only when there has been an untrue statement of material fact or an omission to state a material fact in the registration statement or prospectus — the basic information by which the public was solicited." H.R. REP. NO. 85, *supra* note 35, at 9. The text also mentions that a duty of competence and innocence is thrown on originators of securities. *Id.*; *see also* Landis, *supra* note 165, at 41 (noting 1933 Act's concern with initial offerings and public offerings as compared to secondary and private transactions); *cf. Pacific Dunlop*, 993 F.2d at 589 (allowing for reading of House Report 85 which focuses on initial distributions, but pointing to Senate report as contrary evidence); Peter, Comment, *supra* note 90, at 1225 (conceding that House Report 85 supports limitation of § 12(2) to initial public offerings).

175. *See* Weiss, *supra* note 8, at 20 (suggesting that House Report 85's overall tone, as well as particular statements, support theory of § 12(2) application only to initial distributions).

176. SENATE COMM. ON BANKING AND CURRENCY, REGULATION OF SECURITIES, S. REP. NO. 47, 73d Cong., 1st Sess. 2 (1933) [hereinafter S. REP. NO. 47], *reprinted in* 2 J.S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, item 17, at 1 (1973).

177. *See* S. REP. NO. 47, *supra* note 176, at 4 (discussing application of § 17(a)). The relevant portion reads as follows:

The act subjects the sale of old or outstanding securities to the same criminal penalties and injunctive authority for fraud, deception, or misrepresentation as in the case of new issues put out after the approval of the act. In other words,

in Section 12(2)'s sparse legislative history, scholars who analogize the two sections argue for the same interpretation in deciding the scope of Section 12(2) availability.¹⁷⁸

The *Pacific Dunlop* court cited the Senate version of Section 12(2), Section 9 of the original Senate bill, as support for a broad application of Section 12(2).¹⁷⁹ The conference committee's version of the bill¹⁸⁰ eventually became the Securities Act of 1933. The one real distinction between

fraud or deception in the sale of securities may be prosecuted regardless of whether the security is old or new, or whether or not it is of the class of securities exempted under [old] sections 11 or 12.

Id.; see also *United States v. Naftalin*, 441 U.S. 768, 778 (1979) (relying on above portion of Senate Report 47 as support for application of § 17(a) to initial distributions and secondary trading).

178. See *supra* notes 146-49 and accompanying text (suggesting §§ 12(2) and 17(a) exist as civil and criminal analogues); see also Maynard, *supra* note 8, at 883-85 (concluding that legislative history of 1933 Act requires same results in determining parameters of §§ 12(2) and 17(a)); cf. Hirsh, Comment, *supra* note 107, at 967-68 (admitting § 12(2)'s legislative history fails to offer conclusive evidence about proper scope of provision). Hirsh points out that the lack of explicit language in § 12(2)'s legislative history fails to create negative implication that § 12(2) does not apply to secondary trading. *Id.* at 968. Hirsh concludes that the legislative history of § 12(2)'s silence on the issue fails to yield a definitive answer as to scope and that it thus becomes necessary to return to the statute's language and the nature of its remedy to decide the issue. *Id.* But see Weiss, *supra* note 8, at 22 (claiming that when Senate wanted to regulate secondary trading, as in case of § 17(a), it did so by express language).

179. See *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 590 (7th Cir. 1993) (explaining that Senate version of 1933 Act suggested fraud recovery for sale of any security), *cert. dismissed*, 114 S. Ct. 1146 (1994); see also 77 CONG. REC. 2996-3000 (1933), reprinted in 1 J.S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 item 8, at 2998 (discussing S. 875, which was Senate version of 1933 Act). The relevant statement from the Senate version reads as follows:

Every person acquiring any security by reason of any false or deceptive representation made in the course of or in connection with a sale or offer for sale or distribution of such securities shall have the right to recover any and all damages suffered by reason of such acquisition of such securities from the person or persons signing, issuing, using, or causing, directly or indirectly, such false or deceptive representation, jointly or severally.

Id. The *Pacific Dunlop* court explained that the Senate failed to focus on the term "prospectus" and did not even use the term in the context of §12(2). *Pacific Dunlop*, 993 F.2d at 591. The court concluded that the Senate treatment is entirely different from that of the House and supports a broad reading of § 12(2). *Id.*

180. See H.R. REP. NO. 152, 73d Cong., 1st Sess. 24-28 (1933) [hereinafter H.R. REP. NO. 152], reprinted in 2 J. S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 item 19, at 24-29 (1973) (providing conference committee version of 1933 Act).

the House and Senate versions of the bill consisted of different treatment of exempt securities for Section 12(2) purposes.¹⁸¹ Courts and commentators have viewed the House and Senate treatments as supporting both sides of the controversy.¹⁸² Here, as with all other aspects of the legislative history, arguments exist on either side of the discussion over the scope of Section 12(2).¹⁸³ With viable arguments either for restricting or for expanding the availability of Section 12(2), the only logical conclusion appears to be that the legislative history analysis itself fails to yield a conclusive answer about Section 12(2)'s parameters.

Perhaps the disagreement over the proper roles of text, context, and legislative history in defining the parameters of the Section 12(2) right of action led to the *Gustafson* case. Unfortunately, the *Gustafson* decision also may fail to clarify the availability of Section 12(2)'s rescission remedy.¹⁸⁴ Although the *Gustafson* Court considered these same factors in formulating its analysis, the majority employed entirely new reasoning in arriving at its result.

IV. *An Exposition and Critical Analysis of Gustafson*

A. *The Facts of Gustafson and Decisions of the Lower Federal Courts*

In 1989, petitioners Arthur L. Gustafson, Daniel R. McLean, and Francis I. Butler (Gustafson) were the sole shareholders of Alloyd, Inc. (Alloyd).¹⁸⁵ The respondents, Wind Point Partners (Wind Point), purchased all of the Alloyd stock from Gustafson by means of a private sales contract.¹⁸⁶ Before the execution of the sales contract, the respondents had evaluated

181. See Weiss, *supra* note 8, at 23 (discussing difference between House and Senate treatments). Weiss explains that the House bill applied § 12(2) to all registration-exempt securities while the Senate bill exempted the same securities from both the registration and civil liability provision. *Id.* The conference committee took the middle position of exempting government and bank issued securities from the reach of § 12(2), but applying § 12(2) to all other exempt securities. *Id.*; see also Peter, Comment, *supra* note 90, at 1215 (reviewing differences between House and Senate bills).

182. See Weiss, *supra* note 8, at 23-27 (arguing that conference committee decision to exempt § 3(a)(2), covering government and bank issued securities, from § 12(2) liability reflects congressional intent to limit § 12(2) to initial offerings); cf. *Pacific Dunlop*, 993 F.2d at 592 (asserting that conference report basically follows Senate version of bill that applies to any sale of security). But see Peter, Comment, *supra* note 90, at 1229 (claiming that neither side of argument over import of conference version has clear weight of evidence on their side).

183. See *supra* part III.C (discussing analysis of legislative history of 1933 Act and § 12(2)).

184. See *infra* part IV.D (providing critical analysis of *Gustafson* decision).

185. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1064 (1995).

186. *Id.*

Alloyd with the assistance of a formal business review prepared by KPMG Peat Marwick.¹⁸⁷ A year-end audit later revealed that Alloyd's actual earnings fell below the estimates that the respondents relied on in formulating the terms of the sales contract.¹⁸⁸ Consequently, Wind Point and Alloyd brought suit in the United States District Court for the Northern District of Illinois seeking rescission of the sale based on Section 12(2) of the 1933 Act.¹⁸⁹ Wind Point asserted that Gustafson had misrepresented Alloyd's financial condition and that the contract of sale constituted a prospectus for means of obtaining rescission under Section 12(2).¹⁹⁰ The district court granted Gustafson's motion for summary judgment.¹⁹¹ The district court relied on *Ballay* in deciding that plaintiffs can bring Section 12(2) claims only in the context of initial public offerings.¹⁹² The United States Court of Appeals for the Seventh Circuit vacated the district court's order of summary judgment and remanded the case for reconsideration based on its holding in *Pacific Dunlop*.¹⁹³ To resolve the conflict between the Third and Seventh Circuits, the Supreme Court granted certiorari.¹⁹⁴

B. The Majority Opinion

Justice Kennedy, writing for the majority,¹⁹⁵ framed the determinative issue as "whether the contract between Alloyd and Gustafson is a 'prospec-

187. *Id.* at 1064-65.

188. *Id.* at 1065.

189. *Id.*

190. *Id.* It is interesting to note, that under the terms of the sales contract, the buyers could receive an adjustment for the difference between actual and estimated earnings. *Id.* In fact, the defendants remitted the adjusted amount to the plaintiffs. *Id.*

191. *Id.*

192. *Id.* Although the buyers were the controlling shareholders, the district court reasoned that a private sale agreement is not within the scope of § 12(2) actions. *Id.*; see *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.) (holding that § 12(2) applies only to initial public offerings), *cert. denied*, 502 U.S. 820 (1991); see also *supra* notes 20-42 and accompanying text (discussing *Ballay* decision).

193. *Gustafson*, 115 S. Ct. at 1066; see *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 595 (7th Cir. 1993) (holding initial and secondary transactions within scope of § 12(2)), *cert. dismissed*, 114 S. Ct. 1146 (1994); see also *supra* notes 48-75 and accompanying text (reviewing *Pacific Dunlop* decision).

194. *Gustafson*, 115 S. Ct. at 1061.

195. See *Supreme Court Limits Liability in Private Securities Sales*, 10 LIAB. WK., March 6, 1995, at 10 (suggesting that Justice Kennedy's opinion originally may have been drafted as dissent which won additional support during draft circulation). The facts that Kennedy would not have ordinarily been assigned to write the majority opinion and that his opinion frequently references the dissents are given as support for this theory. *Id.*

tus' as the term is used in the 1933 Act.¹⁹⁶ Justice Kennedy explained that three sections of the 1933 Act were relevant in deciding the question presented.¹⁹⁷ Justice Kennedy began his analysis with the premise that the Court must construe the word "prospectus" in a way that allows the term to maintain a consistent definition throughout the Act.¹⁹⁸ A logical search for the definition of prospectus would begin with Section 2(10), the definitional provision of the 1933 Act.¹⁹⁹ However, in a surprising move, Justice Kennedy focused immediately on Section 10 of the 1933 Act.²⁰⁰ Section 10 sets out the formal content requirements of a prospectus.²⁰¹ Although Justice

196. See *Gustafson*, 115 S. Ct. at 1066 (assuming agreement contained material misstatements of fact); cf. Petitioner's Brief at 1, *Gustafson* (No. 93-404) (stating issue as "whether Section 12(2) of the Securities Act of 1933 extends to a privately negotiated sale of stock"); Respondent's Brief at 1, *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995) (No. 93-404) (defining question presented as "whether Section 12(2) of the Securities Act of 1933 should be limited to public offerings of stock"); Brief for the Securities and Exchange Commission as Amicus Curiae Supporting Respondents at I, *Gustafson* (No. 93-404) (presenting issue narrowly as "whether Section 12(2) of the Securities Act of 1933 is applicable to a privately negotiated resale of all the stock of a corporation").

197. See *Gustafson*, 115 S. Ct. at 1066 (naming §§ 2(10), 10, and 12 of 1933 Act as necessary sections in defining term "prospectus"); see also *supra* note 2 (providing full text of § 12); *supra* note 57 (providing full text of § 2); *infra* note 201 (providing relevant text of § 10).

198. See *Gustafson*, 115 S. Ct. at 1066 (asserting Court's duty to construe entire statutes rather than merely isolated provisions (citing *Philbrook v. Glodgett*, 421 U.S. 707, 713 (1975) and *Kokoszka v. Belford*, 417 U.S. 642, 650 (1974))).

199. See Stephen M. Bainbridge, *Securities Act Section 12(2) After the Gustafson Debacle*, 50 BUS. LAW. 1231, 1235 (1995) (arguing that definitions section presents logical place to begin inquiry into meaning of prospectus).

200. *Gustafson*, 115 S. Ct. at 1066.

201. Securities Act of 1933 § 10, 15 U.S.C. § 77j (1994). The relevant portion of § 10 provides:

(a) Except to the extent otherwise permitted or required pursuant to this subsection or subsections (c), (d), or (e) of this section —

(1) a prospectus relating to a security other than a security issued by a foreign government or political subdivision thereof, shall contain the information contained in the registration statement . . .

(4) there may be omitted from any prospectus any of the information required under this subsection which the Commission may by rules or regulations designate as not being necessary or appropriate in the public interest or for the protection of investors.

