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Hertzberg v. Dignity Partners, Inc.: Standing to Sue Under Section 11 of the Securities Act of 1933; Reflections on *Gustafson**

I. INTRODUCTION

As a result of the stock market crash in October 1929, the face and structure of the stock market began a radical transition period.¹ The total value of the stock market plunged from a high of \$89 billion in October 1929 to \$15 billion in 1932.² In 1933, Congress responded by passing the Securities Act of 1933 (the “1933 Act”) and a year later the Securities Exchange Act of 1934 (the “1934 Act”).³ However, enacting a law is only the beginning. Determining how to apply the law is usually much more difficult.

One such problem escalated with *Gustafson v. Alloyd Co.*⁴ The United States Supreme Court held in *Gustafson* that in order to have standing to sue under section 12(2) of the 1933 Act, one must have purchased stock in an initial public offering.⁵ Since that ruling, there have been conflicting opinions as to whether the same restriction applies to claims falling under section 11 of the same Act.⁶ While many district courts have decided this issue, only one circuit has addressed it – the Ninth Circuit in *Hertzberg v. Dignity Partners, Inc.*⁷ In *Hertzberg*, the court held that *Gustafson* was not applicable to a section 11 claim.⁸ Thus, an investor need not have purchased stock in an initial public offering to

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1. See JAMES D. COX ET AL., *SECURITIES REGULATION, CASES AND MATERIALS* 3, 5 (2d ed. 1997).

2. See *id.* at 5.

3. See *id.*

4. 513 U.S. 561 (1995).

5. See *id.* at 576, 584.

6. Compare *Gould v. Harris*, 929 F. Supp. 353, 359 (C.D. Cal. 1996) (holding *Gustafson* applies to section 11 claims), and *Stack v. Lobo*, 903 F. Supp. 1361, 1375-76 (N.D. Cal. 1995) (holding *Gustafson* applies to section 11 claims), with *In re Websecure, Inc. Sec. Litig.*, 182 F.R.D. 364, 367-68 (D. Mass. 1998) (holding *Gustafson* does not apply to section 11 claims), *Schwartz v. Celestial Seasonings, Inc.*, 178 F.R.D. 545, 554-57 (D. Colo. 1998) (holding *Gustafson* does not apply to section 11 claims), and *Adair v. Bristol Tech. Sys., Inc.*, 179 F.R.D. 126, 131-32 (S.D.N.Y. 1998) (holding *Gustafson* does not apply to section 11 claims).

7. 191 F.3d 1076 (9th Cir. 1999).

8. See *id.* at 1082.

have standing to sue under section 11. This case note analyzes the *Hertzberg* holding and discusses the different arguments used by district courts that came to the opposite conclusion. The case note ultimately concludes that *Hertzberg* is correct.

II. BACKGROUND

In order to appreciate the *Hertzberg* decision, a basic understanding of *Gustafson* is required. Additionally, an understanding of the similarities and differences between section 11 and section 12 of the 1933 Act is necessary.

A. *The Gustafson Decision*

A basic understanding of *Gustafson* is required in order to determine if its decision applies equally to section 11 and section 12 claims. In 1989, Gustafson, McLean, and Butler (collectively "Gustafson"), the sole shareholders of Alloyd, Inc., decided to sell their company.⁹ Wind Point Partners II, L. P. ("Wind Point") and others agreed to purchase all issued and outstanding stock through a holding company, Alloyd Holdings, Inc. ("Alloyd Holdings").¹⁰ After the sale, Alloyd Holdings' earnings were significantly lower than the earning estimates relied upon during negotiations.¹¹ Unhappy with their purchase, Alloyd Holdings and Wind Point sued Gustafson claiming that "the statements made by Gustafson and his coshareholders regarding the financial data of their company were inaccurate, rendering untrue the representations and warranties contained in the contract."¹² They further argued that "the contract of sale was a 'prospectus,' so that any misstatements contained in the agreement gave rise to liability under section 12(2) of the 1933 Act."¹³ The case eventually made its way up to the United States Supreme Court which ruled, inter alia, that section 12 was limited to initial public offerings¹⁴ and denied their claim.¹⁵

9. See *Gustafson*, 513 U.S. at 564.

10. See *id.* at 564-65.

11. See *id.*

12. *Id.* at 565-66.

13. *Id.* at 566.

14. "Initial public offering" as used in this case note means "public offerings by issuers and their controlling shareholders." See *Gustafson*, 513 U.S. at 576. There are two categories of offerings, and within each category, two types. The two categories of offerings are public and private. Public offerings are offerings made to the public at large. These types of offerings are highly regulated by the Securities Exchange Commission ("SEC"). Private offerings are offerings made to a specific group of investors. In the majority of cases, as long as companies follow specific rules, no filings to the SEC are required. Within each category of offerings there are two types, initial and secondary. Initial offerings are offerings that come directly from the issuing company or a controlling shareholder. Any other transfer of a security after the initial offering is a secondary

In making its decision, the Supreme Court noted that, in general, the 1933 Act deals only with public offerings. Yet Congress specifically made an exception for section 17. The Supreme Court held that because Congress had specifically made an exception for section 17, but did not specify an exception for section 12, section 12 is bound by the general rule and is limited to initial public offerings.¹⁶

In deciding *Gustafson*, the Court did not address the issue of whether one had to have purchased securities in the initial public offering in order to have standing to sue under section 11 of the 1933 Act.¹⁷ Rather, the Supreme Court was dealing with section 12(2). Yet, because of their comparison between the legislative history of the two sections and some comments made in the two dissenting opinions, district courts are split on whether the same limitation applies to section 11 claims.¹⁸

B. Sections 11 and 12

With a basic understanding of the *Gustafson* decision, a comparison of section 11 and section 12 is helpful. The Supreme Court has noted that “[i]n the wake of the 1929 stock market crash and in response to reports of widespread abuses in the securities industry, the 73d Congress enacted two landmark pieces of securities legislation: the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act).”¹⁹ Wisely, the authors of the two acts decided not to focus on how to handle fraud after discovering it, but rather on how to prevent fraud from occurring. Thus, the main focus of the Acts is disclosure of information. However, without penalties, no law is effective. Thus, the two acts provide penalties for those who fail to follow their stringent requirements. Section 11²⁰ and section 12²¹ are express remedies made available by the 1933 Act.

offering. Thus, an initial public offering is one that is made to the public at large and is made by the company or its controlling shareholders.

