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# Ralston Redux: Determining which Section 3 Offerings Are Public under Section 12(2) after Gustafson

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# RALSTON REDUX: DETERMINING WHICH SECTION 3 OFFERINGS ARE PUBLIC UNDER SECTION 12(2) AFTER *GUSTAFSON*

*Janet E. Kerr\**

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## I. INTRODUCTION

Last year, in the seminal case of *Gustafson v. Alloyd Co.*,<sup>1</sup> the United States Supreme Court limited the scope of Section 12(2)<sup>2</sup> of the Securities Act of 1933 (the "Securities Act")<sup>3</sup> to include only initial public offerings by issuers or their controlling shareholders.<sup>4</sup> The Court's decision in *Gustafson* has been widely discussed by many commentators<sup>5</sup> and has been criticized as poorly reasoned in its basic misunderstanding of the structure, as well as the purpose, of the Securities Act.<sup>6</sup> As a result of these problems, *Gustafson* has raised many ques-

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

2. 15 U.S.C. § 77l(a)(2) (1995). Following the passage by Congress of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995), § 12(2) was renumbered as § 12(a)(2) and contains the original language of § 12(2). Since many articles and other reference materials were written prior to this change, including the *Gustafson* decision, this Article will refer to the section as § 12(2).

3. Section 12(2) provides for damages and rescission. Such relief may be granted to the buyers of the securities of the transaction in question as long as it can be proven that: (i) there was a sale of a security; (ii) made through the use of interstate commerce or mails; (iii) by means of a prospectus or oral communication; (iv) which included an untrue statement or omission of a material fact; and (v) there is the requisite degree of privity between the plaintiff and defendant. An affirmative defense to the prima facie case is that the seller did not know of—nor could reasonably have known of—the misstatement or omission. 15 U.S.C. § 77l(a)(2) (1995).

4. *Gustafson*, 115 S. Ct. at 1067. As discussed *infra* in Part III of this Article, the Court based its opinion on erroneous statutory interpretations and the application of improper judicial canons. Because of this, the Court's decision does not quite logically reach its holding; however, the Court's intent to limit § 12(2) to include only public offerings is clear.

5. For additional comments regarding the *Gustafson* decision, see Stephen M. Bainbridge, *Securities Act Section 12(2) After the Gustafson Debacle*, 50 BUS. LAW. 1231 (1995); Dennis J. Block & Jonathan M. Hoff, *Scope of Section 12(2) After 'Gustafson'*, 214 N.Y. L.J. 5 (1995); Harold S. Bloomenthal, *Supreme Court Says Section 12(2) Liability Does Not Extend to Private Offerings or Secondary Trading* (pts. 1 & 2), 17 SEC. & FED. CORP. L. REP. 25 (Apr. 1995) [hereinafter Bloomenthal, *Supreme Court, Part 1*], 17 SEC. & FED. CORP. L. REP. 38 (May 1995) [hereinafter Bloomenthal, *Supreme Court, Part 2*]; Ted J. Fiflis, *Significant Securities Law Decisions of the Past Year, as of June 14, 1995*, CA 36 A.L.I.-A.B.A. 51 (1995) [hereinafter Fiflis, *Significant*]; Ted J. Fiflis, *Gustafson v. Alloyd Co., Inc.: Judicial vs. Legislative Power*, 23 SEC. REG. L.J. 423 (1996); Roberta S. Karmel, *Curtailing Civil Liability*, 213 N.Y. L.J. 3 (1995); Therese H. Maynard, *The Impact of Gustafson and Its Methodology*, 24 SEC. REG. L.J. 61 (1996) [hereinafter Maynard, *Impact*]; Steven Thel, *Section 12(2) of the Securities Act: Does Old Legislation Matter?*, 63 FORDHAM L. REV. 1183 (1995); Elliott J. Weiss, *Securities Act Section 12(2) After Gustafson v. Alloyd Co.: What Questions Remain?*, 50 BUS. LAW. 1209 (1995); Laura K. Bancroft, Note, *Gustafson v. Alloyd Co.: The Continued Shrinking of Private-Plaintiff Remedies Under the 1933 Securities Act*, 27 LOY. U. CHI. L.J. 149 (1995); and Note, *Civil Liability Under Section 12(2) of the Securities Act of 1933*, 109 HARV. L. REV. 329 (1995).

6. See Maynard, *Impact*, *supra* note 5, at 62 analyzing the implications of *Gustafson* and discussing the lower court decisions that have followed it. ("[T]he methodology used by the Court to limit the availability of the Section 12(2) express remedy undermines established interpretations of various provisions of the 1933 Act." *Id.*). See also Weiss, *supra* note 5, who agrees with the Court's narrowing of § 12(2) to public offerings of securities, but disagrees with the way the Court reached its decision: "[T]he route the Court took to get [to the decision] strikes me, as it struck the four dissenting Justices, as highly problematic." Weiss, *supra* note 5, at 1210.

tions<sup>7</sup> and has threatened to undermine previously unchallenged principles in securities law.<sup>8</sup>

This Article addresses one of the more important questions following the *Gustafson* decision, that is—what public offerings, besides registered public offerings, are now within the scope of Section 12(2)?<sup>9</sup> Because *Gustafson* provides little, if any, instruction with respect to this issue, it is anticipated that the Court will be faced with this question in the near future. It is the position of this Article that the concept of being able to “fend for oneself,” as developed by the Court forty-three years ago in *SEC v. Ralston Purina Co.*,<sup>10</sup> should be used as the determinative principle in answering this question.<sup>11</sup>

Since many authors have written about the *Gustafson* decision, this Article provides only a brief discussion of the facts and the Court’s approach to defining Section 12(2)’s coverage. The balance of the Article focuses on the Court’s problematic analysis in *Gustafson*, the consequences of that analysis, and the search for, and creation of, a new test based on the

7. As well as the question raised by this Article, some other questions were left unaddressed by the *Gustafson* decision. For one example, see Weiss, *supra* note 5, at 1225, stating that “the three most important such questions” are: (i) the status, with regard to § 12(2), of a “failed” statutory private offering; (ii) whether free writing constitutes a prospectus for purposes of § 12(2); and (iii) the computation of damages in a § 12(2) action. See also Bainbridge, *supra* note 5, at 1231-32, raising the question of whether oral communications made in connection with private placements give rise to § 12(2) liability. Since the scope of this Article is narrow, one should make particular reference to the articles by Bainbridge and Weiss, as well as to articles by the other commentators for further discussion of these issues. See *supra* note 5. For other implications raised by *Gustafson*, see Bruce Angiolillo, “*Gustafson*: Section 12(2) Applies Only to IPOs,” 213 N.Y. L.J. 1 (1995); Glenn M. Reiter & Gregory W. Conway, *Due Diligence in Offerings by Non-U.S. Issuers*, in INTERNATIONAL SECURITIES MARKETS 1995, at 95 (PLI Corp. Law & Practice Course Handbook Series No. 897, 1995); and Margaret A. Bancroft, *Responding to Gustafson: Company Registration and a New Negligence Standard*, 9 INSIGHTS 14 (July 1995).

8. Professor Fiflis observes that the *Gustafson* opinion has created uncertainty in that “there are few reliable points of reference in the securities laws and it’s anyone’s guess as to what lower courts will do, given their new license to forego traditions.” Fiflis, *Significant*, *supra* note 5, at 66. See also Professor Maynard observing the *Gustafson* case fallout upon its one-year anniversary, stating that “further challenges of the federal securities laws are likely to face the federal courts, threatening to further unsettle securities law and practice” and adding later that:

[T]he flawed reasoning of the *Gustafson* opinion will lead to more litigation as the lower courts are asked to revisit established understandings of other provisions of the 1933 Act. While the *Gustafson* opinion can be viewed as a rather crude effort by the Supreme Court to engage in securities litigation reform, by narrowing the scope of section 12(2) and thus narrowing the scope of securities fraud cases brought in federal courts, the ultimate irony is that the Court’s opinion may actually yield even more litigation.

Maynard, *Impact*, *supra* note 5, at 62-63 & n.7.

9. Other authors have also raised this as an issue. See Bainbridge, *supra* note 5, at 1260, stating that “the majority limited section 12(2) to an undefined class of transactions called public offerings. Unfortunately, the majority failed to clarify which transactions fall within that class or even how that determination is to be made.” See also Fiflis, *Significant*, *supra* note 5, at 66, stating that “the Court made no mention of how to define a ‘public offering.’” See generally Weiss, *supra* note 5, at 1220-26.

10. 346 U.S. 119 (1953).

11. See *infra* note 92 for other commentators which mention the importance of revisiting *Ralston Purina*.

*Ralston Purina* case's "self-fending" concept for ascertaining which Section 3 offerings are public and which are private with respect to Section 12(2).

## II. THE FACTS IN *GUSTAFSON* AND THE COURT'S APPROACH

### A. PRE-*GUSTAFSON* HISTORY

Prior to *Gustafson*, it had been well-settled law that Section 12(2) of the Securities Act applied to both private and public offerings in the distribution stage.<sup>12</sup> Additionally, for many years, it had been generally understood that Section 12(2) also applied to secondary market transactions.<sup>13</sup> However, a circuit split arose in 1991 between the Third and Seventh Circuits which called into question both of these applications of Section 12(2).<sup>14</sup> As a result of this split, and because of Section 12(2)'s

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12. The U.S. Supreme Court had implicitly extended § 12(2) to secondary market transactions in several previous cases. As Professor Bainbridge points out, the Court considered the arbitrability of claims arising under § 12(2) of the Securities Act in both *Wilko v. Swan*, 346 U.S. 427 (1953) and *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989). Both of these cases involved secondary market transactions and the Court assumed without question that § 12(2) applied. *Wilko*, 346 U.S. at 428; *Rodriguez de Quijas*, 490 U.S. at 478-79. Professor Bainbridge similarly states that the Court, in a case very similar to *Gustafson*, applied § 12(2) without reservation to a private transaction. *Gould v. Ruefenacht*, 471 U.S. 701, 703-04 (1985) (addressing the applicability of the sale of business doctrine within the context of a private sale). *Bainbridge, supra* note 5, at 1233. See also LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 983 (3d ed. 1995) [hereinafter LOSS, *FUNDAMENTALS*] ("To start with what is clearest, [§ 12(2)] applies to all sales of securities, whether or not registered and whether or not the particular security or transaction is exempted from § 5, with one exception: Securities exempted under § 3(a)(2). . . ." *Id.* (citations omitted)). Professor John Coffee stated: "Currently, it is clear beyond argument that § 12(2) applies to private placements." John C. Coffee, Jr., *A Statutory and Case Law Primer on Due Diligence Under the Federal Securities Law, in CONDUCTING DUE DILIGENCE* 1995, at 11 (PLI Corp. Law & Practice Course Handbook Series No. 886, 1995). See also MARC STEINBERG, *SECURITIES REGULATION* 594 (2d ed. 1993).