(d) In the exercise of its powers under subsections (a), (b), or (c) of this section, the Commission shall have authority to classify prospectuses according to the nature and circumstances of their use or the nature of the security, issue, issuer, or otherwise, and, by rules and regulations and subject to such terms and conditions as it shall specify therein, to prescribe as to each class the form and

Kennedy admitted that Section 10 fails to define the term "prospectus," he asserted that Section 10 explains what a prospectus "cannot be" to remain consistent with the overall regulatory scheme of the 1933 Act.²⁰² According to Justice Kennedy, a prospectus, at a minimum, must contain the information required in a registration statement.²⁰³ Justice Kennedy concluded that the term "prospectus" must reflect the same meaning when used in Section 12(2) as it reflects when used in Section 10.²⁰⁴ Justice Kennedy explained that Section 10 provides guidance for defining the term "prospectus" consistently throughout the 1933 Act.²⁰⁵ However, the logical place for Justice Kennedy to have found a singular definition for use throughout the Act would have been in the definitional section. Justice Kennedy cited recent Supreme Court precedent as support for the proposition that a word should maintain a consistent meaning throughout an act.²⁰⁶ Justice Kennedy implied that the Section 10 definition of prospectus — a document containing the required registration information — must apply every time the term "prospectus" is used in the 1933 Act.²⁰⁷

By its very language, Section 2(10) seems to suggest that at least two potential categories of prospectuses exist.²⁰⁸ However, Justice Kennedy

contents which it may find appropriate and consistent with the public interest and the protection of investors.

Id. The 1933 Act specifically exempts certain classes of securities from its coverage. See Securities Act of 1933 § 3, 15 U.S.C. § 77c (1994) (providing exempt classes of securities).

202. See *Gustafson*, 115 S. Ct. at 1066 (advancing idea that document fails to constitute prospectus when it does not need to comply with § 10 requirements, unless it falls under § 3 exemption).

203. See *id.* at 1067 (explaining that only public offerings by issuers or by controlling shareholders require filing of registration statements and that prospectus, as defined in § 10, is thus limited to documents relating to initial public offerings).

204. See *id.* (asserting that *Gustafson* majority does not use § 10 as definitional section).

205. *Id.*

206. *Id.* (citing *Department of Rev. of Or. v. ACF Indus., Inc.*, 114 S. Ct. 843, 845 (1994)).

207. See *infra* notes 268-77 and accompanying text (suggesting potential anomalies resulting from *Gustafson* majority's reasoning that § 10 prospectus requirements apply throughout 1933 Act).

208. See *supra* note 57 (providing full text of § 2(10)). Section 2(10) begins, "The term 'prospectus' means any prospectus" Securities Act of 1933 § 2(10), 15 U.S.C. § 77b(10) (1994); see also *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 584 (7th Cir. 1993) (stating that 1933 Act contemplates several different definitions of prospectus), *cert. dismissed*, 114 S. Ct. 1146 (1994). The *Pacific Dunlop* court explained that § 2(10) offers an overall broad definition of prospectus and that § 10(a) refers to a distinct document or a prospectus within a prospectus. *Id.* The court relied on § 10(d) as support for the idea that the 1933 Act contemplates multiple definitions of prospectus. *Id.*

refused to accept that the word "prospectus" could have different meanings in different sections of the 1933 Act.²⁰⁹ Consequently, Justice Kennedy rejected the plaintiff's argument that Section 2(10) broadly defines prospectus to include "any communication."²¹⁰ He argued that the word "communication," if taken literally as meaning all written communications, would make the other words of Section 2(10) (notice, circular, advertisement, letter) superfluous because all the other terms are merely forms of written communications.²¹¹ Almost summarily, Justice Kennedy concluded that the term "prospectus" means a document used in selling securities to the public.²¹² In explanation, Justice Kennedy relied on the canon of construction *noscitur a sociis*,²¹³ meaning that words are known by the company they keep, to explain that the other words of the Section 2(10) definition refer to documents of "wide dissemination" and thus refer only to communications directed to the general public.²¹⁴

Finally, Justice Kennedy reviewed precedent and legislative history to find support for his argument that prospectus, as used in Section 12(2), must have a narrow definition.²¹⁵ Justice Kennedy distinguished the Section 12(2) issue from the *Naftalin* decision concerning the scope of Section 17(a).²¹⁶ He explained that Section 17(a), the subject of the *Naftalin* decision, does not include the term "prospectus" in the statutory text.²¹⁷ Justice Kennedy concluded that the absence of the word "prospectus" in Section 17(a) supports a broad reading of that provision, and thus the presence of the term "prospectus" in Section 12(2) implies a limitation on the applicability of that provision.²¹⁸

The *Pacific Dunlop* court argued that § 10(d) gives the SEC power to classify prospectuses. *Id.* In addition, the introduction to definitional § 2 states, "When used in this subchapter, unless the context otherwise requires" See Securities Act of 1933 § 2, 15 U.S.C. § 77b (1994) (defining 1933 Act terms). Implicit in the above introduction to § 2 is the idea that context may require different definitions of prospectus.

209. *Gustafson*, 115 S. Ct. at 1068.

210. *Id.* at 1069.

211. *Id.*

212. *Id.*

213. See *supra* note 28 (explaining *noscitur a sociis* canon of construction).

214. *Gustafson*, 115 S. Ct. at 1070; see also *supra* note 57 (providing § 2(10) definition of prospectus).

215. *Gustafson*, 115 S. Ct. at 1070-73.

216. *Id.* at 1070-71; see *supra* notes 71-73 and accompanying text (discussing *Naftalin* decision).

217. *Id.* at 1071; see *United States v. Naftalin*, 441 U.S. 768, 778-79 (1979) (holding entire selling process subject to § 17(a)).

218. *Gustafson*, 115 S. Ct. at 1071.

In Part II.D of the majority opinion, Justice Kennedy made an abbreviated policy argument for narrowing the scope of Section 12(2)'s applicability.²¹⁹ He then reviewed selected portions of the legislative history to support his interpretation of prospectus.²²⁰ Justice Kennedy suggested that the fact that the legislative history lacks an explicit statement creating liability for private transactions demonstrates more about the proper scope of Section 12(2) than the fact that the legislative history fails to limit Section 12(2) explicitly to public offerings.²²¹ Finally, the majority summarized its holding as follows: "The word 'prospectus' is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder."²²²

C. The Dissenting Opinions

Four Justices dissented, with Justice Thomas and Justice Ginsburg writing dissenting opinions to criticize both the reasoning and the result of the majority decision.²²³ Section 2(10) provided the analytical starting point for the dissenting opinions of both Justice Thomas and Justice Ginsburg.²²⁴ Each Justice began with the broad definition of prospectus provided by Section 2(10) and criticized the majority for using Section 10 to give substantive meaning to Section 12(2).²²⁵ Justice Thomas asserted that Section 2(10)'s inclusion of documents that *confirm* the sale of any security reflects Congress's intent to define the term "prospectus" broadly beyond its "ordinary meaning."²²⁶ Justice Thomas's dissent accused the majority of attempt-

219. *See id.* (commenting that "it is not plausible to infer that Congress created this extensive liability for every casual communication between buyer and seller in the secondary market").

220. *See id.* at 1071-73 (focusing on House Report 85).

221. *Id.* at 1073. *But see id.* at 1076-77 (Thomas, J., dissenting) (arguing that Congress used precise language when it intended to limit provisions of 1933 Act to public offerings). Justice Thomas cited § 4 and § 11 as examples of the use of precise, limiting language and concluded that § 12(2) is notable for its silence. *Id.* (Thomas, J., dissenting).

222. *Gustafson*, 115 S. Ct. at 1073-74.

223. *Id.* at 1074 (Thomas, J., dissenting) Justices Scalia, Ginsburg, and Breyer joined Justice Thomas's dissent. *Id.*; *see id.* at 1079 (Ginsburg, J., dissenting). Justice Breyer joined Justice Ginsburg's dissenting opinion. *Id.*

224. *Id.* at 1074 (Thomas, J., dissenting); *id.* at 1079-80 (Ginsburg, J., dissenting).

225. *See id.* at 1074-75 (Thomas, J., dissenting) (noting need to use § 2(10) to define 1933 Act rather than using 1933 Act to define § 2(10) prospectus); *see also id.* at 1080 (Ginsburg, J., dissenting) (asserting that majority uses backwards reasoning in beginning analysis with § 10).

226. *See id.* at 1074 (Thomas, J., dissenting) (arguing that canon of statutory construction calling for giving term its ordinary meaning applies only "[i]n the absence of [a statutory]

ing to create ambiguity that actually does not exist in Section 2(10).²²⁷ Justice Thomas asserted that each word in Section 2(10) applies with equal weight and that, taken together, the words create an exhaustive and broad definition of prospectus.²²⁸

Justice Thomas agreed with the majority that specific sections of the 1933 Act, such as Section 10, require a narrower definition of prospectus than Section 2(10) provides.²²⁹ However, he pointed out that Congress intended different definitions of prospectus to be used in different statutory provisions of the 1933 Act.²³⁰ In Part II of his opinion, Justice Thomas criticized the majority's reading of the *Naftalin* decision.²³¹ Justice Thomas argued that the majority needed to decide that Section 12(2) reached private transactions in order to maintain consistency with *Naftalin*.²³² Justice Thomas's reading of *Naftalin* suggested that provisions of the 1933 Act apply to both initial and to secondary stock offerings unless the text of a specific

definition" (quoting *FDIC v. Meyer*, 114 S. Ct. 996, 1001 (1994)). Justice Thomas explained that Congress explicitly defined prospectus in § 2(10) of 1933 Act so no need exists to look elsewhere for a definition. *Id.*

227. *See id.* at 1075 (Thomas, J., dissenting) (stating that no need exists to apply *noscitur a sociis* when no doubt initially exists in statutory provision).

228. *Id.* (Thomas, J., dissenting).

229. *Id.* at 1075-76 (Thomas, J., dissenting).

230. *Id.* at 1076 (Thomas, J., dissenting) (citing § 2 introduction stating that definitions apply "unless the context otherwise requires" as support for multiple meanings of prospectus). Thomas urged that § 10 is a prime example of a provision where the context requires a different, narrower reading of prospectus. *Id.* (Thomas, J., dissenting). Justice Thomas also asserted that using "prospectus" to define prospectus implies at least two different definitions of the term. *Id.* (Thomas, J., dissenting). Thomas provided an apt analogy of the majority's use of § 10:

The majority transforms § 10 into the tail that wags the 1933 Act dog. . . . Suppose that the Act regulates cars, and that § 2(10) of the Act defines a "car" as any car, motorcycle, truck, or trailer. Section 10 of this hypothetical statute then declares that a car shall have seatbelts, and § 5 states that it is unlawful to sell cars without seatbelts. Section 12(2) of this Act then creates a cause of action for misrepresentations that occur during the sale of a car. It is reasonable to conclude that §§ 5 and 10 apply only to what we ordinarily refer to as "cars," because it would be absurd to require motorcycles and trailers to have seatbelts. But the majority's reasoning would lead to the further conclusion that § 12(2) does not cover sales of motorcycles, when it is clear that the Act includes such sales.

Id. (Thomas, J., dissenting).

231. *Id.* at 1078-79 (Thomas J., dissenting).

232. *Id.* at 1078 (Thomas, J., dissenting); *see also* *United States v. Naftalin*, 441 U.S. 768, 778-79 (holding private transactions within coverage of § 17(a)); *supra* notes 71-73 and accompanying text (discussing *Naftalin* decision).

provision distinguishes between the two types of offerings.²³³ In addition, Justice Thomas asserted that overlap between Section 12(2) and Section 10(b) of the 1934 Act does not imply any limitation on Section 12(2) liability.²³⁴

The final portion of Justice Thomas's dissent, Part III, accused the majority of letting policy issues dictate its outcome.²³⁵ Justice Thomas implied that the majority began with the policy objective of decreasing private securities litigation and worked backwards from this desired result in formulating its decision.²³⁶ Justice Thomas acknowledged that reducing securities litigation is a valid concern, but refuted the majority's method.²³⁷ Justice Thomas contended that only Congress has the power to limit the application of the 1933 Act and that the majority's reasoning frustrated congressional intent.²³⁸ Justice Thomas argued that the proper role of the Court is to apply policy rather than to make policy.²³⁹

In many respects, Justice Ginsburg's dissent echoed Justice Thomas's dissent.²⁴⁰ Justice Ginsburg also took a literal approach to determining the scope of Section 12(2) liability.²⁴¹ Like Justice Thomas, she used the broad definition of prospectus offered in Section 2(10) to define the parameters of Section 12(2).²⁴² Unlike the majority, Justice Ginsburg asserted that the same word may have different meanings in different provisions of the same act.²⁴³ Justice Ginsburg suggested that a Section 10 prospectus constitutes a discrete type of formal prospectus.²⁴⁴ In Part II of her dissenting opinion,

233. *Gustafson*, 115 S. Ct. at 1078 (Thomas, J., dissenting) (citing *Naftalin*, 441 U.S. at 778).

234. *See id.* (Thomas, J., dissenting) (advancing idea that Congress may not have anticipated overlap between § 12(2) and § 10(b)). Justice Thomas argued that Congress may have intended § 12(2) as a fraud-based cause of action for private and secondary sales because the actual text of § 10(b) and Rule 10b-5 fail to reach private claims. *Id.* (Thomas, J., dissenting) (citing *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 359 (1991)).

235. *Id.* at 1078-79 (Thomas, J., dissenting).

