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Affirmative Defense of Reasonable Care under Section 12(2) of the Securities Act of 1933

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The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of 1933

Therese H. Maynard^{*}

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I. INTRODUCTION

Section 12(2)¹ of the Securities Act of 1933² allows the buyer³ of securities to sue his seller for damages where the seller has misrepresented a material fact or omitted to state a material fact necessary to make the statements made by the seller during the course of the transaction not misleading. Until recently, this express cause of action was a relatively sleepy cousin of Rule 10b-5,⁴ overshadowed by the explosive growth of this implied remedy,⁵ which was invoked by buyers defrauded during the course of securities transactions in *both* the distribution markets⁶ and the secondary trading markets.⁷

1 15 U.S.C. § 77i(2) (1988).

2 15 U.S.C. §§ 77a-77m (1988 & Supp. IV 1992).

3 Defrauded sellers have no cause of action under the 1933 Act. By its own terms, section 12(2) extends relief only to defrauded purchasers. Although the language of section 17(a) of the 1933 Act has been interpreted to extend relief to defrauded sellers, LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* § 9A-1, at 700-01 (2d ed. 1988), most courts have been reluctant to imply a private cause of action under section 17(a), limiting its availability to criminal prosecutions and to the SEC for administrative proceedings. See THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 7.6, at 344, and § 7.8, at 356-57 (2d ed. 1990).

4 17 C.F.R. § 240.10b-5(b) (1992). The failure of section 12(2) to extend relief to the defrauded seller is often given as a primary reason for creating Rule 10b-5 and implying a civil remedy thereunder. See *Gilbert v. Nixon*, 429 F.2d 348, 355 (10th Cir. 1970); HAROLD S. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* § 15.01, at 15-1 to 15-2 (1993); ROBERT W. HAMILTON, *CORPORATIONS: CASES AND MATERIALS* 944-48 (4th ed. 1990); Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Post-Distribution Markets*, 32 WM. & MARY L. REV. 847, 873 n.143 (1991).

5 Since the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (requiring the Rule 10b-5 plaintiff to prove scienter on the part of the defendant), greater attention has been paid to section 12(2), with its lesser burden on the plaintiff as to defendant's knowledge. See Thomas L. Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641, 644 n.15 (1978); Dan Childers, *Recent Developments, Securities Regulation—Sanders v. John Nuveen & Co., Inc.—Underwriter Liability Under Section 12(2) of the Securities Act of 1933*, J. CORP. LAW 157 (Fall 1981); Catherine Masters Epstein, *Comment, Reasonable Care in Section 12(2) of the Securities Act of 1933*, 48 U. CHI. L. REV. 372 (1981).

6 Distribution markets are the primary securities markets wherein issuers raise capital by selling securities to investors through public offerings or private placements or other types of exempt financings. BLOOMENTHAL, *supra* note 4, at § 3.01; RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION* 5 (7th ed. 1992); Maynard, *supra* note 4, at 848 n.9.

7 Secondary markets (also known as trading or post-distribution markets) are securities markets which provide liquidity for investors who have purchased securities in the distribution markets by providing an organized marketplace for the continuous trading of previously issued securities. BLOOMENTHAL, *supra*, note 4, § 3.02; JENNINGS, *supra* note 6,

Significant controversy currently brews, however, over the question of whether the express cause of action for rescissionary damages available under section 12(2) extends to the purchaser defrauded in *secondary* market transactions.⁸ The district courts are split on this question, but the majority of the reported decisions agree with the conclusion of the Third Circuit in *Ballay v. Legg Mason Wood Walker, Inc.*⁹ In the first reported appellate decision to address this issue squarely, the Third Circuit concluded that section 12(2) relief was *not* available to defrauded secondary market buyers, reasoning that the 1933 Act was intended primarily to regulate the *distribution* markets. Accordingly, the Third Circuit concluded that section 12(2) relief is limited to *only* those buyers defrauded during the course of *distribution* transactions.

However, legal scholars,¹⁰ as well as practicing members of the securities bar,¹¹ have largely rejected the Third Circuit's reasoning. Moreover, in May 1993, the Seventh Circuit weighed in on this debate and concluded that the statute on its face affords relief to those secondary market buyers who otherwise satisfy the statutory prerequisites of this express cause of action.¹² In reaching this conclusion, the Seventh Circuit emphasized the express language of section 12(2) and its relationship to other relevant provisions of

at 5; Maynard, *supra* note 4, at 848 n.9.

8 See generally BLOOMENTHAL, *supra* note 4, § 14.05[4]; Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908 (1992) [hereinafter Loss, *The Assault on § 12(2)*]; Louis Loss, *Securities Act Section 12(2): A Rebuttal*, 48 BUS. LAW. 47 (1992) [hereinafter Loss, *A Rebuttal*]; Maynard, *supra* note 4; 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); Adam D. Hirsch, Note, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. CHI. L. REV. 955 (1990); Catherine Zucal, Note, *Does Section 12(2) of the Securities Act of 1933 Apply to Secondary Trading?*: *Ballay v. Legg Mason Wood Walker, Inc.*, 65 ST. JOHN'S L. REV. 1179 (1991).

9 925 F.2d 682 (3d Cir. 1991).

10 See generally Loss, *The Assault on § 12(2)*, *supra* note 8.

11 See Steven W. Hansen et al., *Developments in Broker-Customer Litigation*, 25 REV. SEC. & COMMODITIES L. 193 (1992); Robert N. Rapp, *The Proper Role of Securities Act Section 12(2) as an Aftermarket Remedy for Disclosure Violations*, 47 BUS. LAW 711 (1992). Since *Ballay* was decided, much has been written about the legislative history of the 1933 Act, and of section 12(2) in particular. See, e.g., Loss, *A Rebuttal*, *supra* note 8; Prentice, *supra* note 8; Rapp, *supra*; Weiss, *supra* note 8. As the Seventh Circuit pointed out, however, nothing in the legislative history contradicts the express language of the statute. *Pacific Dunlop Holdings v. Allen & Co.*, 993 F.2d 578, 592 (7th Cir. 1993).

