Washington and Lee Law Review

Volume 46 | Issue 3 Article 5

Summer 6-1-1989

The Reduction in Seller Liability Under the Securities Act of 1933: Good News for Securities Professionals

Follow this and additional works at: https://scholarlycommons.law.wlu.edu/wlulr

Part of the Criminal Law Commons, and the Securities Law Commons

Recommended Citation

The Reduction in Seller Liability Under the Securities Act of 1933: Good News for Securities Professionals, 46 Wash. & Lee L. Rev. 629 (1989).
Available at: https://scholarlycommons.law.wlu.edu/wlulr/vol46/iss3/5

This Note is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact christensena@wlu.edu.

THE REDUCTION IN SELLER LIABILITY UNDER THE SECURITIES ACT OF 1933: GOOD NEWS FOR SECURITIES PROFESSIONALS

Congress enacted the Securities Act of 1933 (the Securities Act) to protect investors from the manipulative activities that preceded the stock market crash of 1929.[1] To protect securities investors against manipulative selling practices, Congress, in section 12[2] of the Securities Act, imposes two significant liabilities on any individual who offers or sells securities in violation of the Securities Act's provisions.[3] First, section 12(1) of the Securities Act imposes financial liability on any person who offers or sells securities in violation of the registration or prospectus requirements listed in section 5 of the Securities Act.[4] Second, section 12(2) of the Securities Act imposes financial liability on any person who offers or sells securities by means of a materially misleading prospectus or a materially misleading oral communication.[5] Although the Securities Act defines the meaning of

---

1. *See Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 1 (1933) (statements of Congressman Sabbath) (stating that Congress enacted Securities Act of 1933 to remedy manipulative practices that caused economic downfall in America). *See generally* Landis, *The Legislative History Of The Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959) (stating that Congress intended Securities Act of 1933 to reduce factors that resulted in market crash of 1929); Douglas & Bates, *Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933) (discussing social and financial forces that resulted in enactment of Securities Act).

2. *See* Securities Act of 1933, ch. 38, title I, § 12, 48 Stat. 84 (1933) (codified as amended at 15 U.S.C. § 77l (1982). Section 12 of the Securities Act of 1933 (Securities Act) provides:

> Any person who—
>
> (1) offers or sells a security in violation of section 77e [the registration requirements] of this title, or
>
> (2) offers or sells a security. . . by the use of any means or instruments of transportation or communication in commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of 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. . . shall be liable 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.

15 U.S.C. § 77l (1982).

3. 15 U.S.C. § 77l (1982); *see infra* notes 29-33 and accompanying text (explaining liabilities imposed upon individuals violating § 12 of Securities Act).

4. 15 U.S.C. § 77l(1) (1982); *see supra* note 2 (setting forth text to § 12(1) of Securities Act); *infra* notes 21-24 and accompanying text (discussing elements of § 12(1) cause of action). The Securities Act's registration requirements are set forth in § 5 of the Securities Act. *See* 15 U.S.C. § 77e (explaining when entities must register securities).

5. 15 U.S.C. § 77l(2) (1982); *see supra* note 2 (setting forth text of § 12(2) of the Securities Act; *infra* notes 25-28 and accompanying text (discussing elements of § 12(2) cause of action).

the terms "sale" and "sell", the Securities Act does not define the term "seller".[6] In the absence of language in the Securities Act defining or clarifying the meaning of the term "seller", the federal courts have assumed the responsibility of determining which persons constitute sellers under section 12 of the Securities Act.[7]

In the 1940's federal courts generally held that an individual was a seller under section 12 of the Securities Act (section 12 seller) if the individual passed title to securities to a buyer or solicited an offer to buy securities from a buyer of securities.[8] The definition of a section 12 seller changed very little until the early 1960's when the federal courts began expanding the class of persons that qualified as section 12 sellers.[9] The expansion came to a peak in the 1970's and 1980's when a number of federal circuit courts adopted the substantial factor test.[10] Under the substantial factor test, any person whose activities constituted a substantial factor in causing a securities transaction to occur qualified as a seller under section 12.[11] Other circuits

---

6. *See* 15 U.S.C. § 77b(3) (1982) (defining terms "sale", "sell", "offer to sale", and "offer to sell"). Section 2(3) of the Securities Act defines the term "sale" or "sell" as "every contract of sale or disposition of a security or interest in a security, for value." *Id.* Section 2(3) also defines the term "offer to sell" or "offer to sale" to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security, for value". *Id*; *see* Lawler v. Gilliam, 569 F.2d 1283, 1287-1288 (4th Cir. 1978) (discussing Securities Act's lack of definition for term "seller"); Katz v. Amos Treat & Co., 411 F.2d 1046, (2d Cir. 1969) (same); Whittaker v. Wall, 226 F.2d 868, 873 (8th Cir. 1955) (same); Loss, THE FUNDAMENTALS OF SECURITIES REGULATION 1016 (1988) (discussing various ways that federal courts define term "seller").

7. *See, e.g.,* Pinter v. Dahl, 108 S.Ct. 2063, 2076 (1988) (explaining that because Securities Act nowhere defines term "seller" federal courts must define term "seller"); Davis v. Avco Fin. Serv. Inc., 739 F.2d 1057, 1064 (6th Cir.), *cert. denied*, 105 S.Ct. 1359, 470 U.S. 1005 (1984) (considering the meaning of the term "seller" in § 12 of Securities Act); Cady v. Murphy, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940) (wrestling with meaning of term "seller" under § 12 of Securities Act).

8. *See* Cady v. Murphy, 113 F.2d 988, 990-991 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940) (holding securities broker liable as seller under § 12 even though securities broker did not pass title of securities to purchaser because broker solicited offer to buy securities from purchaser). Although the statutory language of § 12 appears to include only persons that actually pass title to securities to the purchaser of the securities, early commentators noted that the language of § 12 does not require an individual to actually pass title to the securities to qualify as a seller of securites under § 12. *See* Douglas & Bates, *supra* note 1, at 206-207 (stating that scope of § 12 is wide enough to encompass more than individuals who pass title to securities to purchasers).

9. *See* Lennerth v. Mendenhall, 234 F.Supp. 59, 65 (N.D. Ohio 1964) (outlining proximate cause test of seller liability which expands definition of seller beyond previous interpretations of § 12); *infra* notes 57-71 and accompanying text (discussing *Lennerth* decision and proximate cause test of seller liability).

10. *See* Lewis v. Walston & Co. Inc., 487 F.2d 617, 622 (5th Cir. 1973) (noting that defendant constituted § 12 seller because defendant was substantial factor in causing sale of securities); *infra* notes 88-132 (discussing substantial factor test and noting circuit courts that adopted substantial factor test).

11. *See* Pharo v. Smith, 621 F.2d 656, 667 (5th Cir. 1980) (stating that appropriate definition of § 12 seller includes individuals who are substantial factor in causing sale of securities).

refused to adopt the substantial factor test and instead developed alternative definitions to determine which persons constitute sellers under section 12.[12] In 1988 the United States Supreme Court, in *Pinter v. Dahl*[13], considered the conflicting definitions in the federal circuit courts and rejected the fifteen-year old substantial factor test in favor of a more restrictive definition of the term "seller".[14] The *Pinter* Court defined a section 12 seller as any person who, motivated by the person's own financial gain or the financial gain of the owner of the securities, passes title to the securities or solicits the purchase of securities.[15] By restricting the definition of a section 12 seller, the *Pinter* decision reduced the likelihood that section 12 liability will attach to a securities professional.[16]

The emphasis on which persons constitute section 12 sellers stems from the significant liabilities that Congress chose to place on sellers.[17] Section 12 of the Securities Act imposes liability on persons for violating the Securities Act in two distinct situations.[18] First, section 12(1) imposes liability on a seller of securities for every security that the seller sells to a purchaser in violation of the registration and prospectus requirements set forth in section 5 of the Securities Act.[19] Second, section 12(2) imposes liability on a seller if the seller makes an offer to sell securities or actually sells securities to a purchaser by means of a materially misleading prospectus or a materially misleading oral communication.[20]

To bring a claim against a seller under section 12(1), a purchaser must establish three distinct elements.[21] First, the purchaser must prove that the

---

12. *See* Akerman v. Oryx Communications, Inc., 810 F.2d 336, 344 (2nd Cir. 1987) (stating that definition of seller includes persons passing title to securities to buyer and persons not passing title to securities if buyer proves that seller possessed scienter); *infra* notes 134-35 and accompanying text (discussing Second Circuit privity and scienter test for qualification as § 12 seller); Anderson v. Aurotek 774 F.2d 927, 930 (9th Cir. 1985) (stating that definition of § 12 seller includes persons whose acts are both necessary to and substantial factor in sales transaction); *infra* note 137 and accompanying text (discussing Ninth Circuit's necessary to and substantial factor test for qualification as § 12 seller); Collins v. Signetics Corp. 605 F.2d 110, 112-13 (3d Cir. 1979) (noting that except where some special relationship exists between owner of securities and seller, such as principal-agent relationship, purchaser must be in privity with seller); *infra* note 136 and accompanying text (discussing Third Circuit's privity or controlling relationship test for qualification as § 12 seller).

13. 108 S.Ct. 2063 (1988).

14. Pinter v. Dahl, 108 S.Ct. 2063, 2082 (1988) (rejecting substantial factor test because based on incorrect construction of § 12 and adopting a two part test); *infra* notes 177-82 and accompanying text (discussing Supreme Court's rejection of substantial factor test and explaining new two part test for determining who constitutes § 12 seller).

15. *Pinter*, 108 S.Ct. at 2079; *see infra* notes 172-73 and accompanying text (discussing *Pinter* Court two part test for determining § 12 seller status).

16. *See Pinter*, 108 S.Ct. at 2081 (stating that definition of § 12 seller should not include securities professionals merely performing legal work).

17. 15 U.S.C. § 77l (1)-(2) (1982); *see supra* note 2 (setting out § 12 of Securities Act).

18. 15 U.S.C. § 77l (1982); *see supra* note 2 (setting forth § 12 of Securities Act).

19. 15 U.S.C. § 77l(1) (1982).

20. *Id.* at § 77l(2) (1982).

21. *See* Swenson v. Englestad, 626 F.2d 421, 424 (5th Cir. 1980) (stating elements needed

defendant qualifies as the type of seller that section 12 aims to punish for violating the registration and prospectus requirements of section 5 of the Securities Act.[22] Second, the purchaser must prove that the seller used the mails or some other type of interstate communication to offer or sell securities to the purchaser.[23] Third, the purchaser must prove that in offering or selling securities to the purchaser the seller failed to comply with the registration or prospectus requirement of section 5 of the Securities Act.[24]

To bring a claim against a seller under section 12(2), a purchaser must also prove three distinct elements.[25] First, the purchaser must prove that

---

to establish prima facie case under § 12(1) of Securities Act); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 686 (1971) (discussing necessary elements of prima facie case under section 12(1) of Securities Act).

22. 15 U.S.C. § 77l(1) (1982); *see* Hill York Corp. v. American Int'l Franchises Inc., 448 F.2d 680, 686 (1971) (stating that qualification as seller necessary for liability under § 12(1)); Stokes v. Lokken, 644 F.2d 779, 785 (8th Cir. 1981) (same); Swenson v. Englestad, 626 F.2d 421, 426 (5th Cir. 1980) (same); Lewis v. Walston & Co. Inc., 487 F.2d 617, 621 (5th Cir. 1973) (same). Determining what activities qualify a participant in a securities transaction as a § 12 seller is a controversial issue in § 12 cases. *See* Abrams, *The Scope of Liability Under Section 12 of the Securities Act of 1933: "Participation" and the Pertinent Legislative Materials*, 15 FORD. URB. L. J. 877, 949 (1987) (reviewing various opinions but concluding that only persons transferring title to buyer are liable under § 12). *See generally* Note, *Seller Liability Under Section 12(2) of the Securities Act of 1933: A Proximate Cause-Substantial Factor Approach Limited by a Duty of Inquiry*, 36 VAND. L. REV. 361 (1983) (surveying various tests for determining persons status as § 12 seller).

23. 15 U.S.C. § 77l(1) (1982); *see* Aid Auto Stores, Inc. v. Cannon, 525 F.2d 468, 470 (2d Cir. 1975) (stating that interstate communication or use of mails required for § 12(1) liability). The predominant view on the use of mails or interstate communication is that the defendant must make an offer by mail or interstate oral communication or make the offer by oral communication and make the delivery of the security by mail. Creswell-Keith, Inc. v. Willingham, 264 F.2d 76, 82 (8th Cir. 1959); Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953), *cert. dismissed*, 347 U.S. 925 (1954); Schillner v. H. Vaughan Clarke & Co., 134 F.2d 875, 877 (2d Cir. 1943). Some jurisdictions use the broadest view of the interstate requirement and require only some use of the mails or interstate oral communication in the course of the transaction between the buyer and the seller. Schneider and Zall, *Section 12(1) and the Imperfect Exempt Transaction: The Proposed I & I Defense*, 28 BUS. LAW. 1011, 1021 (1973) (stating that use of intrastate mail and intrastate telephone satisfy § 12 requirement of interstate communication or use of mail). Other circuits apply a very narrow interpretation of the interstate communication requirement. *See* Franklin Savings Bank v. Levy, 406 F.Supp. 40, 42 (S.D.N.Y. 1975), *rev'd on other grounds*, 551 F.2d 521 (2d Cir. 1977) (interpreting interstate communication requirement to exclude intrastate use of telephone).

24. 15 U.S.C. § 77l(1) (1982). The seller's knowledge of the § 5 violation is irrelevant because § 12(1) of the Securities Act is a strict liability statute. SEC v. Holshuh, 694 F.2d 130, 137 n.10 (7th Cir. 1982); Lewis v. Walston & Co., 487 F.2d 617, 621 (5th Cir. 1973); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 694 n.19 (5th Cir. 1971); Wonneman v. Stratford Securities Co., [Decisions] Fed. Sec. L. Rep. (CCH) ¶ 91,034 at 93,459 (S.D.N.Y. 1961).