236. *Id.* (Thomas, J., dissenting).

237. *Id.* (Thomas, J., dissenting).

238. *Id.* at 1079 (Thomas, J., dissenting).

239. *Id.* (Thomas, J., dissenting).

240. *Id.* 1079-83 (Ginsburg, J., dissenting). Justice Ginsburg also joined Justice Thomas's dissent. *Id.* at 1074.

241. *Id.* at 1080-81 (Ginsburg, J., dissenting).

242. *Id.* at 1080 (Ginsburg, J., dissenting).

243. *See id.* (Ginsburg, J., dissenting) (admitting that words are often given same meaning throughout statutes, but asserting that this rule of statutory construction is not absolute (citing *Atlantic Cleaners & Dyers, Inc. v. United States*, 286 U.S. 427, 433 (1932))).

244. *Id.*

Justice Ginsburg briefly examined the legislative history and prior case law and concluded that Section 12(2) applies to private resales of securities.²⁴⁵ In so concluding, Justice Ginsburg pointed out that although the courts of appeals have split on whether Section 12(2) applies to secondary transactions, the courts consistently have decided that private placements fall within the scope of Section 12(2).²⁴⁶ Justice Ginsburg followed her conclusion with the statement: "If adjustment is in order, as the Court's opinion powerfully suggests it is, Congress is equipped to undertake the alteration."²⁴⁷ This statement and its accompanying footnote²⁴⁸ demonstrate that Justice Ginsburg seems to support fully the majority's enunciated policy goal. However, her dissenting opinion reflects an attempt to remain true to the language of Section 12(2) enacted by Congress.

D. *The Critique of the Opinions*

Securities scholars have extensively criticized the *Gustafson* decision.²⁴⁹ One scholar accuses the majority of "rearrang[ing] the face of federal securities law."²⁵⁰ Another commentator characterizes the decision as a debacle,²⁵¹ and the chief supporter of the result reached in *Gustafson* criticizes the Court's reasoning as "highly problematic."²⁵² Results aside, the main controversy centers on Justice Kennedy's method of analysis.²⁵³ Justice Kennedy

245. *Id.* at 1081-83 (Ginsburg, J., dissenting).

246. *Id.* at 1082 (Ginsburg, J., dissenting).

247. *Id.* at 1083 (Ginsburg, J., dissenting).

248. *See id.* at 1083 n.8 (Ginsburg, J., dissenting) (noting that *Gustafson* majority makes "noteworthy practical and policy points").

249. *See, e.g.,* Bainbridge, *supra* note 199, at 1270 (stating that majority opinion "is at best bizarre and borders on the irresponsibly unintelligible"); Booth, *supra* note 4, at 8 (claiming that *Gustafson* decision "rearranged the face of federal securities law"); Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1295 (1995) (asserting that *Gustafson* Court placed "draconian limitation" on scope of § 12(2)); Elliott J. Weiss, *Securities Act Section 12(2) After Gustafson v. Alloyd Co.: What Questions Remain?*, 50 BUS. LAW. 1209, 1210 (1995) (suggesting that *Gustafson* reasoning is "highly problematic").

250. Booth, *supra* note 4, at 8.

251. *See* Bainbridge, *supra* note 199, at 1231-32 (characterizing *Gustafson* as "the most poorly-reasoned, blatantly results-driven securities opinion in recent memory").

252. *See* Weiss, *supra* note 249, at 1210 (agreeing with *Gustafson* result, but criticizing reasoning employed by majority).

253. *See Gustafson*, 115 S. Ct. at 1078-79 (Thomas, J., dissenting) (acknowledging policy goal of majority, but asserting that policy cannot overcome textual analysis); *id.* at 1083 (Ginsburg, J., dissenting) (leaving any needed changes to Congress); Bainbridge, *supra* note 199, at 1270 (admitting possible merits of *Gustafson* result, but criticizing majority

utilized Section 10 of the 1933 Act in forming his definition of prospectus.²⁵⁴ This technique is unusual for several reasons.²⁵⁵ First, when seeking to define a term, the definitional section of the act in question appears to be the logical starting point.²⁵⁶ In addition, the petitioners never even mentioned Section 10 of the 1933 Act in their briefs.²⁵⁷ In other words, Justice Kennedy ignored the petitioner's arguments, prior case law, and commentary, and formulated his own justifications for the result reached. This unexpected choice of reasoning has drawn criticism even from Professor Weiss, who agrees with the result in *Gustafson*.²⁵⁸ Arguably, Justice Kennedy began with a specific result in mind and worked backwards.²⁵⁹ The Section 10 prospectus,²⁶⁰ often characterized as the formal prospectus, clearly reflects a very restrictive meaning of the term.²⁶¹ If Justice Kennedy desired to find a nar-

opinion as unintelligible and likely to cause numerous future problems of interpretation).

254. See *Gustafson*, 115 S. Ct. at 1066-69 (providing Justice Kennedy's analysis of relevance of § 10 for determining scope of § 12(2) actions); *supra* part IV.B (discussing Justice Kennedy's majority opinion).

255. See *infra* notes 256-77 and accompanying text (explaining why Justice Kennedy's reasoning is surprising).

256. See Bainbridge, *supra* note 199, at 1235 (suggesting beginning at definition section, § 2(10)).

257. See generally Petitioner's Brief, *Gustafson* (No. 93-404) (failing to mention § 10 of 1933 Act).

258. See Weiss, *supra* note 249, at 1216 (criticizing majority's approach). Weiss states that the *Gustafson* majority decision brings to mind a comment about a different Supreme Court case. *Id.* He cites John H. Langbein's comment regarding *Firestone Tire & Rubber Co. Id.*; see *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989). "*Bruch* is such a crude piece of work that one may well question whether it had the full attention of the Court. I do not believe that either Justice O'Connor or her colleagues . . . would have uttered such doctrinal hash if they had been seriously engaged in the enterprise." John H. Langbein, *The Supreme Court Flunks Trusts*, 1990 SUP. CT. REV. 207, 228. *But see* Weiss, *supra* note 8, at 1 (arguing for result reached by *Gustafson* Court).

259. See *Gustafson*, 115 S. Ct. at 1078 (Thomas, J., dissenting) (asserting that policy preferences motivated *Gustafson* majority); *id.* at 1080 (Ginsburg, J., dissenting) (accusing majority of backwards reasoning); see also *Civil Liability Under Section 12(2) of the Securities Act of 1933*, 109 HARV. L. REV. 329, 329 (1995) (accusing majority of "profound inconsistencies that reflect the Court's policy-driven desire to preempt a more extensive use of section 12(2) . . .").

260. See *supra* note 201 (providing relevant portion of § 10).

261. See *Gustafson*, 115 S. Ct. at 1080-81 (Ginsburg, J., dissenting) (noting that context of § 10 requires specific definition of prospectus). Justice Ginsburg pointed out that Congress clearly contemplated that the § 10 definition of prospectus would be different than the definition used elsewhere in the 1933 Act. *Id.* at 1081 (Ginsburg, J., dissenting). Justice Ginsburg noted that § 22 of the Investment Company Act of 1940 distinguishes between a prospectus for § 10 purposes and a prospectus as used elsewhere in the 1933 Act.

row definition of prospectus, Section 10 would have emerged as the obvious choice.²⁶² Apparently, Justice Kennedy ensured his intended result by combining this narrow definition of prospectus with the idea that a term should maintain the same meaning throughout the 1933 Act.²⁶³ Separately, neither proposition is troubling. Commentators agree that Section 10 defines prospectus narrowly.²⁶⁴ Also, the general idea of giving a word a consistent meaning throughout a statute is not exceptional as a general tool of statutory construction.²⁶⁵ However, the point of contention arises from using the specialized Section 10 definition of prospectus as the controlling definition throughout the 1933 Act when another obvious and more logical choice exists.²⁶⁶ Justice Kennedy's two arguments combine to achieve his desired result and to narrow yet another federal securities law cause of action.²⁶⁷

The dissenters failed to make the responsive argument that Justice Kennedy's position, when applied, yields ludicrous results.²⁶⁸ Section 5

Id. (Ginsburg, J., dissenting).

262. See Securities Act of 1933 § 10, 15 U.S.C. § 77j (1994) (providing narrow definition of prospectus); see also *supra* note 201 (providing relevant text of § 10).

263. *Gustafson*, 115 S. Ct. at 1066.

264. See Bainbridge, *supra* note 199, at 1236 (noting that § 10 contains most restrictive use of term "prospectus"); Weiss, *supra* note 8, at 9 (referring to § 10 prospectus as "final, or statutory, prospectus").

265. See *Gustafson*, 115 S. Ct. at 1075-76 (Thomas, J., dissenting) (acknowledging presumption that words maintain consistent meaning throughout statutes (citing *Brown v. Gardner*, 115 S. Ct. 552, 555 (1994))). However, Thomas argues that Congress can overcome this presumption by indicating that it intends a term to have different meanings within the act. *Id.* at 1076 (Thomas, J., dissenting).

266. See *supra* note 57 (quoting full text of § 2(10)). Section 2 provides all the definitions of the 1933 Act. Securities Act of 1933 § 2, 15 U.S.C. § 77b (1994). Section 2 states that its definitions apply "unless the context otherwise requires." *Id.* Consequently, § 2 appears to be the clear provision to begin a search for a definition of a specific term. *Cf.* Weiss, *supra* note 8, at 9-16 (using § 2(10) to define prospectus, but asserting that § 2(10) contains implicit limitation to public offerings).

267. See, e.g., *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1455 (1994) (eliminating secondary liability for violations of § 10(b)); *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1106-08 (1991) (increasing difficulty of proving causation element in actions under § 14(a) of 1934 Act); *Pinter v. Dahl*, 486 U.S. 622, 648 (1988) (narrowing definition of "seller" for potential liability under § 12(1)); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (denying existence of implied private right of action under § 17(a) of 1934 Act); *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 35 (1977) (refusing to imply private right of action under § 14(e) of 1934 Act); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (requiring knowing or intentional conduct for § 10(b) actions).

268. See *infra* notes 269-77 and accompanying text (explaining application of Justice Kennedy's reasoning to § 5 of 1933 Act); *cf.* *Civil Liability*, *supra* note 259, at 334 (stating

serves as the linchpin, or "heart," of the 1933 Act.²⁶⁹ Section 5(b)(1) states that it is unlawful, during the time between the filing of a registration statement and its effective date, to use a prospectus that fails to meet the requirements of Section 10.²⁷⁰ According to Justice Kennedy, if a document is not required to comply with the requirements of Section 10, then it fails to constitute a prospectus.²⁷¹ Justice Kennedy's theory implies that if the requirements of Section 10 are not met (or at least are not supposed to be met), then a prospectus cannot exist.²⁷²

The more logical position is that the Section 2(10) definition of prospectus encompasses a Section 10 prospectus as one discrete type of prospectus and that Section 5 builds on the broad definition of Section 2(10).²⁷³ Under Justice Kennedy's reasoning, issuers presumably could use *any* writing in a registered deal without violating Section 5.²⁷⁴ Consequently, issuers would avoid any possibility of charges of fraud under Section 12(1).²⁷⁵ Under this literal reading of Justice Kennedy's opinion, Sections 5 and 12(1) fail to have any force, and the regulation of registered deals is imperiled. Justice Kennedy asserts that the overriding goal of the entire 1933 Act is to protect public, registered offerings.²⁷⁶ However, his reasoning, taken at face value, tends to undercut the entire regulatory scheme of the 1933 Act.²⁷⁷ Although

that *Gustafson* decision implies that "no 'prospectus' can exist within the meaning of any section of the 1933 Act in a transaction exempted by section 4" because document is then not required to comply with § 10).

269. See *Pinter v. Dahl*, 486 U.S. 622, 638 (1988) (commenting that § 5 serves as "heart" of 1933 Act).

270. Securities Act of 1933 § 5(b)(1), 15 U.S.C. § 77e(b)(1) (1994); see *supra* note 129 (providing text of § 5).

271. See *Gustafson*, 115 S. Ct. at 1066 (suggesting that document fails to be prospectus if it does not fulfill requirements of § 10). Justice Kennedy pointed out that a document does not fail to be a prospectus merely because it does not contain all the required information. *Id.* at 1067. Instead, Justice Kennedy argued that if a document is not required to comply with § 10 in the first place, then it ceases to constitute a prospectus. *Id.*

272. *Id.*

273. See Bainbridge, *supra* note 199, at 1241 (explaining that reading §§ 2(10) and 5 together indicates that documents exist that fall within the definition of prospectus, but fail to require compliance with § 10).

274. See *id.* at 1259 (explaining that if documents fail to constitute prospectuses, then no § 5(b)(1) violation possibly can occur).

275. Securities Act of 1933 § 12(1), 15 U.S.C. § 77l(1) (1994); see also *supra* note 2 (providing text of § 12). Section 12(1) provides the rescission remedy for violations of § 5 requirements. 15 U.S.C. § 77l(1).

276. *Gustafson*, 115 S. Ct. at 1070-71.