12 *Pacific Dunlop*, 993 F.2d at 582. For a more thorough analysis of the reasoning employed by the Third Circuit in *Ballay* as contrasted with that of the Seventh Circuit in *Pacific Dunlop*, see Therese H. Maynard, *Section 12(2)'s Availability to the Defrauded Secondary Market Buyer*, 7 INSIGHTS 21 (August 1993).

the federal securities laws.¹³ Furthermore, in its examination of the legislative history of the 1933 Act as a whole and of section 12(2) specifically, the Seventh Circuit found no basis for limiting section 12(2) relief to only those buyers who purchase in distribution transactions.¹⁴ Thus, under the Seventh Circuit's approach, the primary limitation on the availability of section 12(2) relief is the express privity requirement of section 12(2),¹⁵ not an implied standing limitation based on a conclusion that Congress intended the 1933 Act to regulate only distribution transactions, as the Third Circuit held in *Ballay*.¹⁶

Since the *Ballay* decision was handed down in 1991, many observers have expressed concern about the broadened scope of liability that would be imposed on participants in the secondary trading markets, including members of the securities brokerage industry, if the section 12(2) cause of action were made available to buyers in the post-distribution markets.¹⁷ These concerns, how-

13 The rubric of "federal securities laws" generally refers to seven statutes. Congress enacted the first six statutes between 1933 and 1940: the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1988 & Supp. IV 1992); the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (1988 & Supp. IV 1992); the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1988 & Supp. IV 1992); the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbb (1988 & Supp. IV 1992); the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (1988 & Supp. IV 1992); the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1988 & Supp. IV 1992). Congress enacted the seventh statute in 1970, the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78lll (1988). See also 15 U.S.C. § 78c(a)(47) (1988) (as amended, defining "securities laws" to include these seven acts).

14 *Pacific Dunlop*, 993 F.2d at 595.

15 The language of the statute expressly limits the plaintiff-buyer's section 12(2) suit to only those persons who sold the securities to the plaintiff, 15 U.S.C. § 77l (1988). See also *infra* Part II.D for further analysis of the statute's privity requirement.

16 See, e.g., *Pacific Dunlop*, 993 F.2d 578; *PPM America v. Marriott Corp.*, 820 F. Supp. 970 (D. Md. 1993); *Hedden v. Marinelli*, 796 F. Supp. 432 (N.D. Cal. 1992). The author examines these cases in detail in her forthcoming article, *The Future of Litigation Under Securities Act Section 12(2)*, to be published in the symposium issue of the *ALA. L. REV.* (Fall 1993); accordingly, extended analysis of these cases is outside the scope of this Article.

17 See Prentice, *supra* note 8 at 104, 138. To the extent that concern over a threatened flood of litigation by secondary market buyers against their sellers is urged as a basis for denying section 12(2) relief to the defrauded buyer in the post-distribution market, the scope of this potential liability exposure—and particularly that of securities professionals such as broker-dealers—must be placed in the proper context. This Article seeks to provide that context by analyzing how section 12(2) would apply to sellers in the trading markets, with particular focus on the scope of liability of the broker-dealer as a prospective section 12(2) defendant. The Article also demonstrates that the concerns about making section 12(2) relief available to post-distribution buyers are greatly exaggerated. Accordingly, fears about the disproportionate liability exposure of section 12(2)

ever, are misplaced. Indeed, as this Article will demonstrate, the express requirements of section 12(2), in and of themselves, create safety valves that prevent crushing liability wholly disproportionate to the nature of the defendant-seller's underlying wrongful conduct.

At the outset, the express requirement of privity between the plaintiff-buyer and the defendant-seller is an important limitation that significantly narrows the scope of potential section 12(2) liability by holding secondary market sellers liable to only those buyers in privity with that defendant-seller.¹⁸ More importantly, section 12(2) expressly provides the seller with the affirmative defense of reasonable care;¹⁹ thus, the defendant-seller may resist the buyer's section 12(2) suit by claiming that she²⁰ exercised the requisite degree of care. Surprisingly little, however, has been written about the section 12(2) defense of reasonable care,²¹ and only a handful of reported decisions specifically address this aspect of the section 12(2) remedy.

From both a litigation and preventive law perspective, however, it is important to define the standard of care that a seller must exercise so that she may conduct her business affairs and trading activities in the secondary markets without jeopardizing her ability to claim this affirmative defense. From the perspective of a member of the securities industry, the defense of reasonable care must be regarded as one of the most important safeguards underlying this express cause of action. This defense affords the section 12(2) defendant-seller a mechanism wholly within her control by which she can avoid "crushing liability" for her post-distribution trading

sellers, particularly Broker-Dealer Sellers, are misplaced and do not justify denying the section 12(2) express cause of action to the defrauded secondary market buyer.

18 The prospective class of section 12(2) defendant-sellers is limited by the express privity requirement of section 12. The defrauded buyer may obtain relief only from the individual(s) who sold the security to him by way of a materially misleading misrepresentation or omission. See *infra* Part II.D for further analysis of this privity requirement. Moreover, any section 12(2) defendant may seek to resist liability by refuting the other elements of section 12(2). For example, she may claim that the alleged misrepresentation or omission did not relate to a "material" fact; see *infra* notes 84-86 (discussing the relevant standard for materiality).

19 Section 12(2)'s reasonable care defense requires the seller to "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." 15 U.S.C. § 77f(2) (1988).

20 Throughout this Article, the pronoun "she" refers to section 12(2) defendant-sellers and the pronoun "he" refers to the post-distribution buyer suing under section 12(2).

21 BLOOMENTHAL, *supra* note 4, § 14.05, at 14-15; see also LOSS, *supra* note 3, at 894-95; and Epstein, *supra* note 5.

activities. Indeed, as the question of the scope of section 12(2) winds its way to the United States Supreme Court for ultimate resolution,²² it is important to understand and emphasize that the statute itself affords adequate safeguards to prevent draconian liability in claims made by defrauded secondary market buyers against their sellers under section 12(2).²³

This Article therefore focuses its analysis on the seller's section 12(2) affirmative defense of reasonable care, emphasizing the availability of this defense to the broker-dealer acting as a seller in a post-distribution market transaction.²⁴ Part II briefly describes the elements of a section 12(2) cause of action to demonstrate how the statute, by its very terms, limits the availability of this express cause of action. This section will demonstrate that the statute's express requirement of privity, coupled with the other elements of this express cause of action, pose a significant barrier to recovery of substantial damages from secondary market sellers, including securities broker-dealers. Part III continues this discussion by examining the dearth of existing case law analyzing the reasonable care standard contained in the section 12(2) affirmative defense. This discussion will demonstrate that, historically, the courts have relied on a flexible approach in analyzing the statute's reasonable care standard, emphasizing a variety of factors, including the nature of the defendant-seller.

Part IV of the Article is divided into three subparts. Each subpart analyzes the section 12(2) reasonable care standard from the perspective of one of three different classes of prospective

22 Ellen Joan Pollock, *Law: Suing Over Prospectus*, WALL ST. J., May 12, 1993, at B7. In light of the fundamental disagreement regarding the proper scope of section 12(2) relief, this issue will likely make its way to the United States Supreme Court. See Maynard, *supra* note 4, at 849, 892; Maynard, *supra* note 12, at 21; Prentice, *supra* note 8, at 142.