25. 15 U.S.C. § 77l(2) (1982). One major difference between the requirements under § 12(1) and § 12(2) is that § 12(2) applies to all securities whether registered or exempt from § 5 registration whereas § 12(1) applies only to securities that are not exempt from registration and are illegally unregistered. Hill York Corp. v. American Int'l Franchise, Inc., 448 F.2d 680, 695 (5th Cir. 1971). In most cases the registration exemptions of §§ 3 and 4 of the

the defendant qualifies as a seller of the securities.[26] Second, the purchaser must prove that the seller sold the securities by means of the mail or interstate communication.[27] Third, the purchaser must prove that, in the process of selling the securities to the purchaser the seller made an untrue statement of material fact or omitted a material fact that made a statement misleading.[28]

Section 12 places substantial liability on every seller who violates the requirements of section 12(1) or 12(2).[29] If a seller violates either part of section 12, the seller is liable to every purchaser to whom the seller improperly sold securities.[30] The total amount of the seller's liability depends on whether a purchaser still owns the securities purchased from the seller at the time that a court enters judgment for the purchaser.[31] If the purchaser still owns the securities, the purchaser can recover from the seller the consideration the purchaser paid for the securities plus accrued interest.[32] If, however, the purchaser no longer owns the securities, the purchaser can recover the difference between the amount that the purchaser paid for the securities and the amount the purchaser received from the resale of the securities plus any accrued interest.[33]

Securities Act do not alleviate a seller's liability under § 12. Woodward v. Wright, 266 F.2d 108, 116 (10th Cir. 1959); Loss, *supra* note 6, at 887. One exception to the rule exists and that is securities covered by § 3(a)(2) exemptions are outside the purview of § 12. *Id.*

26. *See* Junker v. Crory, 650 F.2d 1349, 1359 (5th Cir. 1981) (noting that to recover under § 12(2) plaintiffs must prove that defendant was seller of securities); HAZEN, THE LAW OF SECURITIES REGULATION 184 (1985) (stating that identifying permissible defendants under § 12(2) is question of who constitutes seller of securities).

27. 15 U.S.C. § 77l(2) (1982). *See supra* note 23 (discussing limits of interstate communication requirement).

28. 15 U.S.C. § 77l(2) (1982). Section 12(2) provides a seller with a statutory defense. *Id.* The defense requires the seller to prove that the seller did not know and in the exercise of reasonable care could not have known of the untruth or omission of facts in connection with the sale of securities. *Id.* Courts considering a defense under § 12(2) generally require the defendant to prove that the defendant could not have known of the untruth or omission which is a heavier burden of proof than the reasonably could not have known standard of the statute. Jackson v. Oppenheim, 533 F.2d 826, 829 n.7 (2d Cir. 1976); Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970); DeMarco v. Edens, 390 F.2d 836, 841-43 (2d Cir. 1968); First Trust & Savings Bank of Zanesville Ohio v. Fidelity-Philadelphia Trust Co., 214 F.2d 320 (3d Cir.), *cert. denied*, 348 U.S. 856 (1954); Loss, *supra* note 6, at 895. The plaintiff need not prove reliance on the misstatement or omission to recover under § 12(2). Wigund v. Flo-Tek, Inc., 609 F.2d 1028, 1034 (2d Cir. 1979); Alton Box Board Co. v. Goldman Sachs & Co., 560 F.2d 916, 919 n.3 (8th Cir. 1977).

29. 15 U.S.C. § 77l (1982). *See* Capri v. Murphy, 856 F.2d 473, 475 (2d cir. 1988) (holding defendants liable for $522,500 worth of limited partnerships sold to plaintiffs); Lewis v. Walston, 487 F.2d 617, 618 (5th Cir 1973) (concluding defendant liable for $70,000 worth of securities sold to plaintiff).

30. 15 U.S.C. § 77l (1982).

31. *Id.*

32. *Id.*

33. *Id.* If the purchaser brings a claim against a seller under § 12(2) of the Securities Act and the seller was a broker, § 12 entitles the purchaser to the entire amount paid for the security without deduction of a transaction commission. Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269, 276 (10th Cir. 1957).

Because section 12 only imposes liability on defendants who qualify as section 12 sellers, many defendants claim that they do not qualify as section 12 sellers.[34] Moreover, because section 12(1) and 12(2) both require a purchaser to prove that a defendant is a section 12 seller before the defendant becomes liable to the purchaser, the question of who constitutes a section 12 seller lies at the heart of every section 12 claim.[35]

When Congress enacted the Securities Act of 1933, Congress defined the terms "sale", "sell", "offer to sell" and "offer for sale".[36] However, Congress did not define the term "seller".[37] In the absence of a statutory definition for the term "seller", the federal courts developed several tests for determining when an individual qualifies as a section 12 seller.[38] The United States Court of Appeals for the First Circuit in *Cady v. Murphy*[39] was one of the first courts to address the question of who constitutes a section 12 seller.[40] In *Cady* a securities broker telephoned Murphy to recommend that Murphy purchase some shares in the South American Utilities Corporation.[41] In the course of the conversation with Murphy, the broker made several false representations about the financial history of South American Utilities.[42] Relying on the representations made by the broker, Murphy purchased stock in South American Utilities.[43] Soon thereafter Murphy discovered that the stock was worthless.[44] The broker's firm

---

34. *See, e.g.,* Abell v. Potomac Ins. Co., 858 F.2d 1104, 1113 (5th Cir. 1988) (stating that all defendants defended against the action by asserting that none of the defendants qualified as § 12 sellers); Lawler v. Gilliam, 569 F.2d 1283, 1286 (4th Cir. 1978) (same); Ahern v. Gaussoin, 611 F.Supp. 1465, 1485 (D.C.Or. 1985) (same).

35. *See* HAZEN, *supra* note 26, at 184 (explaining that § 12 seller status is central to any § 12 cause of action). Although the definition of the term "seller" lies at the heart of § 12 liability, many federal courts decline to draw a distinction between those actions that qualify a defendant as a seller under § 12(1) of the Securities Act and those actions that qualify a defendant as a seller under § 12(2) of the Securities Act. Abell v. Potomac Ins. Co. 858 F.2d 1104, 1115 (5th Cir. 1988); Schillner v. H. Vaughan Clarke & Co., 134 F.2d 875, 878 (2d Cir. 1943).

36. 15 U.S.C. § 77b(3) (1982). *See supra* note 6 (setting forth § 12's definition of terms "sale", "sell", "offer to sell", and "offer for sale").

37. *See* Pinter v. Dahl, 108 S.Ct. 2063, 2076 (noting that Securities Act does not define seller for purpose of § 12 liability).

38. *See infra* notes 132-137 and accompanying text (discussing various tests applied by federal circuit courts of appeal).

39. 113 F.2d 988 (1st Cir.), *cert. denied,* 311 U.S. 705 (1940).

40. Cady v. Murhpy, 113 F.2d 988, 989 (1st Cir.), *cert. denied,* 311 U.S. 705 (1940).

41. *Id.* In *Cady* the plaintiff was a small securities broker and dealer doing business in Maine. *Id.*

42. Cady v. Murphy, 30 F.Supp. 466, 467 (D. Me. 1939). In *Cady* the broker stated falsely that South American Utilities Corporation (South American) had the support of Chase Bank of New York and that Chase thought that South American's stock was a solid investment. *Id.* at 467-68.

43. *Cady,* 30 F.Supp at 468.

44. *Id.* In *Cady* one member of the brokerage house that employed Cady as a broker referred to the stock of South American Utilities as "junk" at the time of the sale to Murphy. *Id.*

refused to buy the securities back from Murphy, forcing Murphy to sell the securities at a substantial loss.[45] Murphy commenced an action against the broker in the District Court of the United States for the District of Maine.[46] Murphy claimed that the broker violated section 12(2) of the Securities Act by selling securities to Murphy by means of materially misleading statements.[47] Before the district court, the broker argued that liability under section 12(2) only applies to the owner of securities when the owner sells the securities to a purchaser.[48] According to the broker, section 12(2) should not apply to the broker because the broker never owned the securities.[49] The district court in *Cady* noted that the definition of the term "to sell" in section 2(3) of the Securities Act provides that an individual must solicit an offer to buy securities to qualify as selling the securities.[50] The district court noted that the broker in *Cady* solicited an offer to buy securities from Murphy.[51] The district court, therefore, found that the broker constituted a seller under section 12.[52] Asserting that the broker did not qualify as a seller, the broker appealed the district court decision to the United States Court of Appeals for the First Circuit.[53] The First Circuit in *Cady* affirmed the decision of the district court and adopted the district court holding that an individual is a section 12 seller if the individual solicits an offer to buy securities.[54] Following the First Circuit decision in *Cady* a number of courts adopted the conclusion in *Cady* that section 12 imposes liability on the seller even without privity between the buyer and the seller.[55]

---

45. Cady v. Murphy, 113 F.2d 988, 990 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940). Before attempting to return the securities in *Cady*, Murphy repurchased all the South American stock Murphy sold to Murphy's customers. *Cady v Murphy*, 30 F. Supp. 466, 467 (D. Me. 1939).

46. *Cady*, 30 F. Supp. at 467.

47. Cady v. Murphy, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940).

48. *Id.* at 989.

49. *Id.* at 990.

50. *Id.* The district court in *Cady* made an important decision to apply the definition of the term "sale" or "offer to sell" in a § 12 case because the injection of the idea of solicitation into the definition of a § 12 seller allowed expansion of § 12 liability beyond purchasers in privity with the owner of the securities. Cady v. Murphy, 30 F. Supp. 466, 469 (D. Me. 1939). The construction of § 12 adopted by the district court allowed the district court to expand § 12 liability to include brokers selling securities for other persons holding title to the securities. *Id.*

51. *Cady v. Murphy*, 113 F.2d 988, 990 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940).

52. *Id.* at 990.

53. *Id.* The broker in *Cady* argued that only the owner of the securities qualified as a § 12 seller because only the owner passed title in the securities to the buyer. *Id.*

54. *Id.* The First Circuit in *Cady* agreed with the district court that in common parlance a person who sells is not only the owner of an object but also the owner's agent authorized to sell the object to a third person. *Id.*

55. Whittaker v. Wall, 226 F. 2d 868 (8th Cir. 1955); Wall v Wagner, 125 F. Supp. 854, 858 (D. Neb. 1954); Wonneman v. Stratford Securities Co., [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,923 (S.D.N.Y. June 26, 1959), *after trial, id.* at ¶ 91,034. The use of § 10b-5 of the Securities Exchange Act of 1934 to bring claims against sellers probably caused the scarcity of § 12 cases prior to the 1970's. *See* O'Hara, *Erosion of the Privity*

Beginning in the 1960's the federal courts began expanding the definition of a section 12 seller far beyond the definition the First Circuit adpoted in *Cady*.[56] The opinion of the United States District Court for the Northern District of Ohio in *Lennerth v. Mendenhall*[57] was largely responsible for the expansion of the definition of section 12 seller.[58] In *Lennerth* an employee of World Wide Automatic Archery Corporation (Archery Corporation) arranged three meetings with the Lennerth family to discuss the financial rewards of purchasing stock in the Archery Corporation.[59] At each of the meetings, the employee told the Lennerths that the Archery Corporation was financially healthy.[60] To improve the employee's credibility, the employee asked Mr. Hegg, the vice president of the Archery Corporation, to attend one of the meetings with the Lennerths.[61] Although the employee solicited an offer to buy stock in the Archery Corporation from the

---

Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller, 31 U.C.L.A. L. Rev. 921, 922-923 (stating that § 12(2) of Securities Act of 1933 is merely a weak stepsister to more powerful § 10(b) of Securities and Exchange Act of 1934). Rule 10b-5 prohibits anyone engaging in a securities transaction from making untrue statements of material facts or omitting facts necessary to make statements true or from engaging in practices that operate a fraud on any person in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5 (1988). Although § 10b of the Securities Exchange Act and rule 10b-5 do not grant expressly a private right of action, federal courts interpret § 10b and rule 10b-5 to provide an implicit private right of action. *See* Herman & Mclean v. Huddleston, 103 S.Ct. 683, 687 (1983) (stating that § 10b implicitly provides private right of action to individuals). In the early 1970's, the United States Supreme Court tightened the requirements necessary for an individual to successfully bring a 10b-5 claim and the stricter requirements contributed to the rise in the number of claims brought under § 12(2) of the Securities Act. *See* O'Hara, *supra*, at 924-26 (explaining increase in popularity of bringing claims under § 12(2) as opposed to rule 10b-5).

56. *See* Abrams, *supra* note 22, at 886-87 (stating that 1964 *Lennerth* decision of Fifth Circuit expanded definition of term "seller" without regard for statutory language of Securities Act); O'Hara, *supra* note 55, at 973-74 (stating that courts adopting proximate cause test promulgated in 1964 *Lennerth* decision significantly expanded § 12(2) liability); *supra* notes 56-131 and accompanying text (discussing expansion of definition of § 12 seller beginning in 1964).

57. 234 F. Supp. 59 (N.D. Ohio 1964).

58. *See* Lennerth v. Mendenhall, 234 F. Supp. 59, 65 (N.D. Ohio 1964) (applying proximate cause theory to securities sales transaction).

59. *Lennerth*, 234 F. Supp. at 64. In *Lennerth*, the World Wide Archery Corporation (Archery Corporation) used newspaper articles to entice individual purchasers to purchase stock in the Archery Corporation. *Id.* at 63. After reading one of the articles, the Lennerths arranged a meeting with the employee to discuss the advantages of investing in the Archery Corporation. *Id.* at 65. According to the employee, the Archery Corporation would use the capital raised by the sale of Archery Corporation's common stock to build a sales center in Cleveland, Ohio. *Id.*

60. *Id.* at 64. In *Lennerth*, at the first meeting between the employee and the Lennerths, the employee described the Archery Corporation as extremely successful and heavily financed. *Id.* At the second meeting between the employee and the Lennerths, the employee told the Lennerth's that the Archery Corporation was financially healthy and displayed a pictorial resume of the proposed sales center. *Id.*

61. *Id.* In *Lennerth*, Hegg assured the Lennerths of the financial health of the Archery Corporation. *Id.*

Lennerths, the employee did not attend the actual transfer of stock from the Archery Corporation to the Lennerths.[62] The Archery Corporation never registered the securities that the corporation sold to the Lennerths with the Securities Exchange Commission (SEC).[63] After the Lennerths discovered that the Archery Corporation was not as financially healthy as the employee had told the Lennerths, the Lennerths commenced an action against the employee and against Hegg in the United States District Court for the Northern District of Ohio.[64] The Lennerths alleged that both the employee and Hegg violated section 12(1) of the Securities Act by selling securities to the Lennerths without complying with the registration requirement of section 5 of the Act.[65]

The district court in *Lennerth* made a lengthy evaluation of whether the employee and Hegg qualified as section 12 sellers.[66] Relying on *Cady*, the *Lennerth* court first stated that a broker can qualify as a section 12 seller even though the broker does not own the securities that the broker sells.[67] The *Lennerth* court reasoned that the liberal remedial spirit of the securities laws mandated that courts could not allow a person to escape liability under section 12 simply because the person was not the actual owner of illegally traded securities.[68] Borrowing principles from common-law negligence, the *Lennerth* court decided that a person qualifies as a seller under section 12 if a sale of the securities flows directly and proximately from the person's actions.[69] Following the proximate cause theory of tort law, the *Lennerth* court found that the Lennerths would not have purchased

62. *Id.*

63. *Id.* at 63.