277. See *Civil Liability*, *supra* note 259, at 333-34 (asserting that *Gustafson* majority's opinion "seriously undermines the effectiveness and coherence of other provisions of the

the dissenters failed to point out this flaw, this problematic reasoning seems to provide ample reason to question Justice Kennedy's analysis — and possibly his motivations.

It remains unclear why the majority did not simply follow the reasoning of the *Ballay* court and rely on the prior arguments about the legislative history and the structure and purpose of the 1933 Act.²⁷⁸ Instead, Justice Kennedy focused on his original Section 10 analysis and discussed limited precedent, legislative history, and other support.²⁷⁹ The *Ballay* court's analysis and result also appear inconsistent with the statutory text and congressional intent; however, the *Ballay* approach presents an academically defensible position.²⁸⁰

The majority's use of policy arguments raises a question about the desirability of making interpretive decisions of statutory securities law based on policy considerations.²⁸¹ Policy goals and ideas change with the composition of the Court,²⁸² yet a conflicting need for stability and consistency exists

[1933] Act").

278. See *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.) (reaching *Gustafson* conclusion that § 12(2) applies only to public offerings), *cert. denied*, 502 U.S. 820 (1991); see also *supra* notes 20-42 and accompanying text (discussing *Ballay* court's approach to defining scope of § 12(2) actions).

279. See *Gustafson*, 115 S. Ct. at 1065-71 (providing reasoning of *Gustafson* majority). Justice Kennedy basically relies on House Report 85, the *Naftalin* decision, and policy reasons as the only supporting arguments for his narrow interpretation of § 12(2). *Id.* at 1069-71.

280. See Weiss, *supra* note 8, at 3 (endorsing *Ballay* court's approach and result); see also *Civil Liability*, *supra* note 259, at 334 n.50 (commenting that Professor Weiss "presents the best scholarly argument for a limited reading of section 12(2)" that results in less damage to regulatory scheme of 1933 Act than "majority's slash and burn expedition through section 2(10)"); *supra* notes 20-42 (presenting *Ballay* court's analysis).

281. See Bainbridge, *supra* note 199, at 1256 (describing 1933 Act as technical statute and asserting that interpretations based on policy considerations could destroy operation of statute); see also Roberta S. Karmel, *Curtailing Civil Liability*, 213 N.Y. L.J., Apr. 20, 1995, at 3 (accusing opinion of being "motivated more by politics than any serious examination of the statute"); cf. *Civil Liability*, *supra* note 259, at 339 (noting that agreement with majority's policy goal may reduce public and legislative scrutiny, but asserting that decision creates "threat to legislative supremacy" which outweighs any policy considerations).

282. See Bainbridge, *supra* note 199, at 1254 (noting that for many years Supreme Court expanded securities liability through use of implied causes of action, but suggesting that Court is now moving in opposite direction). Bainbridge states that if the Supreme Court has changed policy direction, it may be a reflection of the current political atmosphere. *Id.* at 1254 n.153. He points to the limitations on securities litigation proposed in the Republican Contract with America. *Id.* (citing NEWT GINGRICH ET AL., CONTRACT WITH AMERICA 150-51 (Ed Gillespie & Bob Schellhas eds. 1994)); see also Joseph A. Grundfest, *We Must Never Forget That It Is an Inkblot We Are Expounding: Section 10(b) as Rorschach Test*, 29

in this area of the law.²⁸³ The *Gustafson* decision follows a recent trend of narrowing the scope of federal securities causes of action.²⁸⁴ However, the decision goes further than most recent cases because it involves limiting the use of an express cause of action rather than narrowing the availability of implied causes of action.²⁸⁵ As the dissenting Justices pointed out, Congress, rather than courts, should make such policy decisions.²⁸⁶

LOY. L.A. L. REV. 41, 52-53 (1995) (discussing unusual coalitions of *Gustafson* decision); Karmel, *supra* note 281, at 3 (asserting that Supreme Court is "climb[ing] on the tort reform bandwagon" by eliminating potential litigation under § 12(2)); Transcript - Panel Exchange, The Fourth Annual Fritz B. Burns Lecture, Central Bank: *The Methodology, The Message, and the Future*, 29 LOY. L.A. L. REV. 73, 80 (1995) [hereinafter Transcript] (comments of Simon Lorne, General Counsel of the SEC) (recognizing Supreme Court hostility to utilization of federal courts by private litigants). Mr. Lorne suggests that both the *Central Bank* and *Gustafson* Courts remained true to the policy goal of limiting access of private litigants to courts in federal securities actions. *Id.* In addition, Mr. Lorne makes the interesting point that the only recent case where the SEC side prevailed also had the effect of reducing access to the federal courts in the securities field. *Id.* at 80 n.31; *see also* Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S. Ct. 1212, 1215 (1995) (upholding availability of punitive damages in securities arbitration actions). Mr. Lorne suggests that making arbitration actions more attractive implicitly reduces the use of federal courts. Transcript, *supra*, at 80 n.31.

283. *See* Bainbridge, *supra* note 199, at 1270 (asserting that "expansive nature of securities fraud liability" yields corresponding need for certainty and stability).

284. *See, e.g.*, *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1455 (1994) (holding that no implied private right of action exists for aiding and abetting violations of § 10(b) of 1934 Act); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991) (establishing federal statute of limitations for § 10(b) claims under 1934 Act); *id.* at 374 (Kennedy, J., dissenting) (arguing pro-plaintiff position that three year statute of limitations beginning with occurrence of violation endangered purposes of 1934 Act); *see also* *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1104 (1991) (setting high causation requirement in narrowing implied cause of action for material misstatements in proxy statements); *id.* at 1116 (Kennedy, J., concurring in part and dissenting in part) (advancing pro-plaintiff position of lower standards of causation).

285. *See* Transcript, *supra* note 282, at 80 (noting *Central Bank* Court's narrowing of implied cause of action and *Gustafson* Court's narrowing of express cause of action).

286. *See* *Gustafson*, 115 S. Ct. at 1079 (Thomas, J., dissenting) (stating that "it is for Congress, and not for this Court, to determine the desired level of securities liability"). As Justice Thomas pointed out, the *Central Bank* Court emphasized that policy could not override textual analysis unless textual analysis produces such bizarre results that Congress could not possibly have intended them. *Id.* (Thomas, J., dissenting) (citing *Central Bank*, 114 S. Ct. at 1442); *see also* *Gustafson*, 115 S. Ct. at 1083 (Ginsburg, J., dissenting) (suggesting that Congress should make needed policy changes). *But see* Steven Thel, *Section 12(2) of the Securities Act: Does Old Legislation Matter?*, 63 FORDHAM L. REV. 1183, 1183 (1995) (advancing idea that Supreme Court should consider policy in determining scope of § 12(2) action). Professor Thel states that "[t]he Supreme Court ought not lightly abandon the rule of law; but, when it decides the scope of section 12(2), it should

Prior to *Gustafson*, the Supreme Court decided *Central Bank v. First Interstate Bank*.²⁸⁷ In determining the existence of aiding and abetting liability under Section 10(b) of the 1934 Act, the *Central Bank* Court turned to the statutory language as the origin of its analysis.²⁸⁸ Justice Kennedy, writing for the majority, construed the text strictly and concluded that the statute did not encompass aiding and abetting liability because Congress failed to make these terms explicit in the text of the statute.²⁸⁹ In fact, the *Central Bank* Court relied on the idea that in determining the scope of liability under provisions of the securities acts, the Court should ascertain congressional intent by referring to the statute's express language.²⁹⁰ Based upon the *Central Bank* decision, it seemed logical that the Supreme Court would adopt the reasoning and result of the *Pacific Dunlop* court, which focused on a textual analysis.²⁹¹ In fact, one *pre-Gustafson* commentator

follow its own judgment of whether it is wise to limit the remedies available in securities fraud litigation, even if that judgment conflicts with the statute." *Id.* at 1183-84. The Supreme Court appears to have followed Professor Thel's advice.

287. 114 S. Ct. 1439 (1994).

288. *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1446 (1994) (finding no private aiding and abetting liability under § 10(b) of 1934 Act). *Central Bank* served as trustee for a \$26 million bond issue used to finance improvements at a residential development. *Id.* at 1443. The bond covenants required the developer to make an annual report demonstrating continuing compliance with the terms of the bond issue. *Id.* *Central Bank's* in-house appraiser pointed out concerns in the annual report. *Id.* However, *Central Bank*, upon request of the developer, delayed obtaining an outside, independent review of the report findings. *Id.* In the meantime, the issuer defaulted on the bonds. *Id.* Respondents, purchasers of the bonds, sued *Central Bank* under § 10(b), claiming that *Central Bank* was "secondarily liable" because it had aided and abetted the issuer in committing fraud. *Id.* The *Central Bank* Court acknowledged a prior federal court decision finding that aiding and abetting liability existed under § 10(b). *Id.* at 1444. However, the Court explained that the statutory text controlled the issue. *Id.* at 1447. The *Central Bank* Court concluded that the failure of the text to include aiding and abetting liability definitively resolved the issue. *Id.* at 1448. After emphasizing that the language of the statute resolved the case, the Court stated that if the text had proved inconclusive, then it would have attempted to decide how the 1934 Congress would have resolved the issue by reviewing express causes of action under the securities acts. *Id.* The *Central Bank* Court inferred that Congress would not have allowed aiding and abetting liability under § 10(b) even if § 10(b) had been created as an express cause of action because of its failure to allow secondary liability for any other express provisions. *Id.* The Court responded at length to various arguments of the petitioners and amici. *Id.* at 1450-55. The Court concluded that the absence of aiding and abetting liability in the text yielded a conclusive answer to the issue. *Id.* at 1455. Thus, the Court found that *Central Bank* could not be found liable under § 10(b) of the 1934 Act. *Id.*

289. *See id.* at 1446-48 (noting that text of statute resolved case).

290. *Id.* at 1447 (quoting *Pinter v. Dahl*, 486 U.S. 622, 653 (1988)).

291. *See supra* notes 48-75 and accompanying text (discussing reasoning of *Pacific Dunlop* court); *see also* Therese H. Maynard, *Implications of Central Bank on Gustafson*,

suggested that the *Central Bank* decision left the *Gustafson* Court with "no consistent alternative but to agree with the Seventh Circuit that [S]ection 12(2) relief is available to any defrauded buyer who otherwise satisfies the statute's prerequisites."²⁹² In view of the *Central Bank* precedent, a possible explanation for Justice Kennedy's reasoning begins to emerge.²⁹³ Justice Kennedy could not adopt the reasoning of the *Ballay* court and remain consistent with the majority approach of the *Central Bank* decision, which he also authored.²⁹⁴ However, he could not adopt the *Pacific Dunlop* position and achieve his desired policy goals.²⁹⁵ To resolve this dilemma, Justice Kennedy constructed a new textual approach by turning to the text of Section 10.²⁹⁶ Justice Kennedy's desire for consistency is commendable.²⁹⁷ However, his innovative and unsound approach is not.²⁹⁸

212 N.Y. L.J., July 7, 1994, at 5 (arguing that Supreme Court should affirm *Pacific Dunlop* holding in order to maintain consistency with *Central Bank* decision). Maynard argues that both the *Central Bank* Court and the *Pacific Dunlop* court emphasize the use of express statutory language as the main interpretive tool. *Id.* She concludes that the *Pacific Dunlop* court's plain language approach maintains consistency with the analytical approach of the *Central Bank* Court. *Id.*; cf. Dennis J. Block & Jonathan M. Hoff, *Section 12(2): Private and Secondary Transactions*, 212 N.Y. L.J., Dec. 15, 1994, at 5 (predicting that if Supreme Court reached secondary market issue in *Gustafson*, it would probably follow analysis similar to *Pacific Dunlop* court or *Ballay* court).

292. Maynard, *supra* note 291, at 5.

293. See *supra* part IV.B (discussing reasoning of majority opinion).

294. See *supra* notes 20-42 and accompanying text (providing *Ballay* court's approach); cf. *supra* notes 287-90 and accompanying text (explaining *Central Bank* decision).

295. See *supra* notes 48-75 and accompanying text (discussing *Pacific Dunlop* court's reasoning); see also *supra* notes 281-86 (stating policy goals of *Gustafson* Court); cf. Transcript, *supra* note 282, at 85 (comment of Professor Melvin Aron Eisenberg) (emphasizing importance of judicial sincerity in writing opinions).

296. See *supra* notes 200-14 and accompanying text (describing Justice Kennedy's § 10 approach); see also Transcript, *supra* note 282, at 78 (comment of Simon Lorne, General Counsel of United States Securities and Exchange Commission) (arguing that *Gustafson* majority purports to use literal reading); *id.* at 86 (comment of Professor Joseph A. Grundfest) (noting that both majority and dissents allegedly used literal approach). Professor Grundfest asserts that both groups of Justices remain true to the text they are using, but that each group is reading a different version. *Id.* He draws the analogy that, "One group of Justices is literally interpreting the Old Testament, and the other is literally interpreting the New Testament. Each is true and literal to the version of the Book that they are reading . . ." *Id.*

297. But see Transcript, *supra* note 282, at 78 (comment of Simon Lorne) (asserting that Justices Scalia and Thomas remained consistent in *Central Bank* and *Gustafson* by adopting literal approaches in both decisions).