15. *See id.* at 566, 576, 584.

16. The Supreme Court said:

[T]he legislative history . . . showed that Congress decided upon a deliberate departure from the general scheme of the Act in this one instance, and “made abundantly clear” its intent that § 17(a) have broad coverage. No comparable legislative history even hints that § 12(2) was intended to be a freestanding provision effecting expansion of the coverage of the entire statute. The intent of Congress and the design of the statute require that § 12(2) liability be limited to public offerings.

Id. at 577-78 (citations omitted).

17. *See id.* at 566.

18. *See cases cited supra* note 6.

19. *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 170-71 (1994).

20. Section 11 of the 1933 Act provides in part that:

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact

There are three major differences between section 11 and section 12. The first, and seemingly most obvious, is the infraction each was intended to cure.²² Section 11 deals with untrue statements or omissions of material fact found in the registration statement,²³ while section 12 deals with untrue statements or omissions of material fact found in a "prospectus."²⁴ While on its face this is a major difference, the *Gustafson* decision minimized this difference by altering the definition of "prospectus."²⁵

required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue . . .

(e) The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought.

15 U.S.C. § 77k (1994 & Supp. 1998) (emphasis added).

21. Section 12 of the 1933 Act in part provides that:

(a) Any person who—

. . .

(2) offers or sells a security . . . which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statement, in the light of the circumstances under which they were made, not misleading . . . shall be liable subject to subsection (b), to the person purchasing such security from him . . .

15 U.S.C. § 77l (1994 & Supp. 1998).

22. See *infra* note 24.

23. See 15 U.S.C. § 77k.

24. See 15 U.S.C. § 77l. It is important to note that, at least prior to the *Gustafson* decision, there are two different types of prospectuses under the Act, an "informal" prospectus and a "formal" prospectus. An "informal" prospectus is defined as any communication, written or oral, which offers any security for sale. See 15 U.S.C. § 77b(2)(10) (1994 & Supp. 1998). A "formal" prospectus has specific content requirements found in the Act, see *id.* § 77j, and is used during the usual process of a public offering. See *id.* § 77e (1994 & Supp. 1998). Section 5(b) forbids the disclosure of any information, even if it is not an offer, without a valid registration statement unless the information conforms to the requirements of a "formal" prospectus. See 15 U.S.C. § 77e(b). Because the process of obtaining a valid registration statement is a long process, companies issue communications in the form of "informal" prospectuses prior to a valid registration statement to disseminate information about the upcoming offering. However, if the communication does not meet the requirements of a "formal" prospectus, it is considered an "informal" prospectus and the company has violated the 1933 Act.

25. See *supra* note 24. An "informal" prospectus can arise during either a private or public offering while a "formal" prospectus can only arise in a public offering. Because an "informal" prospectus can arise during a private offering, the scope of section 12 (pre-*Gustafson*) was wide enough to include a cause of action under a private offering. In contrast, the only time a registration statement is required is during a public offering which limits the scope of section 11 to public offerings. When the *Gustafson* decision took away the "informal" prospectus it limited section 12 claims to "formal" prospectuses and in doing so, limited the scope of section 12 to public offerings. Thus, *Gustafson* took away a major difference between section 11 and section 12.

The second major difference between section 11 and section 12 lies in the different requirements for updating the information covered by the respective sections. For a registration statement, the information enclosed, and only that information, must be kept accurate after the registration statement effective date.²⁶ Thus, as long as the registration statement is accurate as of the effective date, only the information contained in the registration must be kept current. The same is not true for section 12. Anytime a prospectus is issued, it must accurately reflect the condition of the company at the time the prospectus is issued.²⁷ It is important to note that a prospectus must meet the requirements of section 10,²⁸ which requires the same information as the registration statement.²⁹ Thus, if after the effective date, the registration statement does not contain "a material fact necessary in order to make the statement, in the light of the circumstances under which they were made, not misleading,"³⁰ the issuer must update the registration statement through the prospectus to avoid liability under § 12(a)(2).³¹ The distinction is a subtle one but nonetheless important. If the issuer leaves a fact out of its registration statement and prospectus that was not necessary at the time, but later becomes necessary, the issuer does not have a duty to add it to the registration statement but does have such a duty with respect to the prospectus.

The last major difference between section 11 and section 12 is that different individuals can be held liable for violations of the respective sections. Section 11 lists all of the potential defendants—a very expansive list.³² Under section 12, the only person who can be sued is the person who actually offered to sell or sold the security.³³ The potential defendants list is much broader under section 11 than section 12.

With a basic understanding of sections 11 and 12 and with a knowledge of *Gustafson*, a discussion of *Hertzberg*.³⁴ can be undertaken. Prior to *Hertzberg*, no circuit court had addressed whether the scope of section 11 was limited by the *Gustafson* opinion.³⁵

26. See COX ET AL., *supra* note 1, at 312. The effective date is the date on which the SEC gives its OK to proceed.

27. See 15 U.S.C. § 771(a)(2) (1994 & Supp. 1998).

28. See *Gustafson*, 513 U.S. 561.

29. See 15 U.S.C. § 77j (1994).

30. 15 U.S.C. § 771(a)(2).

31. See COX ET AL., *supra* note 1, at 310.

32. See 15 U.S.C. § 77k(a)(1)-(5) (1994 & Supp. 1998).

33. See 15 U.S.C. § 77l.

34. 191 F.3d 1076 (9th Cir. 1999).

35. The Eighth Circuit had an opportunity, but refused to do so. See *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539 (8th Cir. 1997).