13. A secondary market transaction, defined in its broadest context, is a transaction made on behalf of some person or company other than the original issuer and can include the sale of securities by control persons. 3A HAROLD S. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* § 6.03 (1996). The principal commentators agreeing with the application of § 12(2) to secondary market transactions include Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 917 (1992) [hereinafter Loss, *Assault*]; Louis Loss, *Securities Act, Section 12(2): A Rebuttal*, 48 BUS. LAW. 47 (1992) [hereinafter Loss, *Rebuttal*]; Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 WM. & MARY L. REV. 847, 849 (1991); Therese H. Maynard, *The Future of Securities Act Section 12(2)*, 45 ALA. L. REV. 817, 822 (1994). See also Kevin N. Peter, Comment, *Section 12(2) of the Securities Act of 1933: Does It Apply to the Secondary Market? The Circuits are Fighting*, 31 HOUS. L. REV. 1205 (1994). Examples of commentators arguing to limit the scope of § 12(2) are Robert A. Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 ALB. L. REV. 97 (1991); Elliott J. Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 BUS. LAW. 1 (1992). Many lower court decisions have held that § 12(2) applies to secondary transactions; however, more have held that it does not. See Bancroft, *supra* note 5, at 153-54 nn.32-33 for a list of court decisions falling on both sides of the issue.

14. Compare *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 582 (7th Cir. 1993), cert. dismissed, 114 S. Ct. 1146 (1994) (holding § 12(2) applies to all sales of stock)

newly increased popularity in recent years, the Court decided to make a final determination of the scope of Section 12(2).<sup>15</sup>

### B. THE FACTS

Briefly, *Gustafson* involved investors (the “plaintiffs”) who had purchased all of the outstanding shares of Alloyd Co., Inc. (“Alloyd”) from the controlling stockholders of Alloyd (the “defendants”).<sup>16</sup> The sale of these shares was not made through a public offering, but rather through a private written contract of sale.<sup>17</sup> The plaintiffs negotiated with the defendants to include certain warranties and representations in the contract. Following the sale, the plaintiffs alleged the warranties and representations<sup>18</sup> relating to the financial condition of Alloyd were untrue and that the written contract was a “prospectus” for purposes of Section 12(2) of the Securities Act.<sup>19</sup> The plaintiffs sought the remedy of rescission of the contract as provided by this section.<sup>20</sup>

### C. THE COURT’S APPROACH TO SECTION 12(2)’S COVERAGE

In commencing with the analysis of Section 12(2)’s scope, the Court turned to the phrase “by means of a prospectus or oral communication,” and decided that the term “prospectus” was the focal point in determining Section 12(2)’s coverage.<sup>21</sup> The Court determined that the answer depended on the statutory interpretation of this term.<sup>22</sup> Even though the

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with *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 688 (3d Cir.), *cert. denied*, 502 U.S. 820 (1991) (narrowing § 12(2) to only initial public offerings). *See also* Bainbridge, *supra* note 5, at 1234.

15. Professor Bainbridge gives a lengthy discussion of the advantages of § 12(2) over § 11 of the Securities Act and Rule 10b-5 of the Securities Exchange Act of 1934. Among other things, he mentions the following: (1) Section 12(2)’s remedy of rescission may be more beneficial to the plaintiff than § 11 and Rule 10b-5’s limitation to actual damages, *see Ballay*, 925 F.2d at 693 (comparing § 12(2) and Rule 10b-5 and noting that the remedy of rescission in § 12(2) is often viewed as necessary in order to compensate plaintiffs who have been defrauded in initial security distributions); (2) causation and reliance need not be proven in § 12(2) as compared to a Rule 10b-5 case, where they are *prima facie* elements, and § 11, where they are affirmative defenses; and (3) *scienter* (or reckless disregard) is a *prima facie* element of Rule 10b-5, whereas the defendant’s mental state is not relevant to the plaintiff’s case in § 12(2) and appears only as the affirmative defense of reasonable care. *See* Bainbridge, *supra* note 5, at 1233-34 (citing *Loss, Assault*, *supra* note 13, at 908, 911). An additional reason that § 12(2) has grown in popularity is the Supreme Court’s decision in *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1448 (1994), which limited aiding and abetting liability under Rule 10b-5. Following this case, many litigants had to sue under § 12(2). Another reason for § 12(2)’s popularity has been advanced by Professor Thel. Professor Thel posited that § 12(2) became increasingly popular as a result of Rule 10b-5’s scope becoming narrowed over the last 20 years, while § 12(2)’s coverage (prior to *Gustafson*) had remained unchanged. If § 12(2) was not likewise narrowed, then the effort to do so with respect to Rule 10b-5 would be nullified. Thel, *supra* note 5, at 1192-93.

16. *Gustafson*, 115 S. Ct. at 1064.

17. *Id.* at 1065.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.* at 1066.

22. *Id.*

Court recognized that there were several sections of the Securities Act that included the term prospectus, such as Section 10,<sup>23</sup> Section 2(10),<sup>24</sup> and Section 12,<sup>25</sup> it selected Section 10 as the interpretative section on which to base its analysis.<sup>26</sup>

Having done this, the Court noted Section 10's use of the term "prospectus" and stated that "a prospectus . . . shall contain the information contained in a registration statement."<sup>27</sup> In order to apply Section 10 to Section 12(2), the Court observed that uniformity within the Act was called for, and therefore, determined that the term "prospectus" had the same meaning throughout the Act.<sup>28</sup> As a result, Section 12(2) would only apply to those documents containing such information as required by Section 10.<sup>29</sup> As a result, the Court held that the private sales contract in the case was not a prospectus under Section 10 because the law did not require these contracts to contain all the information in a registration statement.<sup>30</sup> Thus, since the contract was not a "prospectus" for purposes

23. Section 10 of the 1933 Act provides in part:

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

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

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

15 U.S.C. § 77j (1994).

24. Section 2(10) defines prospectus as "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." 15 U.S.C. § 77(b)(10) (1994).

25. Section 12(2) provides in pertinent part:

(a) In general

Any person who—(2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable . . . to the person purchasing such security from him . . . [for] the consideration paid for such security with interest thereon . . . or for damages. . . .

15 U.S.C. § 77l(n)(2) (1995).

26. *Gustafson*, 115 S. Ct. at 1066-67.

27. *Id.* at 1066 (quoting 15 U.S.C. § 77j). The Court noted that "[a]lthough § 10 does not define what a prospectus is, it does instruct us what a prospectus cannot be." *Id.* at 1066-67.

28. *Id.* at 1067. The Court's push for uniformity is most apparent in its statement that "the Act is to be interpreted as a symmetrical and coherent regulatory scheme, one in which the operative words have a consistent meaning throughout." *Id.*

29. *Id.*

30. *Id.* at 1073-74. The Court stated that "a prospectus under § 10 is confined to documents related to public offerings by an issuer or its controlling shareholders," *id.* at 1067, and concluded that this contract did not fall into that category of document. *Id.* at 1074.

of Section 10, it was not one under Section 12(2) either.<sup>31</sup>

In the process of reaching its holding, the Court equivocated. Even though it concluded that Section 10 provided the interpretation for “prospectus” for the *entire* Securities Act, the Court noted that Section 10 in fact *did not* apply to *all* prospectuses.<sup>32</sup> The Court observed that Section 3 offerings were exempt from compliance with the Act, including Section 10.<sup>33</sup> In recognition of this, the Court carved out an exception and held “that a document is not a prospectus . . . if, absent an exemption, it need not comply with § 10’s requirements in the first place.”<sup>34</sup> The Court, however, downplayed this exception by stating that “*whatever else ‘prospectus’ may mean, the term is confined to a document that, absent an overriding exemption, must include the ‘information contained in the registration statement.’*”<sup>35</sup> The Court opined that public offerings require the preparation and filing of a registration statement, and based on that, concluded “that a prospectus under § 10 is confined to documents related to public offerings by an issuer or its controlling shareholders.”<sup>36</sup>

Regardless of the Court’s attempt to declare a uniform definition, the holding recognizes that the term “prospectus,” for the purposes of Section 12(2), embraces at least two types of documents: (1) those documents that include the information required to be contained in a registration statement, and thus are used in connection with registered public offerings; and (2) those documents used in connection with offerings to the public made pursuant to Section 3 of the Act.<sup>37</sup>

### III. PROBLEMS WITH THE COURT’S ANALYSIS

Only a brief discussion of the Court’s analysis and the key points of the dissenting opinions in *Gustafson* is provided in this section, since previous

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31. *Id.* at 1068. Implicit in this statement is the belief that the contract did not fall into the “overriding exemption” language discussed *infra* note 71 and accompanying text.

32. *Id.* at 1066.

33. *Id.* The Court stated: “Save for the explicit and well-defined exemptions for securities listed under § 3, see 15 U.S.C. § 77c (exempting certain classes of securities from the coverage of the Act), [§ 10’s] mandate is unqualified: ‘a prospectus . . . shall contain the information contained in the registration statement.’” *Id.* Since § 3 offerings are exempted from the coverage of the Act (except for their express inclusion under § 12(2)), then they are also exempted from the registration provisions of § 5. Therefore, these offerings need not comply with § 10 of the Act.

34. *Id.* at 1067. The “absent an exemption language,” when read in conjunction with the preceding paragraph in the opinion, refers to exemptions under § 3. See Weiss, *supra* note 5, at 1214 n.26. See also *infra* note 71 and accompanying text.