298. See *supra* part IV.D (criticizing majority decision); see also Grundfest, *supra* note 282, at 61 (advancing strict textualist approach as means of achieving consistency in federal

Another problem with the majority's opinion is that it fails to delineate clearly the scope of its holding.²⁹⁹ Although the original briefs framed the issue as whether Section 12(2) is available for fraud in connection with private offerings, the Court requested supplemental briefs on the issue of availability for *secondary* market transactions.³⁰⁰ In addition, the questions in oral argument often focused on the private placement issue.³⁰¹ However, both the majority and dissenting opinions seem to use the terms "secondary" and "private" interchangeably.³⁰² To determine and to assess the holding, an examination of the post-*Gustafson* commentary and district court decisions follows.³⁰³

V. Assessing the Damage: Implications of the Gustafson Decision

A. A Survey of Post-Gustafson Results in the District Courts

Justice Kennedy concluded the majority opinion in *Gustafson* by stating: "In sum, the word 'prospectus' is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder. . . ." ³⁰⁴ However, Justice Kennedy failed to clarify precisely what he intended to convey through this statement. The post-*Gustafson* district court decisions reflect this lack of clarity.³⁰⁵ The majority of district courts

securities law). Professor Grundfest concedes that a strict textual approach is imperfect, but argues that it is the "best available organizing principle for a rule of narrow construction that can end the string of sharply divided securities law decisions recently emanating from the Supreme Court." *Id.*

299. See, e.g., *Gustafson*, 115 S. Ct. at 1064 (stating question presented as "whether this right of rescission extends to a private, secondary transaction . . ."); *id.* at 1073-74 (holding that prospectus refers to public offerings of securities by issuer or controlling shareholder); *id.* at 1083 (Ginsburg, J., dissenting) (concluding that § 12(2) applies to private resales of securities); Bainbridge, *supra* note 199, at 1234 (interpreting holding to deny § 12(2) liability for secondary market transactions); Dennis J. Block & Jonathan M. Hoff, *Scope of Section 12(2) After 'Gustafson'*, 212 N.Y. L.J., July 6, 1995, at 5 (stating that *Gustafson* holds that private contracts for sale of securities do not constitute prospectuses under § 12(2)); Weiss, *supra* note 249, at 1209 (framing holding as limitation of § 12(2) to public offerings by issuers and their controlling shareholders).

300. See *Gustafson*, 115 S. Ct. at 32 (requesting parties to file supplemental briefs addressing issue of § 12(2) application to secondary market transactions).

301. Block & Hoff, *supra* note 291, at 5.

302. See Bainbridge, *supra* note 199, at 1362 (noting unclear language in majority opinion and suggesting slight possibility that unfamiliarity with securities industry may have caused poor drafting by law clerks or judges).

303. See *infra* part V (evaluating effects of *Gustafson* decision).

304. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1073-74 (1995).

305. See, e.g., *Farley v. Baird, Patrick & Co.*, No. 90 Civ. 2168 (MBM), 1995 WL 498785, at *2 (S.D.N.Y. Aug. 22, 1995) (stating that *Gustafson* Court held that "section 12(2)

that have addressed Section 12(2) claims after *Gustafson* have dismissed outright plaintiffs' claims based on secondary market trading.³⁰⁶ However, the *Gustafson* Court described Section 12(2) as applying to "public offerings by an issuer or its controlling shareholders," which implies that some, although very few, secondary market transactions remain within the scope of Section 12(2).³⁰⁷

The question also arises whether plaintiffs can base Section 12(2) claims on "tracing the purchased shares to an initial public offering."³⁰⁸ Prior to *Gustafson*, at least one district court had found Section 12(2) liability when

applies only to public offerings by issuer or controlling shareholder"); *Stack v. Lobo*, 903 F. Supp. 1361, 1375 (N.D. Cal. 1995) (citing *Gustafson* for proposition that § 12(2) covers only initial public offerings and does not apply to secondary transactions); *Pollack v. Laidlaw Holdings, Inc.*, No. 90 Civ. 5788 (DLC), 1995 WL 261518, at *13 (S.D.N.Y. May 3, 1995) (relying on *Gustafson* to limit § 12(2) to public offerings by issuers or controlling shareholders); cf. *Glamorgan Coal Corp. v. Ratner's Group PLC*, No. 93 Civ. 7581 (RO), 1995 WL 406167, at *2 (S.D.N.Y. July 10, 1995) (extending *Gustafson* holding to exclude private placements from § 12(2) coverage); *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, 899 F. Supp. 1061, 1065 (S.D.N.Y. 1995) (holding that private placement memoranda do not constitute prospectuses within § 12(2) following *Gustafson* decision).

306. See *Baxter v. Baron & Co., Inc.*, No. 94 Civ. 3913 (JGK), 1995 WL 600720, at *4 (S.D.N.Y. Oct. 12, 1995) (dismissing § 12(2) claim with prejudice for failure to state claim because facts of case involved secondary trading transaction); *Farley v. Baird, Patrick & Co.*, No. 90 Civ. 2168 (MBM), 1995 WL 498785, at *2 (S.D.N.Y. Aug. 22, 1995) (granting defendant's motion for summary judgment on § 12(2) claim that involved secondary market transaction); *Pollack v. Laidlaw Holdings, Inc.*, No. 90 Civ. 5788 (DLC), 1995 WL 261518, at *14 (S.D.N.Y. May 3, 1995) (dismissing § 12(2) claims premised on "Portfolio Evaluations and trade confirmations" after plaintiffs conceded that these written documents could not constitute prospectuses under *Gustafson*); *Komanoff v. Mabon, Nugent & Co.*, 884 F. Supp. 848, 857 (S.D.N.Y. 1995) (relying on *Gustafson* to dismiss for failure to state claim when § 12(2) action based on "post-distribution transactions"); cf. *Stack v. Lobo*, 903 F. Supp. 1361, 1377 (N.D. Cal. 1995) (holding that plaintiffs did not have standing to sue under § 12(2)). The *Stack* court stated that because plaintiffs did not purchase their stock in an initial public offering, they did not have standing to bring a § 12(2) claim. *Stack*, 903 F. Supp. at 1375. The court rejected plaintiffs' argument that § 4(3)(B) extends the time period of an initial public offering. *Id.* Section 4(3)(B) requires a prospectus for aftermarket sales of new stock within 90 days of an initial public offering. *Id.*; see also Securities Act of 1933 § 4(3)(B), 15 U.S.C. § 77d(3)(B) (1994). However, the *Stack* court concluded that the plaintiffs failed to allege that they purchased stock in an initial public offering and thus failed to state a viable § 12(2) claim. *Stack*, 903 F. Supp. at 1375.

307. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1074 (1995); see *Block & Hoff, supra* note 299, at 5 (arguing that *Gustafson* Court could not have intended to strip all secondary transactions from reach of § 12(2)). *Block and Hoff* explain that because controlling shareholders must have previously purchased the shares either from the issuer or in secondary trading, offerings from controlling shareholders are automatically one type of secondary transaction. *Id.*

308. *Block & Hoff, supra* note 299, at 5.

the plaintiff could trace the purchase of shares to an initial public offering.³⁰⁹ However, in *In re Valence Technology Securities Litigation*,³¹⁰ the United States District Court for the Northern District of California found that the *Gustafson* decision foreclosed the possibility of Section 12(2) claims based on a tracing theory.³¹¹ The *Valence* court found that if Section 12(2) applies only to initial public offerings, then it necessarily applies only to transactions that require the delivery of a prospectus.³¹² The court stated that *Gustafson*'s language made the tracing question irrelevant and dismissed the plaintiff's Section 12(2) claims with prejudice.³¹³ However, other district court decisions have implied the continued availability of the tracing theory.³¹⁴ For

309. See *In re AES Corp. Sec. Litig.*, 825 F. Supp. 578, 593 (S.D.N.Y. 1993) (holding that plaintiffs who claim traceability of shares to public offerings have standing to bring § 12(2) claims).

310. No. C 95-20459 JW, 1996 WL 37788 (N.D. Cal. Jan. 23, 1996).

311. See *In re Valence Technology Sec. Litig.*, No. C 95-20459 JW, 1996 WL 37788, at *4 (N.D. Cal. Jan. 23, 1996) (concluding that whether transaction can be traced to initial public offerings is irrelevant). The *Valence* litigation arose as a securities class action brought by all persons who bought Valence Technology, Inc. (Valence) stock within a specified time period. *Id.* at *1. The plaintiff class alleged violations of various fraud provisions of the securities acts, including § 12(2). *Id.* Valence engaged in the business of developing and producing lithium polymer rechargeable batteries to use in consumer electronics, such as cellular phones. *Id.* Initially, Valence entered into an acquisition agreement with the Mead Corporation (Mead) to obtain battery technology with the understanding that Mead could terminate the agreement if Valence failed to produce the battery by a set date. *Id.* Valence subsequently made several public stock offerings, each including a prospectus. *Id.* However, Valence failed to meet its deadline with Mead, and its stock price decreased. *Id.* at *2. Plaintiffs claimed that Valence committed fraud by misrepresenting the factual reality about the development of the battery. *Id.* The district court judge originally denied defendant's motion to dismiss § 12(2) claims, but reconsidered following the *Gustafson* decision. *Id.* at *3. In the Third Amended Complaint, one plaintiff alleged that, although he did not purchase his stock during an initial public offering, his purchase was traceable to the initial public offerings. *Id.* The *Valence* court stated that the *Gustafson* decision limits § 12(2) actions to initial public offerings which require the delivery of a prospectus. *Id.* at *3, *4. Accordingly, the court held that whether a purchase is traceable to an initial public offering is irrelevant, and dismissed plaintiff's claim with prejudice for failure to state a claim. *Id.* at *4.

312. *Id.*

313. *Id.*

314. See *In re Media Vision Technology Sec. Litig.*, No. C 94-1015 EFL, 1995 WL 787549, at *2 (N.D. Cal. Oct. 23, 1995) (stating that discussion in *Gustafson* implies that § 12(2) applies only to public offerings, and not redistributions of securities in secondary markets even though facts of *Gustafson* involved private placement). The plaintiffs argued that § 4(3)(B) of 1933 Act allows extension of § 12(2) to purchases in connection with initial public offerings within a 90-day time period. *Id.* at *2; see Securities Act of 1933 § 4(3)(B), 15 U.S.C. § 77d(3)(B) (1994). The *Media Vision* court questioned the validity of this theory, but allowed plaintiffs to submit an amended complaint to re-allege their § 12(2) claim. *Media*

example, in *In re U.S.A. Classic Securities Litigation*,³¹⁵ a New York district court held that Section 12(2) does not apply to secondary or aftermarket transactions.³¹⁶ However, the *USA Classic* court implied the availability of Section 12(2) liability when a plaintiff could trace a purchase directly to an initial offering³¹⁷ and concluded that the court did not reach the issue of "when, in a flurry of transactions, an initial public offering ends and secondary market transactions begin."³¹⁸

In a more troubling move, other district courts also have interpreted the *Gustafson* decision to eliminate the possibility of Section 12(2) actions with regard to private placement transactions.³¹⁹ As Justice Ginsburg's dissent

Vision, 1995 WL 787549, at *2. However, for an unpublished reason, the parties subsequently settled the matter out of court. *In re Media Vision Tech. Litig.*, No. C 94-1015 EFL, 1996 WL 44748, at *1 (N.D. Cal. Jan. 23, 1996); see also *Stack v. Lobo*, 903 F. Supp. 1361, 1375 (N.D. Cal. 1995) (discussing failure of plaintiffs to allege facts demonstrating that purchase of share could be traced to initial public offering); *In re U.S.A. Classic Sec. Litig.*, No. 93 Civ. 6667 (JSM), 1995 WL 363841, at *3 (S.D.N.Y. June 19, 1995) (assuming viability of tracing theory, but declining to reach question of when initial public offerings end and when secondary transactions begin).