64. *Id.*

65. *Id.* at 60. In *Lennerth*, the Lennerth's moved for summary judgment claiming that the defendants violated the Securities Act by not registering the securities. *Id.* However, the Lennerths did not specifically allege a violation of § 12 in the complaint. *Id.* Nevertheless, the district court addressed the issue of whether the defendants violated § 12. *Id.* The *Lennerth* court found that the Archery Corporation never registered the securities. *Id.* The *Lennerth* court also found that the employee used the telephone to arrange the sale of the securities which qualified as interstate communication. *Id.* The *Lennerth* court stated that the employee's use of the telephone satisfied the interstate communication requirement of § 12 even though the call originated and terminated in Ohio. *Id.* The district court reasoned that the character of the instrument used and not whether the telephone lines crossed the state line is important in determining the interstate communications requirement. *Id.*

66. *Id.* at 64-65.

67. *Id.* at 64. Although the district court in *Lennerth* acknowledged that brokers can be liable for selling securities for the owner of the securities, the district court found that the employee did not qualify as a broker. *Id.*

68. *Id.* at 65. In deciding *Lennerth* the Fifth Circuit reasoned that the liberal remedial spirit of the federal securities laws suggests that the district court should deviate from the requirement that privity exist between a buyer and a seller because culpable persons were going unpunished. *Id.*

69. *Id.* The district court in *Lennerth* justified use of a proximate cause theory on the assertion that Congress enacted the Securities Act with a liberal remedial purpose. *Id.* The *Lennerth* court, however, failed to ground the justification for applying proximate cause theory to specific statutory language of the Securities Act. *Id.*

the Archery Corporation securities but for the activities of the employee and Hegg.[70] Because the *Lennerth* court found that the employee and Hegg proximately caused the Lennerths to purchase the Archery Corporation securities, the *Lennerth* court held that the employee and Hegg qualified as section 12(1) sellers and were liable for damages under section 12(1).[71]

In 1971, seven years after *Lennerth*, the Fifth Circuit in *Hill York Corp. v. American International Franchises*[72] expressly adopted the proximate cause test set forth by the district court in *Lennerth*, and began to shape the substantial factor test.[73] In *Hill York* the defendants, officers, directors, and sole shareholders of American International Franchises, Inc. (American), created a pyramiding scheme whereby local sales centers created to fund restaurant frachises sold common stock in the local sales centers and funneled the proceeds from the stock sales back to American.[74] The local sales centers supposedly owned franchise rights to several restaurants, but the sales centers never opened the restaurants.[75] The local sales centers used brochures provided by American to solicit buyers and followed solicitation methods that American prescribed.[76] Many of the promotional brochures contained false representations that the franchises were highly

70. *Id.* The district court in *Lennerth* determined that the employee's persuasion and Hegg's credibility directly led to the Lennerth's purchase of Archery Corporation common stock. *Id.* Going one step further, the *Lennerth* court found that the employee and Hegg were not only the proximate cause of the Lennerths' purchase, but the employee and Hegg actually enticed the Lennerths into investing in the corporation. *Id.* The district court supported the statement that the employee and Hegg enticed the Lennerth's to buy Archery Corporation common stock by drawing a now famous analogy between the defendants and hunters. *Id.* The *Lennerth* court stated that a hunter enticing prey towards a trap is no less guilty than the hunter that springs the snare and catches the prey. *Id.* Similarly, the *Lennerth* court analogized that the employee and Hegg enticed the Lennerth's toward the purchase of securities and someone else sprang the trap by consummating the sale of common stock to the Lennerths. *Id.*

71. *Id.*

72. 448 F.2d 680 (5th Cir. 1971).

73. Hill York Corp. v. American International Franchises, 448 F.2d 680, 693 (5th Cir. 1971); *see infra* notes 89-133 and accompanying text (discussing origins and development of substanital factor test).

74. *Id.* at 684. The defendants in *Hill York* developed a pyramid sales scheme to funnel money from the sale of stock in the local sales centers to American International Franchises. *Id.* The local sales centers supposedly would produce income for the investors by investing in restaurant franchises. *Id.* Instead, the proceeds from the sale of the stock in the local sales centers went back to the shareholders of American International Franchises because no actual local restaurant franchises existed. *Id.* Because no actual restaurant franchises existed, the defendants as sole stockholders of American International Franchises reaped the financial benefits of any funds collected by the local representatives from the sale of stock in the local sales centers. *Id.*

75. *Id.*

76. *Id.* at 685. In *Hill York* the defendants gave the local representatives very detailed instructions on methods of persuading investors to purchase stock in the local sales centers. *Id.* The instructions included advice on what type of investors were most susceptible to the purchase of the stock. *Id.* Also, the defendants explained to the local representatives the type of sales pitch that was most effective in selling the securities. *Id.*

successful.[77] A number of persons purchased stock in the franchises and discovered that the stock was worthless.[78] The purchasers commenced an action against American in the United States District Court for the Southern District of Florida.[79] The plaintiffs alleged that the defendants violated sections 12(1) and 12(2) of the Securities Act by failing to register the stock sold to the plaintiffs and by making material misstatements about the value of the stock.[80] The district court in *Hill York* entered judgment in favor of the plaintiffs and granted the plaintiffs damages.[81] The defendants appealed the decision of the district court to the United States Court of Appeals for the Fifth Circuit.[82]

On appeal to the Fifth Circuit, the defendants argued that the defendants were not liable to the plaintiffs under section 12 because the defendants were not the sellers of the securities.[83] To determine whether the defendants qualified as section 12 sellers, the *Hill York* court adopted the proximate cause test described by the district court in *Lennerth*.[84] The *Hill York* court found that because the defendants were the motivating force behind the enterprise, trained the local representatives, provided the sales brochures, the defendants proximately caused the sales transaction.[85] The *Hill York* court, therefore, held the defendants liable as sellers under section 12 of the Securities Act because the defendants were the proximate cause of the sale of securities to the plaintiffs.[86] The *Hill York* court's decision to adopt

---

77. *Id.* The promotional literature shown to the purchasers in *Hill York* falsely stated that one of the defendants was an experienced capitalization consultant. *Id.* The local representatives provided purchasers with glowing reports about the success of other sales centers but failed to mention that other centers were under investigation by the SEC. *Id.*

78. *Id.* Basically, all the purchasers in *Hill York* bought shares in the regional sales centers. *Id.* However, the money to support the sales centers supposedly came from the restaurants franchises. *Id.* Because only one restaurant opened and operated only for a brief period, the shares in the sales centers were worthless. *Id.* at 684.

79. *Id.* at 685.

80. *Id.* In *Hill York* the plaintiffs brought suit against the defendant under § 12 of the Securities Act for return of the money that the defendants paid for the stock plus interest. *Id.*

81. *Id.* at 685-686. The jury awarded to all but two of the plaintiffs return of the purchase price that the plaintiffs paid for stock in the sales centers. *Id.* The jury also assessed punitive damages against American and the two defendants. *Id.* at 686.

82. *Id.*

83. *Id.* at 692. On appeal to the Fifth Circuit the defendants in *Hill York* also argued that the securities in question were exempt from the registration requirement. *Id.* at 686.

84. *Id.* at 693. In considering which test to apply in *Hill York*, the Fifth Circuit rejected the strict privity test as too narrow and accepted the broader proximate cause test as set forth in *Lennerth*. *Id.* at 692.

85. *Id.* at 693. In *Hill York*, the Fifth Circuit stated that a court could find with certainty that the defendant's promotional sales ideas persuaded the plaintiffs to purchase American stock. *Id.*

86. *Id.* Although the *Hill York* court held that the defendants were liable for damages under § 12(1) of the Securities Act, the *Hill York* court stated that § 12 did not allow a plaintiff to recover punitive damages. *Id.* at 698. The *Hill York* court, therefore, reversed the district court's grant of punitive damages to the plaintiffs. *Id.* at 697.

the proximate cause test set forth by the *Lennerth* court marked the first time that a federal court of appeals adopted tort law principles to determine section 12 liability.[87]

Two years after the Fifth Circuit decided *Hill York*, the Fifth Circuit in *Lewis v. Walston & Co.*[88] revised the meaning of the term seller under section 12.[89] In *Lewis* the defendant stock broker telephoned Lewis to discuss the advantages of buying common stock in Allied Automation, Inc. (Allied).[90] Lewis accepted the advice of the broker and purchased stock in Allied.[91] Allied never registered the common stock pursuant to the registration requirement of section 5 of the Securities Act.[92] Soon after Lewis purchased the securities, Allied went into receivership and Lewis' stock became worthless.[93] Lewis commenced an action against the broker in the United States District Court for the Southern District of Florida.[94] Lewis alleged that the broker violated section 12(1) of the Securities Act by selling to Lewis unregistered shares in Allied.[95] The jury in Lewis returned a verdict against the broker.[96] Lewis appealed the district court verdict to the United States Court of Appeals for the Fifth Circuit.[97]

On appeal to the Fifth Circuit, the broker argued that the jury lacked a substantial basis for concluding that the broker was the proximate cause of the sale to Lewis.[98] The broker further argued that because the broker did not proximately cause Lewis to purchase the securities, the broker did

---

87. *See* Note, *supra* note 22, at 372 (stating that *Hill York* was first time any federal circuit court of appeals specifically adopted the proximate cause test for determining § 12 seller liability).

88. 487 F.2d 617 (5th Cir. 1973).

89. *See* Lewis v. Walston & Co., Inc., 487 F.2d 617 (5th Cir. 1973) (revising meaning of term seller by requiring higher standard of proof; substantial factor test).

90. *Lewis*, 487 F.2d at 619. In *Lewis* the broker called Lewis many times to discuss investment opportunities. *Id.* The broker serviced Lewis' securities trading account for approximately one year. *Id.* The broker made very optimistic statements about the prospect of appreciation of the value of the Allied Automation (Allied) stock because Allied was developing a money changing machine. *Id.* The broker compared Allied to IBM. *Id.*

91. *Id.* In *Lewis* Lewis purchased $50,000 worth of Allied stock. *Id.* Another plaintiff in the suit, Mcdonald, purchased $20,000 worth of Allied stock from the broker. *Id.*

92. *Id.* at 621.

93. *Id.* at 619.

94. *Id.* at 618. In *Lewis* Lewis also commenced an action against the brokerage house. *Id.*

95. *Id.* In addition to alleging that the broker in *Lewis* violated § 12(1) & (2) of the Securities Act, Lewis alleged that the broker violated § 10b of the Securities Exchange Act of 1934. *Id.* The trial judge directed verdicts on the § 10b claim in favor of the broker. *Id.* Lewis did not appeal the directed verdict to the Fifth Circuit. *Id.*

96. *Id.* at 619. In *Lewis* the jury awarded the plaintiffs $70,000, which was the equivalent of the purchase price paid by the plaintiffs for the Allied stock. *Id.* After the jury returned a verdict against both the broker and the brokerage firm, however, the judge granted a judgment not withstanding the verdict to the brokerage firm and denied judgment not withstanding the verdict to the broker. *Id.*

97. *Id.* at 617.

98. *Id.* at 622.

not qualify as a seller under section 12.[99] The *Lewis* court noted that the appropriate test for determining whether a person constitutes a section 12 seller is whether the person was the proximate cause of the sale.[100] The *Lewis* court noted that the broker telephoned and persuaded the plaintiffs to purchase the securities.[101] The *Lewis* court reasoned that the jury in *Lewis* permissibly could infer that the broker's actions were a substantial factor in causing the purchase and, therefore, that the broker was the proximate cause of the transaction.[102] Consequently, the *Lewis* court concluded that because the broker was a substantial factor in bringing about the sale of Allied securities, the broker was liable as a section 12 seller.[103] Accordingly, the *Lewis* court affirmed the district court holding of liability on the part of the broker.[104]

Although the *Lewis* court replaced the proximate cause test with the substantial factor test, the *Lewis* court provided no explanation or guidance for future courts to look to when applying the substantial factor test.[105] In an attempt to clarify the substantial factor test, the Fifth Circuit in *Pharo v. Smith*[106] revisited section 12 liability.[107] In *Pharo* the plaintiff, Pharo, purchased common stock in Smith's Pride Foods (Smith's Pride) on the recommendation of Wright, Smith's Pride's vice president for sales.[108] Wright informed Pharo that Smith's Pride planned to make a public offering and that Pharo could resell the securities after the public offering at a sizable profit.[109] While Smith's Pride was considering a public offering of

---

99. *Id.*

100. *Id.* In deciding which test to use to determine a § 12 seller, the *Lewis* court rejected the privity test and adopted the proximate cause test. *Id.* at 621. The *Lewis* court also noted that courts traditionally hold brokers liable as § 12 sellers. *Id.*

101. *Id.* at 622. The Fifth Circuit in *Lewis* noted that the broker called Lewis to advise Lewis to buy Allied stock. *Id.* The *Lewis* court also noted that the broker arranged a meeting with Lewis to discuss investing in Allied stock. *Id.* Additionally, the *Lewis* court noted that the defendant notified Lewis when the defendant located Allied stock for Lewis to purchase. *Id.*

102. *Id.* The *Lewis* court noted that although Lewis was an interested party, the jury found Lewis' testimony that he relied on the representations of the broker reliable. *Id.*

103. *Id.*

104. *Id.* In deciding *Lewis* the Fifth Circuit did not provided an detailed analysis of the substantial factor test. *Id.* Instead the Fifth Circuit merely stated any person who is a substantial factor in bringing about a buyer's purchase of securities is a seller of securities. *Id.*

105. *See* Pharo v. Smith, 621 F.2d 656, 667 (5th Cir. 1980) (noted that *Lewis* statement of substantial factor test is fact specific because court failed to clarify the substantial factor language).

106. 621 F.2d 656 (5th Cir. 1980).

107. Pharo v. Smith, 621 F.2d 656, 667 (5th Cir. 1980).

108. *Pharo*, 621 F.2d at 660.