III. FACTS

Dignity Partners, Inc. (“Dignity”) approached individuals with terminal illnesses, the majority of which had contracted AIDS, and purchased their life insurance policies. This gave the terminally ill customers much needed cash to live more comfortably the remainder of their shortened lives.³⁶ At first the business endeavor was successful, but Dignity soon encountered a problem they had not anticipated. A major source of Dignity’s business was comprised of people with AIDS. With the discovery of drugs that prolonged the lives of individuals suffering from AIDS, Dignity was no longer able to adequately predict their customers’ life expectancies.³⁷ In order for Dignity’s business to be profitable, Dignity had to be able to predict, with a certain degree of accuracy, how long the customers were going to live.³⁸ With customers living longer, Dignity had to wait longer than originally anticipated to collect on their customers’ outstanding policies.³⁹ This caused both immediate and long-term cash problems.⁴⁰

Prior to common knowledge of the widespread use of these life prolonging drugs, Dignity went public.⁴¹ Shortly after, however, public awareness heightened, causing Dignity’s stock to plummet.⁴² Once stock prices dropped, Howard Hertzberg and two other investors (“Hertzberg”) filed a class action lawsuit claiming, among other things, that Dignity knew of the new drugs on the market and knew of the effect it would have on the company before it went public but intentionally left that information out of the registration statement in violation of section 11 of the 1933 Act.⁴³

Dignity filed a motion to dismiss, arguing that because Hertzberg had not purchased the securities in the initial public offering, the suit was barred under *Gustafson*.⁴⁴ The district court, ruling from the bench, granted the motion. Hertzberg appealed to the Ninth Circuit.⁴⁵

36. See *Hertzberg*, 191 F.3d at 1078; Plaintiff-Appellant’s Opening Brief at 4-5, *Hertzberg*, 191 F.3d at 1076 (No. 98-16394).

37. See *Hertzberg*, 191 F.3d at 1078; Plaintiff-Appellant’s Opening Brief at 4-5, *Hertzberg* (No. 98-16394).

38. See Plaintiff-Appellant’s Opening Brief at 5, *Hertzberg* (No. 98-16394).

39. See *Hertzberg*, 191 F.3d at 1078; Plaintiff-Appellant’s Opening Brief at 5-6, *Hertzberg* (No. 98-16394).

40. See Plaintiff-Appellant’s Opening Brief at 6, *Hertzberg* (No. 98-16394).

41. See *Hertzberg*, 191 F.3d at 1077.

42. See *id.* at 1077-78.

43. See *id.*; Plaintiff-Appellant’s Opening Brief at 12, *Hertzberg* (No. 98-16394).

44. See *Hertzberg*, 191 F.3d at 1078.

45. See *id.*

IV. REASONING

In deciding the case, the Ninth Circuit first looked to the plain meaning of section 11.⁴⁶ The relevant portion of section 11 states that “any person acquiring such security” may sue.⁴⁷ Looking first to Webster’s Dictionary, the court focused on the word “any” and concluded that it meant “ALL” persons acquiring such security, subject only to the limitation that they purchase “such security.”⁴⁸ The court further held that this limitation only requires that the purchaser trace its security back to the initial offering encompassing the false statement.⁴⁹

The court then focused on the damages provisions of the section, which states that “[t]he suit . . . may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public)” and the price at the time of trial.⁵⁰ Based on the fact that Congress put in a provision that provided for a price other than the initial offering price, the court reasoned that Congress’s intention was for this to apply to secondary transfers.⁵¹ The court concluded by quoting *Gustafson*, “We will ‘avoid a reading which renders some words altogether redundant.’”⁵²

Finally, the court rejected Dignity’s argument that the restriction set forth in *Gustafson* applied to section 11 claims based on the fact that the Court in *Gustafson* was not dealing with a section 11 claim.⁵³ The court went further by stating that “the [Supreme] Court gave no indication that it intended this restriction to apply to section 11.”⁵⁴ The *Hertzberg* court further noted that since the decision was issued, no circuit court had changed its analysis of section 11 claims, and that only three district courts had disallowed standing to sue under section 11 at that time.⁵⁵

46. *See id.* at 1079-80.

47. 15 U.S.C. § 77k(a).

48. *See Hertzberg*, 191 F.3d at 1080 (citing WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY (3d ed. 1986)).

49. *See id.* (discussing 15 U.S.C. § 77k(a)).

50. *Id.* (quoting 15 U.S.C. § 77k(e)). The statute actually defines three alternative points to measure the price difference; however, for the purposes of this discussion, the price at the time of trial is sufficient.

51. *See id.*

52. *Id.* (quoting *Gustafson*, 513 U.S. at 574).

53. *See id.*

54. *Id.*

55. *See id.* at 1081. The Ninth Circuit listed two district courts in addition to the district court that it reversed. *See id.* (listing *Gould*, 929 F. Supp. at 353, and *Gannon v. Continental Ins. Co.*, 920 F. Supp. 566 (D.N.J. 1996)). Prior to *Hertzberg*, the only circuit court that had the opportunity to look at the issue refused to do so. *See Parnes*, 122 F.3d at 539.

The *Hertzberg* decision was simply a reiteration of the Ninth Circuit's traditional way of interpreting a section 11 claim. But is it the correct view, particularly in light of *Gustafson*?

V. ANALYSIS

Prior to *Gustafson*, courts were split on the scope of section 11. Many courts followed the more expansive interpretation found in the Second Circuit's decision, *Barnes v. Osofsky*,⁵⁶ which limited standing to sue to those investors who could "trace" their securities to a defective registration statement.⁵⁷ The "trace" principle not only allows standing to investors who purchased their securities during an initial public offering, but also gives standing to investors who purchased their securities on the secondary market and can trace their securities back to a defective registration statement in an initial public offering. Notwithstanding the *Barnes* decision, other courts limited section 11's scope to only those investors who purchased their securities in an initial public offering with a defective registration statement, denying any investor who purchased in the secondary market.⁵⁸

Even after the *Gustafson* opinion, courts remain split on the scope of section 11. Each side continued to use the same basic arguments as before. These arguments rely upon the legislative history of the 1933 Act, comments found in the majority opinions of both *Gustafson* and *Naftalin*, comments found in the dissenting opinions of the *Gustafson* opinion, and the statutory text of section 11. Each of these arguments are discussed below.