35. *Gustafson*, 115 S. Ct. at 1067 (emphasis added) (citations omitted).

36. *Id.*

37. The first category of prospectus would also include those documents that are arguably required to comply with § 10, but for some reason fail to do so. See Bainbridge, *supra* note 5, at 1238. In regard to this, the Court stated that this “does not mean that a document ceases to be a prospectus whenever it omits a required piece of information.” *Gustafson*, 115 S. Ct. at 1067. But see *infra* note 68 and accompanying text discussing that this statement is ambiguous since it leaves unclear when a document that omits a required piece of information nonetheless qualifies as a prospectus.



articles have devoted ample coverage.<sup>38</sup> For the most part, criticisms of the Court's decision emphasize two major errors upon which the Court based its analysis. First, the Court's reliance on Section 10 for its interpretation of the term "prospectus" was incorrect. Second, the Court exacerbated this error by wrongly assuming that this interpretation should uniformly apply throughout the Act, including Section 12(2). Both of these errors resulted from the Court's lack of understanding and/or disregard for the statutory framework of the Act.<sup>39</sup>

#### A. RELIANCE ON SECTION 10

With respect to the Court's first error, Section 2, not Section 10, is the recognized definitional section of the Securities Act.<sup>40</sup> Therefore, the selection of Section 10 was in violation of the well-established judicial rule

38. See *supra* note 5 for a list of articles which provide a critique of the Court's analysis and discussion of the dissenting opinions. Justice Kennedy wrote the majority opinion with Justices Thomas and Ginsburg writing separate dissenting opinions. Those Justices comprising the majority, besides Justice Kennedy, were Chief Justice Rehnquist and Justices O'Connor, Stevens, and Souter. Those Justices joining Justice Thomas in his dissent were Justices Scalia, Ginsburg, and Breyer. Justice Breyer also joined Justice Ginsburg in her separate dissenting opinion. *Gustafson*, 115 S. Ct. at 1064.

39. Some articles have surmised that the Court had a pre-determined goal to narrow § 12(2)'s application to include only public offerings and selected § 10, which uses the term "prospectus" in the most "restrictive sense," to serve that end. See Bainbridge, *supra* note 5, at 1236; Maynard, *Impact*, *supra* note 5, at 63. See generally Thel, *supra* note 5, at 1183, and Fiflis, *Significant*, *supra* note 5, at 64, in agreement that the Court was determined to narrow § 12(2). Justice Thomas noted that the majority, in making its decision, considered the public policy ramifications of § 12(2)'s application to all types of offerings in disregard of the legislative history and established statutory intent of this section. Justice Thomas stated:

The majority is concerned that a contrary reading would have a drastic impact on the thousands of private and secondary transactions by imposing new liabilities and new transaction costs. But the majority forgets that we are only enforcing Congress' decision to impose such standards of conduct and remedies upon sellers. If the majority believes that § 12(2)'s requirements are too burdensome for the securities markets, it must rely upon other branches of government to limit the 1933 Act.

*Gustafson*, 115 S. Ct. at 1079 (Thomas, J., dissenting). The Court implicitly admitted its intentions to narrow § 12(2) when it stated:

It is not plausible to infer that Congress created this extensive liability for every casual communication between buyer and seller in the secondary market. It is often difficult, if not altogether impractical, for those engaged in casual communications not to omit some fact that would, if included, qualify the accuracy of a statement. Under Alloyd's view any casual communication between buyer and seller in the aftermarket could give rise to an action for rescission, with no evidence of fraud on the part of the seller or reliance on the part of the buyer.

*Id.* at 1071.

40. Professor Bainbridge noted that "prospectus is a defined term under the Act, specifically section 2(10) thereof." Bainbridge, *supra* note 5, at 1235. Professor Fiflis pointed this out, stating:

The major sin of the [*Gustafson*] opinion is that in construing the word "prospectus" in § 12(2) it began not by referring to § 2(10), which defines that term, but with § 10, which uses the term to indicate what a prospectus must contain to satisfy § 5, the registration and prospectus delivery requirement.

Fiflis, *Significant*, *supra* note 5, at 63. See also Weiss, *supra* note 5, at 1213-16 for similar criticism.

of construction that "when one sets out to define a term; it is the definition section of an act that should be first consulted."<sup>41</sup> Surprisingly, the Court conceded that Section 10 is *not* the definitional section for the term "prospectus," and vigorously denied it was using it in such a way.<sup>42</sup> Yet regardless of this hollow protestation, the Court's reliance on this section and upon no other for its interpretation of the term "prospectus" was demonstrated when it concluded that Section 10's "*mandate is unqualified*: 'a prospectus . . . shall contain the information contained in the registration statement.'"<sup>43</sup>

It was only after the Court concluded that Section 10 was the determinative section to be used that it referred to Section 2(10). The Court's only purpose for referring to Section 2(10) was to argue that it did not

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41. Justice Ginsburg, in her dissent, noted the error by saying that "[i]nstead of beginning at the beginning, by first attending to the definition section, the Court . . . proceeds backward; it reads into the literally and logically prior definition section, § 2(10), the meaning 'prospectus' has in § 10." *Gustafson*, 115 S. Ct. at 1080 (Ginsburg, J., dissenting). The Court in prior cases had observed the importance of starting with the definitional section of acts. Justice Thomas pointed this out in his dissent in *Gustafson* and criticized the Court for "turning to sources outside the four corners of the statute [in order to interpret the word 'prospectus'] rather than adopting the definition provided by Congress." *Gustafson*, 115 S. Ct. at 1074 (Thomas, J., dissenting). For an example, see *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring) ("[t]he starting point in every case involving construction of a statute is the language itself")). Professor Bainbridge argues that if the Court was determined not to look at § 2(10), then § 5 of the Act, which also contains the word prospectus, may have been a better choice since the registration process was created by § 5 and this process, as he explains, is the "very core of the Act: 'All the other provisions of the Act serve merely to implement § 5.'" Bainbridge, *supra* note 5, at 1241 (quoting LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 384 (3d ed. 1989)).

In contrast . . . section 10 is of relatively minor importance in the statutory scheme. In particular, the majority overlooked the fact that section 10 is not self-executing; it merely sets forth the information that must be contained in a prospectus in order to avoid violating section 5(b)(1). Starting with section 10 thus puts the cart before the horse.

*Id.*

42. *Gustafson*, 115 S. Ct. at 1067. The Court emphatically declared that it was not using § 10 as a definitional section when it denied making "the mistake of treating § 10 as a definitional section." *Id.* Regardless, this is exactly what the Court did. Professor Weiss states that

[The Court's] reasoning seems to be that only those documents that the Act requires to meet the requirements of section 10 (or that are exempt from those requirements by reason of section 3) qualify as prospectuses for purposes of section 12(2). In this sense, at least, the Court clearly treats section 10 as definitional in nature.

Weiss, *supra* note 5, at 1214. Professor Bainbridge concurs stating:

One definition of 'definition' is 'sharp demarcation of outlines or limits.' Is that not an apt description of the purpose for which Justice Kennedy employed section 10? By limiting the definition of prospectus to the meaning he believes is contemplated by section 10, he effectively makes section 10 the working definition of a prospectus.

Bainbridge, *supra* note 5, at 1239 (citing WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 334 (1987)).

43. *Gustafson*, 115 S. Ct. at 1066 (quoting 15 U.S.C. § 77c) (emphasis added) (citation omitted).

conflict with Section 10.<sup>44</sup> Section 2(10), which is much broader than Section 10, appears to define the term "prospectus" as including *all* written communications that offer a security for sale or confirming its sale.<sup>45</sup> The Court, however, ignored the plain meaning of this section and applied several judicial canons in order to narrow its scope, and to bring it within seeming conformity with Section 10.<sup>46</sup> Based on the application of these canons, the Court concluded that the term "prospectus" was a "term of art" and a communication "of wide dissemination" and in general, a "public communication."<sup>47</sup>

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44. Justice Thomas observed that the majority discussed § 2(10) only "to show that it does not utterly preclude [the majority's] preferred meaning." *Id.* at 1079. See also Justice Ginsburg's statement that "[t]he Court then proceeds backward; it reads into the literally and logically prior definition section, § 2(10), the meaning 'prospectus' has in § 10." *Id.* at 1080.

45. Section 2(10) defines "prospectus" as "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." 15 U.S.C. § 77(b)(10) (1994). Section 2(10) exempts from the term prospectus certain communications (such as free writing and tombstone ads). *Id.* See *infra* note 49 for more discussion.

46. The Court first applied a canon that refused to read some of the language in § 2(10) as redundant and stated:

If "communication" included every written communication, it would render "notice, circular, advertisement, [and] letter" redundant, since each of these are forms of written communication as well. Congress with ease could have drafted § 2(10) to read: "The term 'prospectus' means any communication, written or by radio or television, that offers a security for sale or confirms the sale of a security." Congress did not write the statute that way, however, and we decline to say it included the words "notice, circular, advertisement, [and] letter" for no purpose.

*Gustafson*, 115 S. Ct. at 1069. The second canon employed by the majority to narrow § 2(10)'s definition of a prospectus was *nosctur a sociis*. "This doctrine stands for the belief that a word is known by the company it keeps." *Id.* Applying this canon, the Court observed that, with the exception of communication, all of the words in § 2(10) refer to "documents of wide dissemination." *Id.*

Professor Bainbridge argues that these two canons were applied in error. Bainbridge, *supra* note 5, at 1248-50. He explains that application of the first canon ignored that redundancies clearly do in fact exist in the Securities Act, citing for example the definition of a security which "contains a long list of instruments, and concludes with the phrase or, in general, any interest or instrument commonly known as a 'security.'" *Id.* at 1249. With respect to the second canon, Bainbridge argues that the word "letter" is not a document of wide dissemination and, in fact, only the term prospectus "clearly relates only to public offerings." *Id.* Therefore, the canon of "*nosctur a sociis* is offset by the canon that 'general terms are to receive a general construction.'" *Id.* at 1249 n.124 (quoting Karl Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to be Construed*, 3 VAND. L. REV. 395, 404 (1950) [hereinafter Llewellyn, *Remarks*]). For a critical discussion of the erroneous application of these judicial canons to § 2(10), see Bainbridge, *supra* note 5, at 1248-50. See also Justice Thomas explaining that the doctrine of *nosctur a sociis* should only be employed where ambiguity exists, adding "which I do not find in § 2(10)." *Gustafson*, 115 S. Ct. at 1075 (Thomas, J., dissenting).

