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Misrepresentation in the Sale of Stock: Which Buyers are Protected?

by J. William Hicks

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ISSUE

Does Section 12(2) of the Securities Act of 1933 extend to a privately negotiated sale of stock?

FACTS

Arthur Gustafson, Daniel McLean, and Francis Butler (collectively the "Gustafson Group"), were the sole shareholders of Alloyd Company, Inc. ("Alloyd"), a manufacturer of clear plastic blister packaging and automatic heat seal packaging equipment. In May 1989, the Gustafson Group decided to sell Alloyd and engaged KPMG Peat Marwick ("Peat Marwick"), a national accounting firm, to locate a buyer. Peat Marwick prepared a detailed profile of Alloyd in order to solicit prospective buyers.

Wind Point Partners II ("Wind Point"), an experienced and sophisticated investment partnership, received a copy of the profile. In

August 1989, after conducting extensive due diligence regarding Alloyd, visiting Alloyd's facility, and interviewing key Alloyd executives, Wind Point submitted a written proposal to purchase Alloyd by buying the stock held by the Gustafson Group. The Gustafson Group agreed to sell Alloyd to Alloyd Holdings, Inc. ("Holdings"), a corporation formed by Wind Point to effectuate the purchase.

Two members of the Gustafson Group, McLean and Butler, invested in Holdings and, together with three other individuals and Wind Point, became its shareholders. McLean and Butler also became officers and directors of the new company.

Prior to signing the Stock Purchase Agreement at the closing of the transaction on December 20, 1989, Wind Point attempted to learn as much as it could about Alloyd's business and financial condition. It retained Peat Marwick to help in this

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ARTHUR L. GUSTAFSON *et al.* v.
ALLOYD CO., INC. AND WIND
POINT PARTNERS II, L.P.
DOCKET NO. 93-404

ARGUMENT DATE:
NOVEMBER 2, 1994
FROM: THE SEVENTH CIRCUIT

Case at a Glance

This case concerns the civil liability of persons who misrepresent material facts in a privately negotiated sale of securities. The Supreme Court will decide whether Section 12(2) of the Securities Act of 1933 provides a buyer of securities with a right to rescind the purchase both in public and private offerings.





endeavor. Peat Marwick provided Wind Point with information about Alloyd's inventory but, because Alloyd took inventory only at the end of each year, the inventory information was based on estimates of the cost of goods sold and of gross profits. The parties discussed the appropriateness of taking a physical inventory but, ultimately, closed their agreement without having taken a physical audit.

At the closing of the transaction, Holdings acquired all of Alloyd's stock for approximately \$18.7 million plus \$2.1 million to reflect an estimate of Alloyd's increase in net worth from December 31, 1988, through the closing. A provision in the Stock Purchase Agreement required that after the year-end audit of Alloyd's financial statements, sellers or buyers would remit an appropriate amount to cover any variance between the estimated change in Alloyd's net worth for 1989 and the actual change.

By February 8, 1990, McLean, who by then had become president of Holdings, learned that Alloyd's actual earnings and net book value for 1989 were significantly lower than the estimates relied upon by Wind Point in making its offer to buy Alloyd. This variance was attributed to the fact that Alloyd's year-end inventory was significantly lower than the estimates provided by the Gustafson Group to Wind Point. After confirming the discrepancy, McLean informed Wind Point of the inventory shortfall. Later, the Gustafson Group paid \$815,000 plus interest to Holdings pursuant to the adjustment provision in the Stock Purchase Agreement.

On February 11, 1991, Wind Point and Holdings sued the Gustafson Group in the United States District Court for the Northern District of Illinois. They asserted two claims: 1)

violation of Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2) ("Section 12(2)") and 2) breach of the representations and warranties made in the Stock Purchase Agreement.

Both sides conducted extensive discovery and filed cross-motions for summary judgment. (See Glossary for the definition of summary judgment.) On May 29, 1992, the district court entered an unpublished order granting the Gustafson Group's motion for summary judgment. In ruling for the Gustafson Group, the district court relied heavily on the reasoning of the Third Circuit in *Ballay v. Legg Mason Wood Walker*, 925 F.2d 682 (3d Cir. 1991), which held that Section 12(2) applies only to initial offerings by a company and not to subsequent trading by security holders.

Wind Point and Holdings appealed to the Seventh Circuit Court of Appeals. In an unpublished order, the Seventh Circuit vacated the district court's order and sent the case back to the district court for further proceedings in light of the Seventh Circuit's recent decision in *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578 (7th Cir. 1993), which concluded that Section 12(2) was not limited to initial offerings. The Gustafson Group responded to this setback by filing a petition for certiorari with the Supreme Court seeking review of the Seventh Circuit's action, which the Court granted.