A. *The Legislative History of the 1933 Act*

The Legislative History of the 1933 Act is by far the biggest weapon used by those who have eliminated or simply never adhered to the "trace" principle set forth in *Barnes* and supposedly eliminated by *Gustafson*.⁵⁹ Yet both sides claim the legislative history supports their proposition.

56. 373 F.2d 269 (2d Cir. 1967).

57. See *PPM Am. v. Marriott Corp.*, 820 F. Supp. 970 (D. Md. 1993); *In re Crazy Eddie Sec. Litig.*, 792 F. Supp. 197 (E.D.N.Y. 1992); *In re Elscint, Ltd. Sec. Litig.*, 674 F. Supp. 374 (D. Mass. 1987); *Abbey v. Computer Memories, Inc.*, 634 F. Supp. 870 (N.D. Cal. 1986); *Gibb v. Delta Drilling Co.*, 104 F.R.D. 59 (N.D. Tex. 1984); *In re Data Access Sys. Sec. Litig.*, 103 F.R.D. 130 (D.N.J. 1984); *Kirkwood v. Taylor*, 590 F. Supp. 1375 (D. Minn. 1984); *Turner v. First Wis. Mortgage Trust*, 454 F. Supp. 899 (E.D. Wis. 1978).

58. See *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 691 (3d Cir. 1991); *In re Delmarva Sec. Litig.*, 794 F. Supp. 1293, 1309 (D. Del. 1992); *Franklin Life Ins. Co. v. Commonwealth Edison Co.*, 451 F. Supp. 602, 607 n.1 (S.D. Ill. 1978).

59. Of the nine cases that interpreted *Gustafson* as eliminating the "trace" rule examined in

Those who would limit section 11's scope to initial offerings point to the *Gustafson* opinion where the Court noted that sections 11 and 12 have similar legislative history.⁶⁰ They argue that because both sections came from the same legislative history, the analysis under *Gustafson* should be applied the same way for section 11 as it was for section 12.⁶¹ This reasoning has two problems. First, section 11 and section 12 apply to two distinctly different situations. Second, if these courts were to read further in the legislative history, they would discover that the same legislative history they quote cuts out an exception to the general rule for claims under section 11.

Sections 11 and 12 not only differ in requirements to file suit but also in those who may be sued. While it is true that they do have many similarities (particularly after *Gustafson*), to claim that because they have the same legislative history they should be treated the same is one more step toward abrogating the need for two separate sections. If this trend is followed, sections 11 and 12 will soon be indistinguishable.

The majority of those who claim *Gustafson* reversed the "trace" principle⁶² look to the legislative history dealing with the 1933 Act in general, which states, "The bill affects only new offerings of securities It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering."⁶³ The proponents of the "trace" principle correctly acknowledge that the legislative history indicates that the 1933 Act deals generally with initial offerings of securities.⁶⁴ However, they point out that the same House Report later states "that § 11 remedies are available 'regardless of whether [plaintiffs] bought their securities at the time of the original offer or at some later date.'"⁶⁵ To stop short of this important

this note, none of them supported their decision with any other reasoning other than the Legislative History and the *Gustafson* opinion, nor refuted the other issues outlined. See *Broschius v. Children's Place Retail Stores*, No. 97-5021JCL, 1999 U.S. Dist. LEXIS 12986 (D.N.J. Aug. 23, 1999); *In re Summit Med. Sys.*, 10 F. Supp. 2d 1068 (D. Minn. 1998); *Warden v. Crown Am. Realty Trust*, No. 96-25J, 1998 U.S. Dist. LEXIS 16194 (W.D. Pa. Oct. 15, 1998); *In re WRT Energy Sec. Litig.*, 96 Civ. 3610, 1997 U.S. Dist. LEXIS 14009 (S.D.N.Y. Sept. 15, 1997); *Zeid v. Open Envtl. Corp.*, NO. 96-12466-EFH, 1997 U.S. Dist. LEXIS 23469 (D. Mass. Dec. 16, 1997); *Gannon*, 920 F. Supp. at 566; *Gould*, 929 F. Supp. at 359; *Murphy v. Hollywood Entertainment Corp.*, No. 95-1926-MA, 1996 U.S. Dist. LEXIS 22207 (D. Or. May 9, 1996); *Stack*, 903 F. Supp. 1361.

60. See *Gustafson*, 513 U.S. at 580-81.

61. See *Stack*, 903 F. Supp. at 1375; *Gould*, 929 F. Supp. at 358; *In re WRT Energy Sec. Litig.*, 1997 U.S. Dist. LEXIS 14009 at *18-*19; *In re Summit Med. Sys.*, 10 F. Supp. 2d at 1070.

62. See *In re Summit Med. Sys.*, 10 F. Supp. 2d at 1070 (quoting *Gustafson*, 513 U.S. at 580-81); *In re WRT Energy Sec. Litig.*, 1997 U.S. Dist. LEXIS 14009 at *18-19; *Gould*, 929 F. Supp. at 358; *Stack*, 903 F. Supp. at 1375.