109. *Id.* In *Pharo* the plaintiffs purchased Smith's Pride stock over an eight month period from mid-September 1968 to April 1969. *Id.* at 659. W.L. Smith and A.J. Smith incorporated Smith's Pride in February 1968 and the financial outlook for the company was encouraging. *Id.* at 659. Within six months after incorporation Smith's Pride considered going public and discussed the possibility of going public with an underwriter. *Id.* The underwriter agreed that Smith's Pride possessed great potential but concluded that Smith's Pride was too young and

stock, the Deltec Corporation (Deltec), Smith's Pride's beef supplier, sued A.J. Smith and W.L. Smith the principle shareholders in Smith's Pride for the balance of credit that Deltec had extended to the Smiths prior to the Smiths incorporation of Smith's Pride.[110] The Smiths settled with Deltec out of court.[111] The settlement agreement provided that the Smiths would transfer 100,000 shares of Smith's Pride stock to Deltec and thereafter would repurchase the shares from Deltec over a period of twelve months.[112] Soon after the settlement a federal audit resulted in a substantial claim for back taxes, therefore, Smith's Pride never made the public offering and never registered the securities with the SEC.[113] Because Smith Pride never made a public offering Pharo never realized a sizeable profit from the stock.[114] Pharo, therefore, commenced an action against both Smith and Deltec in the United States District Court for the Northern District of Alabama.[115] Pharo alleged that the Smiths and Deltec violated section 12(1) of the Securities Act because the defendants sold the Smith's Pride stock

---

unproven to go forward with the public offering. *Id.* However, the underwriter advised Smith's Pride to reincorporate under Delaware law and to hire a nationally certified public accounting firm in anticipation of a public offering. *Id.* The underwriter also promised to reevaluate Smith's Pride in nine months. *Id.* Smith's Pride reincorporated in Delaware and hired a nationally certified public accounting firm. *Id.* W.L Smith and A.J Smith, the founders of Smith's Pride, owned approximately one million shares which was the equivalent of 90% of the Smith's Pride stock. *Id.* To allow a few purchasers to benefit from the future public offering, the Smiths sold some shares of Smith's Pride stock at approximately five dollars per share. *Id.* The Smiths informed the purchasers that Smith's Pride's intended to make a public offering of Smith's Pride securities. *Id.*

110. *Id.* at 662. In *Pharo* Smith's Pride's beef supplier was the Deltec Corporation (Deltec), one of the largest foreign beef packing corporations in the United States. *Id.* When A.J. Smith and W.L. Smith incorporated Smith's Pride, A.J. Smith and W.L. Smith accepted Smith's Pride common stock in exchange for $212,000 worth of foreign beef that the Smiths purchased from Deltec. *Id.* Deltec claimed that the Smith's owed Deltec $493,000 prior to the formation of Smith's Pride. *Id.* The Smiths denied owing Deltec $493,000 and Deltec initiated a suit against the Smiths. *Id.* On October 3 , 1968, after the swearing in the jury, Deltec and the Smith's settled. *Id.* The settlement required the Smith's to transfer to Deltec 100,000 shares of the Smith's stock in Smith's Pride. *Id.* The settlement contract required the Smith's to repurchase the shares transferred to Deltec for five dollars per share. *Id.*

111. *Id.*

112. *Id.* In *Pharo* the Smith's settled with Deltec because the Smith's believed that pending litigation with Deltec would reduce the chances of a public offering of Smith's Pride stock. *Id.* The settlement agreement precluded Deltec from selling the shares to anyone but the Smiths unless the shares were registered pursuant to the requirements of the Securities Act. *Id.* Deltec retained the right to cancel the buy back agreement at any time and keep the shares unencumbered by the Smiths. *Id.* The settlement agreement stated, however, the Smith's Pride shares were subject to the registration requirements of the Securities Act. *Id.*

113. *Id.* at 661. In *Pharo* after a federal tax audit of Smith's Pride, the federal government concluded that Smith's Pride owed the Government two million dollars. *Id.* In addition to the federal tax audit, a downturn in the over-the-counter market in 1969 vastly reduced Smith's Pride's chances of offering stock to the public. *Id.*

114. *Id.* In *Pharo* W.L. Smith offered to buy back all the plaintiffs shares for five dollars per share but the plaintiffs rejected the offer. *Id.*

115. *Id.* at 659.

in violation of the registration requirements of section 5 of the Securities Act.[116] The Smiths and Deltec moved for summary judgment on the grounds that the Smiths and Deltec did not qualify as sellers under section 12.[117] The district court granted Deltec's motion for summary judgment and denied Smiths' motion for summary judgment without making any findings of fact or any conclusions of law.[118] Pharo appealed the district court's grant of summary judgment to Deltec to the United States Court of Appeals for the Fifth Circuit.[119]

On appeal to the Fifth Circuit, Pharo argued that Deltec qualified as a section 12 seller because Deltec played a substantial factor in bringing about the sale of securities to Pharo.[120] Pharo argued that Deltec had a motive to encourage sales of Smith's Pride stock to increase the value of the Smith's Pride stock that Deltec held.[121] Pharo claimed that Deltec especially encouraged the sales of the Smiths' stock because the sale of the Smiths' stock could provide the funds necessary to repay Deltec.[122] Pharo claimed that Deltec encouraged the Smiths and Smith's Pride to sell as much stock as possible and that Deltec's encouragement was a substantial factor in the sale of stock to Pharo.[123] In considering Pharo's argument the Fifth Circuit stated that the proper test for evaluating whether a person constitutes a section 12 seller is a combination of the tests outlined in *Hill York* and *Lewis*.[124] The *Pharo* court noted that the *Hill York* court set forth a proximate cause test[125] while the *Lewis* court declared that an individual is the proximate cause of a sale if the individual is a substantial factor in causing the sale to occur.[126] The *Pharo* court noted that the *Lewis*

---

116. *Id.* The plaintiffs in *Pharo* commenced an action against Smith's Pride under § 12(1) of the Securities Act on May 4, 1971. *Id.* On February 1, 1972, before the parties could settle or adjudicate the § 12(1) action, general creditors filed an involuntary bankruptcy petition against Smith's Pride. *Id.* at 661. On March 9, 1972 a bankruptcy court adjudicated Smith's Pride as bankrupt. *Id.* On May 5, 1972, the district court granted plaintiffs leave to amend the complaint to include Deltec as a defendant. *Id.*

117. *Id.* at 663. In *Pharo* the plaintiff, Pharo, alleged that Deltec violated §§ 12(2) and 17(a) of the Securities Act of 1933. *Id.* Pharo further alleged that Deltec violated § 10(b) and rule 10b-5 the anti-fraud provision of the Securities and Exchange Act of 1934. *Id. See supra* note 55 (discussing § 10b of Securities and Exchange Act of 1934).

118. *Pharo*, 621 F.2d at 663.

119. *Id.*

120. *Id.* at 667-668. In *Pharo* Pharo claimed that Deltec was looking for satisfaction of the debt owed to Deltec by the Smiths. *Id.* Pharo inferred from the fact that Deltec had an option to retain all the shares and seek satisfaction of the debt by selling the shares that Deltec wanted to increase the demand for Smith's Pride shares. *Id.*

121. *Id.* at 667.

122. *Id.*

123. *Id.* The Fifth Circuit in *Pharo* concluded that Deltec contemplated that Smith's Pride would complete the public offering and thus increase the value of the Smith's Pride stock held by Deltec. *Id.*

124. *Id.*

125. *Id. See supra* note 84 and accompanying text (discussing proximate cause test adopted by Fifth Circuit in *Hill York*).

126. *Pharo*, 621 F.2d at 667. *See supra* note 100 and accompanying text (discussing substantial factor analysis applied by Fifth Circuit in *Lewis*).

court defined a substantial factor as more than mere participation in the events that lead up to a sale of securities.[127] The *Pharo* court also noted, however, that other than the statement that the mere participation is not enough to constitute a substantial factor, the only guide to interpreting a substantial factor are the factual situations presented in *Lewis* and *Hill York*.[128] The *Pharo* court decided that an individual is a substantial factor in the sale of securities if the individual's participation in a purchase of securities is a substantial factor in causing the transaction to occur.[129] Turning to the facts in *Pharo* the Fifth Circuit concluded that Deltec was not a substantial factor in the sale of securities to Pharo because Deltec possessed no knowledge of the purchase agreement between Smith's Pride and Pharo.[130] The *Pharo* court, therefore, held that Deltec did not qualify as a seller of Smith's Pride securities and that Deltec was not liable under section 12.[131]

After the Fifth Circuit adopted the substantial factor test in *Pharo*, the Circuit Courts of Appeal for the Fourth, Sixth, Eighth and Eleventh Circuits followed the lead of the Fifth Circuit, and adopted the substantial factor test to determine when an individual qualifies as a seller under section 12.[132]

---

127. *Id.*

128. *Id.*

129. *Pharo*, 621 F.2d at 667. Although the *Pharo* court stated that the substantial factor test is the appropriate test for determining § 12 seller status in the Fifth Circuit, the *Pharo* court acknowledged that the substantial factor test is difficult to articulate and very fact specific. *Id.*

130. *Id.* The *Pharo* court noted that Pharo produced no evidence at trial demonstrating that Deltec had any knowledge of the fact that the Smiths were selling stock to anyone. *Id.* The *Pharo* court further noted that the settlement agreement between Deltec and the Smiths prohibited the Smiths from selling the repurchased shares without registering the stock under the Securities Act. *Id.* Therefore, the *Pharo* court reasoned that Deltec was probably unaware of the sale of Smith's Pride stock to Pharo. *Id.* Because Deltec was unaware of the stock sales, the *Pharo* court concluded that Deltec was not a substantial factor in causing the sales to occur. *Id.* at 668.

131. *Id.*

132. *See* Adalman v. Baker, Watts & Co., 807 F.2d 359, 363 (4th Cir. 1986); Davis v. Avco Fin. Serv., Inc, 739 F.2d 1057, 1066 (6th Cir. 1984); Stokes v. Lokken, 644 F.2d 779, 785 (8th Cir. 1981). In *Adalman*, Baker, Watts & Co. (Baker), an investment banking partnership in Maryland, purchased one third of the stock of Superior Petroleum, Inc. *Adalman*, 807 F.2d at 361. Baker used the one third interest in Superior Petroleum for a private offering of limited partnership interests as tax shelters. *Id.* Baker then solicited buyers for the tax shelters. *Id.* at 362. Baker also employed two securities dealers to assist in the private offering. *Id.* Baker instructed the two securities dealers to use only the prospectus supplied by Baker. *Id.* Adalman and nineteen other investors purchased $1,702,500 worth of interests in the limited partnership. *Id.* Unfortunately for the purchasers of the partnership interest, the partnership went into receivership in 1982 and Clinton Oil Corporation managed the operation of the partnership. *Id.* In April 1983 Adalman and the other investors commenced an action against Baker and the two securities dealers under § 12 of the Securities Act in the United States District Court for the District of Maryland. *Id.* The district court held that Baker qualified as a § 12 seller and held Baker liable under § 12. *Id.* Baker appealed to the United States Court of Appeals for the Fourth Circuit asserting that the district court erred

The Second, Third and Ninth Circuits, however, rejected the substantial

---

by deciding as a matter of law that Baker qualified as a § 12 seller. *Id.*

The Fourth Circuit in *Adalman* stated that persons who are a substantial factor in causing a sale of securities qualify as § 12 sellers. *Id.* at 363. The *Adalman* court further stated that the substantial factor test excludes persons who execute an unsolicited order or have no causal connection in the transaction. *Id.* at 364. The *Adalman* court noted that Baker solicited offers to buy the securities and controlled the solicitations of the two securities brokers employed to solicit offers. *Id.* Therefore, the Fourth Circuit concluded that Baker was a § 12 seller and affirmed the decision of the district court. *Id.* By narrowing the substantial factor test to only those persons soliciting an order to buy or participating in a more significant manner, the Fourth Circuit narrowed the definition of seller from the definition provided by the Fifth Circuit in *Pharo*. *Id.*

Like the Fourth Circuit in *Adalman* the Sixth Circuit adopted the substantial factor test. Davis v. Avco Fin. Serv., Inc., 739 F.2d 1057, 1066 (6th Cir. 1984). In *Davis* the manager of Avco, a finance company, convinced Davis and other investors to purchase shares in a pyramid scheme called "Dare to be Great"(DTBG). *Davis*, 739 F.2d at 1059. A manager of Avco convinced the plaintiffs that DTBG was a sound investment. *Id.* The manager also convinced the plaintiffs to finance the purchase by taking a loan from Avco. *Id.* at 1061. The plaintiffs purchased shares in DTBG financed by Avco loans. *Id.* As with all pyramid schemes, the venture eventually failed and the shares became worthless. *Id.* Davis commenced a suit against Avco in the United States District Court for the Northern District of Ohio. *Id.* The plaintiffs alleged that Avco and the Manager violated § 12(2) of the Securities Act. *Id.* The district court ruled in favor of the plaintiffs and the defendant appealed to the United States Court of Appeals for the Sixth Circuit. *Id.* On appeal, the Sixth Circuit in *Davis* concluded that the appropriate test for determining § 12 seller status was the substantial factor test. *Id.* at 1066. The court reasoned that without the assistance of Avco the plaintiffs would not have purchased the DTBG securities. *Id.* The *Davis* court reasoned that because Avco's loans were necessary for the plaintiffs to purchase the shares of DTBG, the manger and Avco were a substantial factor in causing the sales to occur. *Id.* The *Davis* court, therefore, held that Avco qualified as a § 12(2) seller. *Id.* at 1063.

In addition to the Fourth and Sixth Circuit, the Eighth Circuit adopted the substantial factor test. Stokes v. Lokken, 644 F.2d 779, 785 (8th Cir. 1981). In *Stokes* Stokes purchased gold and silver in bulk from Continental Financial Corporation (CFC) on margin accounts. *Stokes*, 644 F.2d at 785. Prior to the purchases in question, CFC hired Touche, Ross & Co., certified public accountants, to audit CFC's accounts. *Id.* Touche, Ross requested that Lokken's law firm examine CFC's bulk sales of coins on margin accounts to determine if the sales qualified as securities. *Id.* Lokken advised CFC that the bulk sales of coins did not constitute sale of securities. *Id.* Stokes commenced a suit against CFC in the United States District Court for the Northern District of Minnesota. *Id.* Stokes alleged that CFC sold securities without benefit of registration as required by the Securities Act. *Id.* CFC encountered financial difficulties and eventually filed a petition in bankruptcy. *Id.* at 781. After termination of the bankruptcy proceedings, the district court allowed Stokes to amend the complaint to include Lokken. *Id.* The district court granted summary judgment for Lokken and Stokes appealed to the United States Court of Appeals for the Eighth Circuit. *Id.*

On appeal Stokes argued that Lokken qualified as a § 12 seller and that the district court erred in granting summary judgment to Lokken. *Id.* at 781-82. The *Stokes* court concluded that the appropriate test for determining § 12 seller status is whether privity existed between the buyer and seller or the seller was a substantial factor in causing the sales transaction to occur. *Id.* at 785. The *Stokes* court noted that Lokken was not in privity with Stokes and that Lokken's only relation to the sales transaction was a letter responding to the request for legal advice by Touche, Ross. *Id.* The *Stokes* court reasoned that Lokken's involvement in the transaction was too remote to qualify as a substantial factor. *Id.* Therefore, the *Stokes* court held that Lokken did not qualify as a § 12 seller and affirmed the district court grant

factor test and developed alternative tests to define seller's under section 12.[133] For example, under the Second Circuit test, a person was a section 12 seller if privity existed between the person and the individuals that purchased securites from the person.[134] Without privity, the Second Circuit imposes an element of intent on the seller by requiring proof that the seller had knowledge of a material misstatement or had knowledge that the security is illegally unregistered at the time the plaintiff purchased the securities.[135] The Third Circuit, however, held that two types of persons constituted sellers under section 12: an owner of securities who passes title to the securities to a buyer and any person who sells securities to a purchaser while under the control of the owner of the securities.[136] Finally, the Ninth

---

of summary judgment in favor of Lokken. *Id.*

The substantial factor test adopted by the Fifth Circuit in *Pharo* is binding on the Eleventh Circuit due to the division of the Fifth Circuit into the Fifth Circuit and the Eleventh Circuit in 1981. The Fifth Circuit Court of Appeals Reorganization Act of 1980, PUB. L. No. 96-452, 94 Stat. 1994. *See* Foster v. Jesup & Lamont Sec. Co., 759 F.2d 838, 843 & n.14 (11th Cir. 1985) (stating that previous Fifth Circuit § 12 opinions decided before 1981 are binding in Eleventh Circuit).