CASE ANALYSIS

Section 12(2) of the Securities Act of 1933 (the "1933 Act" or the "Act") creates an expansive civil remedy for misrepresentations made by sellers of securities. It provides that any person who sells, or offers to sell, a security "by means of a written prospectus or oral communication"

that contains materially misleading statements is liable to the purchaser of the security.

Until the late 1980s, most attorneys and courts did not question that Section 12(2) applied to all fraudulent sales of securities — those sales by a company when the securities were originally distributed to the public as well as to those sales by security holders when the securities were traded privately or through broker-dealers in public markets. Recently, however, several federal district courts and two federal appellate courts have invoked a restrictive reading of Section 12(2) to deny protection to buyers of securities in private resale transactions and to customers of broker-dealer firms seeking relief against allegedly fraudulent conduct of individual brokers. See *Ballay*, 925 F.2d 682, and *First Union Discount Brokerage Serv. v. Milos*, 997 F.2d 835 (11th Cir. 1993) (both courts reading Section 12(2) as applying only to the original public offering of a security). The only other federal appellate court to address the issue squarely, the Seventh Circuit, determined, as noted above, that Section 12(2) does apply to resales of securities. *Pacific Dunlop*, 993 F.2d at 582.

In this case, the Supreme Court will resolve this conflict and, in doing so, will decide the scope of protection afforded to buyers of securities under Section 12(2). The issue raises questions regarding the language and structure of the 1933 Act, the purpose of the statute, legislative history, and public policy.

Both sides agree that the starting point in every case involving statutory construction is the statutory language. However, as sellers in a private resale transaction, the Gustafson Group argues that the language of Section 12(2), especially the term prospectus, indicates that



Congress intended the remedy to apply to public, not private, sales of stock. The term is defined broadly in Section 2(10) of the 1933 Act, 15 U.S.C. Section 77b(10) ("Section 2(10)"), but this definition is explicitly withdrawn where "the context otherwise requires." Not surprisingly, the Gustafson Group contends that the *context* for this term in Section 12(2) is public distributions of newly created securities by corporate issuers.

The Supreme Court has recognized that the 1933 Act was "primarily concerned with the regulation of new offerings." *United States v. Naftalin*, 441 U.S. 768 (1979). Given this legislative objective as demonstrated in the legislative history, the Gustafson Group contends that Congress used the term prospectus in Section 12(2) in its usual and customary sense, i.e., as a reference to a document that solicits public investors to purchase securities. Furthermore, they see this construction as entirely consistent with the 1933 Act's liability scheme which, in their opinion, is limited to public offerings.

In contrast, Wind Point and Holdings argue that the terms prospectus and oral communication in Section 12(2) are unambiguous and that, under rules of statutory construction employed by the Court, the plain meaning of the provision controls without any need to examine the legislative history. *King v. St. Vincent's Hosp.*, 112 S. Ct. 570, 575 n. 14 (1991), quoting *Rubin v. United States*, 449 U.S. 424, 430 (1981).

Wind Point and Holdings stress the broad definition of the term prospectus in Section 2(10), noting that it is not limited to primary offerings. Although the statutory definition of the term prospectus is qualified by the phrase "unless the context otherwise requires," Wind Point and Holdings assert that there is nothing

unusual about resales, public or private, that warrants a restrictive application of Section 2(10) in the context of the liability for misrepresentations established by Section 12(2). Moreover, argue Wind Point and Holdings, the language of Section 12(2) does not limit its application to fraud in connection with initial distributions of securities. According to Wind Point and Holdings, the absence of ambiguity in the definition of prospectus means that the profile and the Stock Purchase Agreement each constituted a prospectus within the meaning of Section 12(2). This result, they urge, is consistent with a major goal of the 1933 Act — the protection of all purchasers against misrepresentation in public and private transactions.

Legislative history is frequently helpful in determining the meaning of statutory terms and provisions. In this case, both sides rely on it, despite the fact that the legislative history of Section 12 is sparse at best. *Pinter v. Dahl*, 486 U.S. 622 (1988).

The Gustafson Group invokes the legislative history of the 1933 Act to demonstrate that the primary concern of Congress was the regulation of public securities offerings and infers from that history that Section 12(2) should have a consistent purpose. Wind Point and Holdings, on the other hand, argue that the silence of the legislative history as to Section 12(2) justifies a literal interpretation of the provision, a construction that protects all buyers regardless of the nature of the transaction.

It is appropriate for the Court to address public policy considerations involved in the construction of Section 12(2). *Pinter*, 486 U.S. at 653. On this point, the Gustafson Group offers several arguments in

support of its narrow reading of Section 12(2). First, the Gustafson Group observes that Congress in 1933 imposed stringent duties only on sellers engaging in public offerings, interfering as little as possible with private business transactions. Thus, the Gustafson Group argues that Section 12(2) should not reach the type of transaction involved in this case — a privately negotiated sale of stock to experienced, sophisticated buyers. Second, the Gustafson Group contends that a broad construction of Section 12(2) is unnecessary in view of the even more expansive protection that buyers enjoy under Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934. 15 U.S.C. § 78j(b). Finally, the Gustafson Group maintains that extending the remedy of Section 12(2) to privately negotiated transactions would interfere with the ability of private persons to place limits on their bargains, would add to the cost of private transactions, and would increase litigation in federal courts.