63. H.R. REP. NO. 73-85, at 5 (1933).

64. See *Adair*, 179 F.R.D. at 132.

65. *Id.* at 132 (quoting H.R. REP. NO. 73-85, at 22 (1933)); *Schwartz*, 178 F.R.D. at 566 (quoting H.R. REP. NO. 73-85, at 22 (1933)); *Cooperman v. Individual, Inc.*, No. 96-12272-DPW,

passage would give the impression that the legislative history supports eliminating the “trace” principle. A thorough reading of the legislative history makes it clear that Congress created more than one exception to the general rule that the 1933 Act is limited to initial offerings, one of those exceptions being the expansion of who may sue under section 11.⁶⁶

B. *The Gustafson and Naftalin Opinions*

Another argument commonly used by those who have eliminated the “trace” principle is found in both the majority and dissenting opinions of *Gustafson*.⁶⁷ The court in *Brosious*⁶⁸ set forth this argument, when discussing the scope of section 17(a) of the 1933 Act:

The Court in *Gustafson* noted that an earlier decision, *United States v. Naftalin*, interpreted “the *one* provision of the Act that extends coverage beyond the regulation of public offerings, § 17(a) of the 1933 Act.” This language implies that section 11 only regulates public offerings. The Court explained that “the legislative history relied upon in *Naftalin* showed that Congress decided upon a deliberate departure from the general scheme of the Act in this *one* instance and ‘made abundantly clear’ its intent that § 17(a) have broad coverage. See [*Naftalin*, 441 U.S. at 778] (quoting legislative history stating that “‘fraud or deception in the sale of securities may be prosecuted regardless of whether . . . or not it is of the class of securities exempted under sections 11 or 12,’”⁶⁹)

The argument states that, because the Court categorized sections 11 and 12 as limited when demonstrating the broad scope of section 17(a), sections 11 and 12 must be similarly limited in scope.

This argument, however, is misguided. A closer reading of *United States v. Naftalin*⁷⁰ is revealing. The full text of the *Naftalin* opinion dealing with this topic is as follows:

Although it is true that the 1933 Act was primarily concerned with the regulation of new offerings, respondent’s argument fails because the antifraud prohibition of § 17 (a) was meant as a major departure from that limitation. Unlike *much* of the rest of the Act, it was intended to cover any fraudulent scheme in an offer or sale of securities, whether *in the course of an initial distribution or in the course of ordinary market*

1998 U.S. Dist. LEXIS 22126, at *20 (D. Mass. May 27, 1998) (quoting H.R. REP. NO. 73-85, at 22 (1933)).

66. See 15 U.S.C. § 77q (1994).

67. See *In re Summit Med. Sys.*, 10 F. Supp. 2d at 1070; *In re WRT Energy Sec. Litig.*, 1997 U.S. Dist. LEXIS 14009 at *20-*21.

68. No. 97-5021JCL, 1999 U.S. Dist. LEXIS 12986, at *14.

69. *Id.* (citations omitted, emphasis added).

70. 441 U.S. 768 (1979).

trading. This is made abundantly clear both by the statutory language, which makes no distinctions between the two kinds of transactions, and by the Senate Report, which stated:

“The act subjects the sale of old or outstanding securities to the same criminal penalties and injunctive authority for fraud, deception, or misrepresentation as in the case of new issues put out after the approval of the act. In other words, fraud or deception in the sale of securities may be prosecuted *regardless* of whether the security is *old or new, or whether or not it is of the class of securities exempted under sections 11 or 12.*”

Accord, H. R. Rep. No. 85, 73d Cong., 1st Sess., 6 (1933). Respondent is undoubtedly correct that [the 1933 and 1934 Acts] prohibit some of the same conduct. But “[the] fact that *there may well be some overlap is neither unusual nor unfortunate.*”⁷¹

In response to this passage, three points are worth making. First, the *Naftalin* Court recognized that although section 17(a) was “a major departure” from the primary concern of the 1933 Act, it was not the only departure.⁷² Second, an interpretation that the scope of section 11 is greater than section 12(a), but less than section 17(a), is consistent with the *Naftalin* decision. And finally, the *Gustafson* and subsequent decisions that quote the Senate Report used in *Naftalin* fail to quote the entire relevant text.

1. Section 17(a)

The *Naftalin* Court recognized that although section 17(a) was “a major departure” from the primary concern of the 1933 Act, it was not the only departure.⁷³ The Court’s statement “[u]nlike *much* of the rest of the Act”⁷⁴ indicates that there are other exceptions. If section 17(a) was the only exception, the Court would have left out the words “much of,” making the statement “unlike the rest of the Act.” Furthermore, the Court later recognizes that there is some overlap between the 1933 Act and the 1934 Act.⁷⁵ Because the main focus of the 1934 Act deals with old securities, or securities sold after the initial offering, the only reason they would mention the overlap is to demonstrate that there are exceptions in the 1933 Act that deal with old (or secondary) securities.

71. *Naftalin*, 441 U.S. at 777-78 (emphasis added, citations omitted).

72. *See id.*

73. *See id.*

74. *Id.* (emphasis added).

75. *See id.*

The Court in *Gustafson*, while attempting to prove that Congress intended section 12(a) to be limited only to those who purchased directly from the initial offering, noted that Congress cut out an exception to the general rule for section 17.⁷⁶ Quoting *Naftalin*, the Court noted that this was “a major departure from the limitation [of the 1933 Act to new offerings].”⁷⁷ The Court reasoned that because Congress did not make it clear that section 12(a) (and section 11, so the argument goes) is an exception to the general rule (the general rule being that the 1933 Act deals only with initial offerings), these sections are limited to initial offerings.⁷⁸ However, if the *Gustafson* Court had been specifically addressing section 11, it certainly would have noted that Congress did make it clear that section 11 has an exception from the general rule.⁷⁹ Yet, because this exception only applies to section 11 and not to section 12(a), it is logical that this was not mentioned by the Court.

Furthermore, the legislative history did not state that section 17 was the only section to deviate from the primary purpose of the Act.⁸⁰ Because such a statement is lacking, it can easily be concluded that Congress intended other exceptions. This notion finds great support in the previously cited legislative history. It also finds support in the fact that as far back as 1951, circuit courts were allowing a private cause of action for security holders who purchased securities in a secondary offering under section 11.⁸¹ Congress has had plenty of time to amend and make clear its intent. If that intent is different from that which the courts have articulating, then Congress would certainly have made that known by now.

2. *The Naftalin decision*

An interpretation that the scope of section 11 is greater than section 12(a), but less than section 17(a), is consistent with the *Naftalin* decision. The *Gustafson* court held that because, as stated in the *Naftalin* decision, the legislative history specifically stated that section 17 was broad as opposed to sections 11 and 12, section 12 must be limited.⁸² While this may be true,⁸³ the same limitation does not necessarily apply with the

76. See *Gustafson*, 513 U.S. at 577-78.

77. *Id.* at 577 (quoting *Naftalin*, 441 U.S. at 777-78).