47. *Gustafson*, 115 S. Ct. at 1070. In order to make the term "prospectus" more susceptible to the Court's interpretation as a communication to the public, it labeled it as a "term of art." The Court opined that "the term 'written communication' must be read in context to refer to writings that, from a functional standpoint, are similar to the terms 'notice, circular, [and] advertisement.'" *Id.*

## B. THE PUSH FOR UNIFORM APPLICATION OF SECTION 10

After mistakenly relying on Section 10, the Court committed its second error by selecting the incorrect judicial canon of interpretation, which presumes that “all terms in an act have the same meaning.”<sup>48</sup> Based on established rules of judicial construction, when a word within a statute has different meanings, and the meaning in one context is unsuitable in another, the statutory intent must be honored and the presumption of uniformity disregarded.<sup>49</sup> The Securities Act on its face clearly reveals that it contemplates different kinds of documents as prospectuses,<sup>50</sup> a fact which the majority knew.<sup>51</sup>

The illogic of the Court’s reliance on Section 10 and its application to Section 12(2) is revealed when the Court inevitably dealt with Section

48. *Id.* at 1067. The Court noted that § 12(2) must be considered in light of § 10 in order to promote a uniform interpretation of “prospectus” throughout the Act. *Id.* at 1066-67.

49. *Id.* at 1080 (Ginsburg, J., dissenting) (citing *NationsBank of N.C. v. Variable Annuity Life Ins. Co.*, 115 S. Ct. 810, 816 (1995)). See also Bainbridge, *supra* note 5, at 1237 (“If the majority set out to restrict prospectus to its narrowest meaning, coupling this canon with section 10 may have appeared to be the simplest way of doing so.”).

50. The Act expressly refers to numerous documents that are prospectuses for the purpose of the Act, but which are not required to contain the information of a registration statement. Such documents are: (1) preliminary and summary prospectuses authorized by § 10(b); (2) documents used in connection with registered public offerings which violate § 5(b)(1) of the Act (which prohibits the transmission of a prospectus that does not comply with § 10, such as confirmations and free writing that are not exempted by §§ 2(10)(a) or 2(10)(b) of the Act); and (3) documents used in § 3 offerings. Bainbridge, *supra* note 5, at 1238.

51. The majority, however, conceded that the term “prospectus” has multiple definitions, as Professor Bainbridge notes, “[t]he majority opinion appears to contemplate at least three classes of documents that fall within the definition of prospectus: (i) documents that comply with section 10; (ii) documents that are required to comply with section 10, but fail to do so; and (iii) documents that are exempted from compliance with section 10.” Bainbridge, *supra* note 5, at 1238. Therefore, the Court conceded § 10’s non-exclusivity, yet attempted at the same time to argue for its uniform application. The minority also noted that the manifest intent of Congress is that the term “prospectus” be given different meanings. Justice Ginsburg observed that in “the Investment Company Act of 1940, Congress explicitly recognized that the Securities Act uses ‘prospectus’ in two different senses—one in § 10, and another in the rest of the Act.” *Gustafson*, 115 S. Ct. at 1080 (Ginsburg, J., dissenting). Justice Thomas agreed that the wrong canon was applied and observed, “there are several indications that Congress did not use the word ‘prospectus’ in the same sense throughout the statute,” such as the inclusion within § 2(10)’s definition of “prospectus” of confirmation slips, which do not contain most of the information required by § 10. *Id.* at 1076. See also Bainbridge, *supra* note 5, at 1237 (quoting Llewellyn, *Remarks*, *supra* note 46, at 404 n.49 (“This presumption will be disregarded where it is necessary to assign different meanings to make the statute consistent.”)). Bainbridge argues that the Court did not apply the correct canon. *Id.* at 1237-39. One proof of the untenable application of § 10 as an all encompassing definition is that it leaves a key issue unresolved—whether free writing and other selling documents used in connection with a registered offering fall within the term “prospectus” for § 12(2) purposes. Discussion of this issue, however, is beyond the scope of this Article. It does serve to demonstrate, though, that § 10 can only be applied so far, and no matter how intent the Court was in arguing for its uniform application, it is literally impossible to do so. For a discussion of the issues left open by *Gustafson*, see Bainbridge, *supra* note 5, at 1258-60, and Weiss, *supra* note 5, at 1226-27, as well as other sources cited *supra* notes 5 and 7.

12(2)'s express inclusion of Section 3 offerings.<sup>52</sup> As mentioned previously, Section 3 offerings are exempted from all other sections of the Act, including Section 10.<sup>53</sup> In light of this inclusion, two results of the Court's analysis become apparent: (1) the term prospectus, as found in Section 12(2), contemplates a broader meaning than that found in Section 10; and (2) concomitant with this outcome, Section 10, by its own terms, can only be used to define *one* type of "prospectus" for Section 12(2) purposes (those used in registered offerings), thus leaving the term undefined for offerings made pursuant to Section 3.

With respect to this dilemma, the Court had no other choice than to implicitly admit that the term "prospectus" *must* have another meaning than that under Section 10. This concession is demonstrated when the Court fashioned an exception to Section 10's uniform application: "A document is not a prospectus . . . if, absent an exemption [under Section 3], it need not comply with § 10's requirements in the first place."<sup>54</sup>

The Court weakly asserted that any apparent conflict between Section 12(2)'s and Section 10's usage of the term prospectus does not exist. As authority for this, the Court observed that Section 12(2) exempted from its coverage Section 3 offerings which involved the sale of government issued securities,<sup>55</sup> and argued that this exemption provided proof that Section 12(2) did not cover misrepresentations made in all written communications.<sup>56</sup> The Court argued that if Congress had intended to create such coverage under Section 12(2), then it would not have provided an exemption for government-issued securities.<sup>57</sup> As a result, the Court concluded that any conflicting interpretation of "prospectus" disappears if the term is limited "only to documents that offer securities sold to the public by an issuer."<sup>58</sup> The Court further stated that "[t]he exemption for government issued securities makes perfect sense on that view, for it then becomes a precise and appropriate means of giving immunity to governmental authorities."<sup>59</sup>

52. See 15 U.S.C. § 77l(a)(2) (1995) (applying the provision to securities "whether or not exempted by the provisions of Section 77c").

53. See *supra* notes 33-34 and accompanying text.

54. *Gustafson*, 115 S. Ct. at 1067. With regard to this exception, Professor Fiflis observed:

As stated, the majority reaches its result by construing the term "prospectus" in § 12(2) to mean the full preliminary or final prospectus required by § 10 for registered offerings. However, Justice Kennedy recognized that § 12(2) expressly applies to offerings exempted from registration by § 3 (and hence from the prospectus delivery requirements of § 5) other than for government and bank securities exempted by § 3(a)(2). He therefore is forced to conclude that § 12(2) applies if a § 10 prospectus is required for the sale, or would have been required but for the § 3 exemption, except for offerings exempted by § 3(a)(2).

Fiflis, *Significant*, *supra* note 5, at 62.

55. Section 3(a)(2) is found in 15 U.S.C. § 77a(2) (1994).

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

57. *Id.*

58. *Id.*

59. *Id.*

The Court's reliance on Section 3(a)(2) as indicative of something more than what it clearly states is questionable at best. As Justice Thomas observed in his dissenting opinion, one could reasonably argue the opposite position—that when Congress excluded Section 3(a)(2) from Section 12(2), it had the chance of specifically narrowing Section 12(2) to include only public offerings, but did not do so.<sup>60</sup>

### C. THE INSUPPORTABLE RESULT

When all of the Court's arguments are reviewed, one thing becomes painfully evident—in its attempt to narrow Section 12(2) to include only public offerings, the Court did not understand (or ignored) the nature of these offerings and, consequently, how to define them.<sup>61</sup> This crucial mis-

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60. Justice Thomas reasoned that the express exemption (§ 3(a)(2)) only excluded this type of offering from the reach of § 12(2) and did not indicate a broader exclusion. *Id.* at 1077 (Thomas, J., dissenting). Justice Thomas argued that if Congress intended such a limitation for all private or secondary transactions then Congress would have expressly stated such, or the exemption for government securities would have included those types of offerings. *Id.* Professor Bloomenthal commented upon the majority's argument concerning § 3(a)(2): "This is such rank speculation that if the rules of evidence were applicable to such testimony, it would probably not be admissible." See Bloomenthal, *Supreme Court, Part I, supra* note 5, at 26.

61. It is interesting to note that it was only after the Court rendered its conclusion as to the scope of § 12(2) that it examined the original purposes of the 1933 Act. The Court observed that Congress's primary purpose in passing the Act was the creation of federal duties or requirements involving the registration and disclosure obligations for public offerings. *Gustafson*, 115 S. Ct. at 1068. The Court cited to several cases which observed that the 1933 Act affected public or initial offerings of securities: *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975); *SEC v. Ralston Purina Co.*, 346 U.S. 119, 122 n.5 (1953). Having observed this, the Court concluded that the 1933 Act provided remedies *only* for violations of these requirements. The Court intentionally ignored that the *primary purpose* language was non-exclusive, and even conceded this when it stated, "[i]t is more reasonable to interpret the liability provisions of the 1933 Act as designed for the primary purpose of providing remedies for violations of the obligations it had created." *Gustafson*, 115 S. Ct. at 1068. Thus, the Court ignored the equally important non-exclusionary thrust of other purposes of the Act. With regard to this, Professor Loss stated:

[I]ronically from my point of view, several courts have quoted the opening paragraph of my discussion elsewhere of the statutory pattern of the 1933 Act:

The 1933 Act is concerned primarily with *distributions*. Postdistribution trading was to be the subject of further legislation, which turned out to be the 1934 Act.

Having thus set the terms of the discourse, some courts (along with Professor Weiss) have overlooked, or at any rate ignored, the word "primarily," without which the quoted paragraph would be inaccurate.

Loss, *Rebuttal, supra* note 13, at 55-56.