Wind Point and Holdings counter by arguing that none of these policy arguments demonstrates that applying Section 12(2) to private transactions is beyond the scope of what a rational Congress could possibly have intended. They argue that congressional sensitivity toward private business transactions was reflected in the registration and prospectus delivery requirements of the 1933 Act, but not in the Act's civil liability provisions. As to the possibility of rendering superfluous Rule 10b-5 by expanding protection under Section 12(2) to all buyers, Wind Point and Holdings observe that the Gustafson Group's argument ignores the important substantive differences between the two remedies, and also overlooks the obvious fact that "it is hardly a novel proposition that the Securities Exchange

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Act and the Securities Act prohibit some of the same conduct.”
Herman & MacLean v. Huddleston, 459 U.S. 375 (1983). And, in response to the contention that a narrow construction of Section 12(2) will reduce transaction costs and litigation, Wind Point and Holdings assert that a policy requiring a party to tell the truth is not antiefficient or antibusiness. Finally, Wind Point and Holdings argue that affirming the Seventh Circuit in this case would merely maintain the status quo of case law that for 50 years has permitted any sophisticated party represented by competent counsel to use Section 12(2) to rescind, i.e., to cancel, a privately negotiated securities transaction because of a seller’s material omission or misrepresentation.

SIGNIFICANCE

Section 12(2) offers important benefits to defrauded buyers in private securities transactions that are unavailable under the all-purpose antifraud remedy found in Rule 10b-5. Under Section 12(2), a buyer can recover for negligent misstatements or omissions, while the seller must prove that he or she acted with due care. Under Rule 10b-5, however, a buyer must establish that the seller actually knew that the communication was inaccurate. In addition, a buyer under Section 12(2) need not prove that he or she relied upon a misstatement or omission in making a purchase. Finally, unlike buyers proceeding under Rule 10b-5 who must bring suit in federal court, Section 12(2) buyers may sue either in state or federal court.

The Supreme Court’s decision in *Gustafson* will determine whether all securities buyers will enjoy these advantages. The outcome takes on even greater meaning for investors in view of decisions by the Court during the past 20 years that have significantly weakened both Section

12, *Pinter*, 486 U.S. at 647, and Rule 10b-5, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S.Ct. 1439 (1994); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

ARGUMENTS

For Arthur L. Gustafson (Counsel of Record: Donald W. Jenkins; Vedder, Price, Kaufman & Kammholz; 222 North LaSalle Street, Chicago, IL 60601; (312) 609-7500) and for **Daniel R. McLean and Francis I. Butler** (Counsel of Record: Harold C. Wheeler; Seyfarth, Shaw, Fairweather & Geraldson; 55 East Monroe Street, Chicago, IL 60603; (312) 346-8000):

1. The language and structure of the 1933 Act demonstrate that Section 12(2) applies to public, not private, sales of securities.
2. The 1933 Act was intended to interfere as little as possible with private business. Section 12(2) is an unusually powerful remedy that has no proper place in a privately negotiated transaction.

For Alloyd Company, Inc. and Wind Point Partners II, L.P. (Counsel of Record: Robert J. Kopecky; Kirkland & Ellis; 200 East Randolph Drive, Chicago, IL 60601; (312) 861-2000):

1. The language and structure of the 1933 Act demonstrate that Section 12(2) applies to both public and private sales of securities.
2. Application of Section 12(2) to private transactions is consistent with the broad remedial purpose of the 1933 Act. The interests of the purchaser in having truthful information about the securities is the same in either a private or public transaction.

AMICUS BRIEFS

In support of Arthur L. Gustafson, Daniel R. McLean, and Francis I. Butler

Securities Industry Association, Inc. (Counsel of Record: Robert L. Schnell; Faegre & Benson; 2200 Northwest Center, 90 South 7th Street, Minneapolis, MN 55402; (612) 336-3000).

In support of Alloyd Company, Inc. and Wind Point Partners II, L.P.

The National Association of Securities and Commercial Law Attorneys (Counsel of Record: Patrick E. Cafferty; Miller Faucher Chertow Cafferty and Wexler; 30 North LaSalle Street, Suite 3200, Chicago, IL 60602; (312) 782-4880);

North American Securities Administrators Association, Inc. (Counsel of Record: Karen M. O’Brien, General Counsel; North American Securities Administrators Association, Inc.; One Massachusetts Avenue, NW, Washington, DC 20001; (202) 737-0900);

Securities and Exchange Commission (Drew S. Days, III, Solicitor General; Department of Justice, Washington, DC 20530; (202) 514-2217).