23 In deciding whether to allow the defrauded post-distribution buyer to sue under section 12(2), the Supreme Court presumably will be sensitive to the question of whether this rule of standing will "open the floodgates" of litigation. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 n.33 (1976). As this Article demonstrates, however, this express cause of action is carefully tailored, see *infra* Part II, and further, it provides the defendant-seller with an affirmative defense that allows the scrupulous seller to conduct her dealings so as to avoid culpability under section 12(2). See *infra* Part IV.

24 This Article, therefore, assumes that *Pacific Dunlop* was correctly decided and that a section 12(2) cause of action does exist on behalf of the defrauded post-distribution buyer. Accordingly, this Article's analysis of the parameters of the section 12(2) reasonable care defense should provide further support for the position that *Ballay* was wrongly decided and, therefore, when the issue is finally before it, the Supreme Court should conclude that section 12(2) relief is available to the defrauded secondary market buyer.

section 12(2) defendant-sellers in the secondary markets.²⁵ Subpart (A) deals with an ordinary seller: one who is neither a control person of the issuer of the securities that are the subject of sale, nor a securities professional (hereinafter an "Ordinary Seller"). Next, subpart (B) examines the situation of a seller who is a "control person"²⁶ of the issuer of the securities that are the subject of the sale (hereinafter a "Control Person Seller"). Finally, subpart (C) focuses on a seller who, as a member of the securities brokerage industry, buys and sells securities for her own account and/or the account of others (hereinafter a "Broker-Dealer Seller").²⁷ The objective of each subpart of Part IV is to describe the criteria for applying the section 12(2) reasonable care defense to each respective category of prospective secondary market sellers. This analysis will demonstrate that, generally, the least onerous standard of reasonable care applies to the transaction involving the Ordinary Seller and the most onerous burden will be imposed on the Control Person Seller.²⁸

Trading market transactions involving a Broker-Dealer Seller, however, pose the most complex analysis of the relevant standard of reasonable care.²⁹ In this situation, analysis of the section 12(2) affirmative defense is further complicated by fiduciary duty principles that derive from both common law agency principles and the federal securities laws. These fiduciary duties, generally not relevant to other classes of prospective section 12(2) sellers, play a crucial role in defining the scope of the broker-dealer's reasonable care burden as a section 12(2) seller in a secondary market transaction.

Because the most frequent targets of section 12(2) suits arising out of secondary market sales activity are likely to be broker-dealers,³⁰ Part IV emphasizes the relevant criteria to be applied in

25 While not exhaustive, the classification scheme used in this Article covers most of the customary participants in the secondary markets.

26 See *infra* notes 197-99 and accompanying text, which address the concept of control.

27 See 15 U.S.C. § 77b(12) (1988) (defining the statute's use of the term "dealer" to include brokers as well as those persons who trade for their own account); 15 U.S.C. § 77i(2) (1988).

28 See *infra* Parts IV.A (discussing the scope of Ordinary Seller's liability under section 12(2)), IV.B (discussing the scope of Control Person Seller's liability under section 12(2)).

29 See *infra* Part IV.C.

30 See Prentice, *supra* note 8, at 104; see also Marc I. Steinberg, *Securities Symposium*, 19 PEPP. L. REV. 1105, 1113 (1992).

analyzing the section 12(2) defense from the perspective of the Broker-Dealer Seller. The analysis of the broker-dealer's exercise of reasonable care demonstrates that section 12(2) liability is not a monster of draconian proportions—at least not where the broker-dealer conducts her business affairs properly, by scrupulously complying with the otherwise applicable fiduciary duty principles that govern the broker-dealer's relationship with her customers. This analysis of the section 12(2) reasonable care defense thus provides guidelines to the broker-dealer community for conducting their future dealings in the secondary markets to avoid section 12(2) liability, thereby preserving the basis for their section 12(2) affirmative defense.

The Article concludes in Part V by recommending that the courts continue to adhere to a flexible, fact-oriented approach to the application of the seller's section 12(2) affirmative defense.³¹ The contrasting situations posed by the various classes of potential section 12(2) defendant-sellers reinforce the need for such judicial flexibility in describing the nature of section 12(2)'s reasonable care requirement.³² The relevant standard for the seller's exercise of reasonable care is not capable of definition with any mathemat-

31 Accordingly, it is appropriate to rely on common law to provide further refinement of the flexible approach recommended in this Article. However, the development of standards for the exercise of reasonable care sufficient to establish the section 12(2) defense—at least as to Broker-Dealer Sellers—will be affected by the brokerage industry's increasing use of arbitration clauses in its agreements with its customers. Because the Supreme Court has upheld the validity of these arbitration clauses, *see* *Rodriguez de Quijas v. Shearson/American Express*, 490 U.S. 477 (1989); *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987), increasing reliance has been placed on arbitration to resolve customers' disputes with their broker-dealers. Obviously, reliance on the arbitration process to resolve these disputes will impact the common law evolution of standards for the broker-dealer's exercise of reasonable care under section 12(2). *See generally*, David A. Lipton, *The Standard on Which Arbitrators Base Their Decisions: The SROs Must Decide*, 16 SEC. REG. L.J. 3 (1988). Detailed examination of the impact of arbitration on the development of common law standards, however, lies outside the scope of this Article.

32 Indeed, section 1703(f) of the American Law Institute's FEDERAL SECURITIES CODE, which is the proposed successor to section 12(2) of the 1933 Act, requires the defendant to establish that "he reasonably did not believe that there was a misrepresentation." Section 202(131) defines "reasonably" to require the defendant to exercise "reasonable care," with the further admonition that "the questions whether reasonable care requires an investigation or inquiry and, if so, its extent are left to construction in context and in the light of the circumstances." *See also* 9 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4211 n.70 (3d ed. 1989 & Supp. 1992). To provide more substantive guidance to the broker-dealer community, the SEC might be called upon to develop a safe harbor provision in a manner similar to the SEC's adoption of Rule 176, which gives guidance to the broker-dealer industry as to the scope of the reasonable investigation requirement of section 11 of the 1933 Act. *See* 17 C.F.R. § 230.176 (1992).

ical precision as to any potential category of section 12(2) seller. Rather, a fact-intensive analysis is required, including a careful balancing of the criteria identified in Part IV of the Article, of which the most important is the nature of the section 12(2) defendant-seller.