Additionally, Professor Loss asserts that these courts ignored the prefatory language to his discussion of § 12(2): "To start with what is clearest, the section applies to all sales of securities." LOSS, *FUNDAMENTALS, supra* note 12, at 1021. For further support of this assertion, see Bancroft, *supra* note 5, at 152 (quoting President Roosevelt when he referred to the Securities Act of 1933 as ensuring that "every issue of new securities . . . [would] be accompanied by full publicity and information' with the burden of truthful disclosure on those that issued securities"). Additionally, Justice Ginsburg cites William O. Douglas and George E. Bates, who noted shortly after the passage of the Securities Act that § 12(2) would apply to all material untrue statements or omissions, *whether or not* the security was

understanding is apparent from the Court's first attempt to define all public offerings as those that are registered; the Court thus embraced Section 10 to conform to this understanding. However, contrary to the Court's interpretation, not all public offerings are registered,<sup>62</sup> a fact which is well known in securities law.

The Court manifested its confusion again when, faced with the possible conflict between Section 10 and Section 2(10) and the inapplication of Section 10 to Section 3 offerings, it proffered the *generic* definition of "prospectus" as: A "public communication" involving a "document of wide dissemination."<sup>63</sup> This definition directly opposes long-standing authority that public offerings are not necessarily defined by the number of participants and, thus, neither by the number of documents disseminated.<sup>64</sup>

Besides the Court being off-base in its rudimentary understanding of these basic securities law concepts, it is clear that it did not anticipate the anomalous consequences of its decision. If it had, it would have realized that, for the purpose of Section 3 offerings, an issuer could easily circumvent Section 12(2) by limiting the dissemination of documents to a few

registered. *Gustafson*, 115 S. Ct. at 1082 (Ginsburg, J., dissenting) (citing William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 *YALE L.J.* 171, 177 (1933)).

The Court also relied on § 17(a) of the 1933 Act to support its narrow interpretation of § 12(2), noting that 17(a) covered not only public offerings, but also other types of offerings since it did not contain the limiting words "by means of prospectus or oral communications." *Gustafson*, 115 S. Ct. at 1071 (citing *United States v. Naftalin*, 441 U.S. 768 (1979), in which the Court interpreted § 17(a) of the Act to cover all types of offerings). In the alternative, Professor Loss explains that §§ 12(2) and 17(a) are comparable: "The scope of liability under Section 12(2) and 17(a), the [Act's] two antifraud Sections, is substantially the same. In effect, Section 12(2) is to Section 17(a) what Section 12(1) is to Section 5." See Bainbridge, *supra* note 5, at 1245 (quoting Loss, *Assault*, *supra* note 13, at 915).

The Court also misinterpreted the legislative history of § 12(2) by misconstruing provisions relating to § 11 with § 12(2). For a further discussion of this point, see Bloomenthal, *Supreme Court, Part I*, *supra* note 5, at 29-31.

62. This misunderstanding was revealed by the Court when it incorrectly observed that the preparation and filing of a registration statement is generally required only for a public offering of a security, and concluded that "a prospectus under § 10 is confined to documents relating to public offerings by an issuer or its controlling shareholders." *Gustafson*, 115 S. Ct. at 1067. This is erroneous when one considers that a public offering can embrace offerings that are non-registered, and thus not required to comply with § 10. See *infra* notes 63-64 and accompanying text. This misinterpretation leaves open the question of which non-registered public offerings are included within the scope of § 12(2).

63. *Gustafson*, 115 S. Ct. at 1070.

64. See *infra* notes 76-78 and accompanying text. See also *Fiftis, Significant*, *supra* note 5, at 66 (quoting Viscount Sumner's dictum in *Nash v. Lynde* (1929) A.C. 158, 169: "'The public' . . . is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve: perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceedings needless by himself subscribing the whole"). See also *Ralston Purina*, 345 U.S. at 125 ("the statute would seem to apply to a 'public offering' whether to few or many"); *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 467 (2d Cir. 1959) ("we think that the *Ralston Purina* case clearly rejected a quantity limit"). In *Gilligan*, the court held that the offering to the four persons was public. *Gilligan*, 267 F.2d at 467.

persons.<sup>65</sup> Automatically treating such offerings as private, and therefore excluded, flies in the face of well-established authority that offerings involving only a few individuals (and/or entities) can still be public.<sup>66</sup> An equally anomalous result flows from the opposite situation. A Section 3 offering involving the wide dissemination of a prospectus would be *automatically* treated as public and included within Section 12(2), even though the nature of the offering itself may be considered private.<sup>67</sup> Because both of these outcomes are so heretical when compared with established securities law and practice, such a definition cannot be seriously followed.

Needless to say, the focus on documents and their dissemination is imperfect, if not wrong altogether. The only sure conclusion that can be reached from *Gustafson* is that registered public offerings are covered by Section 12(2). As to any Section 3 offerings, the intent of the Court is clear—they must be public in order to be included within Section 12(2).<sup>68</sup>

#### IV. THE IMPACT OF *GUSTAFSON* AND THE SEARCH FOR AN APPROPRIATE TEST

##### A. THE INAPPROPRIATENESS OF USING SECTION 4(2) TO EXCLUDE SECTION 3 OFFERINGS

It has been suggested that the starting point in defining a public offering should begin with what it is not.<sup>69</sup> Based on this, one conclusion may

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65. Such an easy loophole serves as an invitation for fraud and renders § 12(2) toothless. This could conceivably even embrace an offering to a large group of shareholders as long as only a few within the group receive a prospectus.

66. For example, Rule 504 of Regulation D, § 3(a)(11) and Rule 147 are regarded as public offerings since there can be an unlimited number of investors in these offerings. The fact that only a few investors are offered securities in one of these offerings would not generally change the public nature of the offering, since investors need not meet stringent qualification requirements. There are no investor qualifications under Rule 504, and only a minimal investor requirement that offerees and purchasers be residents of the state of the offering for purposes of Rule 147 and § 3(a)(11). See Bainbridge, *supra* note 5, at 1266 (“they are all usually regarded as public”).

67. For example, Rule 506 of Regulation D, which contains no requirement limiting the number of accredited investors, is the safe harbor to § 4(2) for private placements. Thus, offerings made pursuant thereto are deemed non-public. In light of this, if the dissemination of documents controls and documents are given to a large number of accredited investors (making the offering public under this definition), express statutory intent that the offering be considered private is nullified.

68. Even after conceding that § 12(2) included § 3 offerings and the inapplicability of § 10 to these offerings, the Court *still* insisted that “prospectus” has the same meaning in § 12(2) as it does in § 10. “[P]rospectus under § 10 is confined to documents *related to* a public offering by an issuer or its controlling shareholders.” *Gustafson*, 115 S. Ct. at 1067 (emphasis added). Professor Bainbridge raised the possibility that *Gustafson* included *all* § 3 offerings within § 12(2), and therefore any document used in connection therewith would automatically be a prospectus covered by § 12(2)—whether or not the offering was public. Bainbridge, *supra* note 5, at 1260-65. Professor Bainbridge, however, argued against adoption of this interpretation because it would go against the intent of the Court’s opinion to include only public offerings within § 12(2)’s scope. *Id.* at 1264-65. See also Weiss, *supra* note 5, at 1220 (arguing that not all § 3 offerings are subject to § 12(2)).

69. It has been posited that a public offering begins with the definition of a private offering, and through negative inference the definition is formed. In contrast to private offerings, in which the sale of securities occurs through a private agreement, a public offering is commonly accomplished through the use of securities exchanges or through broker-



be readily advanced—those offerings that rely on the Section 4(2) exemption of the Securities Act are deemed private offerings and, therefore, any private placement documents used pursuant thereto would not be covered by Section 12(2). In agreement with this are the lower court cases that have followed *Gustafson* and uniformly excluded these offerings from Section 12(2)'s scope.<sup>70</sup>

Yet the exclusion of these offerings from Section 12(2) should not be taken for something more than it is—an imprimatur for determining which other unregistered offerings are private, and therefore, not covered under Section 12(2). Put simply, Section 4(2) offerings are excluded from Section 12(2)'s scope for no other reason than by virtue of the Court's "absent an overriding exemption" language in *Gustafson*, which expressly includes within Section 12(2) only those offerings that are exempted under Section 3, not Section 4.<sup>71</sup> Therefore, the use of the Section 4(2)

dealer relationships. WILLIAM M. PRIFTI, SECURITIES: PUBLIC & PRIVATE OFFERINGS § 1:06-1:07 (1983). "A private offering is the opposite of a public offering." *Id.*

70. In a recent article, Professor Maynard discussed several cases decided after *Gustafson* which have denied recovery under § 12(2) in exempt private placements. These decisions relied on *Gustafson* for the proposition that § 12(2) was narrowed to cover only public offerings. See Maynard, *Impact*, *supra* note 5, at 63 (discussing *Glamorgan Coal Corp. v. Ratner's Group PLC*, No. 93 Civ. 7581 (RO), 1995 WL 406167 (S.D.N.Y. July 10, 1995)). Professor Maynard, although noting that the *Glamorgan* opinion was not clear as to whether the facts involved a private placement made pursuant to § 4(2) or Rule 506 of Regulation D, observed that the district court opined that "[e]very court since *Gustafson*, including this district, has held in light of *Gustafson*, that § 12(2) applies *only* to initial public offerings." *Glamorgan*, 1995 WL 406167 at \*2 (emphasis added). Based on this analysis, the court granted the defendant's motion to dismiss the § 12(2) claims as they pertained to private placement offering materials. *Id.* The court concluded that the private placement memorandum was not a prospectus as used in § 12(2) and stated its reasoning was based on *Gustafson*'s holding "that the term prospectus has the same meaning for purposes [of] Section 10 and Section 12(2)." *Id.* at 3 n.3. Professor Maynard also cites other cases which similarly held that § 12(2) covers only public offerings. Maynard, *Impact*, *supra* note 5, at 67-70 (discussing *Whirlpool Fin. Corp. v. GN Holdings, Inc.*, No. 95-1292, 1995 WL 571397, at \*3 (7th Cir. Sept. 28, 1995) (excluding private placement memoranda from § 12(2) since "a 'prospectus' for Section 12(2) purposes includes *only* public offerings by issuer or their controlling shareholders") (emphasis added)); *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, No. 94 Civ 019 (RLC), 1995 WL 547779 (S.D.N.Y. June 14, 1995) (with regard to the private placement memoranda used in connection with the sale of limited partnership interests, the district court concluded that "[i]n light of the Supreme Court's clear ruling that [Section] 12(2) covers only public offerings, private offering memoranda can no longer be considered prospectuses within the meaning of [Section] 12(2)"); *Haerting v. One Toucan Du, Inc.*, No. Civ. A-94-0142, 1995 WL 244489, at \*1 (E.D. La. Apr. 16, 1995) (where the plaintiffs voluntarily abandoned their § 12(2) claims in light of the United States Supreme Court ruling in *Gustafson*).