78. See *id.* The court in *Brosious* used this line of reasoning to argue that *Gustafson* eliminated the “trace” rule. See *Brosious*, No. 97-5021JCL, 1999 U.S. Dist. LEXIS 12986, at *14.

79. See H.R. REP. NO. 73-85, at 22 (1933).

80. See S. REP. NO. 73-85, at 5 (1933).

81. See *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

82. See *Gustafson*, 513 U.S. at 577-78.

83. For our purposes, it is true because the Supreme Court said so.

same degree to section 11. As long as sections 11 and 12 are more limited than section 17, the statement remains true.

Section 12(a) is limited to securities purchased in an initial public offering, while section 11 is limited to securities purchased or traced to an initial public offering. Yet, both sections 11 and 12 are more limiting than section 17(a). Section 17(a) encompasses “an offer or sale of securities, whether in the course of an initial distribution or *in the course of ordinary market trading*.”⁸⁴ Section 17(a)’s scope encompasses all securities transactions; this is broader than the scope of section 11, which only covers transactions that either took place during an initial offering or are traceable to such an offering. Section 12’s scope, in turn, is the least expansive of the three; it includes only those transactions that occur during an initial public offering.

3. *The Legislative History*

The *Gustafson* and subsequent decisions that quote the Senate Report used in *Naftalin* fail to quote the entire relevant text.⁸⁵ The *Naftalin* Court was not trying to insinuate that sections 11 and 12 are identical. Rather, it was illustrating the broad scope of section 17(a). This is illustrated by looking at the entire *Naftalin* quote, a portion of which is often omitted.⁸⁶ “In other words, fraud or deception in the sale of securities may be prosecuted *regardless of whether the security is old or new, or whether or not it is of the class of securities exempted under sections 11 or 12.*”⁸⁷ If we read the legislative history in such a way that “will avoid a reading which renders some words altogether redundant,”⁸⁸ it is clear that *Naftalin* does not purport to similarly limit sections 11 and 12. According to *Gustafson*, section 12(a) is limited to new securities, defining an old security as any security not sold during an initial offering. Thus, if the Court in *Naftalin* was placing the scope of sections 11 and 12 in the same category, then the phrase “old or new” and “the class of securities exempted under sections 11 or 12” would mean the same thing. However, if we read the statement in a way that avoids conflict, then it is clear that the scope of sections 11 and 12 are different.

84. *Naftalin*, 441 U.S. at 778 (emphasis added).

85. See *Gustafson*, 513 U.S. at 577-78; *Brosious*, 1999 U.S. Dist. LEXIS 12986 at *14.

86. See *id.*

87. *Naftalin*, 441 U.S. at 778 (citations omitted, emphasis added).

88. *Gustafson*, 513 U.S. at 574.

C. *The Gustafson Dissenting Opinions*

Another argument raised by the proponents of eliminating the “trace” principle is found in the two *Gustafson* dissenting opinions. In her dissent, Justice Ginsburg stated with regard to sections 11 and 12, “There is no dispute that the latter two provisions apply only to public offerings – or, to be precise, to transactions subject to registration.”⁸⁹ In Justice Thomas’s dissent, he stated, “Nor did Congress limit section 12(2) to issuers, as it chose to do with other provisions that are limited to initial distributions. See section 11 of the 1933 Act, 15 U.S.C. § 77k(a)(2).”⁹⁰ The courts in both *In re Summit Medical Systems, Inc.* and *In re WRT Energy* take these portions of the opinion as an affirmation that the “trace” principle has been effectively overruled.⁹¹

A closer look at the two dissenting statements reveals that they are consistent with the “trace” principle when taken in the context in which they were made. As District Judge Robert W. Sweet noted in *Adair v. Bristol Technology Systems, Inc.*, in context, Justice Ginsberg’s “statement is intended to support Ginsberg’s view that section 12(2), in contrast with section 11, is not limited to public offerings, but rather includes within its sweep the private securities transaction at issue.”⁹² Judge Sweet’s argument is particularly enlightening when considering that the main issue in *Gustafson* was “whether [the] right of rescission extends to a *private*, secondary transaction.”⁹³ Section 11 is limited to public offerings (whether initial or secondary is irrelevant for this analysis). In referencing section 11, Justice Ginsberg was simply contrasting the scope of section 11 (limited to public offerings) with what she felt the scope of section 12 should be (encompassing both public and private offerings). The statement should not be read to mean that section 11’s scope does not include the “trace” principle.

Addressing Justice Thomas’s dissent, Judge Sweet further noted:

In his textual analysis of § 12(2), Justice Thomas contends that § 11’s text limiting liability to “every person who was a director of . . . or partner in the issuer” at the time of filing indicates that its scope is limited to initial public offerings, whereas the absence of such language in § 12(2) is persuasive that private transactions not involving an issuer are included. There is no dispute here, however, that § 11 liability extends beyond its specifically enumerated potential defendants, or that

89. *Id.* at 600.

90. *Id.* at 590.

91. See *In re Summit Med. Sys.*, 10 F. Supp. 2d at 1070; *In re WRT Energy Sec. Litig.*, 96 Civ. 3610, 1997 U.S. Dist. LEXIS 14009, at *20-21.

92. *Adair*, 179 F.R.D. at 132.

93. *Gustafson*, 513 U.S. at 564 (emphasis added).

liability is limited to public offerings. Therefore, as with Justice Ginsberg's proposition, this statement is consistent with retention of the tracing requirement for standing to sue under § 11.⁹⁴

As Judge Sweet suggests, Justice Thomas was using the description of potential defendants to show that section 11 is limited to initial public offerings and then contrasting that to the broad scope of section 12(2). Nowhere in Justice Thomas's dissent does he suggest that those who can trace their security to a defective registration statement issued in an initial public offering do not have standing to sue. Furthermore, the fact that both sections 11 and 12 are limited to initial public offerings is consistent with the "trace" principle. Only those investors who can trace their security back to the initial offering have standing to sue. While Justice Thomas's statement may not actively support the "trace" principle, it certainly can be read to be consistent with it.