133. *See infra* notes 134-37 and accompanying text (discussing tests adopted by Second, Third & Ninth Circuits in place of substantial factor test).

134. *See* Mayer v. Oil Field Sys. Corp., 803 F.2d 749, 756 (2d Cir. 1986) (stating that privity or scienter is necessary to prove § 12 seller liability).

135. *See* Akerman v. Oryx Communications, Inc., 810 F.2d 336, 344 (2d Cir. 1987). In *Akerman* the Second Circuit required proof of the seller's scienter in the absence of privity. *Akerman*, 810 F.2d at 344. In *Akerman* Akerman bought Oryx securities from an underwriter for $4.75 per share after Oryx registered the securities with the SEC. *Id.* at 338. Oryx made a material misstatement in the prospectus filed with the SEC overstating net earnings and earnings per share. *Id.* Oryx revealed the mistake to the SEC and the price of shares eventually dropped to $3.50 per share. *Id.* Because of the decline in share price, Akerman commenced an action in the United States District Court for the Southern District of New York. *Id.* Akerman alleged that Oryx violated § 12(2) by making a material misstatement of fact in Oryx's prospectus. *Id.* Oryx motioned for summary judgment arguing that the misstatements were not material and that Akerman was not in privity with Oryx because Oryx bought the securities from the underwriter not from Oryx. *Id.* The district court granted Oryx's motion stating that Akerman lacked privity with Oryx because Akerman purchased the securities from the underwriters. *Id.* at 339. Akerman appealed the decision of the district court to the United States Court of Appeals for the Second Circuit. *Id.*

On appeal to the Second Circuit, Akerman argued that privity is not required to establish Oryx as a seller under § 12 of the Securities Act. *Id.* at 344. The *Akerman* court stated that a successful § 12(2) claim requires a showing of privity between the plaintiff and defendant or in the absence of privity proof of scienter on the part of the seller. *Id.* As proof of scienter the *Akerman* court required knowing misconduct on the part of the seller. *Id.* The *Akerman* court noted that Akerman failed to make a showing that Oryx possessed the requisite knowledge concerning the material misstatement in the registration materials to constitute scienter on the part of Oryx. *Id.* The *Akerman* court, therefore, held that the grant of summary judgment of the district court was appropriate. *Id.*

136. *See* Collins v. Signetics Corp., 605 F.2d 110, 113 (3d Cir. 1979). In *Collins* the Third Circuit set forth the privity based test of seller liability. Collins, 605 F.2d at 113. In *Collins* Collins purchased stock in the Signetics Corporation (Signetics) from Signetics' underwriter Lehman Brothers Company for seventeen dollars a share. *Id.* at 12. Shortly after Collins purchased Signetics stock, the United States Phillips Corporation (Phillips) merged with

Circuit held that a person qualified as a section 12 seller if the person's actions were not only a substantial factor in a sale of securities but also a necessary factor in the sale of the securities.[137]

Signetics. *Id.* Phillips required Collins to surrender Collins' shares for eight dollars a share. *Id.* Collins commenced an action against Signetics in the United States District Court for the Eastern District of Pennsylvania. *Id.* Collins alleged that Signetics violated § 12(2) of the Securities Act because the majority shareholder of Signetics intended to sell his shares in Signetics for along time before Collins purchased stock in Signetics but Signetics never informed Collins of the planned sale. *Id.* at 112-113. The district court construed § 12 to require some form of privity between a seller and a purchaser in the absence of a special relationship such as control of the seller by the issuer before the court would hold a defendant liable as a § 12 seller. *Id.* at 112. The district court found that although privity existed between Collins and the underwriter, privity did not exist between Collins and Signetics. *Id.* The district court concluded that Signetics did not qualify as a § 12 seller and dismissed Collins' claims. *Id.* Collins appealed the district court decision to the United States Court of Appeals for the Third Circuit. *Id.* at 113.

On appeal the *Collins* court agreed with the district court that § 12 requires privity between the seller and buyer in the absence of a controlling relationship. *Id.* at 112. The *Collins* court reasoned that the language of § 12 required privity because § 12 only allows the purchaser to bring a claim against the purchaser's immediate seller. *Id.* at 113. Adding to the analysis of the language, the *Collins* court noted that any broader interpretation of § 12 would torture the plain meaning of the language. *Id.* The *Collins* court reasoned that Collins did not have a § 12 claim against Signetics because the transfer of title to the securities was between the underwriter and Collins. *Id.* at 114. The *Collins* court also found that Signetics was not in a special relationship with the underwriter because Signetics did not control the selling practices of the underwriter. *Id.* at 113. The *Collins* court, therefore, held that Collins had no claim under § 12 against Signetics because Signetics did not constitute a seller under § 12 of the Securities Act. *Id.* at 114.

137. Anderson v. Aurotek, 774 F.2d 927, 930 (9th Cir. 1985). In *Anderson* the Ninth Circuit applied a test requiring that a seller's actions be necessary to and a substantial factor in the sales transaction. *Anderson*, 774 F.2d at 930. In *Anderson* the defendants formed a joint venture to exploit a mining claim in Idaho. *Id.* at 929. To exploit the mining claim, the defendants formed the Aurotek Corporation and sold fractional interests in the mining claim. *Id.* The defendants never registered the fractional interests with the SEC. *Id.* The defendants hired a retailer of tax shelters to sell the securities and Anderson purchased interests in the mining claim from the retailer. *Id.* When the mine failed to produce gold, Anderson commenced an action against the defendants under § 12 in the United States District Court for the Western District of Washington. *Id.* The district court held that the defendants violated § 12 and granted summary judgment against the defendants. *Id.* The defendants appealed to the United States District Court for the Ninth Circuit. *Id.*

On appeal the defendants argued that the defendants failed to qualify as sellers of the fractional interests because the defendants did not offer or sell the securities to Anderson. *Id.* In reviewing the defendants claim, the Ninth Circuit directly quoted an earlier Ninth Circuit decision that required a showing of necessary and substantial involvement in a sales transaction by a defendant to qualify the defendant as a seller under § 12. *Id.* The Ninth circuit further stated that the terms substantial and necessary involvement included a showing that the defendant's actions were the "but for" cause of the sale and that the defendant's involvement was more that incidental. *See id.* at 930 (quoting SEC v. Murphy, 626 F.2d 633, 649-650 (9th Cir. 1980). The *Anderson* court found that the defendants actions were not necessary to and a substantial factor in the sales transaction because the defendants left the solicitation of offers to buy the interests and the closing of sales of the interests to the tax shelter retailer. *Id.* at 930. Accordingly, the *Anderson* court held that the defendants were not sellers of the securities and reversed the district court grant of summary judgment in favor of Anderson. *Id.*

Because the circuit courts employed four different tests to determine which individuals constitute a seller under section 12, the circuit courts produced conflicting results.[138] In addition to the conflict among the federal circuit courts, the tests lacked clarity.[139] As a result of the lack of clarity, securities professionals increasingly were unable to predict the level of involvement in a securities transaction that qualified a participant as a section 12 seller.[140]

As a result of conflict between the federal courts of appeal, and the lack of clarity surrounding the substantial factor test, the United States Supreme Court in *Pinter v. Dahl*[141] addressed the question of who constitutes a seller under section 12.[142] Pinter was an oil and gas producer in Texas and Oklahoma.[143] Dahl was a California real estate broker and investor pursuing oil and gas ventures.[144] Dahl advanced Pinter $20,000 to locate oil and gas leases with the understanding that if Pinter located any viable leases, Pinter would hold the leases in the name of Pinter's Black Gold Oil Company.[145] Pinter located some oil and gas leases in Oklahoma and Dahl invested approximately $310,000 in the leases.[146] Believing that the leases were a sound investment, Dahl advised friends, family and business associates to buy the leases and assisted the investors in purchasing the leases.[147] Dahl did not receive a commission for convincing the other investors to invest in the leases.[148] Although section 5 of the Securities Act required Pinter to register the leases before selling the leases to Dahl and the other

138. *See supra* notes 132-137 and accompanying text (discussing various test applied by various circuits and results of various test).

139. *See* Comment, *Attorneys Beware: Increased Liability for Providing Advice to Corporate Clients Issuing Securities*, 20 Akron L. Rev. 525-527 (1987) (discussing lack of specificity of various tests that courts use to determine § 12 seller status).

140. *See id.* (discussing increasing § 12 liability for securities professionals due to changing definitions of § 12 seller); Rapp, *Expanded Liability Under Section 12 of the Securities Act: When Is A Seller Not A Seller?*, 27 Case W. Res. L. Rev. 445 (1977) (discussing varying tests of § 12 liability since enactment of Securities Act).

141. 108 S.Ct. 2063 (1988).

142. Pinter v. Dahl, 108 S.Ct. 2063, 2067 (1988).

143. *Pinter*, 108 S.Ct. at 2063. In *Pinter* Pinter formed several corporations to effectuate Pinter's production of oil and gas. *Id.* The companies were Black Gold Oil Company, Pinter Energy Company, and Pinter Oil Company. *Id.* at n.1.

144. *Id.* at 2067.

145. *Id.* In *Pinter* Dahl advanced $20,000 to Pinter to locate the oil and gas leases with the understanding that Dahl would have the right of first refusal to drill wells on leased properties. *Id.*

146. *Id.* In *Pinter* Dahl toured property that Pinter located and discussed the possibilities of discovering oil on the property with Dahl. *Id.* Dahl also examined the geology, drilling logs, and production histories of the property and concluded that the leases were a sound investment. *Id.*

147. *Id.* In *Pinter* Dahl convinced his brother, his accountant, his partner in a construction business, the bank officer handling his construction loans, his construction-business insurance agent, and several friends to purchase Pinter's leases. *Id.* at n.2.

148. *Id.* at 2068.

investors, Pinter never complied with section 5.[149] Eventually the oil venture failed and the leases proved worthless.[150] Dahl and the other investors commenced an action against Pinter in the United States District Court for the Northern District of Texas.[151] Dahl claimed that Pinter violated section 12(1) of the Securities Act because Pinter sold the leases without registering the leases as section 5 of the Securities Act required.[152] After the district court entered judgment against Pinter, Pinter appealed the decision of the district court to the United States Court of Appeals for the Fifth Circuit.[153]

On appeal to the Fifth Circuit Pinter claimed that Dahl committed fraud by inducing Pinter to sell the leases in violation of the registration requirements of the Securities Act.[154] The Fifth Circuit rejected Pinter's claim of fraud and affirmed the district court's judgment against Pinter.[155] The Fifth Circuit next considered whether Dahl qualified as a seller under section 12 because the Fifth Circuit assumed that if Dahl qualified as a seller under section 12, Dahl's activities entitled Pinter to recover contribution from Dahl.[156] The Fifth Circuit applied a modified version of the substantial factor test.[157] The Fifth Circuit stated that a person qualifies as a section 12 seller if the person either transfers title to the securities in exchange for consideration, or if the person's participation in the sale of

149. *Id.* In *Pinter* Pinter disclosed on the securities that the securities were not registered with the SEC. *Id.* at 2067. Pinter stated on the face of the securities that the securities were available to a limited number of sophisticated investors and, therefore, SEC Rule 146 exempted the securities from the registration requirement of § 5 of the Securities Act. *Id.* at 2068. *See* Rule 146, 17 C.F.R. § 230.146 (1982) (codifying exceptions to registration requirement of § 5). Rule 146 prohibited general advertising of the securities offering and only allowed the sale of securities to sophisticated buyers who had access to the same kind of information contained in a registration statement. 17 C.F.R. § 230.146 (1982). SEC Rule 146 has been superceded by Regulation D, 17 C.F.R. § 425 (1988).

150. *Pinter*, 108 S.Ct. at 2068.

151. *Id.*

152. *Id.* at 2068. In addition to claiming in *Pinter* that Pinter violated § 12(1) of the Securities act, Dahl also claimed that Pinter violated § 12(2) of the Securities Act because Pinter made material misrepresentations about the oil and gas leases and Pinter's experience in the oil and gas industry. *Id.* at 2068 n.4. Pinter counterclaimed that Dahl, by means of fraudulent misrepresentation, induced Pinter to sell the securities without benefit of registration. *Id.* In addition to claiming that Dahl induced Pinter to sell the oil and gas leases by fraud, Pinter also claimed that the oil and gas interest were exempt from registration and, therefore, § 12 did not apply to the sales transaction. *Id.* at 2069. Pinter alleged that Dahl promised Pinter that only qualified, sophisticated and knowledgeable buyers would purchase the securities. *Id.* at 2068.

153. Dahl v. Pinter, 787 F.2d 985, 987 (5th Cir. 1986).

154. *Id.*

155. *Id.* at 991.