II. ELEMENTS OF SECTION 12(2) CAUSE OF ACTION

Any analysis of the provisions of the federal securities laws must start with the statute's language.³³ By its terms, section 12(2) entitles the purchaser of a security to rescission from his seller (or, in the event that the purchaser no longer owns the security, to receive damages equivalent to rescission) if the purchaser can establish that (1) the seller used the facilities of interstate commerce or the mails; (2) to offer to sell or to sell securities to the purchaser; (3) by means of a "prospectus" or oral communication; (4) that misstated or omitted a material fact; (5) of which the purchaser did not have knowledge; (6) *unless* the seller sustains the burden of proving that she did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.³⁴

A detailed examination of each of these elements indicates that, contrary to the Third Circuit's ruling in *Ballay*, "[s]ection 12(2) on its face applies to the offer or sale of any security,"³⁵ whether such purchase is made in the primary or secondary market. Given the possibility that section 12(2) relief could be extended to fraudulent secondary market trading, the facts of *Ballay* present a good illustration of the type of recurring transactions involving Broker-Dealer Sellers³⁶ that some commentators fear will spawn a flood of deleterious litigation, perhaps ultimately threatening the financial integrity of the brokerage industry as a whole.

This Part, therefore, will analyze the elements of section 12(2) relief against the facts of the *Ballay* case. By applying the required elements of section 12(2) to the facts of the secondary market transactions at issue in *Ballay*, this Part will demonstrate that the

33 See *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206-11 (1976).

34 15 U.S.C. § 771(2) (1988); see also *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1128 (4th Cir. 1970); *Monetary Management Group v. Kidder, Peabody & Co.*, 615 F. Supp. 1217, 1222 (E.D. Mo. 1985).

35 Patricia A. O'Hara, *Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller*, 31 UCLA L. REV. 921, 928 n.18 (1984).

36 See Steinberg, *supra* note 30, at 1113.

restrictions Congress placed on this remedy, in and of themselves, severely limit the availability of section 12(2) relief. More importantly, this Part will demonstrate that the liability exposure of defendant-sellers is curtailed further by the statute's affirmative defense of reasonable care. As applied to the type of secondary market transactions at issue in *Ballay*, the elements of the section 12(2) cause of action allow the meritorious plaintiff to prevail, but do not result in draconian damage awards wholly out of proportion to the nature of the defendant-seller's wrongful conduct.

A. *The Facts of Ballay v. Legg Mason Wood Walker, Inc.*

In *Ballay*, several investors sued the brokerage firm of Legg Mason Wood Walker, Inc. ("Legg Mason") on account of alleged oral misrepresentations made by the firm³⁷ and its representatives concerning the book value calculation of certain securities of the Wickes Company ("Wickes"). The investors claimed that Legg Mason had touted these securities as a promising investment in the undervalued stock of a company that showed significant potential for future growth.³⁸ Relying on these representations, the plaintiffs purchased Wickes securities in the secondary markets using the brokerage services of Legg Mason during the period from June 1986 through August 1987.³⁹

Legg Mason analysts tracked the performance of companies whose profiles complied with the investment criteria underlying the Legg Mason "value philosophy" of investing, a philosophy that was widely promoted to its clients.⁴⁰ In furtherance of this investment strategy, Legg Mason often produced research reports regarding the securities of companies that it had identified as attractive investment opportunities.

One such company, Wickes, had emerged from bankruptcy protection in January 1985 and had pursued a restructuring course that involved sizeable acquisitions as well as dispositions of certain of its holdings.⁴¹ From June 1986 through November 1987, Legg

37 *Ballay*, 925 F.2d at 684. Legg Mason was registered as a broker-dealer under the 1934 Act. *Id.* at 685. The potential liability under section 12(2) of a securities professional registered only under the Investment Advisers Act, 15 U.S.C. §§ 806-1 to -21 (1988 & Supp. IV 1992), lies outside the scope of this Article.

38 *Ballay*, 925 F.2d at 685.

39 *Id.*

40 *Id.*

41 *Id.*

Mason recommended investment in Wickes securities⁴² by means of an interoffice "squawk box" that disseminated the firm's recommendations to its representatives.⁴³ Legg Mason also communicated these recommendations in various writings, which were circulated to both the clients and the brokers of the Legg Mason firm.⁴⁴ One such communication over the squawk box mistakenly reported that Wickes had a book value of \$5 per share excluding goodwill.⁴⁵ Subsequently, Legg Mason's research reports contained various other references to the valuation of the goodwill of Wickes, all of which were erroneous.⁴⁶ On November 27, 1987, and December 17, 1987, Legg Mason corrected these prior misleading statements in a report which clarified the calculation of Wickes' book value, including the value of goodwill.⁴⁷ The plaintiff investors, all clients of Legg Mason, had purchased Wickes stock prior to the dissemination of these curative investment reports of November and December.⁴⁸

Following the Third Circuit's ruling in *Ballay*, several commentators have suggested that imposition of liability on a broker-dealer firm (such as Legg Mason) for communications directed to buyers in the secondary market (such as the research reports disseminated by Legg Mason to its customers) could lead to an overwhelming volume of lawsuits against Broker-Dealer Sellers that would threaten the very viability of the brokerage industry. This Part will demonstrate, however, that the underlying philosophy of the 1933 Act is intended to eliminate the very type of misrepresentations of material fact reflected in the *Ballay* fact pattern. At the same time, the reasonable care defense and other procedural safeguards expressly afforded under section 12(2) are designed to protect sellers, including Broker-Dealer Sellers such as Legg Mason, against the very type of unwarranted, crushing liability that is so feared.

B. *Interstate Commerce*

Despite a dearth of reported cases under section 12(2) dealing specifically with the jurisdictional issue of interstate commerce, commentators generally agree "that the misrepresentation itself

42 *Id.*

43 *Id.*

44 *Id.* at 685-86.

45 *Id.* at 685.

46 *Id.* at 686.

47 *Id.*

48 *Id.* at 685-86

need not have been made in interstate commerce; the jurisdictional requirement is satisfied if the mails or interstate commerce were utilized for *any* part of the transaction.⁴⁹ In deciding whether a plaintiff has satisfied the interstate commerce requirement, courts generally look to the entire transaction, not to its isolated parts.⁵⁰ For example, in *Ballay*, as to many of the forty-three plaintiffs, the fraudulent communications were made orally, in face-to-face communications, or perhaps during the course of telephone conversations. The use of the telephone generally will be sufficient to establish jurisdiction.⁵¹ Moreover, the use of the facilities of interstate commerce need not coincide with the misrepresentation or omission that is the subject of the 12(2) cause of action. It is enough that the use of interstate commerce occurs *in connection with* the offer or sale of securities.⁵²

49 Martin I. Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares With Rule 10b-5*, 13 HOUS. L. REV. 231, 240 (1976).