315. No. 93 Civ. 6667 (JSM), 1995 WL 363841 (S.D.N.Y. June 19, 1995).

316. See *In re U.S.A. Classic Sec. Litig.*, No. 93 Civ. 6667 (JSM), 1995 WL 363841, at *3 (S.D.N.Y. June 19, 1995) (refusing to decide issue of when initial public offering becomes secondary transaction). *USA Classic* functioned as a sportswear designer and manufacturer. *Id.* at *1. Prior to a public offering beginning in November 1992, defendant Orbit owned all of the stock of *USA Classic*. *Id.* Plaintiffs purchased *USA Classic* stock at various dates between November 20, 1992 and September 22, 1993. *Id.* On September 23, 1993, *USA Classic* released its past-year earnings, at a figure below the expected amount. *Id.* Plaintiffs brought suit, alleging fraud in connection with the initial public offering. *Id.* Plaintiffs claimed that the defendants failed to disclose material facts in the prospectus, as well as including other false statements. *Id.* Plaintiffs alleged § 12(2) liability on the basis that the registration statement and the prospectus contained misstatements of material facts. *Id.* at *3. In response, the defendants argued that the plaintiffs purchased their stock in aftermarket transactions. *Id.* The *USA Classic* court concluded that secondary or aftermarket transactions are not within the scope of § 12(2). *Id.* However, the court distinguished the facts from *Gustafson* by explaining that a public offering began on November 20, 1992 and that plaintiffs made subsequent purchases pursuant to the prospectus. *Id.* The court stated that a viable § 12(2) claim existed for plaintiffs who bought stock "pursuant to the Prospectus." *Id.* (citing *In re AES Corp. Sec. Litig.*, 825 F. Supp. 578, 592 (S.D.N.Y. 1993) for proposition that § 12(2) is not limited to newly registered securities). Therefore, the court denied the defendant's motion to dismiss the § 12(2) claim. *Id.* at *6. However, the *USA Classic* court left open the issue of when "an initial public offering ends and secondary market transactions begin." *Id.* at *3.

317. *Id.*

318. *Id.*

319. See *Glamorgan Coal Corp. v. Ratner's Group PLC*, No. 93 Civ. 7581 (RO), 1995 WL 406167, at *3 (S.D.N.Y. July 10, 1995) (holding private placements outside parameters

indicated,³²⁰ this position overturns years of seemingly settled precedent.³²¹ In *ESI Montgomery County, Inc. v. Montenay International Corp.*,³²² the district court stated that *Gustafson* decided the issue of which transactions are exempt from Section 12(2).³²³ The court concluded that private offering

of § 12(2) coverage). The plaintiff based his § 12(2) claims on a "Final Private Placement Memorandum" which consisted of 275 pages of material similar to that contained in a "public offerings prospectus." *Id.* at *1. The *Glamorgan* court explained that if a document is not required to comply with § 10, and does not fall within a § 3 class of exempt securities, then it fails to constitute a prospectus for purposes of § 12(2). *Id.* at *2. The court explained that a transactional exemption under § 4(2) is irrelevant because the *Gustafson* Court made clear that only § 3 exemptions matter for § 12(2) purposes. *Id.* at *3 n.3. The *Glamorgan* court dismissed the plaintiff's claims and denied him the right to replead stating "no matter how the plaintiff might word the claim, the document involved cannot be 'silkenized' into a section 12(2) 'prospectus.'" *Id.* at *3 (citing *Acito v. Imcera Group, Inc.*, 47 F.3d 47, 55 (2d Cir. 1995)); see also *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, 899 F. Supp. 1061, 1065 (S.D.N.Y. 1995) (holding that private offering memoranda do not fall within scope of § 12(2) following *Gustafson* decision).

320. See *supra* notes 240-48 and accompanying text (providing summary of Justice Ginsburg's dissent).

321. See, e.g., *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 587 (7th Cir. 1993) (deciding that § 4 exemptions do not apply to § 12(2) claims), *cert. dismissed*, 114 S. Ct. 1146 (1994); *Metromedia Co. v. Fugazy*, 983 F.2d 350, 361 (2d Cir. 1992) (holding § 12(2) applicable to private placements), *cert. denied*, 508 U.S. 952 (1993); *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1043 (5th Cir. 1990) (finding § 12(2) applicable to private stock offerings); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973) (noting that § 4(2) private offering exemption fails to simultaneously exempt transaction from § 12(2)), *cert. denied*, 415 U.S. 977 (1974); *Woodward v. Wright*, 266 F.2d 108, 116 (10th Cir. 1959) (suggesting applicability of § 12(2) claim to private offering).

322. 899 F. Supp. 1061 (S.D.N.Y. 1995).

323. See *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, 899 F. Supp. 1061, 1065 (S.D.N.Y. 1995) (holding § 12(2) inapplicable to private offering memoranda). In *ESI*, the plaintiffs purchased a limited partnership interest in Montenay Montgomery Limited Partnership (MMLP). *Id.* at 1061. The plaintiffs' interest in Montenay stemmed from a letter and two investment memoranda prepared by Salomon Brothers on behalf of Montenay. *Id.* After negotiations, ESI entered a purchase agreement for a portion of Montenay's limited partnership interest in MMLP. *Id.* Subsequently, ESI brought suit claiming violations of § 12(2) based on material misrepresentations in the purchase agreement. *Id.* The defendants responded that the privately negotiated purchase agreement did not fall within the coverage of § 12(2). *Id.* In the meantime, the *Gustafson* decision overturned the precedent on which the plaintiffs had relied. *Id.* at 1064. However, the plaintiffs moved to amend their complaint to allege fraud in the investment memoranda. *Id.* The *ESI* court stated that the *Gustafson* Court decided the issue of the scope of § 12(2) coverage with regard to specified transactions rather than classes of securities. *Id.* The court concluded that the plaintiffs had viable § 12(2) claims only if the plaintiffs purchased their partnership interest within a public offering. *Id.* at 1065. The *ESI* court acknowledged that if plaintiffs had alleged that the transaction stemmed from a public offering, then the court would have

memoranda cannot fall within the coverage of Section 12(2).³²⁴ Part IV.B discusses the troubling implications of this extension of the *Gustafson* holding.³²⁵

Recently, the Supreme Court avoided an opportunity to clarify its *Gustafson* holding.³²⁶ In *Anheuser-Busch Cos. v. Summit Coffee Co.*,³²⁷ on remand from the Supreme Court for reconsideration based on the *Gustafson* decision, the Texas Court of Appeals stated that it originally found that Section 12(2) reached private, secondary transactions.³²⁸ However, the court asserted that it did not need to consider the effect of *Gustafson* on the plaintiff's securities claims because the Texas Securities Act was sufficient to uphold the original judgment for the plaintiffs.³²⁹ The *Anheuser-Busch* court explained that the Texas Securities Act does not contain the language "by means of a prospectus or oral communication" and thus encompasses a broader scope of transactions than does Section 12(2).³³⁰ The court concluded that *Gustafson* did not control its interpretation of the state statute.³³¹ This case provided a chance for the Supreme Court to specify the extent of its holding. The failure to do so leaves many issues unanswered.³³² However, the *Anheuser-Busch* decision demonstrates that *Gustafson* fails to impose similar limitations on the availability of state courts for defrauded plaintiffs.

had to decide how to characterize the transaction. *Id.* However, plaintiffs conceded that they relied on "private placement memoranda," but attempted to distinguish between private purchase agreements and private placement memoranda offering to sell securities. *Id.* The *ESI* court rejected this distinction, denied the plaintiffs' motion to amend, and granted the defendant's motion for summary judgment. *Id.*

324. *Id.*

325. See *infra* part V.B (summarizing potential implications of *Gustafson* decision).

326. See *Anheuser-Busch Cos. v. Summit Coffee Co.*, 858 S.W.2d 928, 941 (Tex. Ct. App. 1993) (holding § 12(2) applicable to single owner sale of all stock of corporation), *vacated, remanded*, 115 S. Ct. 1309 (1995) (mem.). The Supreme Court granted the writ of certiorari, vacated the judgment below, and remanded to the Court of Appeals of Texas for reconsideration based on *Gustafson*. 115 S. Ct. at 1309.

327. No. 05-92-00389-CV, 1996 WL 14061 (Tex. Ct. App., Jan. 12, 1996).

328. See *Anheuser-Busch Cos. v. Summit Coffee Co.*, No. 05-92-00389-CV, 1996 WL 14061, at *1 (Tex. Ct. App. Jan. 12, 1996) (upholding judgment for plaintiff based on Texas Securities Act rather than on *Gustafson*).

329. *Id.*

330. *Id.* at *2.

331. *Id.* at *3.

332. See *infra* part V.B (discussing implications of *Gustafson* and remaining unresolved questions about scope of § 12(2)).

B. An Overview of the Potential Implications of *Gustafson*

Given the presumed goal of decreasing securities litigation in the federal courts,³³³ the *Gustafson* Court failed to employ a method that serves the majority's desired end.³³⁴ The *Gustafson* decision creates more questions than it resolves.³³⁵ In fact, the majority opinion may lead to substantial future litigation attempting to define the remaining scope of Section 12(2).³³⁶ In addition, the majority opinion tends to undercut investor protection against fraud.³³⁷ Although a detailed examination of each potential implication of *Gustafson* goes beyond the scope of this Note, this part provides an overview of the apparent concerns.³³⁸

Although the *Gustafson* majority did not explicitly remove all private placements from the coverage of Section 12(2), this possibility arises as a probable interpretive result of the *Gustafson* opinion.³³⁹ Section 4(2) of the 1933 Act exempts "transactions by an issuer not involving any public

333. See *supra* notes 281-86 and accompanying text (discussing policy goals of majority).

334. See Bainbridge, *supra* note 199, at 1270 (suggesting that *Gustafson* decision creates uncertainty in areas of settled law and that majority's reasoning merely amplifies that confusion); Bruce Angiolillo, 'Gustafson': *Section 12(2) Applies Only to IPOs*, 213 N.Y. L.J., March 7, 1995, at 1 (accusing *Gustafson* majority of "impos[ing] additional securities litigation risks on the capital markets without a compelling justification").

335. See *infra* part V.B (discussing implications and unresolved issues of *Gustafson* decision); see also *Civil Liability*, *supra* note 259, at 329 (suggesting that *Gustafson* Court's reasoning may produce "severe and unintended consequences").

336. See Bainbridge, *supra* note 199, at 1270-72 (asserting that *Gustafson* decision will require "substantial further litigation" to resolve open issues concerning scope of § 12(2)).

337. See Karmel, *supra* note 281, at 3 (asserting that *Gustafson* places severe limits on investor protection against fraud under 1933 Act by excluding private placements from protection of § 12(2) and endangers administration of 1933 Act by SEC).

338. See *infra* notes 339-78 and accompanying text (providing summary of problems created by *Gustafson* decision).

339. See, e.g., *Glamorgan Coal Corp. v. Ratner's Group PLC*, No. 93 Civ. 7581 (RO), 1995 WL 406167, at *3 (S.D.N.Y. July 10, 1995) (holding § 12(2) inapplicable to private placements); *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, 899 F. Supp. 1061 (S.D.N.Y. 1995) (same); see also *Civil Liability*, *supra* note 259, at 335 (concluding that all private placements, including those by initial issuers, have exemption from coverage of § 12(2)); John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1173 n.83, 1177 n.94 (1995) (noting that *Gustafson* decision implies that § 12(2) does not apply to private placements); Margaret A. Bancroft, *Responding to Gustafson: Company Registration and a New Negligence Standard*, INSIGHTS, July 1995, at 14 (asserting that *Gustafson* removes private placements from potential § 12(2) liability); Roberta S. Karmel, *The Suitability Doctrine*, 213 N.Y. L.J., June 15, 1995, at 3 (stating that *Gustafson* held § 12(2) inapplicable to private placements); Karmel, *supra* note 281, at 3 (explaining that *Gustafson* removes § 12(2) liability from private placements).

offering" from Section 5 registration requirements.³⁴⁰ The Section 4(2) exemption has created an expansive private placement market.³⁴¹ However, exemption from registration need not create a corresponding exemption from the civil liability provisions of the securities acts.³⁴² The concern about removing private placements from the parameters of Section 12(2) stems from a review of the alternative antifraud provisions of the 1933 and 1934 Acts. Although the Supreme Court has interpreted Section 17(a) to extend to private placement transactions,³⁴³ lower courts have failed to find an implied private right of action to enforce Section 17(a).³⁴⁴ The Supreme Court to date has not addressed the issue for Section 17(a) purposes, but some cases suggest the disinclination of the Court to find the existence of an implied private right of action.³⁴⁵

Clearly, civil fraud liability under Section 11 fails to extend to private placements because private placements do not require registration statements.³⁴⁶ Thus, Section 10(b) of the 1934 Act emerges as the only alternative civil liability provision available to private placement investors.³⁴⁷ One

340. See Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1994) (exempting specified transactions from registration requirements).

341. See Karmel, *supra* note 339, at 3 (stating that "huge private placement market" has resulted from § 4(2)).

342. See *id.* (noting that it is "axiomatic" that exemptions from registration do not also create exemptions from civil fraud liability provisions).

343. See *United States v. Naftalin*, 441 U.S. 768, 778-79 (1979) (holding that § 17(a) applies to all sales of securities).

344. See Karmel, *supra* note 339, at 3 (providing summary of courts that have found that no private implied cause of action exists under § 17(a)); see also *supra* notes 138-51 and accompanying text (discussing relationship of § 17(a) to § 12(2)).

345. See *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (holding that no implied private right of action exists under § 17(a) of 1934 Act); *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 35 (1977) (refusing to imply private right of action under § 14(e) of 1934 Act); H. Miles Foy, III, *Some Reflections on Legislation, Adjudication, and Implied Private Actions in the State and Federal Courts*, 71 CORNELL L. REV. 501, 506, 574-75 (1986) (commenting on Supreme Court's increased reluctance to imply remedies in absence of explicit statutory language).