156. *Id.* at 990. The Fifth Circuit, in *Pinter* considered whether Dahl qualified as a seller of the securities even though none of the other investors brought a § 12 claim against Dahl. *Id.* The Fifth Circuit addressed the issue of whether Dahl was a § 12 seller because Pinter made the § 12 seller claim on appeal. *Id.*

157. *Id.* In deciding *Pinter*, the Fifth Circuit applied a modified substantial factor test. *Id.* The Fifth Circuit modified the substantial factor test by adding a financial motivation requirement to the traditional substantial factor test. *Id.*

the securities is a substantial factor in causing the sale to occur.[158] The Fifth Circuit also conditioned the determination of whether an individual qualifies as a section 12 seller on the requirement that the person must be motivated by a desire to benefit someone other than the person purchasing the securities.[159] After examining the facts in *Pinter* the First Circuit reasoned that because Dahl neither sought nor received any form of commission in return for advising the investors to buy the securities, Dahl was motivated only by a desire to help other investors.[160] The Fifth Circuit concluded, therefore, that Dahl was not a seller for purposes of section 12 and that Dahl did not owe any contribution to Pinter.[161] Pinter appealed the Fifth Circuit's decision to the United States Supreme Court.[162]

The Supreme Court granted *certiorari* in *Pinter* because of the importance of the issue of section 12 liability in the administration of federal securities law.[163] In considering *Pinter* the Supreme Court first noted that the Securities Act does not define the term "seller" and that the legislative history of the Securities Act provides little assistance in defining the term "seller".[164] The *Pinter* Court found that, at the very least, the language of section 12 requires that an individual who transfers title of securities to another for value must qualify as a section 12 seller.[165] The Court further noted, however, that section 2(3) of the Securities Act defines the terms "sale" and "sell" to include every attempt or offer to dispose of securities and every solicitation of an offer to buy securities.[166] The *Pinter* Court reasoned that the language of section 2(3) broadens the range of persons potentially liable under section 12 beyond those persons who simply transfer title to the securities to another for value.[167] The Court found that the inclusion of the phrase "solicitation of an offer to buy" in the definition of the phrase "offer to sell" is expansive enough to encompass the entire selling process.[168]

---

158. *Id.*

159. *Id.* at 991. In deciding which persons constitute § 12 sellers the Fifth Circuit, in *Pinter*, reasoned that imposing liability on an individual for giving gratuitous advice to friends and family unnecessarily interferes with patterns of social discourse. *Id.* The Fifth Circuit, therefore, added the requirement that a § 12 seller act out of motivation for himself or the owner of the securities. *Id.*

160. *Id.* at 992. The dissent in *Pinter* argued that Pinter was motivated by a desire to help himself. *Id.* at n.3. The dissent maintained that by increasing the number of investors, Dahl increased the amount of capital and decreased the amount of risk per investor. *Id.* By increasing capital in the venture and decreasing the risk, the dissent noted that Pinter benefitted financially. *Id.*

161. *Id.* at 990. The Fifth Circuit, in *Pinter*, acknowledged that Dahl was a substantial factor in causing the sale of the securities to the other investors. *Id.*

162. Pinter v. Dahl, 481 U.S. 1012 (1987).

163. *Id.* at 2070.

164. *Id.* at 2076. The *Pinter* court stated that the statutory construction of the Securities Act must begin with the plain language of the Securities Act. *Id.*

165. *Id.*

166. *Id.* at 2076. *See supra* note 6 (setting forth § 2(3) of Securities Act).

167. *Pinter*, 108 S.Ct. at 2076.

168. *Id.* The *Pinter* court reasoned that solicitation of an offer to buy is not an activity

The *Pinter* Court stated, however, that not everyone involved in the selling process should qualify as a section 12 seller.[169] The Court stated that section 12 only imposes liability on persons from whom a buyer purchased securities.[170] Balancing the definition of the term "sale" and the requirement that a buyer must purchase from a section 12 seller, the *Pinter* Court promulgated a new test for determining whether a person qualifies as a section 12 seller.[171] To qualify as a section 12 seller under the *Pinter* test, a person must either transfer the title of securities to a purchaser or successfully solicit an offer to buy securities from the purchaser.[172] The *Pinter* test also requires that a person who solicits the sale of the securities must be motivated by a desire to provide financial benefit to himself or to the owner of the securities.[173]

---

confined to the actual owner of the securities. *Id. See supra* note 6 (setting forth § 2(3) definition of "offer to sell").

169. *Pinter*, 108 S.Ct. at 2077. Although the *Pinter* Court expanded the definition of seller beyond persons in privity with the buyer, the *Pinter* Court acknowledged that liability attaches only to the immediate purchaser of the security from the seller. *Id.* at n.21. Therefore, liability attaches only to the buyer's immediate seller. *Id.*

170. *Id.* at 2077. The *Pinter* Court noted that the Securities Act neglects to define the term "purchase" but that the best construction of the term "purchase" is a correlative to the terms "sell" and "offer". *Id.* The *Pinter* Court found that the term "purchase" requires an individual to actively solicit an offer to buy securities. *Id.*

171. *Id.* at 2079. In deciding to promulgate a test for determining who constitutes a § 12 seller, the Supreme Court, in *Pinter*, acknowledged that most courts and commentators use the same definition of a seller under § 12(1) or § 12(2) regardless of the fact that § 12(1) and (2) apply to different situations. *Id.* at 2076 n.20. The *Pinter* Court relied on both § 12(1) and (2) cases to develop the *Pinter* Court's definition of the term seller. *Id.* However, because the decision in *Pinter* concerned § 12(1) of the Securities Act the Supreme Court declined to take a position concerning the application of the *Pinter* definition of the term seller to claims under § 12(2) of the Securities Act. *Id.*

172. *Id.* at 2079. In deciding *Pinter*, the Supreme Court reasoned that solicitation of an offer to sell is important because solicitation is the point in the sale of securities in which the investor is most likely to receive information about the security. *Id.* at 2078. The *Pinter* Court reasoned that because Congress enacted the Securities Act to prevent injury to buyers of securities and that solicitation is the stage when most investors receive information about the stock, solicitation is very important to the definition of seller. *Id.*

173. *Id.* at 2079. The *Pinter* Court stated that a person does not qualify as a seller by soliciting an offer to buy securities if the person simply gives gratuitous advice intended to benefit another. *Id.* at 2078. Interestingly, the *Pinter* Court's reasoning closely parallels the reasoning of the First Circuit's decision in *Cady v. Murphy*. Cady v. Murhpy, 113 F.2d 988, 990 (1st Cir), *cert. denied*, 311 U.S. 705 (1940). In *Cady* the First circuit construed the term "seller" to include more than those persons who transfer title to securities. *Cady*, 113 F.2d at 990. *See supra* notes 50-55 and accompanying text (discussing First Circuit's reasoning in *Cady* for expanding definition of term seller beyond persons transferring title to securities). Like the Fifth Circuit in *Cady*, the *Pinter* court also interpreted § 12 to include more than persons who transfer title to securities. Pinter v. Dahl, 108 S.Ct 2063, 2076 (1988). In addition to expanding the term seller beyond those individuals who pass title to the securities, the *Cady* court construed § 12 to require a seller to solicit an offer to buy from the purchaser. *Cady*, 113 F.2d at 990. Similarly, the Supreme Court in *Pinter* interpreted § 12 to require a seller to solicit an offer to buy securities from the purchaser. *Pinter*, 108 S.Ct. at 2077. Additionally, while the First Circuit in *Cady* expressly declined to decide whether the motivation of the

In deciding *Pinter*, the Supreme Court determined that Dahl's activities in contacting and assisting friends, family members, and business associates in buying the oil and gas leases qualified as soliciting offers to buy the securities.[174] The Court found the record unclear, however, on whether Dahl solicited the offers to buy the leases because of a desire to benefit Pinter or himself, or whether Dahl was motivated solely by a desire to benefit Dahl's friends, family members, and business associates.[175] The *Pinter* Court, therefore, vacated the Fifth Circuit's decision and remanded the case to the Fifth Circuit instructing the Fifth Circuit to determine Dahl's motivation for soliciting offers to buy the leases.[176]

In deciding *Pinter* the Supreme Court expressly rejected the substantial factor test.[177] The *Pinter* Court noted three reasons for rejecting the substantial factor test.[178] First, the *Pinter* Court stated that the substantial factor test divorces analysis of who constitutes a section 12 seller from the applicable statutory scheme of the Securities Act.[179] Second, the *Pinter* Court stated that the language of section 12 focuses on the relationship between the seller and the purchaser while the substantial factor test incorrectly focuses on the defendant's degree of involvement in a securities transaction.[180] Third, the *Pinter* Court stated that the broad remedial goals of the Securities Act do not support a test such as the substantial factor test without some statutory language or legislative history supporting the test.[181] The *Pinter* Court concluded that a person is not liable as a section

---

person soliciting an offer to buy may disqualify that person as a § 12 seller, the dissent in *Cady* argued that a person motivated solely by a desire to benefit the purchaser and not the owner of the securities is not a § 12 seller. *Cady*, 113 F.2d at 991. The *Pinter* court similarly stated that if a person solicits the purchase of securities motivated by a desire to benefit the purchaser, the person does not qualify as a seller for § 12 purposes. *Pinter*, 108 S.Ct. at 2079. The similarities between the Supreme Court's decision in *Pinter* and the First Circuit's decision in *Cady* stem from a philosophy of closely construing sections of the Securities Act according to the language of the Act and the intent of the drafters. *Pinter*, 108 S.Ct. at 2081-2082; *Cady*, 113 F.2d at 990-991.

174. *Pinter*, 108 S.Ct. at 2082.

175. *Id.* at 2083.

176. *Id.*

177. *Id.* at 2082. The Supreme Court in *Pinter* expressly rejected the substantial factor test but declined to comment on the definition of the term seller as adopted by other federal circuit courts of appeal. *Id.*

178. *Id.* at 2079-2082.

179. *Id.* at 2080. The *Pinter* Court noted that when federal courts employ the substantial factor test, the federal courts substitute tort concepts of proximate causation for the statutory language of the terms "offer" or "sell" that Congress provided in § 2(3) of the Securities Act. *Id.* at 2080-81.

180. *Id.* at 2081. In *Pinter* the Supreme Court stated that by focusing on a defendant's relationship with the securities transaction and not the defendant's relationship with the purchaser, courts extend liability to persons only remotely related to the relevant aspects of the securities transaction. *Id.* The *Pinter* Court stated that the substantial factor test improperly exposes securities professionals to liability under § 12 merely because the professional performs duties that are necessary to the completion of the transaction. *Id.*

181. *Id.* at 2081-82. The *Pinter* Court stated that courts must construe the Securities Act

12 seller simply because the person is a substantial factor in causing the sale of securities.[182]

The *Pinter* decision will affect many federal courts because the *Pinter* decision rejects the substantial factor test and introduces a new test for determining when individuals qualify as sellers under section 12.[183] Under the *Pinter* test an individual constitutes a seller for purposes of section 12 if the individual either transfers the title of securities to a purchaser or successfully solicits an offer to buy securities.[184] The *Pinter* test also requires that an individual be motivated by a desire to benefit financially the individual or the owner of the securities.[185]

By replacing the substantial factor test with the *Pinter* test, the *Pinter* Court narrowed the range of persons who qualify as sellers under section 12.[186] For instance, prior to the *Pinter* decision courts applying the substantial factor test found that attorneys drafting securities agreements,[187] accountants analyzing investments,[188] and investment bankers assisting in

---

by evaluating both the statutory language and the legislative intent of Congress. *Id.* at 2082. The *Pinter* Court noted that § 12 does not reveal any congressional intent to inject tort law concepts such as reliance and causation into the elements of § 12 liability. *Id.*

182. *Id.*

183. *Id.* By expressly overruling the Fifth Circuit's use of the substantial factor test in § 12(1) cases, the *Pinter* Court nullified the substantial factor tests of the Fourth, Sixth, Eighth and Eleventh Circuits. *See supra* note 132 and accompanying text (discussing adoption of substantial factor test by Fourth, Sixth, Eighth and Eleventh Circuits). Similarly, the *Pinter* court rejected the Second Circuit's requirement of privity between a buyer and a seller. *Pinter,* 108 S.Ct. at 2076. *See supra* notes 134-35 and accompanying text (discussing Second Circuit's interpretation of § 12 as requiring privity between the seller and purchasers or proof of scienter on the part of sellers). Additionally, the Third Circuit's requirement of privity between a buyer and § 12 seller or a special relationship the owner and the owner's agent now conflicts with the *Pinter* Court's decision to reject the privity test. *See supra* note 136 and accompanying text (discussing Third Circuit's test for determining which persons constitute § 12 sellers). Finally, the Ninth Circuit's test requiring that § 12 sellers must be a substantial factor in completing a sale along with a necessary component of the sale now stands in conflict with the Supreme Court's decision in *Pinter. Pinter,* 108 S.Ct. at 2082. *See supra* note 137 and accompanying text (discussing Ninth Circuit's test for determining § 12 liability).

184. *Pinter,* 108 S.Ct. at 2078.

185. *Id.* at 2079. *See supra* notes 172-174 and accompanying text (discussing *Pinter* test for § 12(1) seller).

186. *Id.* at 2081. In rejecting the substantial factor test, the *Pinter* Court stated that the substantial factor test was too expansive. *Id.* The *Pinter* Court stated that the substantial factor test imposed liability on persons who were only remotely related to the sale of securities. *Id.* The *Pinter* Court noted that the substantial factor test could result in the imposition of § 12 liability on lawyers and securities professionals who merely operated in a professional capacity but did not solicit purchase of securities. *Id.*

187. *See* Koehler v. Pulvers, 1985-86 Fed. Sec. L. Rep. (CCH) ¶ 92,232 at 91,666 (S.D.Cal. July 9, 1985) (holding attorney liable as § 12 seller for preparing loan brokerage agreement that allowed sale of securities to go forward).

188. *See* Gold v. LTV Corp., 1984 Fed. Sec. L. Rep. (CCH) ¶ 91,654 at 99,307 (N.D. Texas Aug. 24, 1984) (denying reconsideration of judgement against accountant because accountant's evaluation of company's financial position could be a substantial factor inducing sales of stock).

securities transactions[189] all qualified as section 12 sellers.[190] After *Pinter*, however, attorneys, accountants, and bankers are less likely to qualify as sellers by merely performing professional services that do not involve direct solicitation of buyers of securities.[191] The *Pinter* test of section 12 liability requires the attorneys, accountants and investment bankers to solicit directly an offer to buy securities from their clients.[192] Although the *Pinter* test narrows the test for determining section 12 seller liability, certain ambiguities arise from the language of the test.[193] First, the *Pinter* Court did not define the level of participation in a sales transaction that qualifies as solicitation of an offer to buy securities.[194] The *Pinter* Court stated that securities brokers solicit sales of securities.[195] The *Pinter* Court also stated that attorneys who merely perform legal services do not qualify as sellers.[196] The *Pinter* court did not explain, however, the level of participation between the two extremes that will qualify an individual as a seller under section 12.[197] Second, the requirement that financial benefit must accrue to the seller or owner as a result of an offer to buy securities is ambiguous because the *Pinter* Court did not define financial benefit.[198] Thus after *Pinter*, federal courts must decide on their own, within limits, the level of involve-

---

189. *See* Adalman v. Baker, Watts & Co., 807 F.2d 359, 365 (4th Cir. 1986) (holding that investment banker's role in arrangement of limited partnerships sold to plaintiffs was substantial factor in causing sale of securities).