The courts that eliminated the "trace" principle seem to think that the legislative history combined with the *Gustafson* opinion are persuasive enough to ignore all other arguments raised, for they fail to address them.⁹⁵

D. The Statutory Text of Section 11

When trying to decide the meaning of a statute courts look to the statute itself.⁹⁶ Several portions of the statute show that Congress intended section 11 to apply to transactions other than the initial public offering. First, the statute gives a cause of action to "any person acquiring *such* security."⁹⁷ Second, the statute specifically contemplates the price of the securities to be different from the initial offering price at the time the suit is commenced.⁹⁸ Third, the statute has a higher standard for plaintiffs if an earnings statement has been on the market for a period of twelve months prior to the effective date of the registration statement.⁹⁹

94. *Adair*, 179 F.R.D. at 132.

95. Although the court opinions cited do not address the following arguments, in the memorandum prepared by Dignity during the *Hertzberg* hearing, Dignity articulates the opposing argument. This opposing argument is incorporated below. See Answering Brief of Defendant/Appellees, *Hertzberg*, 191 F.3d at 1076 (No. 98-16394).

96. "[W]hen interpreting a statute, we look first and foremost to its text." *United States v. Alvarez-Sanchez*, 511 U.S. 350, 356 (1994).

97. 15 U.S.C. § 77k(a).

98. *See id.* § 77k(e).

99. *See id.* § 77k(a).

I. "Any person acquiring such security"

The statute gives a cause of action to "any person acquiring such security."¹⁰⁰ The court in *Hertzberg*, while finding that the "trace" principle is valid, stated, "The term 'any person' is quite broad, and we give words their ordinary meaning. According to Webster's Dictionary, 'any' means 'one, no matter what one'; 'ALL'; 'one or more discriminately from those of a kind.'"¹⁰¹ Likewise, the court in *Schwartz v. Celestial Seasonings, Inc.* held that "under the plain language of § 11, any purchaser may bring a claim as long as he can prove that the securities acquired were issued in connection with a false registration statement, i.e., if the shares can be traced to the offering."¹⁰² Furthermore, the court in *In re Fine Host Corp.* noted an important distinction between the texts of section 11 and section 12(2): "Section 12 expressly limits recovery to only those purchasers who purchase their shares directly from a seller who makes a false or misleading prospectus. . . . In contrast, section 11 permits recovery by 'any person acquiring such security.'"¹⁰³

While the preceding argument seems strong, none of the courts focused on the pivotal word in the statute, "any person acquiring *such* security."¹⁰⁴ In the Defendants/Appellees' brief, Dignity points out that nowhere does Congress define the word "such".¹⁰⁵ Dignity then traces the history of the 1933 Act, pointing to what was happening at the time and arguing that the term "*such* security" is meant to limit the scope of the remedy, making it only available to those who purchased the security from the initial offering.¹⁰⁶ However, the Ninth Circuit rejected this argument, holding that "[t]he limitation on 'any person' is that he or she must have purchased 'such security.'"¹⁰⁷

The United States Supreme Court has stated that "[w]hen interpreting a statute, we look first and foremost to its text."¹⁰⁸ Furthermore, when the text is clear, no further analysis is needed.¹⁰⁹

100. *See id.* § 77k(e).

101. *Hertzberg*, 191 F.3d at 1080 (citations omitted).

102. *Schwartz*, 178 F.R.D. at 556.

103. *In re Fine Host Corp. Sec. Litig.*, 25 F. Supp. 2d 61, 67 (D. Conn. 1998) (citations omitted). *See also* *Danis v. U.S. Comm., Inc.*, 73 F. Supp. 2d 923, 931-32 (N.D. Ill. 1999).

104. 15 U.S.C. § 77k(a) (emphasis added).

105. *See* Answering Brief of Defendant/Appellees at 11, *Hertzberg*, 191 F.3d at 1076 (No. 98-16394).

106. *See id.*

107. *Hertzberg*, 191 F.3d at 1080.

108. *Alvarez-Sanchez*, 511 U.S. at 356.

109. *See* *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992). The Court stated: "We have stated time and again that courts must presume that a legislature says in a statute what it

Webster's Dictionary defines "such" as "of the same class, type, or sort; in the same category; similar."¹¹⁰ Applying that definition to the text, the term "such security" means a security that falls within the category set forth previously in the text, i.e. a security sold under a faulty registration statement.

Nowhere in the language of section 11 does it state that you must purchase your securities during the initial offering. Instead, it clearly states that "any person acquiring such security"¹¹¹ may sue. Because the plain meaning of the text is available, logical, and unambiguous, no court need look further to determine who has standing to sue.

2. *The damages provision*

Another portion of the statute that supports the "trace" principle is found in the damages provision where the statute allows for a price other than the initial offerings price. The court in *Adair* reasoned that "[i]f Congress intended to limit liability to purchasers in the [Initial Public Offering], the language could simply read 'at the offering price.' Instead, the language permits recovery for purchases at prices other than the offering price, as long as the liability is so limited."¹¹² As the court in *Hertzberg* points out, "[s]uch provision would be unnecessary if only a person who bought in the actual offering could recover, since, by definition, such a person would have paid 'the price at which the security was offered to the public.'"¹¹³

The Defendants in *Adair* argued that a price differential could occur during an Initial Public Offering if that offering were a shelf offering, and thus, the language in the statute was necessary to account for shelf registrations.¹¹⁴ As the *Adair* court correctly pointed out, this argument fails because shelf registrations are allowed under Rule 415, which was promulgated in 1982, almost fifty years after the 1933 Act was passed.¹¹⁵

In *Hertzberg*, the Defendants argued that Congress, in providing for a price different than that of the initial offering, was simply protecting

means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'" *Id.*

110. WEBSTER'S SECOND INTERNATIONAL DICTIONARY (2d ed. 1941).

111. 15 U.S.C. § 77k(a).