71. In other words, authority for the exclusion of § 4(2) offerings from § 12(2) is not based on the general intent of *Gustafson* to include only public offerings within § 12(2), although it is certainly in line with this intent. Instead, it is grounded in the specific language of the case, which provides that a "'prospectus,' absent an overriding exemption must include the 'information contained in the registration statement.'" Section 3—not § 4—is considered to be the "overriding exemption." With respect to this language, Professor Bainbridge argues (although he ultimately rejects the position) that since § 12(2) does not expressly exclude § 4 offerings from its scope, it could be argued that these offerings are included. He posits that Congress only expressly included § 3 offerings within § 12(2) because § 3 offerings are exempt from the entire Securities Act, while § 4 offerings are only exempt from § 5 of the Act. Section 4 offerings would thus be subject to the rest of the Act, including § 12(2). Professor Bainbridge acknowledges, though, that this argu-

exemption *and* its common law requirements to go one step further and additionally exclude from the scope of Section 12(2) those Section 3 offerings which can *also* meet this exemption clearly goes farther than the Court intended in *Gustafson*.<sup>72</sup>

Despite this, it has been posited that Section 4(2) and its common law requirements should serve as *the* appropriate test in determining which Section 3 offerings are public and which are private. Therefore, using Section 4(2) in such a way deserves close scrutiny. Upon examination, several problematic results would occur from such a usage.

First, failure to prove compliance with Section 4(2) and its common law requirements does not necessarily mean the transaction involved is a public offering. An issuer may not be able to meet the burden of proof needed to demonstrate compliance with Section 4(2)'s requirements, yet the offering may still be considered private in nature.<sup>73</sup> Second, Section 4(2) exempts offerings from only the registration provision of the Securities Act found in Section 5, *not* the antifraud provision of Section 12(2). Therefore, use of a registration exemption to exclude offerings from an antifraud provision is permitting a usage which was never statutorily in-

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ment is weak and agrees that § 4 offerings are excluded. See Bainbridge, *supra* note 5, at 1262-65. See also Weiss, *supra* note 5, at 1220 (stating that § 4 offerings are excluded from § 12(2) simply based on the Court's intent to include only § 3 offerings within the context of "overriding exemption"). Additionally, Professor Fiflis refers to this exemption language:

This [exemption language] necessarily implies that offerings exempted from registration by § 4, on the other hand, are not vulnerable to § 12(2) liability. Justice Kennedy attempts to state the rule of the case as being that:

[t]he liability imposed by § 12(2) cannot attach unless there is an obligation to distribute the prospectus in the first place (or unless there is an exemption).

By "exemption" he clearly means only under § 3, not only by virtue of the necessary implication above, but from the ultimate holding that § 12(2) covers only public offerings by issuers or control persons.

Fiflis, *Significant*, *supra* note 5, at 62.

72. Professor Weiss asserts that those § 3 offerings which are also exempt under § 4 (that is, those that can also meet the common law requirements of § 4(2)) should be excluded from § 12(2). Weiss, *supra* note 5, at 1221. Professor Bainbridge argues against using § 4(2) in this way, stating that "his approach overlooks the essentially non-public nature of many exempt transactions." Bainbridge, *supra* note 5, at 1266-67. See *infra* notes 73-83 and accompanying text for some of these arguments. This Article is against the application of § 4(2) in such a way to *any* § 3 offering, whether the issuer relied on § 4(2) to *begin with* as an additional exemption to § 3 or it is applied to the § 3 offering *after the fact* to see if it *also* meets § 4(2)'s requirements.

73. Professor Bainbridge argues:

Although a transaction that qualifies for exemption under Section 4(2) by definition does not involve a public offering, the converse is not necessarily true. Professor Weiss ignores the allocation of the burden of proof with respect to exemptions from registration. To say that the defendant failed to carry its burden of proving that the transaction did not involve any public offering is not the same as saying the transaction in fact involved a public offering.

Bainbridge, *supra* note 5, at 1266-67.

tended.<sup>74</sup> Third, compliance with Section 4(2)'s common law requirements may not necessarily be determinative of what is private. Offerings that may not be able to meet Section 4(2)'s common law requirements may still be private *in nature*, yet *deemed* public under this test. As a consequence, fundamentally private offerings may be included within Section 12(2), a result contrary to the express intent in *Gustafson*.<sup>75</sup>

Several examples of this odd result are found with respect to Regulation D. Rule 505, which is considered essentially private, has more liberal requirements than those found in Section 4(2).<sup>76</sup> Yet offerings made pursuant to this rule are still viewed as basically private since Rule 505 restricts the number and type of investors and prohibits general solicitation.<sup>77</sup> Regardless of this, these offerings would be deemed public merely because of their inability to meet the Section 4(2) requirements and they would therefore be included within Section 12(2).<sup>78</sup>

An additional anomaly involves Rule 506 of Regulation D, which was passed pursuant to Section 4 of the Securities Act with the express intent to provide a safe harbor to this section. Rule 506 also has more liberal requirements than Section 4(2)'s common law requirements.<sup>79</sup> Yet again, failure to meet these requirements would make Rule 506 offerings public.<sup>80</sup> Treatment of Rule 506 offerings in such a way would *work against* the congressional intent in passing Rule 506—to act as a safe harbor for *private* placements.<sup>81</sup>

The fourth and final problematic use of Section 4(2) also involves Regulation D. Regulation D expressly states that any offerings made pursuant to it are not exempt from Section 12(2).<sup>82</sup> This statement is

74. Professor Bainbridge stated that “it seems odd that one’s compliance with Section 4(2), which on its face exempts the issuer only from Section 5, could determine whether liability arises not only under Section 12(1), but also under Section 12(2).” *Id.*

75. *See supra* notes 65-67 and accompanying text.

76. 17 C.F.R. § 230.505 (1995). Rule 505 only requires purchasers, not offerees, to meet certain requirements. Additionally, Rule 505 allows up to 35 non-accredited investors, meeting no requirements. *Id.* Section 4(2), on the other hand, requires that *all* offerees and purchasers be sophisticated under § 4(2) as defined in note 79 *infra*.

77. *See* Bainbridge, *supra* note 5, at 1267 referring to Rule 505: “[B]y its terms [it limits] both the size of the offer and the allowable number of purchasers and also precludes general advertising and solicitation which gives it most of the key characteristics of a private placement.” *But see* Bloomenthal, *Supreme Court, Part 2, supra* note 5, at 39 (arguing that since Rule 505 was adopted pursuant to § 3(b) rather than § 4(2), “it is an indicator that the Commission does not regard it as a private offering”).

78. Bloomenthal, *Supreme Court, Part 2, supra* note 5, at 39.

79. Rule 506 does not require offerees to meet investor qualification requirements; however, § 4(2) does. Additionally, an investor could be accredited for the purposes of Rule 506 (for example, meeting wealth requirements under Rule 501 of Regulation D) but not necessarily be sophisticated as required by § 4(2), which requires offerees and purchasers to be knowledgeable about the investment as well as financially sophisticated (able to bear the risk). As Professor Weiss states: “Court’s interpreting Section 4(2) require sellers to establish the eligibility of all offerees, not merely all purchasers. Thus, liability under Section 12(2) could attach to a Rule 506 offering where the seller is unable to establish that all offerees were able to ‘fend for themselves.’” Weiss, *supra* note 5, at 1222.

80. *See* Bainbridge, *supra* note 5, at 1267.

81. *Id.*

82. Professor Weiss admits this is a problem for the SEC, but states:

substantively true for registration exemptions (that is, those that are transactional) as a whole, since it recognizes that these exemptions are not meant to be applied to nor are they used for such a *cross-sectional* purpose. Therefore, if Section 4(2) (and its common law requirements) is used to exclude Rule 505 and 506 offerings from Section 12(2), it not only indirectly accomplishes what Regulation D expressly prohibits but also would disregard the general intent of the 1933 Act to confine these exemptions to Section 5.<sup>83</sup>

#### B. THE CONCEPT OF "FENDING FOR ONESELF"

What appears to lie behind the proffered application of Section 4(2) and its common law requirements to Section 3 offerings is in fact an *attempt to limit* the number of offerings that can truly be excluded from Section 12(2) as private.<sup>84</sup> No where is this better demonstrated than the suggested application of Section 4(2) to Rule 506 offerings. Such a use intimates that the preexisting requirements within Rule 506 are not stringent enough in their protection of investors when faced with the possible exclusion of these offerings from the antifraud provisions of Section 12(2).<sup>85</sup>

Section 4(2)'s common law requirements were originally based on the

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When the Commission issued Regulation D, it undoubtedly believed that Section 12(2) applied to all Regulation D offerings. Preliminary Note 1 to Regulation D represents the SEC's efforts to confirm that all Regulation D transactions will be subject to the same liability standards. *Gustafson* now makes clear that they are not. Section 12(2) applies to some Regulation D transactions, but not to all.

Weiss, *supra* note 5, at 1223. Professor Weiss argues that using § 4(2) and its common law requirements to exempt Regulation D offerings from § 12(2) does not violate the express mandate that all Regulation D offerings be included. *Id.* at 1221. He reasons that neither Preliminary Note 1 nor Regulation D as a whole can have the effect of subjecting to liability under § 12(2) a transaction to which that section would not otherwise apply (that is, a transaction that does not involve the use of a "prospectus"). *Id.* Professor Weiss's reasoning assumes, however, that § 4(2) *should be allowed* to exempt such a transaction when the arguments *against* such usage are clearly forceful, as demonstrated in this section of the Article. Additionally, if § 4(2) were allowed to do this, the spirit of Regulation D's express inclusion within § 12(2) is also abrogated. Transactional exemptions exempt offerings from § 5, *not* § 12(2).