50 *Id.* at 240 n.43. See also JENNINGS, *supra* note 6, at 1252-53; *Hill York Corp. v. America Int'l Franchises*, 448 F.2d 680, 692 (5th Cir. 1971).

51 Only one case has directly confronted the issue of whether a purely intrastate telephone call satisfies the interstate commerce requirement of section 12(2). *Lennerth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964). That court held that any use of the telephone is sufficient. *Id.* at 63 ("Use of the telephone is the use of a means of interstate communication."). But see *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967) (holding that intrastate phone call was sufficient use of interstate commerce to give federal courts jurisdiction under rule 10b-5, but distinguishing similar language under section 12(2)), *cert. denied*, 390 U.S. 951 (1968). Most commentators agree, however, that an intrastate telephone call is sufficient to give rise to jurisdiction under section 12(2) because the same telephone wires carry both intrastate and interstate messages. See JENNINGS, *supra* note 6, at 1252-53; 8 LOSS & SELIGMAN, *supra* note 32, at 3927-28; 1 *id.* at 430 n.96.

52 See, e.g., *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028 (2d Cir. 1979); *Franklin Sav. Bank of New York v. Levy*, 551 F.2d 521 (2d Cir. 1977); *Moses v. Michael*, 292 F.2d 614 (5th Cir. 1961); *Cresswell-Keith, Inc. v. Willingham*, 264 F.2d 76 (8th Cir. 1959); *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir.), *cert. granted*, 346 U.S. 908 (1953), and *cert. dismissed*, 347 U.S. 925 (1954); *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943). But see *Kemper v. Lohnes*, 173 F.2d 44 (7th Cir. 1949) (holding that facilities of interstate commerce must carry the misrepresentation or omission itself to state section 12(2) cause of action).

In *Wigand*, for example, the defendant seller made several oral misrepresentations to the plaintiff buyer in a series of face-to-face meetings regarding a negotiated merger between two companies in which the two parties were majority shareholders. *Wigand*, 609 F.2d at 1031-32. After the parties consummated the transaction, the defendant mailed a stock certificate to the plaintiff representing the purchase of 25,000 shares. *Id.* at 1032. The court held that the transfer by mail of the stock certificate was sufficient to support jurisdiction under section 12(2) even though use of the mail was collateral to the real transaction and the defendant's misrepresentations. *Id.* at 1033.

Similarly, in *Lennerth*, the defendant made an intrastate telephone call to the plaintiff to arrange the face-to-face meeting at which the defendant made the oral misrepresentations which were the subject of the plaintiff's section 12(2) cause of action. *Lennerth*,

In secondary market transactions, most of the trades executed on behalf of customers, such as the clients of Legg Mason, are executed on the exchanges or in the over-the-counter (OTC) market through the facilities sponsored by the National Association of Securities Dealers.⁵³ Access to these markets generally depends on some use of the telephone, computerized wire messages, or other forms of communication devices that necessarily implicate the "use of the facilities of interstate commerce." Accordingly, jurisdiction in these types of secondary market trading cases should not be difficult to establish.⁵⁴

C. "Sale" of a "Security"

Second, the plaintiff must show that he was a purchaser in a transaction involving the sale of a security.⁵⁵ Section 2(3) of the 1933 Act defines the term "sale." The original issuance of securities, conventionally referred to as a distribution transaction,⁵⁶ is a sale under this definition.⁵⁷ Courts, however, have treated many

234 F. Supp. at 63. The misrepresentations themselves were not carried by the facilities of interstate commerce. However, because the intrastate phone call was connected with the transaction, jurisdiction was proper. *Id.*

53 The National Association of Securities Dealers (the "NASD") is registered under section 15A of the 1934 Act, which was enacted by Congress in 1938 to authorize SEC registration and regulation of a new kind of self-regulatory organization known as "national securities associations." The NASD is the only such organization of its type. Today, most over-the-counter equity trading is handled through the NASDAQ quotation system, the automated quotation system sponsored by the NASD. 5 LOSS & SELIGMAN, *supra* note 32, at 2580. The NASD, as part of its ongoing effort to enhance its competitive posture, has adopted several measures to automate many of the steps involved in the OTC trading process. For a more detailed discussion of the technological improvements and other developments that have enabled the OTC market to match orders and otherwise develop execution capability, see *id.* at 2578-91; Michael J. Simon & Robert L.D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17, 21 (1986).

54 9 LOSS & SELIGMAN, *supra* note 32, at 4208-11. Generally, some aspects of the activity involved in a secondary market transaction—typically involving the broker-dealer's routing of an order deposited by the customer with the broker-dealer (in person or through some other means of communication) to the destination market (whether it be an exchange facility or some other dealer in the OTC market) for execution in that market—will involve the use of the facilities of interstate commerce at some point, thereby creating the basis for federal jurisdiction. *Id.*

55 See Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1988) (defining the term "security"). This threshold issue is likewise jurisdictional. See JENNINGS, *supra* note 6, at 264-65; 9 LOSS & SELIGMAN, *supra* note 32, at 4198-99; *Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680, 692-93 (5th Cir. 1971).

56 See *supra* note 5.

57 See 9 LOSS & SELIGMAN, *supra* note 32, at 4199; *In re Gap Stores Sec. Litig.*, 79 F.R.D. 283, 307 (N.D. Cal. 1978); *In re Intel Sec. Litig.*, 89 F.R.D. 104, 115-16 (N.D. Cal. 1981).

transactions occurring in the secondary markets, including mergers,⁵⁸ stock exchanges, and stock pledges,⁵⁹ as sales under this definition.

Indeed, the *Ballay* court did not dispute that plaintiffs' purchase of securities from the defendant broker-dealer firm was a "sale" as that term is defined in section 2(3). In *Ballay*, the plaintiff-buyers brought a section 12(2) suit against their broker based on the broker's alleged misrepresentations concerning the book value of certain Wickes securities that the plaintiffs purchased during the regular course of trading transactions in the secondary market. The Third Circuit did not rule that these trading transactions did not involve the "sale" of a "security." Instead, the court reasoned that such a sale was outside the protections of section 12(2) of the 1933 Act because the sale did not occur during the course of a "distribution" transaction.⁶⁰

The approach of the Third Circuit in *Ballay* on the sale element of the section 12(2) cause of action is laudable because it is consistent with other courts' prior interpretation of the term "sale" as used in other provisions of the federal securities laws, including other aspects of the 1933 Act.⁶¹ At first blush, this interpretation may appear to lead to an overly expansive view of the broker-dealer's potential liability under section 12(2), since most purchasers in secondary market trades, like the plaintiffs in *Ballay*, rely on a broker-dealer for their participation in, and access to, these markets.⁶² However, the courts' broad interpretation of "sale," as underscored by the *Ballay* decision, will not open the floodgates of litigation because other more restrictive components of this ex-

58 See, e.g., *Folder Adam Co. v. PMI Indus.*, 938 F.2d 1529 (2d Cir.), cert. denied, 112 S. Ct. 587 (1991); *Junker v. Crory*, 650 F.2d 1349, 1359 (5th Cir. 1981). Mergers and certain other forms of business combinations are likewise treated as sales under the SEC's Rule 145. 17 C.F.R. § 230.145 (1992).