112. *Adair*, 179 F.R.D. at 133.

113. *Hertzberg*, 191 F.3d at 1080.

114. See *Adair*, 179 F.R.D. at 133-34. A shelf registration is where a company is allowed to register securities, but must wait for a certain amount of time before offering them to the public. Thus, under a shelf registration, it would be possible to have a time gap between the effective date of the registration statement and the time that the company offers the securities to the general public.

115. See *Adair*, 179 F.R.D. at 133-34.

investors against “unscrupulous” brokers.¹¹⁶ However, the Ninth Circuit rejected this argument because “it makes the unlikely assumption that Congress chose to prevent victims of broker fraud from recovering the additional amount out of which they were cheated.”¹¹⁷

Other courts have used the damages provision as support for the “trace” principle. In so doing, they have held that because of the appropriation for damages based on the securities price being different than that of the initial public offering, the drafters intended section 11 to apply to secondary transactions.¹¹⁸

3. The heightened burden for plaintiffs starting a year after the effective date of the registration statement

Statutory support for the “trace” principle is also found in the heightened burden for plaintiffs starting a year after the effective date of the registration statement. Section 11(a) provides that a plaintiff must show reliance on the untrue statement found in the registration statement if there has been an earning statement on the market that covers a period of at least a year after the registration statement.¹¹⁹ Furthermore, the legislative history on the 1934 amendment, which added the requirement of reliance where there was a valid earning statement, declared, “The basis of this provision is that in all likelihood the purchase and price of the security purchased after publication of such an earning statement will be predicated upon that statement rather than upon the information disclosed upon registration.”¹²⁰

Schwartz recognized the implications of this section 11 provision when it stated, “By requiring those who purchase registered stock after the publication of the twelve-month earning statement to prove reliance, the statute contemplates relief for those who purchase shares after the public offering.”¹²¹ Congress realized that the price of securities fluctuates with information received by the market about a certain company. Without this provision, there could be an investor who only purchased securities from companies with known faulty registration statements. By doing this, the investor would always be able to recover his purchase price from companies whose stock prices dropped, but keep

116. See *Hertzberg*, 191 F.3d at 1080; Answering Brief of Defendant/Appellees at 11, *Hertzberg* (No. 98-16394); The argument is that an unscrupulous broker could actually charge more for the security than the company had offered it for, thus creating a difference in the price.

117. *Hertzberg*, 191 F.3d at 1080 n.6.

118. See *Schwartz*, 178 F.R.D. at 556; *Cooperman*, 1998 U.S. Dist. LEXIS 22126 at *20.

119. See 15 U.S.C. § 77k(a).

120. *Hertzberg*, 191 F.3d at 1082-83 (quoting H.R. REP. NO. 73-1838, at 41 (1933)).

121. *Schwartz*, 178 F.R.D. at 556. See also *Cooperman*, 1998 U.S. Dist. LEXIS 22126 at *19-20.

those stocks whose prices went up. While the example is a bit far fetched, it illustrates the need for Congress to include the reliance requirement under section 11.

In *Hertzberg*, Dignity argued that when the 1933 Act was passed it was common for a public offering to take more than a year.¹²² Because a public offering could last for more than a year, the “recognition that Section 11 claims may be based upon purchases more than a year after the effective date of registration” is no support for the “trace” principle.¹²³ Assuming that Dignity is correct, their argument certainly does not preclude the “trace” principle.

E. Plain Logic and the World We Live In

Putting aside Congress’s intent, a look at the remedies from a logical perspective is worthwhile. Our society has become extremely complex. The price a particular security sells for is a function of multiple factors, one of which is the registration statement. No one has argued or can argue that once a security is sold in a public offering, the registration statement ceases to be useful. In many situations, the registration statement must be updated to accurately reflect the company’s current situation.¹²⁴ Dignity noted in *Hertzberg* that

individuals who make aftermarket purchases of stock originally issued in prior public offerings or in private placements are no less affected by a false registration statement than those making aftermarket purchases of stock that was sold in the registered public offering. . . . Such a distinction simply introduces an element of arbitrariness and unfairness.¹²⁵

Yet, is it really that arbitrary or unfair? Securities purchased prior to the defective registration statement were priced according to all of the required correct information. Thus, their original price was “correct”, for lack of a better word. Any trading after that point until the faulty registration statement would also be “correct.” Thus, only those securities bought or sold immediately after the faulty registration statement would be affected. For those transactions, the “trace” principle may seem arbitrary and unfair. Yet, because the majority of the transactions occurring during a public offering will consist of the securities being offered, this rule encompasses a majority of the affected

122. See Answering Brief of Defendant/Appellees at 18, *Hertzberg*, 191 F.3d at 1076 (No. 98-16394).

123. See *id.*

124. See 15 U.S.C. § 77.

125. See Answering Brief of Defendant/Appellees at 34, *Hertzberg*, 191 F.3d at 1076 (No. 98-16394).

investors. While the “trace” principle might not be perfect, it is the best that we have under the statutory language of section 11.

VI. CONCLUSION

When the stock market crashed back in 1929, Congress knew that changes had to be made. Back then, our society was significantly different than it is today, yet somehow we trust that Congress’s intentions from the 1930s are still appropriate today. Whether or not this is true is a moot point now. The Supreme Court has made it clear that they intend to follow those intentions. The question now becomes, what exactly did Congress intend for section 11? Many courts, even prior to *Gustafson*, felt that Congress intended to limit section 11 to public offerings, but other courts saw an expansive section 11.

When all of the arguments on both sides are lined up and compared, no one side is an absolute winner. However, after looking at the evidence presented by the different courts throughout the country, it seems clear that the 73rd Congress did not intend section 11 to be limited only to those investors who purchased their securities in an initial public offering. The 73rd Congress intended to give standing to sue to those investors that can trace their securities back to a faulty registration statement.

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