83. It could be argued that the Court's language including § 3 offerings within § 12(2) while excluding § 4 offerings from its scope has the same impact of excluding some Regulation D offerings (*all* 506 offerings) from § 12(2), while others remain. Since Rule 506 was passed pursuant to § 4, the argument follows that all Rule 506 offerings would be automatically excluded from § 12(2). Professor Bloomenthal argues along these same lines, stating that for purposes of § 12(2) liability, Rule 506 offerings are clearly private "as the Rule is an interpretation of § 4(2) of the Securities Act," and thus no § 12(2) liability would attach. *See Bloomenthal, Supreme Court, Part 2, supra* note 5, at 38. In comparison, § 4(2) and its common law requirements would have the effect of excluding *some* Rule 506 offerings on a case-by-case basis (that is, those that could also comply with it). *See Weiss, supra* note 5, at 1222-23.

84. Few § 3 offerings (even those which by their nature are considered private) would satisfy § 4(2) and its common law requirements, since those requirements are very stringent in their application to not only purchasers but *also* offerees. *See supra* notes 72-78 and accompanying text. On the other hand, Regulation D applies only to investors. *Id.*

85. *See infra* notes 87 and 89.

concept founded in the *Ralston Purina*<sup>86</sup> case that if one were able to “fend for oneself”<sup>87</sup> in an offering, then the full protection of the registration provision of Section 5 was unnecessary, and the issuer could rely on the private offering exemption in Section 4(2).<sup>88</sup> Reliance on Section 4(2)’s requirements for antifraud purposes, however, is imperfect. Fending for oneself under an antifraud section raises concerns other than fending for oneself in a registration setting. Providing adequate disclosure in some form or another pursuant to a registration exemption *does not* necessarily insure that this disclosure is truthful, a protection that no exemption—including Section 4(2)—provides.<sup>89</sup>

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86. SEC v. *Ralston Purina Co.*, 346 U.S. 119 (1953).

87. In the *Ralston Purina* case, the Securities and Exchange Commission sought to enjoin the *Ralston Purina* Company from making unregistered stock offerings to hundreds of its employees whom it had designated as “key employees” pursuant to the private offering exemption under § 4(1) (now § 4(2)) of the Securities Act of 1933. *Id.* at 120. The issue in the case was to determine the scope of § 4(2) under the Act. *Id.* The Court noted that the Act did not define “public offering” or the scope of § 4(2); however, the Court observed that the purpose of the Act was to protect investors by promoting full disclosure of information considered necessary to make an informed decision. *Id.* The Court stated that since exempt transactions are those where there is no practical need for full application of the registration provisions of § 5, the applicability of § 4(2) should turn on whether the particular class of persons affected *needs the protection of the Act*. *Id.* The Court concluded that “[a]n offering made to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’” *Id.* (emphasis added). The Court held that since many of the employees who were offered securities were not “key employees” in the management sense, but were lower level employees (such as clerical workers, foremen, and others), it could not be said that the offering was made only to “self-fending” types, since these types of employees did not have access to the kind of information which registration would disclose. *Id.* at 127-28. Therefore, the offering was public and § 4(2) did not apply. *Id.*

88. Arguing for § 4(2)’s application to § 12(2), Professor Weiss states that § 4(2)’s “central teaching” is that to qualify as private, an offering must be made only to persons who “can fend for themselves” and who “have access to the same kind of information.” Weiss, *supra* note 5, at 1221.

89. See generally Maynard, *Impact*, *supra* note 5. Professor Maynard notes this difference and the inability of § 4(2) alone to provide such protection to those offerings in compliance with this exemption. *Id.* Professor Maynard argues that since § 12(2) probably excludes private placements from its coverage under *Gustafson*, the buyer is left with Rule 10b-5 of the Securities Exchange Act as the only recourse under the federal law. *Id.* at 79. Because of this, Professor Maynard argues that § 12(1) of the Securities Act should be reinterpreted as providing an alternative remedy. *Id.* Noting that *Ralston Purina* required issuers relying on § 4(2) to establish that all offerees are qualified as self-fending types, Professor Maynard argues:

In light of *Gustafson*’s holding, one could make a good argument that where a PPM [private placement memoranda] is used rather than providing access to such information, the defendant’s Section 4(2) exemption should be conditioned on providing all offerees with a truthful and accurate PPM. In other words, the plaintiff-buyer could argue that the issuer’s use of a misleading PPM creates a Section 5 violation entitling the buyer to relief under Section 12(1).

*Id.* at 71. Professor Maynard posits that buyers cannot be “self-fending” types under *Ralston Purina* without having truthful and accurate information, which § 4(2) does not currently require. *Id.* at 71-72. Although noting that no cases have construed § 4(2) as requiring this, Professor Maynard cites SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1096-1100 (2d Cir. 1972), which held that there was a § 5 violation in the case of a false and misleading material statement in a registered offering. The court held that § 5 required not only the delivery of a prospectus satisfying the § 10(a) requirements, but also implicit in

What is correct, therefore, about any reference to Section 4(2) is *not* the use of its common law requirements to determine which Section 3 offerings should be excluded from Section 12(2), but rather the use of the *concept* upon which it is grounded—that of being able to “*fend for oneself*”—as the determinative factor for establishing who needs protection under Section 12(2). Application of this concept to Section 12(2) is not only appropriate but called for since the concept prevails throughout the Securities Act.<sup>90</sup>

Therefore, reliance on Section 4(2) and its common law requirements *stops* with Section 5.<sup>91</sup> Reference should be made once again to the *Ralston Purina* case in order to establish new requirements for determining who are “self-fending” types for the purpose of ascertaining which Section 3 offerings should be excluded from Section 12(2)’s coverage.<sup>92</sup>

this was the delivery of a truthful document. Professor Maynard argues that this implication would be extended to private placement memoranda through § 12(1). Maynard, *Impact*, *supra* note 5, at 72-74.

90. See generally *Ralston Purina*, 346 U.S. at 127. See also *supra* notes 88-89 for a discussion of applying the “self-fending concept” to § 12(2). See also Maynard, *Impact*, *supra* note 5, at 71.

91. Section 4(2) does not require truthful disclosure, a factor which § 12(2) mandates. Therefore, if § 4(2) cannot ensure truthful disclosure for its own offerings, it cannot possibly provide such to those § 3 offerings that can also comply with it. Additionally, as Professor Maynard argues, it is not likely that § 12(1) will be used to ensure this protection for offerings exempted under § 4(2). See Maynard, *Impact*, *supra* note 5, at 72-73. Professor Maynard admits that the use of a non-antifraud section such as § 12(1) to enforce the truthfulness of a document ignores the structure of the Securities Act and has been heavily criticized. *Id.* She additionally notes that no case other than *Manor Nursing Ctrs.* has implied such a condition under § 5, and no cases have implied such a condition with respect to § 12(1). *Id.*

92. Some commentators have mentioned the necessity for revisiting the *Ralston Purina* case because of the problems associated with the *Gustafson* decision. See, e.g., Fiflis, *Significant*, *supra* note 5, at 66-67, arguing that the Court implicitly recognized *Ralston Purina* and, necessarily, the concept upon which that case is based: “Although the Court made no mention of how to define a ‘public offering,’ it referred to the concept in the context of registration and, therefore, the test of *SEC v. Ralston-Purina Co.*, 345 U.S. 119 (1953), must apply.” But Professor Fiflis further observed:

[I]t is clear that the majority in *Gustafson* did not have *Ralston-Purina* clearly in mind, because the opinion refers to an understanding of public offerings as involving ‘widespread’ offerings and offerings ‘to the public at large’; and refers to prospectuses as being documents ‘of wide dissemination.’ This naivete about the concept of a public offering is the insecure foundation of the Court’s opinion. This may presage an overruling of *Ralston Purina* as a further insult to legislative intent, but until that occurs *Ralston Purina* must be taken as the determinant of a public offering.

Fiflis, *Significant*, *supra* note 5, at 67. See Maynard, *Impact*, *supra* note 5, at 70-74 for the proposition that the long-standing concept of public offerings, based on *Ralston-Purina* and its progeny has been called into question, if not jeopardized altogether by the Court’s reasoning in *Gustafson*. See also *ESI Montgomery County, Inc. v. Montenay Int’l Corp.*, where the court observed that whether an offering was public or private would be based on the criteria in the *Ralston Purina* case and its progeny. *ESI Montgomery County, Inc. v. Montenay Int’l Corp.*, 899 F. Supp. 1061, 1065 (S.D.N.Y. 1995). The court stated that the relevant factors to be considered in such a determination depended upon “(1) the number of offerees; (2) the sophistication of the offerees; and (3) the manner of the offering.” *Id.* Application of these factors was not called for in the case since the plaintiff had not alleged that the offering was public, but had conceded that the memoranda used in the offerings were “private placement memoranda.” *Id.*

## V. THE TEST

Towards this end, at least two categories of "self-fending" types could be used to form the new test for determining which Section 3 offerings are private and therefore not covered by Section 12(2). The first category focuses on the preexisting *relationship* that offerees and purchasers have with the issuer, while the second category relates to the *ability* of offerees and purchasers to *contractually protect* themselves in the offering.<sup>93</sup>

### A. TWO CATEGORIES

#### 1. *Insiders*

With respect to the first category, since Section 12(2) requires that prospectuses covered thereby provide truthful disclosure, then those offerees and purchasers who are in a position to ascertain the truthfulness of such information would be able to "fend for themselves." Most likely, this category of "self-fending" type would be insiders of the issuer, such as executive officers, directors, general partners of the issuer of the securities being offered or sold, or any directors, executive officers, or general partners of a general partner of that issuer.<sup>94</sup> These types of individuals are in management roles and are in a position to know the inner-workings of the issuer. Therefore, they are best able to judge the veracity of

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93. Commentators have generally agreed that the concept of "self-fending" for § 12(2) purposes should include both offerees and purchasers. See Maynard, *Impact, supra* note 5, at 85. See also Fiflis, *Significant, supra* note 5, at 68, arguing that Rule 506 offerings may be public and even offerees may have to be self-fending for purposes of Rule 506:

Even Rule 506 of Reg. D (the private offering safe harbor) may involve a "public offering" because an exempt 506 offering may be made to an unlimited number of accredited investors, some of whom (such as a wealthy young athlete or a naive heir to a million dollar inheritance) may not be able to "fend for themselves." Rule 506 by its terms is expressly limited to exemption from registration, so that a seller defending against a § 12(2) action could not claim that § 19(a) also exempts the transaction from § 12(2).