346. See Securities Act of 1933 § 11, 15 U.S.C. § 77k (providing strict liability for material omissions or misstatements within registration statements).

347. See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994) (providing general civil remedy against securities fraud); see also Karmel, *supra* note 249, at 1290 (suggesting that investors may be limited to implied causes of action under § 10(b)); Robert B. Robbins, *Due Diligence in Private Placement Offerings*, 28 REV. SEC. & COMMODITIES REG. 109, 110 (1995) (noting that post-*Gustafson*, private placement purchasers can only turn to § 10(b) to seek redress for fraud); *supra* notes 152 and 153 (providing text of § 10(b) and SEC Rule 10b-5). Robbins notes that § 10(b) requires intentional fraudulent statements, and thus, no remedy exists for negligent misstatements in private placements. Robbins, *supra*, at 110.

problem with using Section 10(b) lies in its scienter requirement.³⁴⁸ The scienter requirement and other court-imposed limits on Section 10(b) actions decrease the possibility of recovery for fraudulent misstatements in private placements via claims under Section 10(b).³⁴⁹ In addition, one must question the logic of relegating defrauded investors to an *implied* private right of action that Congress arguably never intended to exist.³⁵⁰ In fact, one securities scholar has suggested that, starting with a "clean slate," it seems unlikely that the Court would find an implied cause of action under Section 10(b).³⁵¹ Query, therefore, where defrauded investors would turn for redress of fraudulent acts. The danger of the *Gustafson* decision arises from the fact that it increases the incentive to use private placements for raising capital by stripping away any real threat of liability for negligent misstatements within these offerings.³⁵² This result tends to compromise the integ-

348. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976) (imposing scienter requirement on § 10(b) actions).

349. See, e.g., *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1444 (1994) (abolishing § 10(b) liability for aiding and abetting); *Chiarella v. United States*, 445 U.S. 222, 225-37 (1980) (rejecting § 10(b) conviction based on idea that courts cannot impose liability for silence and thus no general duty of disclosure exists); *Santa Fe Indus. v. Green*, 430 U.S. 462, 477-78 (1977) (finding that § 10(b) did not apply to corporate directors' breach of fiduciary duty and expressing idea that issue fell under state corporation law rather than federal securities law); *Ernst & Ernst*, 425 U.S. at 189 (requiring proof of scienter for § 10(b) claims); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) (limiting class of plaintiffs who can bring suit under § 10(b)).

350. See *Grundfest*, *supra* note 282, at 44 (asserting that Congress and SEC never intended to create private right of action under § 10(b)); see also *Ernst & Ernst*, 425 U.S. at 196 (stating that § 10(b) "does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission [SEC] when adopting Rule 10b-5, contemplated such a remedy"); *Bainbridge*, *supra* note 199, at 1255 (suggesting that it "flouts Congress' right to make the law" to prevent express cause of action from reaching "its intended target" because broad interpretation would conflict with "subsequently created implied private right of action"). *Bainbridge* adds that the "Supreme Court's illegitimate creation of implied rights of action should not be used to justify a misinterpretation of an express right of action." *Bainbridge*, *supra* note 199, at 1255-56 n.159. He concludes that "two wrongs don't make a right." *Id.*

351. See *Grundfest*, *supra* note 282, at 57 (stating that it is "improbable in the extreme" that Supreme Court of today would uphold implied § 10(b) right of action); see also *Joseph A. Grundfest, Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 986-89 (suggesting that it appears unlikely that today's Court would imply private right of action under § 10(b)).

352. See *Bancroft*, *supra* note 339, at 14 (explaining that *Gustafson* removes private placements from § 12(2) during time of expanded use of private placements); cf. *Karmel*, *supra* note 281, at 3 (arguing that breadth of private placement market reflects buyers' assumption that private transactions are not exempt from antifraud provisions). *Karmel* asserts that a "predicate" for the existence of the private placement market is an assumption

riety of the entire disclosure scheme of the 1933 Act.³⁵³

In addition, the *Gustafson* opinion creates additional definitional and line-drawing problems. As discussed previously, the *Gustafson* decision apparently removes transactions that are exempt under Section 4(2) from the coverage of Section 12(2).³⁵⁴ Section 4(2) exempts from registration transactions by issuers "not involving any public offering."³⁵⁵ Section 4(2) presents the problem of distinguishing between a public offering and a private offering. Although Section 4(2) has generated complicated case law,³⁵⁶ the general standard emerges that private offerings consist of offerings made to offerees who have the ability to "fend for themselves" and who have access to information similar to that required in a registration statement.³⁵⁷ This analytical method focuses on the characteristics of the

by buyers that sellers will provide "truthful equivalent information about an issuer's business and financial condition." *Id.*

353. See Bancroft, *supra* note 339, at 14 (asserting that *Gustafson* removes threat of liability for negligent misstatements in private placements). Bancroft explains that the decreased threat of liability will lead to increased use of private placements. *Id.* She concludes that the effect is to dismiss the securities acts as irrelevant, which compromises the integrity of the 1933 Act and its disclosure scheme. *Id.*

354. See *supra* notes 339-42 and accompanying text (discussing fact that *Gustafson* decision implies end of § 12(2) liability for private placement transactions).

355. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1994).

356. See Weiss, *supra* note 249, at 1221 (commenting on complexity of § 4(2) case law).

357. See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125-26 (1953) (establishing "fend for themselves" test for distinguishing between private and public offerings); Ted J. Fiflis, *Significant Securities Law Decisions of the Past Year as of June 14, 1995*, A.L.I.-A.B.A. (1995), available in Westlaw File No. CA36 ALL-ABA 51 (suggesting application of *Ralston Purina* test to decide whether transaction qualifies as private offering); Weiss, *supra* note 249, at 1222 (listing *Ralston Purina* qualifications of private offerings). According to Weiss, a § 4(2) private offering requires that all offerees —

- (i) be financially sophisticated
- (ii) be able to assume the risk of loss
- (iii) have access to the kind of information they would receive in a registration statement.

Id. See generally Carl W. Schneider, *The Statutory Law of Private Placements*, 14 REV. SEC. REG. 869 (1981) (reviewing and discussing uncertainty of common-law private offering criteria). *But see* Bainbridge, *supra* note 199, at 1266-67 (asserting that *Ralston Purina* "common-law" standard does not necessarily provide correct analysis for forming distinction between private and public offerings). Bainbridge criticizes Weiss's suggestion that any transaction not qualifying for an exemption under § 4(2) is automatically a public offering. Bainbridge, *supra* note 199, at 1266; see Weiss, *supra* note 249, at 1226. Bainbridge asserts that although transactions exempt under § 4(2) cannot constitute public offerings, it does not necessarily follow that non-exempt transactions are necessarily public offerings. Bainbridge, *supra* note 199, at 1266. Bainbridge points to specific securities offerings which

offerees, rather than on the quantity of offerees involved.³⁵⁸ However, the *Gustafson* majority demonstrated a different understanding of the term "public offering."³⁵⁹ The *Gustafson* Court focused on offerings made to the public at large and emphasized that prospectuses are "documents of wide dissemination."³⁶⁰ As a net result, courts may apply Section 12(2) to public offerings that look to the layperson like private offerings.³⁶¹ Again, the *Gustafson* decision further fails to create stability and certainty or to reduce federal securities litigation.

The *Gustafson* decision also creates uncertainty about the scope of Section 11 of the 1933 Act. Section 11 serves as a civil liability provision imposing strict liability for material misstatements or omissions in the registration statement.³⁶² The *Gustafson* opinion suggests that Section 11 liability no longer may exist for secondary market transactions.³⁶³ Again,

exemplify the flaws in this allegedly artificial distinction. *Id.* at 1267. He argues that the coverage of § 12(2) should not "turn on the arcane and ambiguous requirements of section 4(2)," and suggests that exemption from registration should not be the primary factor in determining civil liability exposure. *Id.* However, Bainbridge concedes that no other readily available definition of public offering currently exists, and that consequently the *Ralston Purina* common-law standard "might prevail, but it will do so only by default." *Id.*

358. See *Ralston Purina*, 346 U.S. at 125 (stating that "the statute would seem to apply to a 'public offering' whether to few or many"); *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 467 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959) (invoking *Ralston Purina* standard to establish public offering when only four offerees existed).

359. See Fiftlis, *supra* note 357, at 66 (stating that *Gustafson* majority did not use *Ralston Purina* as standard for determining existence of public offering).

360. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1070 (1995); see Fiftlis, *supra* note 357, at 66 (reading *Gustafson* majority to focus on quantity of offerees involved and "public" nature of offering). Professor Fiftlis suggests that this "naivete about the concept of a public offering is the insecure foundation of the [*Gustafson*] Court's opinion." *Id.* He predicts that the Supreme Court may overrule *Ralston Purina* and establish its own quantitative definition of public offering in order to further its policy goals, thereby adding "further insult to legislative intent." *Id.*; see also Weiss, *supra* note 249, at 1222 n.88 (suggesting that Supreme Court, acting on same policy concerns enunciated in *Gustafson*, may reconsider *Ralston Purina* and rework distinction between public and private offerings).

361. See Fiftlis, *supra* note 357, at 67 (pointing out potential surprise to litigants when courts apply § 12(2) to cases which look to "uninitiated" like private offerings). Fiftlis suggests that further litigation will be required to resolve this issue. *Id.*

362. Securities Act of 1933 § 11, 15 U.S.C. § 77k (1994) (imposing strict liability for material misstatements or omissions in registration statements).

363. See *Stack v. Lobo*, 903 F. Supp. 1361, 1375-76 (1995) (holding that *Gustafson* applies with equal force to § 11 claims so as to preclude liability under § 11 for secondary transactions); Karmel, *supra* note 249, at 1291 (suggesting that *Gustafson* decision creates questions about scope of liability under § 11); Karmel, *supra* note 339, at 3 (same); see also Judith Welcom & Elizabeth Lynch, *After 'Gustafson' Does Section 11 Apply Only to IPOs?*,

narrowing the scope of Section 11 liability would relegate defrauded investors to the Section 10(b) implied cause of action, triggering the same concerns previously discussed with regard to Section 12(2).³⁶⁴

In addition, the *Gustafson* decision generates implications for the status of transactions that fall within the SEC's safe harbor rules.³⁶⁵ The most common of these transactions concerns Regulation D³⁶⁶ and Rules 144 and 144A.³⁶⁷ The Preliminary Note of Regulation D expressly states that although the offerings receive exemption from registration requirements, the offerings do not gain exemption from the federal civil liability provisions of the securities laws.³⁶⁸ This statement reflects the SEC's assumption that all Regulation D offerings fall within the coverage of Section 12(2).³⁶⁹ However, the *Gustafson* decision endangers the validity of this assumption. The result is that Section 12(2) may apply to some Regulation D offerings and not to others depending on whether the offering has the characteristics of a public or of a private offering.³⁷⁰

213 N.Y. L.J., Apr. 21, 1995, at 1, 4 (discussing *Gustafson* ramifications for future of § 11 of 1933 Act).

364. See *supra* notes 348-54 and accompanying text (discussing problems with relegating defrauded investors to § 10(b)).

365. See Angiolillo, *supra* note 334, at 1 (noting that *Gustafson* decision will create debate over many safe harbor transactions); see also Weiss, *supra* note 249, at 1220-21 (noting complex implications of *Gustafson* on SEC safe harbor transactions). Weiss explains that § 19(a) of the 1933 Act authorizes the SEC to promulgate rules which exempt specified securities and transactions from other sections of the Act. *Id.* In effect, these rules create a safe harbor by disallowing liability for persons who engage in transactions according to a safe harbor rule. *Id.*; see also Securities Act of 1933 § 19(a), 15 U.S.C. § 77s(a) (1994) (providing SEC authority to issue safe harbor rules).

366. See 17 C.F.R. §§ 230.501 to 230.508 (1995) (exempting offerings of limited dollar value or limited number of purchasers from registration requirements).

367. See *id.* §§ 230.144, 230.144A (facilitating subsequent distributions of unregistered securities).

368. *Id.* §§ 230.501 to 230.508 (Preliminary Note 1).

369. See Weiss, *supra* note 249, at 1223 (stating that when SEC promulgated Regulation D it believed that § 12(2) would cover all of these offerings).