59 See, e.g., *Rubin v. United States*, 449 U.S. 424, 428-31 (1981) (holding that pledge of securities is a sale).

60 *Ballay v. Legg Mason Wood Walker, Inc.* 925 F.2d 682, 688 (3d Cir.), cert. denied, 112 S. Ct. 79 (1991).

61 *United States v. Naftalin*, 441 U.S. 768 (1979); *Loss, A Rebuttal, supra* note 8, at 52-55.

62 Most purchasers need the assistance of a broker-dealer to gain access to secondary trading markets because the markets only permit member broker-dealers to execute trades in those markets. See *Maynard, supra* note 4, at 866-67; Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883, 889 (1981); Nicholas Wolfson et al., *The Securities Markets: An Overview*, 16 HOW. L.J. 791, 812-14 (1971).

press cause of action, particularly the privity requirement, compensate for the liberal interpretation of this element.

D. Definition of "Seller": The Privity Requirement of Section 12(2)

The plaintiff-buyer must show that the defendant-seller offered or sold the securities at issue to the plaintiff. This built-in privity requirement, an essential component of the section 12 cause of action, was the source of considerable controversy among the federal appellate courts⁶³ until 1988, when the United States Supreme Court decided *Pinter v. Dahl*.⁶⁴ In construing the definition of "seller" for purposes of section 12(1)⁶⁵ liability, the Court held that the plaintiff must show that the defendant's activity was "motivated at least in part by a desire to serve his own financial interests or those of the securities owner."⁶⁶ Under this formulation, prospective defendants in a section 12(1) suit include not only the person who passes title or otherwise transfers an interest in the security for value, but also certain persons who solicit prospective buyers.⁶⁷ A defendant's indirect involvement in the selling process, however, should not give rise to section 12(1) liability since generally it will not meet the *Pinter* formulation.⁶⁸

Limiting its analysis to section 12(1), the *Pinter* Court expressly declined to rule on the standard to be used for section 12(2) purposes.⁶⁹ However, the Court discussed cases that primarily address section 12(2) issues.⁷⁰ Moreover, the relevant language of

63 See generally Douglas E. Abrams, *The Scope of Liability Under Section 12 of the Securities Act of 1933: "Participation" and the Pertinent Legislative Materials*, 15 FORDHAM URB. L.J. 877-79 (1987) (describing different approaches used by courts); O'Hara, *supra* note 35, at 947; Leonard A. Silverstein, Note, *Seller Liability Under Section 12(2) of the Securities Act of 1933: A Proximate Cause—Substantial Factor Approach Limited by a Duty of Inquiry*, 36 VAND. L. REV. 361 (1983).

64 486 U.S. 622 (1988).

65 15 U.S.C. § 77f(1) (1988).

66 *Pinter*, 486 U.S. at 647.

67 As the Court observed:

The solicitation of a buyer is perhaps the most critical stage of the selling transaction In addition, brokers and other solicitors are well positioned to control the flow of information to a potential purchaser, and, in fact, such persons are the participants in the selling transaction who most often disseminate material information to investors.

Id. at 646.

68 See 1 THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* 322 (2d ed. 1990).

69 *Pinter*, 486 U.S. at 642 n.20. See also William O. Fisher, *Parsing Pinter Four Years Later: Defining a Statutory Seller Under Section 12 of the Securities Act*, 21 SEC. REG. L.J. 46 (1993).

70 See, e.g., *Adalman v. Baker, Watts & Co.*, 807 F.2d 359 (4th Cir. 1986); *Anderson*

both subsections is substantially identical, suggesting that the same definition of "seller" should apply to both. Indeed, many courts have since ruled that the *Pinter* standard applies to section 12(2) claims,⁷¹ and the commentators generally agree that the *Pinter* formulation of "seller" applies to section 12(2) as well.⁷²

v. Aurotek, 774 F.2d 927 (9th Cir. 1985); *Foster v. Jessup and Lamont Sec. Co.*, 759 F.2d 838 (11th Cir. 1985); *Davis v. AVCO Fin. Serv.*, 739 F.2d 1057 (6th Cir. 1984), *cert. denied*, 470 U.S. 1005 (1985); *Pharo v. Smith*, 621 F.2d 656 (5th Cir. 1980); *Croy v. Campbell*, 624 F.2d 709 (5th Cir. 1980); *Collins v. Signetics Corp.*, 605 F.2d 110 (3d Cir. 1979); *Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680 (5th Cir. 1971); *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943); *Cady v. Murphy*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940).