Further, the Rule 506 exemption from registration goes beyond Ralston Purina in another respect because it does not require all offerees to be able to fend for themselves. It refers only to purchasers. Of course those who fail to register, relying in good faith on Rule 506, are protected by § 19 for that failure. *But because Rule 506 exempts only from registration, not civil liability otherwise, and therefore, if in fact the offering is to some who cannot fend for themselves, it is public, there should be no protection against § 12(2) liability.*

*Id.* (emphasis added).

94. This category is taken from Rule 501(a)(4) of Regulation D. The definition of executive officer is also provided by Rule 501(f) of Regulation D, which defines "executive officer" as:

[T]he president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer. Executive officers of subsidiaries may be deemed executive officers of the issuer if they perform such policymaking functions for the issuer.

17 C.F.R. § 230.501(f) (1995).

Professor Loss states: "Similarly, the Commission staff has recognized the executive officer of the parent of a Regulation D issuer *may* perform a policymaking function for its subsidiary and be deemed an 'executive officer' of the subsidiary." LOSS, FUNDAMENTALS, *supra* note 12, at 317.

any statement made about the issuer, and any other statements in the prospectus. In fact, many insiders work with the issuer's counsel in the preparation of the prospectus and provide, on some level, the information used in the prospectus.

Even if the issuer distributed prospectuses to non-insiders *and* provided all of these individuals with access to corporate files and information, this would still not ensure protection under Section 12(2). The amount of information given is irrelevant. Non-insiders are not in a position *to effectively assess* the truthfulness of such information since they lack the necessary two tools to do so—(1) internal knowledge about the issuer and (2) experience therewith. Only those two tools provide the necessary basis upon which all other information can be compared and measured for its veracity. This statement remains true no matter how knowledgeable non-insiders are about the type of investment offered and/or how financially sophisticated they are (that is, able to bear the risk). Both of these types of sophistication do not provide the necessary sophistication *about the issuer* that comes only from the knowledge and experience gained from *managing the issuer*. Only an insider position provides this. This insider category must be applied, however, in such a way that form does not overcome substance. If certain individuals are insiders only by virtue of their title, then this requirement would not be met.

## 2. *Contractually Sophisticated*

The second category of the “self-fending” type would be offerees and purchasers who are able to enter into arm's-length private negotiations with the issuer, and who can ultimately condition any purchase of securities on obtaining written contractual provisions that afford the same protection that Section 12(2) would normally provide.<sup>95</sup> An example of this would be the plaintiffs in *Gustafson* who had negotiated with the sellers for warranties and representations in the private written sales contract that in effect fully protected them without the necessity of seeking protection under Section 12(2).<sup>96</sup> This category of “self-fending” type would be

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95. An arm's-length transaction assumes there is no undue influence, duress, or other contractual heavy-handedness, so that the parties entering into the contract can freely bargain for the necessary protections.

96. See Bancroft, *supra* note 5, at 188 n.245, agreeing that the purchasers were “self-fending” types:

An argument can be made for narrowing the *Gustafson* case to its facts, as the Court appeared to do here. The Buyers in this case were sophisticated and had fully researched the company before purchasing it. *Gustafson*, 115 S. Ct. at 1064-65. They evidenced their sophistication when they insisted on a remedial clause in the Agreement, and were fully compensated pursuant to this clause. *Id.* at 1065. *Thus there was no need to apply § 12(2) to the Agreement, because the plaintiffs had already received full compensation.* In future cases, however, with less sophisticated buyers, there may be a need to impose § 12(2) liability when the buyers could not otherwise be compensated.

*Id.* (emphasis added).

Professor Weiss raises a possible argument in support of these types of individuals being excluded from § 12(2): “The facts of *Gustafson* thus made it clear that one consequence of a holding that Section 12(2) applies to private negotiated sales of stock would be to pre-



those who are deemed to be "contractually sophisticated." Unlike Section 4(2)'s sophistication requirement, this type of sophistication would be based on objective criteria since it is easy to ascertain whether contractual provisions will be fully protective.

## B. THE APPLICATION

A test is only as good as its successful application. Therefore, one of the primary advantages of both categories of this new test is that they provide a bright-line rule for issuers. In comparison, Section 4(2) would be applied on a case-by-case basis and, as a result, gives issuers little comfort.<sup>97</sup>

With respect to the new test's application to Regulation D, Rule 504 offerings (offerings to unlimited numbers of investors without regard to investor qualification) would be considered to be public under Section 12(2) unless all of the offerees and purchasers were self-fending types under either category as provided by the test.<sup>98</sup> Rule 505 offerings would likewise be treated the same. These offerings would be public unless all offerees and purchasers could meet either prong of the new test. Offer-ees and purchasers meeting the accredited investor definition of Rule 501(a)(4) would automatically be "self-fending" types under the new test. Those who are accredited by virtue of some other definition under Rule 501(a) (such as being able to meet income, net worth, qualified entity, or other requirements) would only be self-fending for the purposes of Section 12(2) if they were able to qualify under the second category of the

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clude sophisticated parties to such transactions from structuring their obligations as they deemed fit." Weiss, *supra* note 5, at 1211.

97. Professor Bainbridge notes that the current status of determining which § 3 offerings are included within § 12(2) leads to a case-by-case approach. Additionally, the applicability of § 4(2) as the test would lead to the same result. He argues that, as the law currently stands, there is much uncertainty which would be the same if § 4(2) (and its common law requirements) were used.

On the other hand the majority's statement 'that a document is not a prospectus . . . if, absent an exemption it need not comply with § 10's requirements in the first place,' seems to call for a case-by-case analysis of whether a particular document would be required to comply with Section 10. So too does the already noted statement that 'prospectus under Section 10 is confined to documents related to a public offering'.

If it turns out that a case-by-case analysis is necessary, as I suspect it will, sorting out the answers to these questions will not produce closure. Instead, issuers and affiliates often will be deprived of the predictability and *ex ante* certainty that promotes liquidity because it is possible a court would determine, with the benefit of hindsight, that their transaction involved a public offering. The inherently vague 'common law' standards applicable under Section 4(2), if adopted as the means for determining whether a public offering is involved, will further compound the problem by adding even greater uncertainty. All of this, of course, merely serves to illustrate further the problems created by the majority's approach to statutory interpretation and the significance of the ambiguities created by the majority opinion.

Bainbridge, *supra* note 5, at 1268.

98. 17 C.F.R. § 230.504 (1995).

new test.<sup>99</sup>

The same approach would apply to Rule 506.<sup>100</sup> Rule 506 offerings would be covered under Section 12(2) unless all of the offerees and purchasers are self-fending types under either prong. Accredited individuals or entities in a Rule 506 offering would be treated in the same manner under the new test as a Rule 505 offering. Being “sophisticated” as defined by Rule 506 would be irrelevant since this term does not comport with either category of self-fending types.<sup>101</sup> Other Section 3 offerings (such as offerings made pursuant to Rule 147, Section 3(a)(11), Section 3(a)(9), Section 3(a)(10), Regulation A, or Rule 701) would be public unless all offerees and purchasers are “self-fending types” under the new test.<sup>102</sup>

Needless to say, the application of the new test would cause most Section 3 offerings to be included within Section 12(2). However, this is in line with the inherent difficulty of being self-fending for antifraud purposes. To this extent, the test may be somewhat in sync with *Gustafson*'s generic definition of public offerings since offerings to large groups of people (that is, those involving the wide dissemination of the prospectus) would probably not involve self-fending types only. The categories of the new test are by their nature self-limiting due to their difficulty of qualification.

Besides providing a bright-line test, another advantage flows from its application. The test obviates the use of non-determinative factors, like the number of investors, the dissemination of documents, or whether the offering has met its exemption requirements for Section 5 purposes. This is because the test's focus is truly based on the one factor that counts—who needs protection *under Section 12(2)*.

## VI. CONCLUSION

At some future point in time, the Court will be faced with resolving the issue raised by this Article. If the Court returns to the *Ralston Purina*

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99. This refers to the accredited investor definitions under Rule 501(a)(1)-(8), excluding Rule 501(a)(1)(4). It is recognized that the term investor under Regulation D means purchaser; however, for § 12(2) antifraud purposes, the two categories of the new test include offerees. Section 12(2) strives to ensure the truthfulness of a prospectus, whether or not parties actually purchase. See also *supra* notes 79 and 93 and accompanying text in support of this.

100. Determining that Rule 505 and 506 offerings are public in some instances for purposes of § 12(2) is not necessarily in conflict with prior statements in this Article stating that those offerings are essentially private. The term “public” with regards to §§ 5 and 12(2) rests on the same fundamental test of who is “self-fending” yet varies in application since each section speaks to different concerns in the disclosure process.

101. Rule 506(b)(2)(ii) allows up to 35 sophisticated investors each of whom, either alone or with a purchaser's representative, has sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment. See Sec. Act Rel. 6825 43 SEC Dock. 704-707 (1989) (amendment).

102. With respect to Rule 144 and Rule 144A, both offerings are automatically excluded from § 12(2) as types of resale transactions and, therefore, secondary market transactions. See Weiss, *supra* note 5, at 1224-25. Application of the new self-fending test to these offerings would be unnecessary since they are already excluded under *Gustafson*.

case and embraces the concept of being able to “fend for oneself” for purposes of Section 12(2), then a new test based upon this concept should be developed for excluding Section 3 offerings from Section 12(2)’s scope. Whether or not the Court adopts the specific test posited by this Article and/or adds categories of “self-fending” types, this Article underscores the dubious application of Section 4(2) (and its common law requirements) to resolve the issue.