190. *See supra* notes 187-89 and accompanying text (discussing application of § 12 to accountants, investment bankers, and attorneys).

191. *See* Murphy and Weiss, *Decision Clarifies Who is Liable In Sales of Unregistered Securities*, Nat'l L.J., Oct. 3, 1988, at 20, col. 2. (discussing narrowing affect of *Pinter* decision especially concerning courts formerly applying substantial factor test and impact of *Pinter* decision on securities professionals).

192. *See* Pinter v. Dahl, 108 S.Ct. 2063, 2078 (1988) (stating solicitation as requirement for § 12 liability).

193. Weiss & Murphy, *supra* note 191, at 20, col. 2.

194. *Id.* at 21, col. 1. Commentators have speculated that after *Pinter* parties will litigate the question of whether participants in a securities transaction solicited a sale of securities. *Id.* Since the *Pinter* decision, several defendants in § 12 actions have argued that the defendants did not qualify as § 12 sellers under the *Pinter* test because the defendants did not solicit offers to buy the securities. *See* Lee v. Spicola, [Current Decisions] Fed. Sec. L. Rep. ¶ 94,120 at 91,263-264 (M.D.Fla. Dec. 9, 1988) (motioning for summary judgment on theory that defendant did not solicit offer to buy securities); Jackson v. First Federal Savings of Arkansas, [Current Decisions] Fed. Sec. L. Rep. (CCH) ¶ 94,123 at 91,307 (E.D. Ark. Nov. 15, 1988) (accepting defendants argument that defendants did not qualify as a § 12(2) seller because plaintiff failed to plead that defendant solicited purchase of securities from plaintiffs).

195. Pinter v. Dahl, 108 S.Ct. 2063, 2078 (1988). Although the *Pinter* Court did not define solicitation, the *Pinter* Court found that when a securities broker contacts an investor and convinces the investor to purchase securities, the broker's actions qualify as soliciting an offer to buy securities. *Id.*

196. *Id.*

197. Murpy & Weiss, *supra* note 191, at 21, col. 1.

198. *See id.* (concluding that federal courts will define on their own what constitutes solicitation and financial benefit).

ment in a securities sales transaction and the type of financial gain that will qualify an individual as a section 12 seller.[199]

Since the Supreme Court's decision in *Pinter* in June 1988, several federal circuit courts have considered whether an individual qualifies as a seller under section 12.[200] In *Abell v. Potomac Insurance Co.*[201] the Fifth Circuit applied the *Pinter* test to evaluate the question of a defendant's liability under section 12.[202] In *Abell* the defendant, a real estate developer, created a nonprofit corporation, Westside, for the care of severely mentally and emotionally disturbed individuals.[203] The developer funded the project by issuing municipal bonds.[204] The second defendant in *Abell*, a law firm, acted as counsel in preparing the bond offering.[205] The plaintiffs in *Abell* purchased Westside bonds from a securities broker.[206] Soon after Westside issued the bonds, Westside's financial structure began to deteriorate and eventually the underwriter revealed to the bondholders all the information that the developer had originally withheld from the bondholders.[207] After the underwriter disclosed the fact that the offering materials were incorrect, the plaintiffs commenced an action in the United States District Court for the Western District of Louisiana against the developer and the law firm.[208] The plaintiffs claimed that because the developer and the law firm developed Westside, the defendants' actions were substantial factors in causing the issuance of the Westside bonds that the plaintiffs purchased.[209] The plain-

---

199. *See infra* notes 200-46 and accompanying text (discussing subsequent federal court opinions attempting to delineate what activities constitute solicitation).

200. *See id.* (discussing decision of Fifth Circuit in Abell v. Potomac Ins. Co., Second Circuit in Capri v. Murphy and Ninth Circuit in Harleson v. Miller Fin. Corp.).

201. 858 F.2d 1104 (5th Cir. 1988).

202. Abell v. Potomac Ins. Co., 858 F.2d 1104, 1113 (5th Cir. 1988).

203. *Abell*, 858 F.2d at 1109. The developer in *Abell* purchased seven acres of land and a thirty year old vacant school building in Cheneyville, Louisiana for $100,000. *Id.*

204. *Id.* at 1110. The developer in *Abell* incorporated Westside with the intent of financing the corporation initially with a sale of municipal bonds. *Id.* The developer convinced the town of Cheneyvile to back a $13,550,000 municipal bond issue for Westside. *Id.*

205. *Id.* at 1111. The underwriter for the Westside project hired the law firm of Wright, Lindsey & Jennings (WLJ) to act as bond counsel for the project. *Id.* WLJ proceeded to do a "due diligence" review of the underwriter's public offering materials to assure compliance with federal securities laws. *Id.* WLJ failed, however, to discover a feasibility study prepared before WLJ joined the project. *Id.* The feasibility study concluded that the Westside project was unfeasible because the Westside project depended on Medicaid for revenue. *Id.* WLJ prepared and distributed the offering materials without mention of the unfavorable feasibility study. *Id.*

206. *Id.* at 1112.

207. *Id.*

208. *Id.* In *Abell*, two months after the plaintiffs commenced the suit against the developer and WLJ, Westside filed a voluntary petition for bankruptcy. *Id.* The bankruptcy court restructured the interest on the bonds by reducing the annual interests from approximately 16% to approximately 10% on most of the bonds. *Id.* As a result of the reduction in the annual yield of Westside's bonds, the Westside bondholders suffered a significant reduction in income. *Id.*

209. *Id.* at 1115.

tiffs, therefore, claimed that the defendants were liable under section 12 because the defendants were a substantial factor in causing the sale of securities.[210] The district court, in *Abell*, entered judgment for the plaintiffs.[211] The defendants appealed the district court decision to the United States Court of Appeals for the Fifth Circuit.[212]

On appeal to the Fifth Circuit, the defendants argued that the defendants did not qualify as section 12 sellers.[213] In deciding *Abell* the Fifth Circuit relied on *Pinter* to determine whether the defendants qualified as section 12 sellers.[214] The *Abell* court decided that under *Pinter* a court should make two inquiries to determine whether an individual qualifies as a section 12 seller.[215] According to the *Abell* court, the first inquiry considers whether the defendant passed title to the securities to a purchaser or solicited the transaction in which title passed to the purchaser.[216] The second inquiry asks whether the purchaser bought the securities from the defendant.[217] The *Abell* court noted that if a person solicited an offer to buy, the person also must have solicited the sale because of a desire to benefit the person or the owner of the securities to qualify as a seller under section 12.[218] The Fifth Circuit found in *Abell* that title to the Westside bonds and the solicitation of the offers to buy the bonds came from the underwriter and the previous owners of the bonds.[219] The *Abell* court further found that none of the plaintiffs purchased Westside bonds from the developer or the law firm that prepared the offering materials.[220] The *Abell* court held, therefore, that the defendants were not liable as sellers under section 12 of the Securities Act because the defendants did not satisfy the two part test set forth in *Pinter*.[221]

---

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.* at 1113. The *Abell* court noted that the defendants asserted a valid defense by claiming not to qualify as sellers because only sellers of securities are liable under § 12. *Id.*

214. *Id.* at 1113.

215. *Id.*

216. *Id.* In deciding *Abell*, the Fifth Circuit stated that determining whether a defendant passed title to the securities is possible by referring to common principles of privity. *Id.* The *Abell* court stated that determining whether a defendant solicited an offer to buy is possible by legal parsing and linguistic analysis of § 2(3) of the Securities Act defining the term "offer to sell". *Id.*

217. *Id.* The *Abell* court concluded that because the Securities Act does not define the term "purchase" a court must apply the common meaning of the term purchase. *Id.*

218. *See id.* at 1114 (quoting directly *Pinter* requirement that seller of securities must be motivated by financial benefit to seller or to owner of securities).

219. *Id.* The Fifth Circuit in *Abell* stated that the activities of a corporate developer, unlike the activities of an underwriter hired to sell securities, do not qualify as solicitation merely because the developer was a substantial factor in creating the corporation. *Id.*

220. *Id.*

221. *Id.* at 1115. In addition to claiming that the defendants were sellers under the *Pinter* test, the plaintiffs in *Abell* also claimed that *Pinter* applies only to § 12(1) actions. *Id.* The plaintiffs noted that *Pinter* dealt with § 12(1) claims and that the *Pinter* Court expressed no

By applying the Fifth Circuit's interpretation of the *Pinter* test to the facts in *Abell*, the Fifth Circuit excluded from liability individuals that may have qualified as section 12 sellers when the Fifth Circuit employed the substantial factor test to determine section 12 liability.[222] For instance, a jury reasonably could conclude that without the developer's assistance the Westside bond offering would not have occurred.[223] Because the developer's assistance was a necessary element of the bond offering, a jury could conclude that the developer's actions were a substantial factor in causing the offering to occur.[224] Accordingly, under the substantial facotr test, a jury could have found that the developer constituted a section 12 seller under the substantial factor test.[225] Instead of the substantial factor test, however, the Fifth Circuit applied the *Pinter* test and found the developer not liable.[226] Thus, the *Pinter* test appears to narrow the scope of persons who qualify as section 12 sellers by limiting the definition of section 12 seller to individuals who actually solicit the purchase of securities or actually pass title to securities and not extending the definintion to individuals who are merely substantial factors in causing the sale of securities.[227]

---

opinion as to § 12(2) claims. *Id.* Therefore, the plaintiffs claimed that the *Abell* court should not apply the substantial factor test to the plaintiffs' § 12(2) claim. *Id.* The *Abell* court, however, rejected the plaintiffs contention that *Pinter* only applies to § 12(1) claims because the plain language of subsections (1) and (2) concerning seller status is exactly the same. *Id.* *See supra* note 2 (setting forth langauage of §§ 12(1) and 12(2)).

222. *Id.* at 1114-1115; *See supra* notes 247-251 and accompanying text (explaining that under Fifth Circuit's application of substantial factor test individuals constitute sellers under § 12 simply by having substantial involvement with corporation that issues securities).

223. *See supra* notes 203-204 and accompanying text (discussing developer's involvement in creating Westside).

224. *See id.* (discussing substantial involvement of both defendants in *Abell* which jury could construe as substantial factor in causing sale of securities).

225. *See supra* notes 205-212 and accompanying text (revealing that under facts in *Abell*, developer was not only substantial factor in bond offering but director also constituted primary factor in bond offering).

226. *Abell*, 858 F.2d at 1115.

227. *See* Murphy & Weiss, *supra* note 191, at 20, col. 4. (discussing reasons why *Pinter* test is more narrow than substantial factor test); Commins v. Johnson & Higgins, Inc., [Current Decisions] Fed. Sec. L. Rep. (CCH) ¶ 94,092 at 91,096 (N.D. Cal. Sept. 28, 1988). The decision of the United States District Court for the Northern District of California in *Commins* demonstrates the narrowing effect of the *Pinter* test in comparison to the substantial factor test. *Commins*, [Current Decisions] Fed. Sec. L. Rep. (CCH) ¶ 94,092 at 91,096. In *Commins* the defendant filed a motion to dismiss, therefore, the district court considered the facts alleged by the plaintiff in the light most favorable to the plaintiff. *Commins*, [Current Decisions] Fed. Sec. L. Rep. (CCH) ¶ 94,092 at 91,099. In *Commins* the plaintiff alleged in the complaint that the attorney involved in a securities sales transaction violated both § 12(1) and § 12(2) of the Securities Act. *Id.* at 91,103. The plaintiff alleged that the attorney prepared portions of the placement memoranda and advised persons selling the stock to the plaintiffs. *Id.* The plaintiffs also alleged that one of the plaintiffs telephoned, and the attorney told the plaintiff that the corporation selling the securities was legitimate. *Id.* Applying the *Pinter* test to the facts of *Commins*, the district court dismissed the plaintiffs § 12(1) claim stating that the attorney's limited contact with the plaintiff did not constitute solicitation. *Id.* However, when the district court considered the plaintiffs § 12(2) claim against the attorney the district court

Like the Fifth Circuit in *Abell*, the Ninth Circuit in *Harelson v. Miller Financial Corporation*[228] considered which persons qualify as section 12 sellers subsequent to the Supreme Court's decision in *Pinter*.[229] In *Harelson* the defendant, Wilson, worked as a salesman for the Carter Company, a company that bought and serviced the promissory notes of doctors.[230] Harelson contacted Wilson and arranged an appointment to talk about the benefits of investing in the Carter Company.[231] After meeting with Wilson and listening to Wilson's sales pitch, Harleson invested in the Carter Company by purchasing promissory notes from the Carter Company.[232] Within a year of Harelson's purchase of the promissory notes, the Carter Company defaulted and Harelson's notes became worthless.[233] Harelson commenced an action against Wilson in the United State District Court for the Northern District of California. [234] Harelson alleged that Wilson violated section 12(1) of the Securities Act by selling unregistered securities to Harelson.[235] The district court found that Wilson qualified as a seller under section 12, and that the Carter Company never registered the securities.[236] The district court, therefore, held Wilson liable under section 12(1).[237] Wilson appealed the decision of the district court to the United States Court of Appeals for the Ninth Circuit.[238]

On appeal to the Ninth Circuit, Wilson argued that he did not qualify as a seller of securities.[239] The Ninth Circuit found that Wilson represented the typical American salesman who earns a commission on every sale.[240]

---

applied the substantial factor test. *Id.* The district court reasoned that the *Pinter* test only applies to § 12(1) actions because the *Pinter* decision involved a § 12(1) claim. *Id.* The district court reasoned further that because the Ninth Circuit employed the substantial factor test in § 12(2) cases prior to the Supreme Court's decision in *Pinter*, the district court must employ the substantial factor test when evaluating a § 12(2) claim. *Id.* The district court noted that on the facts alleged in the plaintiffs' complaint a jury reasonably could conclude that the attorney was a substantial factor in causing the sales transaction to occur. *Id.* Therefore, the district court denied the attorney's motion to dismiss the § 12(2) claim. *Id.*

228. 854 F.2d 1141 (9th Cir.), *cert. denied*, 109 S.Ct. 274 (1988).

229. Harelson v. Miller Fin. Corp., 854 F.2d 1141 (9th Cir.), *cert. denied*, 109 S.Ct. 274 (1988).

230. *Harelson*, 854 F.2d at 1141. In *Harelson* the Carter Company paid Wilson a commission for every promissory note that Wilson sold. *Id.*

231. *Id.* at 1142.