71 *Ryder Int'l Corp. v. First Am. Nat'l Bank*, 943 F.2d 1521 (11th Cir. 1991); *Cortec Indus. v. SUM Holding L.P.*, 949 F.2d 42 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1561 (1992); *Ackerman v. Schwartz*, 947 F.2d 841 (7th Cir. 1991); *Moore v. Kayport Package Express*, 885 F.2d 531 (9th Cir. 1989); *Decker v. Kraftsow (In re Craftmatic Sec. Litig.)*, 890 F.2d 628 (3d Cir. 1989); *Royal Am. Managers v. IRC Holding Corp.*, 885 F.2d 1011 (2d Cir. 1989); *Schlifke v. Seafirst Corp.*, 866 F.2d 935 (7th Cir. 1989) (holding that defendant was not seller under section 12(2) under substantial factor test or under *Pinter* but not deciding whether or not *Pinter* applies to § 12(2) claims); *Wilson v. Saintine Exploration and Drilling Corp.*, 872 F.2d 1124 (2d Cir. 1989); *Crawford v. Glens, Inc.*, 876 F.2d 507 (5th Cir. 1989); *Capri v. Murphy*, 856 F.2d 473, 478 (2d Cir. 1988); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1113-15 (5th Cir. 1988); *Pompano-Windy City Partners v. Bear, Stearns & Co.*, 794 F. Supp. 1265 (S.D.N.Y. 1992); *Scholes v. Stone, McGuire & Benjamin*, 786 F. Supp. 1385 (N.D. Ill. 1992); *Davis v. Coopers & Lybrand*, 787 F. Supp. 787 (N.D. Ill. 1992); *In re Newbridge Networks Sec. Litig.*, 767 F. Supp. 275 (D.D.C. 1991); *In re Sahlen & Assoc. Sec. Litig.*, 773 F. Supp. 342 (S.D. Fla. 1991); *Mabon, Nugent & Co. v. Borey*, 127 B.R. 727 (S.D.N.Y. 1991); *Dawe v. Main Street Management Co.*, 738 F. Supp. 36 (D. Mass. 1990); *Sellin v. Rx Plus, Inc.*, 730 F. Supp. 1289 (S.D.N.Y. 1990); *Epstein v. Haas Sec. Corp.*, 731 F. Supp. 1166 (S.D.N.Y. 1990); *Morin v. Trupin*, 747 F. Supp. 1051 (S.D.N.Y. 1990); *Dalton v. Alston & Bird*, 741 F. Supp. 1322 (S.D. Ill. 1990); *VT Investors v. R & D Funding Corp.*, 733 F. Supp. 823 (D.N.J. 1990); *Wiley v. Hughes Capital Corp.*, 746 F. Supp. 1264 (D.N.J. 1990); *Craig v. First Am. Capital Resources*, 740 F. Supp. 530 (N.D. Ill. 1990); *Mix v. E.F. Hutton & Co.*, 720 F. Supp. 8 (D.D.C. 1989); *In re Worlds of Wonder Sec. Litig.*, 721 F. Supp. 1140 (N.D. Cal. 1989); *Levine v. Diamantheset, Inc.*, 722 F. Supp. 579 (N.D. Cal. 1989); *Buford White Lumber Co. v. Octagon Properties*, 740 F. Supp. 1553 (W.D. Okla. 1989); *Mercer v. Jaffe, Snider, Raitt & Heuer, P.C.*, 713 F. Supp. 1019 (W.D. Mich. 1989); *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962 (E.D.N.Y. 1988); *Laven v. Flanagan*, 695 F. Supp. 800 (D.N.J. 1988); *In re Professional Fin. Management*, 692 F. Supp. 1057 (D. Minn. 1988); *Jackson v. First Fed. Sav. of Ark., F.A.*, 709 F. Supp. 863 (E.D. Ark. 1988); *Scotch v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 709 F. Supp. 95 (M.D. Pa. 1988); *Marshall v. Quinn-L Equities*, 704 F. Supp. 1384 (N.D. Tex. 1988); *Flournoy v. Peyson*, 701 F. Supp. 1370 (N.D. Ill. 1988).

72 See generally *Fisher*, *supra* note 69, at 48 ("[V]irtually every subsequent 12(2) decision has applied *Pinter's* definition in addressing a statutory seller issue").

In the course of a distribution transaction, the issuer,⁷³ as the transferor of title, may be subject to section 12(2) liability under the *Pinter* analysis.⁷⁴ However, the *Pinter* analysis suggests that other participants in the distribution effort may be subject to section 12(2) liability as well.⁷⁵ Apart from the issuer, the most important group of prospective section 12(2) defendants in a distribution transaction is the individuals, generally broker-dealers, who act on behalf of the sellers to recruit buyers to the offering.

Similarly, in a post-distribution trading transaction, the most important, readily-identifiable group of prospective section 12(2) defendants is broker-dealers, whose involvement as "sellers" in secondary market transactions may arise in several ways. In a *broker* capacity, a broker-dealer may act as an agent of the seller in the execution of a customer's sell order.⁷⁶ When acting in this brokerage capacity, the broker-dealer represents the interests of the actual transferors of title to the securities that are the subject of that particular trading transaction, and generally receives a commission for such services. Thus, the broker-dealer falls within the *Pinter* formulation of the privity requirement as one who was "motivated at least in part [if not exclusively] by a desire to serve his own financial interests or those of the securities owner."⁷⁷ The actual owner of such securities, who may be a Control Person Seller or an Ordinary Seller, will also generally be a potential section 12(2) defendant.

73 This Article is not concerned with defining the standard to be used in determining the issuer's exercise of reasonable care under section 12(2). See *infra* note 154 and accompanying text.

74 Generally, whether or not the issuer in a distribution transaction can be held liable under section 12(2) depends upon the nature of the underwriting. If the underwriting is a "firm commitment" underwriting, the issuer transfers title to the securities to the underwriter who in turn, sells the securities to the ultimate purchasers. In that case, the buyer usually will be found to lack privity with the issuer and therefore cannot maintain a section 12(2) claim against the issuer. BLOOMENTHAL, *supra* note 4, § 14.05, at 14-26 to 14-27; LOSS, *supra* note 3, at 1023-24. In a "best-efforts" underwriting, however, the underwriter usually acts as the issuer's agent. The issuer passes title to the securities directly to the buyer, paying a commission to the underwriter on the sale. In that case, the buyer usually is in privity with the issuer and therefore can maintain a section 12(2) cause of action against the issuer. BLOOMENTHAL, *supra* note 4, § 14.05, at 14-27; LOSS, *supra* note 3, at 1024.

75 The post-*Pinter* commentary suggests, however, that many of these collateral participants do not qualify as "sellers" under the *Pinter* formulation. See HAZEN, *supra* note 68, at 322.

76 See 17A J. WILLIAM HICKS, CIVIL LIABILITIES: ENFORCEMENT & LITIGATION UNDER THE 1933 ACT 6-122 to -123 (1989).

77 *Pinter v. Dahl*, 486 U.S. 622, 647 (1988).

On the other hand, a broker-dealer may act in a *dealer* capacity, selling securities as a principal to a buyer in a secondary market transaction. In such cases, the dealer is the actual owner, transferring title to the securities in question to a buyer who often has been solicited by the dealer.⁷⁸ In executing such trades, the dealer often acts in an agency capacity as well since the buyer is often a customer of the broker-dealer, further complicating the scope of this seller's obligations to the prospective buyer.⁷⁹

In *Ballay*, the court faced a transaction in which the broker-dealer firm appears to have acted in a dealer capacity. The Legg Mason firm sold Wickes securities to buyers that it had recruited largely through the dissemination of its materially misleading research reports. As such, it did not appear to act on behalf of any named sellers. Instead, Legg Mason, presumably acting in a dealer capacity, sold Wickes securities directly to the plaintiffs as a principal. This selling activity was still well within the scope of the *Pinter* analysis since the trades Legg Mason executed for its customers were motivated in substantial measure by a desire to further its own financial interests, in the form of a mark-up, representing the firm's profit on its sale as a dealer to the plaintiff-buyer. Section 12(2) liability seems well-predicated in situations such as this one because the seller (Legg Mason) is alleged to have recruited these investors (clients of the firm) through misleading communications, which are prohibited by the very terms of section 12(2). Moreover, the customers of Legg Mason appear to be the archetype of prospective investors-turned-purchasers that Congress intended to protect by the enactment of the 1933 Act.⁸⁰