370. See *id.* (finding that § 12(2) applies only to some Regulation D offerings). Weiss suggests that the SEC cannot restore § 12(2) liability to all Regulation D offerings. *Id.* He asserts that if the SEC desires a consistent standard of liability for all Regulation D offerings, then its only alternative is to exempt all Regulation D offerings from registration requirements and § 12(2). *Id.* However, this is unlikely given that the SEC supported broad availability of § 12(2) in the *Gustafson* case. But see Bainbridge, *supra* note 199, at 1266 (discussing status of Regulation D offerings following *Gustafson* decision). Although Bainbridge agrees with Weiss that *Gustafson* causes only some Regulation D offerings to be within the scope of § 12(2), he predicts the result will be the need for case-by-case analysis of unregistered transactions. *Id.*

Similar questions now exist about whether Section 12(2) covers Rule 144 and 144A transactions.³⁷¹ At least one scholar has argued that these transactions consist of secondary trading transactions and thus fall outside the parameters of Section 12(2).³⁷² Additional implications of the *Gustafson* decision include the resulting uncertainty as to the interpretation of similar state law provisions,³⁷³ the interference with Section 5(b)(1) discussed previously,³⁷⁴ and the creation of doubts about the status of various other types of securities transactions.³⁷⁵

The *Gustafson* opinion has created more questions than it has answered. One probable outcome is that courts will need to employ case-by-case analysis.³⁷⁶ Case-by-case analysis deprives securities issuers and attorneys of reliability and certainty.³⁷⁷ In addition, the *Gustafson* decision will require substantial future litigation to resolve specific issues.³⁷⁸ Using the common-law technique of adjudication to distinguish the case at issue from precedent may provide the only method available to plaintiffs in an attempt to salvage any remaining coverage under Section 12(2).

371. See Fiflis, *supra* note 357, at 70 (stating that under "face value" reading of *Gustafson*, § 12(2) applies to offerings under Rule 144). *But see* Weiss, *supra* note 249, at 1224 (arguing that Rule 144 and 144A transactions involve secondary trading and thus fall outside scope of § 12(2)).

372. See Weiss, *supra* note 249, at 1224-25 (asserting that Rule 144 and 144A offerings are not subject to § 12(2) liability).

373. See *Anheuser-Busch Cos. v. Summit Coffee Co.*, No. 05-92-00389-CV, 1996 WL 14061, at *2 (Tex. Ct. App. Jan. 12, 1996) (finding that *Gustafson* does not control interpretation of Texas Securities Act because of differences in language); *see also* Fiflis, *supra* note 357, at 72 (noting potential effect of *Gustafson* on state law remedies).

374. See *Civil Liability*, *supra* note 259, at 334 (discussing *Gustafson* impact on operation of § 5(b)(1)); *see also supra* notes 268-77 and accompanying text (pointing out § 5(b)(1) issue as flaw in *Gustafson* majority's analysis).

375. See Bainbridge, *supra* note 199, at 1257-69 (discussing status of various § 3 exempt securities, effect on meaning of "oral communications in § 12(2), and other implications of *Gustafson* decision); Booth, *supra* note 4, at 8 (commenting on specific effects of *Gustafson* on exempt and offshore offerings); Fiflis, *supra* note 357, at 66-72 (providing general discussion of "real world implications of *Gustafson*"); Weiss, *supra* note 249, at 1225-29 (suggesting that *Gustafson* opinion left open several important questions about applicability of § 12(2)).

376. See Bainbridge, *supra* note 199, at 1268 (predicting need for case-by-case analysis to resolve issues left open by *Gustafson* Court).

377. See *id.* (noting that lack of certainty will arise as to transactions because of possibility that, through hindsight, courts will decide transaction involved public offering).

378. See *id.* at 1271 (pointing out that *Gustafson* will necessitate "substantial future litigation" to resolve many questions it created).

VI. *Living in a Post-Gustafson World: Proposals for Action*

A. *Legislative Clarification*

Prior to 1995, suggesting remedial legislative action as a response to *Gustafson* may have drawn little attention as a viable proposal.³⁷⁹ However, the current legislative interest in federal securities law reform reflects a more receptive climate to such a possibility.³⁸⁰ One scholar has suggested that *Gustafson* provides new evidence of the need for rejuvenation of the federal securities laws.³⁸¹ More specifically, another commentator has enunciated the need for a legislative reversal of the *Gustafson* decision.³⁸² In effect, a legislative reversal of *Gustafson* would require restoration of Section 12(2) liability, at least to all private securities offerings.³⁸³

Although Congress failed to address the *Gustafson* issue in the recently enacted Private Securities Litigation Reform Act of 1995,³⁸⁴ a simple amendment to the 1933 Act could restore the full scope of Section 12(2) coverage. In fact, Congress already has heard testimony about the need for legislative action in response to the *Gustafson* decision.³⁸⁵ Legislative

379. See Coffee, *supra* note 339, at 1145 (explaining that statutory structure of federal securities laws has not undergone significant change since its inception). Coffee also points out the proposal of the Federal Securities Code, at which Congress "essentially yawned." *Id.* See generally AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE (1980) (exemplifying attempt to combine six existing federal securities statutes into one comprehensive code under direction of Louis Loss).

380. See Mark H. Anderson, *Republicans in the House Begin Push to Overhaul U.S. Securities Laws*, WALL ST. J., July 27, 1995, at A2 (announcing introduction of securities reform bill by Representative Jack Fields, Chairman of House Subcommittee on Telecommunications and Finance).

381. See Bainbridge, *supra* note 199, at 1269 (asserting that *Gustafson* lends "new impetus" to congressional review of various civil liability provisions of federal securities acts).

382. See Coffee, *supra* note 339, at 1187 n.116 (suggesting need for legislative reversal of *Gustafson*).

383. See *id.* at 1187 (advocating restoration of § 12(2) liability to all private market offerings and to all offering material by issuers).

384. H.R. 1058, 104th Cong., 1st Sess., 109 Stat. 737 (1995) (enacting reforms to federal securities acts).

385. See *Sensible Deregulation: Hearings on H.R. 1058 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Commerce*, 104th Cong., 1st Sess. (1995), available in Westlaw, File No. 1995 WL 703417 (F.D.C.H.) (prepared testimony of John C. Coffee, Jr.) (urging Congress to restore § 12(2) coverage to private placements). Although Coffee discusses the overall need for deregulation, he asserts that Congress should reinstate full liability under § 12(2). Coffee points out that a uniform standard of liability is needed in order to avoid a disincentive to register offerings. *Id.* Coffee also notes that 60 years of precedent support § 12(2) liability for private placements. *Id.*

reversal serves as the preferred solution to eradicate the damage of the *Gustafson* decision.³⁸⁶ The clearest way to restore Section 12(2) to its intended parameters involves a simple clarification in the language of Section 12(2).³⁸⁷ The relevant portion of the amended Section 12(2) would read as follows:

Any person who —

(2) offers or sells a security (whether or not exempted by the provisions of Section 77c of this title other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus (as defined in section 77b(10) of this title) or oral communication, . . .

Adding the parenthetical reference after the term "prospectus" clearly indicates that the broad Section 2(10) definition of prospectus applies for purposes of Section 12(2).³⁸⁸ This proposed amendment to Section 12(2) serves to clarify the text of Section 12(2) rather than to change its original meaning. By merely re-emphasizing what should be clear from the original statutory text, this change remains consistent with the textual analysis of the *Pacific Dunlop* court and the suggested literal approach of Professor Loss.³⁸⁹ Congress should adopt this amendment to Section 12(2) and restore Section 12(2) to its intended parameters.

B. SEC Mitigation

Although legislation provides the only opportunity to reinstate Section 12(2) liability completely, intense SEC involvement provides a chance at least to mitigate the damage that the *Gustafson* decision created. Immediately prior to the *Gustafson* decision, the SEC formed the Advisory Committee on the Capital Formation and Regulatory Processes to re-evaluate the regulatory scheme of the federal securities acts.³⁹⁰ One member has sug-

386. See *supra* part V.B (discussing dangerous implications of *Gustafson* decision).

387. See *supra* note 2 (providing original text of § 12(2)).

388. See *supra* note 57 (providing § 2(10)'s broad definition of prospectus).

389. See *supra* notes 48-75 and accompanying text (explaining textual analysis of *Pacific Dunlop* court); see also *supra* notes 95-100 and accompanying text (describing Professor Loss's literal approach to interpreting § 12(2)).

390. See Advisory Committee on the Capital Formation and Regulatory Processes, Securities Act Release No. 7135, Exchange Act Release No. 35,368, 60 Fed. Reg. 9415, 9415 (Feb. 13, 1995) (announcing formation of committee to propose changes in current procedures and investor rights); see also John C. Coffee, Jr., *Company Registration: Has Its Time Come?*, 213 N.Y. L.J., May 25, 1995, at 5 (summarizing possible changes that

gested that the Advisory Committee may propose legislation to restore Section 12(2) liability to private offerings.³⁹¹ In the meantime, the SEC should continue amicus participation in lower court cases that attempt to discern the extent of the *Gustafson* holding. In its *Gustafson* amicus brief, the SEC states that "private actions under the securities laws serve as a necessary supplement to Commission enforcement actions and provide compensation to injured investors."³⁹² To salvage what remains of the private action under Section 12(2), the SEC should remain active in lower court litigation and should take interpretive positions consistent with a narrow reading of the *Gustafson* holding. In addition, defrauded purchasers should continue to bring suits under Section 12(2) and should attempt to distinguish their facts from the *Gustafson* facts.³⁹³ Limiting the *Gustafson* decision to its specific facts has the potential to ameliorate its harmful effects. Consequently, although legislative reversal of *Gustafson* constitutes the most desirable option to remain true to the congressional text and to the regulatory scheme,³⁹⁴ the SEC and defrauded investors should take all other possible steps in an attempt to confine the *Gustafson* holding to its facts.

VII. Conclusion

One commentator has stated that a Supreme Court decision "if not reasoned, is at least authoritative. In the law, that's generally enough."³⁹⁵ However, this statement fails to hold true for the *Gustafson* decision. By extending the *Gustafson* holding to exclude private offerings from the scope of Section 12(2) liability,³⁹⁶ the majority unnecessarily overturns sixty years

committee plans to consider).

391. See Coffee, *supra* note 390, at 5 (asserting need for restoration of § 12(2) liability to unregistered offerings in conjunction with revoking § 11 liability from all but initial public offerings). Coffee asserts that this proposal has no effect on liability in the aggregate. *Id.* However, it seems that his proposal would reduce the *Gustafson*-created uncertainty as to defining private offerings. See also *supra* notes 354-61 and accompanying text (suggesting post-*Gustafson* difficulties in distinguishing between private and public offerings).

392. See Brief for the Securities and Exchange Commission as Amicus Curiae Supporting Respondents at 1, *Gustafson* (No. 93-404) (describing SEC interest in *Gustafson* proceedings).

393. See *supra* part IV.A (providing facts of *Gustafson*).

394. See *supra* notes 48-75 and accompanying text (providing *Pacific Dunlop* textual analysis).

395. James D. Gordon, III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383, 391 n.71 (1990).

396. See *supra* notes 339-42 and accompanying text (finding that *Gustafson* decision

of seemingly settled precedent.³⁹⁷ Results aside, the *Gustafson* majority's novel rationale for its decision creates far more questions than it resolves.³⁹⁸ To remain true to congressional intent, the majority should have followed the textual approach of the *Pacific Dunlop* court.³⁹⁹ Alternatively, the majority could have adopted the *Ballay* approach, which constitutes at least an academically defensible position.⁴⁰⁰ Instead, the *Gustafson* Court ignored years of scholarly commentary and judicial precedent and charted its own course led by Section 10 of the 1933 Act.⁴⁰¹ A simple legislative amendment would clarify the scope of Section 12(2) and restore the section to its full scope of intended coverage.⁴⁰² Barring legislative reversal, the only remaining option consists of damage control in the form of attempts to narrow the holding of the *Gustafson* decision.⁴⁰³ Unfortunately, this route of action will require substantial litigation.⁴⁰⁴ Increased federal securities litigation means that nobody really wins. The majority fails to achieve its policy goals, defrauded investors face decreased protection under the securities laws, and issuers gain uncertainty and the costs of future litigation. The dubious benefits of the Supreme Court's "authoritative" answer to defining the parameters of Section 12(2) fail to outweigh its potential costs, and thus, in this case, the weight of authority alone is not enough.

excludes private offerings from scope of § 12(2) protection against fraud).

397. See *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1082 (1995) (Ginsburg, J., dissenting) (stating that "every Court of Appeals to consider the issue has ruled that private placements are subject to section 12(2)"); Bainbridge, *supra* note 199, at 1270 (accusing majority of overturning settled law); see also *supra* part V (describing implications of *Gustafson* decision).

398. See *supra* part IV.D (criticizing *Gustafson* majority opinion).

399. See *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 595 (7th Cir. 1993) (upholding broad application of § 12(2) to both initial and secondary market transactions), *cert. dismissed*, 114 S. Ct. 1146 (1994); see also *supra* notes 48-75 and accompanying text (providing *Pacific Dunlop* analysis).

400. See *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.) (holding that § 12(2) applies only to initial public offerings), *cert. denied*, 502 U.S. 820 (1991); see also *supra* notes 20-42 and accompanying text (explaining approach of *Ballay* court). See generally Weiss, *supra* note 8 (advocating *Ballay* approach and result).

401. See *supra* part III (reviewing past analyses of text, context, and legislative history of § 12(2) of 1933 Act).

402. See *supra* part VI.A (proposing legislative change to § 12(2)).

403. See *supra* part VI.B (suggesting SEC and investor remedial actions).

404. See *supra* notes 333-36 and accompanying text (describing need for further litigation to answer questions left open by *Gustafson* Court).