232. *Id.* In *Harelson*, Wilson used brochures produced by the Carter Company to convince individuals to purchase stock in the Carter Company. *Id.* Wilson told Harelson that the expected return on investment in the Carter Company ranged from twenty to thirty percent annually. *Id.* Wilson also told Harelson that the Carter Company always paid investors. *Id.*

233. *Id.* In *Harelson* Harelson invested $34,500 in the Carter Company and another plaintiff invested $13,000. *Id.*

234. *Id.* at 1141.

235. *Id.*

236. *Id.*

237. *Id.*

238. *Id.*

239. *Id.* Wilson argued in *Harelson* that Wilson did not qualify as a § 12 seller because the purchasers sought out Wilson instead of Wilson seeking out the purchasers. *Id.*

240. *Id.*

Although Wilson did not seek out Harelson in an effort to make a sale, the Ninth Circuit concluded that Wilson used all the measures within Wilson's power to convince Harleson to purchase the unregistered promissory notes when Harleson came to Wilson's office.[241] Finding that Wilson was a typical salesman, the *Harelson* court reasoned that Wilson's activities were classic examples of solicitation.[242] The court held that Wilson qualified as a seller of unregistered securities and, therefore, held Wilson liable under section 12.[243] The *Harelson* court declined to discuss the application of the *Pinter* test in great detail.[244] The Ninth Circuit in *Harelson* believed that the record presented such a clear case of solicitation that the Ninth Circuit devoted one sentence of reasoning to the subject of solicitation stating that Wilson solicited the sale and Wilson was the seller.[245] The limited reasoning of the *Harelson* decision provides little guidance to anyone attempting to discern the limits of solicitation or the financial benefit needed to qualify a defendant as a section 12 seller.[246]

---

241. *Id.* The Fifth Ciruit in *Harelson* noted that Wilson presented no more than the basic facts necessary to effectuate the sale. *Id.*

242. *Id.*

243. *Id.* at 1142.

244. *Id.*

245. *See id.* (stating that Wilson solicited sale of securities by using Wilson's skills of persuasion).

246. *See id.* (presenting reasoning of Ninth Circuit in one paragraph in which Ninth Circuit mostly repeats relevant facts from trial record). In addition to the Fifth Circuit's decision in *Abell* and the Ninth Circuits decision in *Harelson* the Second Circuit considered the meaning of the term seller after the Supreme Court's decision in *Pinter.* Capri v. Murphy, 856 F.2d 473 (2d Cir. 1988). In *Capri* the plaintiffs purchased limited partnerships in Greenwich Coal Associates (GCA). *Id.* at 475. The defendants, Murphy and Greenwich Coal Company (GCC) were the two general partners in GCA. *Id.* Murphy and GCC formed GCA for the purpose of exploiting coal mining properties in West Virginia. *Id.* Murphy hired an engineering company to study the feasibility of mining the West Virginia coal properties. *Id.* at 476. The feasibility study overvalued GCA because the report failed to take certain expenses into account. *Id.* at 475-476. Even though Murphy knew the study was overly optimistic, Murphy used the feasibility study in the GCA offering materials. *Id.* at 476. An attorney whose law firm assisted in drafting the offering materials and performed other legal work in the venture directly contacted the plaintiffs who purchased securities in GCA. *Id.* at 478. The coal mining venture never materialized and the plaintiffs securities became worthless. *Id.* The plaintiffs commenced an action against Murphy and GCA in the United States District Court for the District of Connecticut. *Id.* The plaintiff alleged that Murphy and GCC, as the general partners of GCA, violated § 12(2) of the Securities Act by making material misstatements of fact in the sale of the securities. *Id.* at 476. The district court entered judgment for the defendants and the plaintiffs appealed to the United States Court of Appeals for the Second Circuit. *Id.*

On appeal to the Second Circuit, Murphy and GCC argued that Murphy and GCC were not seller's under § 12 because Murphy and GCC never contacted the plaintiffs in connection with the sale of the securities. *Id.* Murphy and GCC argued further that the attorney should bear full responsibility under § 12 because the attorney contacted the plaintiffs. *Id.* In deciding *Capri* the Second Circuit relied on the Supreme Court's decision in *Pinter. Id.* at 478. The *Capri* court repeated the language of the *Pinter* decision and stated that only individuals who solicit the purchase of securities motivated by financial gain for themselves or the owner of the securities are liable as sellers under § 12. *Id.* The *Capri* court reasoned that by preparing

As *Harelson*, *Abell* and various other cases illustrate, many different grades of participation in a sale of securities may qualify as solicitation.[247] Even under the *Pinter* test, attorneys or securities professionals must remain sensitive to the level of interaction between the securities professional and potential purchasers of securities.[248] For instance, if a client hires an attorney to do the legal work on a private offering of a company's securities and the attorney introduces the client to a potential buyer, the attorney's actions may qualify as solicitation.[249] Furthermore, payment of an attorney to do legal work for a company issuing securities may satisfy the financial benefit criterion of the *Pinter* test.[250] Although questions remain after *Pinter* concerning the extent of participation that qualifies as solicitation and the type of benefit that qualifies as financial benefit to the seller, securities professionals can remain confident that simply completing the legal or financial work necessary for the sale of the securities will not subject the securities professional to section 12 liability.[251]

---

and circulating the offering materials to plaintiffs, Murphy and GCC solicited the purchases of the plaintiffs. *Id.* The *Capri* court, therefore, held Murphy and GCC liable as § 12 sellers. *Id.* The *Capri* court also noted that the attorney would have qualified as a seller, however, the plaintiffs failed to name the attorney as a defendant. *Id.*

By imposing § 12 liability on a defendant for merely distributing offering materials to potential purchasers the Second Circuit sets a low standard for the types of actions that qualify as soliciting an offer to buy. *Id.* The *Capri* court concluded that the defendants were liable as § 12 sellers even though the defendants never contacted the plaintiffs. *Id.* The behavior that qualified the defendants as § 12 sellers in *Capri* is the type of behavior that the *Pinter* decision appears to exclude from the definition of the term seller. Pinter v. Dahl, 108 S.Ct. 2063, 2078 (1988). The *Pinter* Court stated that courts considering whether a defendant qualifies as a § 12 seller should investigate the relationship between the defendant and the plaintiff and not the defendants general relationship to the transaction. *Pinter*, 108 S.Ct. at 2081. In *Capri* the court focused on the defendant's relationship to the transaction instead of focusing on the defendant's relationship to the plaintiff. *Capri*, 856 F.2d at 478. Because Murphy and GCC prepared the prospectus circulated by the attorney to the plaintiffs, the *Capri* court concluded that Murphy and GCC solicited offers to buy the securities from the plaintiffs. *Id.* The *Pinter* Court's dicta excluding from liability persons merely performing services, such as drafting offering materials, clearly rejects the idea that defendants similar to Murphy and GCC qualify as § 12 sellers. *Pinter*, 108 S.Ct. at 2081.

247. *See supra* notes 132-37 and accompany text (providing examples of participation of alleged § 12 sellers in pre-*Pinter* § 12 cases); *supra* notes 200-46 and accompanying text (providing examples of participation of alleged sellers in post-*Pinter* cases).

248. *See supra* notes 193-99 and accompanying text (discussing ambiguities that remain after *Pinter* concerning degree of activity that qualifies as solicitation).

249. *See* Capri v. Murphy, 856 F.2d 473, 478 (2d Cir. 1988) (stating that an attorney working on legal aspect of offering who has direct contact with purchasers may qualify as soliciting offers to buy securities). *But see* Commins v. Johnson & Higgins, Inc., [Current Decisions] Fed. Sec. L. Rep. (CCH) ¶ 94,092 at 91,103 (N.D. Cal. Sept. 28, 1988) (dismissing a § 12(1) action against an attorney completing legal services for an offering because the attorney merely responded to purchaser question over telephone); *supra* note 227 (setting forth facts and holding of *Commins*).

250. Pinter v. Dahl, 108 S.Ct. 2063, 2078 (1988).

251. *See id.* at 2081 (stating that securities professionals do not qualify as § 12 sellers when securities professionals engage in *pro forma* activities).

Applying the *Pinter* test and the substantial factor test to two examples of attorney involvement in a securities transaction illustrates the narrowing effect of the *Pinter* test.[252] In the first situation, Attorney A drafts a prospectus and promotes the sale of securities by directly contacting potential purchasers of the securities in an effort to persuade the potential purchasers to buy the securities.[253] Because Attorney A goes beyond merely completing the legal work for the issuer of the securities and actually promotes the sale of the securities by contacting purchasers, Attorney A effectively solicits the purchases of securities.[254] At the same time, Attorney A has solicited the sale of the securities on account of personal financial benefit because the issuer of the securities paid Attorney A for Attorney A's legal services.[255] Thus, under the *Pinter* test Attorney A may qualify as a section 12 seller because court's might find that Attorney A solicited the purchase of securities and that he was motivated by a desire to benefit himself financially.[256] Additionally, under the substantial factor test Attorney A qualifies as a section 12 seller because Attorney A's actions were a substantial factor in causing the sale of the securities.[257]

In contrast to Attorney A, consider the involvement of Attorney B in a sale of securities.[258] In the second situation a developer hires Attorney B to complete the legal work necessary to make a private offering of limited partnerships.[259] Attorney B prepares all of the offering materials including an opinion letter stating that the securities are exempt from registration with the SEC.[260] The developer needs the prospectus and opinion letter to persuade potential purchasers that the limited partnerships are a sound investment.[261] In the second situation, however, Attorney B never personally contacts potential purchasers.[262] Additionally, Attorney B never contacts or

---

252. *See infra* notes 252-57 and accompanying text (providing hypothetical example of liability under *Pinter* test and substantial factor test).

253. *See* Capri v. Murphy, 856 F.2d 473, 476 (2d Cir. 1988) (involving facts similar to facts in hypothetical in text).

254. *See id.* at 478 (concluding that attorney in circumstances similar to hypothetical solicited an offer to buy from purchasers).

255. *See id.* (concluding that attorney benefitted personally from sale of securities because issuer paid attorney); Lee v. Spicola, [Current Decisions] Fed. Sec. L. Rep. (CCH) ¶ 94,120 at 91,264 (stating that accountant who was employee of issuer financially benefitted from sale of securities).

256. *See* Pinter v. Dahl, 108 S.Ct. 2063, 2079 (1988) (stating appropriate test for determining § 12(1) seller status).

257. *See* Pharo v. Smith, 621 F.2d 656, 667 (5th Cir. 1980) (stating substantial factor test); *supra* notes 124-31 and accompanying text (discussing *Pharo* court's formulation and application of substantial factor test).

258. *See infra* notes 259-68 and accompanying text (providing hypothetical alternative to Attorny A's involvement in sale of securities).

259. *See* Koehler v. Pulvers, [1985-1986] Fed. Sec. L. Rep. (CCH) ¶ 92,232 at 91,660 (involving facts similar to facts in hypothetical in text).

260. *Id.*

261. *Id.* at 91,661.

262. *Id.* at 91,660-663.

introduces the issuer of the securities to potential purchasers or urges the potential purchasers to buy the securities.[263] Under the *Pinter* test Attorney B fails to qualify as a section 12 seller because Attorney B did not solicit the purchase of securities from the purchasers nor did Attorney B pass title to the securities to the purchasers.[264] Instead, Attorney B merely completed the legal work necessary to make the offering.[265] Under the substantial factor test, however, Attorney B qualifies as a section 12 seller.[266] Attorney B qualifies as a section 12 seller under the substantial factor test because Attorney B's opinion letter and prospectus were substantial factors in making the offering and convincing the purchasers to buy the securities.[267] Because the *Pinter* test denies section 12 seller status to Attorney B and the substantial factor test subjects Attorney B to section 12 seller status, the *Pinter* test effectively reduces the possibility of section 12 liability extending to securities professionals.[268]

The Supreme Court's decision in *Pinter* marks a return to a narrow interpretation of who consitutes a section 12 seller.[269] The *Pinter* decision rejects the more expansive substantial factor test as a means of discerning section 12 sellers.[270] In place of the substantial factor test, the *Pinter* decision presents a two-part test for determining whether an individual qualifies as a section 12 seller.[271] First, an individual qualifies as a seller if the individual passes title of the securities to the purchaser.[272] Second, an individual qualifies as a seller if the individual solicits an offer to buy for the individual's benefit or the benefit of the owner of the securities.[273] The *Pinter* test is not flawless because the Supreme Court did not comment on the question of how much participation in the sale of securities constitutes

---

263. *Id.*

264. *See supra* note 172 and accompanying text (explaining *Pinter* test's requirement of solicitation).

265. *See* Pinter v. Dahl, 108 S.Ct. 2063, 2079 (1988) (stating that mere performance of legal duties necessary in drafting prospectus or preparing offering materials is not enough to invoke § 12(1) seller status).

266. *See* Koehler v. Pulvers, [1985-1986] Fed. Sec. L. Rep. (CCH) ¶ 92,232 at 91,666 (holding attorney liable under similar circumstances as set forth in hypothetical).

267. *See id.* (concluding that attorney is liable under § 12 for completing offering materials).

268. *See supra* notes 186-93 and accompanying text (explaining that Supreme Court's decision in *Pinter* appears to narrow definition of term seller under § 12 of Securities Act).

269. *See supra* notes 50-54 and accompanying text (discussing statutory interpretation of § 12 in 1940 *Cady* decision); *supra* note 173 (comparing *Cady* decision to *Pinter* decision).

270. *See supra* notes 178-83 and accompanying text (discussing *Pinter* Court's rejection of substantial factor test).

271. *See supra* notes 173-74 and accompanying text (discussing *Pinter* test for determining § 12 seller status).

272. *See supra* notes 166 and accompanying text (discussing *Pinter* Court's statement that an individual who passes title of securities to buyer qualifies as seller).

273. *See supra* notes 167-70 and accompanying text (discussing *Pinter* test's requirement of solicitation of offer to buy securities).

solicitation and what qualifies as a financial benefit.[274] However, the *Printer* test does provide one test to replace the four different tests applied by federal courts of appeal prior to the *Pinter* decision.[275] Additionally, the *Pinter* test appears to narrow the scope of liability for claims arising under section 12.[276] The narrowing of the scope of section 12 liability is obvious good news for securities professionals considering whether their activities fall within the ambit of a section 12 seller.

David L. Goode

---

274. *See supra* notes 193-99 and accompanying text (discussing ambiguities created by *Pinter* test).

275. *See supra* notes 200-46 and accompanying text (discussing federal appeals courts application of different tests for determining § 12 seller status).

276. *See supra* notes 247-68 and accompanying test (discussing narrowing effect of *Pinter* test).