⁷⁸ *Id.*

⁷⁹ See JENNINGS, *supra* note 6, at 646-48; LOSS, *supra* note 3, at 821-29; Quincy Coop. Bank v. A.G. Edwards & Sons, 655 F. Supp. 78 (D. Mass. 1986). The *Quincy* case involved a secondary market transaction in which the broker-dealer firm (Edwards) sold mortgage bonds that were trading in the secondary bond market to the buyer, a bank. As such, the court found that Edwards was "a 'seller' for purposes of section 12(2), despite Edwards' contention that it acted merely as the Bank's [buyer's] broker." *Id.* at 82. In an early case, the First Circuit concluded that a broker who acted as an agent for the seller, or as an agent for both buyer and seller, could be liable as a seller under section 12(2). *Cady v. Murphy*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940). See also *infra* notes 246-54 and accompanying text.

⁸⁰ In enacting the 1933 Act, Congress had a dual purpose in mind: first, "to provide investors with material financial and other information concerning the issues of securities offered for sale to the public, and [secondly] to prohibit fraudulent sales of securities." See JENNINGS, *supra* note 6, at 103. Congress' preoccupation under the 1933 Act with buyers of securities has previously been noted. See *supra* note 3 and accompanying text. There is some disagreement over whether Congress' concerns about securities fraud, as

On the other hand, the Legg Mason firm could have been acting as an agent for the actual seller of the Wickes securities, who could be either a Control Person Seller or an Ordinary Seller. In either case, the broker-dealer who assists the actual owner of the security generally would be treated as a seller under the *Pinter* analysis because her activities on behalf of the actual owner are motivated by the desire to receive financial remuneration, usually in the form of a sales commission, rather than a mark-up. In such situations, however, the actual owner, whether a Control Person Seller or an Ordinary Seller,⁸¹ is also treated as a prospec-

manifested in the 1933 Act's anti-fraud provisions, extended beyond the buyer of securities. Some commentators believe that Congress' protections against fraud were motivated only by concerns for defrauded buyers. See, e.g., Loss, *A Rebuttal*, *supra* note 8, at 56-57; Weiss, *supra* note 8, at 30.

81 As to trading transactions involving Control Person Sellers or Ordinary Sellers as the actual owners of the underlying securities, these sellers must also establish the basis for an exemption from the section 5 registration obligation of the 1933 Act. See Loss, *A Rebuttal*, *supra* note 8, at 48-49. Generally, the relevant exemption will be section 4(1). In the case of Ordinary Sellers, this exemption should be readily established. *Id.* See also JENNINGS, *supra* note 6, at 110-11, although there may be some issue as to the availability of this exemption in situations where the Ordinary Seller attempts to resell restricted stock. See *infra* notes 162-64.

Similarly, the control person generally will rely on the section 4(1) exemption so long as the quantity sold does not rise to the level of a "distribution," thereby triggering a section 5 registration obligation. See *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969); JENNINGS, *supra* note 6, at 486-89. Where the control person effects resales of "controlled securities" in the secondary markets, the scope of the control person's resale activity will always be subject to a different analysis under section 12(2)'s requirement of the exercise of reasonable care, a conclusion that is reinforced by examining the availability of the "section 4(1½)" styled exemption for the control person's private resales of control securities. See *infra* notes 202-11 and accompanying text, discussing the basis for a section 4(1½) exemption for control persons' resale activity and the implications thereof for the section 12(2) affirmative defense as to such sellers.

Finally, where either of these secondary market sellers relies on the services of a broker-dealer to execute their sell orders, or alternatively, where the broker-dealer is herself the holder of the securities to be sold to the buyer, the broker-dealer must establish an exemption from the section 5 registration obligation for her involvement in this trading activity. Generally speaking, the section 4(3) exemption, known as the "dealer's exemption," is available since the broker-dealer's regular trading activities do not constitute a "distribution" and, therefore, do not rob this securities professional of her registration exemption by triggering a statutory underwriter analysis under section 2(11) of the 1933 Act. See generally, JENNINGS, *supra* note 6, at 459-62, 480-83, 487-91. Where the broker-dealer facilitates the Ordinary Seller's disposition of restricted securities in a secondary market transaction, or alternatively, where the broker-dealer facilitates the trading activities of a Control Person Seller in the secondary markets, additional concerns about the availability of the section 4(3) exemption are raised that are addressed today primarily through the requirements of Rule 144. *Id.* None of these exemptions from registration, however, absolve any of these secondary market sellers of fraud liability under section 12(2).

tive section 12(2) defendant under the *Pinter* definition of "seller."

Where the plaintiff-purchaser brings suit against the transferor of title (whether a Control Person Seller or an Ordinary Seller) and the broker-dealer who recruited the investor to purchase the securities, each section 12(2) defendant must establish her affirmative defense of the exercise of reasonable care. In the case of multiple persons who satisfy the *Pinter* analysis, the defendant's exercise of reasonable care will depend in substantial measure on both the nature of the defendant-seller (*i.e.*, Control Person Seller, Ordinary Seller, or Broker-Dealer Seller) and the nature of the material misstatement or omission communicated to the buyer, which is the topic taken up in the next subpart.

E. "Material" Misstatement or Omission

The defendant-seller must have engaged in fraudulent conduct "by means of a prospectus or oral communication" to be held liable under section 12(2). Therefore, any materially misleading oral communication gives rise to liability under section 12(2).⁸² Additionally, the seller's use of a materially misleading "prospectus" may also create liability under section 12(2). Analysis of the term "prospectus" as used in section 12(2), however, is complex.

Under section 2(10) of the 1933 Act, a "prospectus" is "any 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."⁸³ Congress defined this term very broadly to capture almost any written communication that "offers" a security for sale, no matter what form it takes.⁸⁴ As envisioned by Congress, the section 2(10) "prospectus" definition obviously includes the traditional offering circular prepared in connection with registered distribution transactions, as well as other, perhaps more unusual, writings that market participants—in both the distribution and the trading markets—may disseminate to solicit investor interest, such as research reports, letters, or sales brochures.⁸⁵

82 The Seventh Circuit rejected the Third Circuit's narrow interpretation of the term "oral communication" in favor of focusing on the substance of the message to be communicated, not the form by which the message is to be communicated. *See Pacific Dunlop Holdings v. Allen & Co.*, 993 F.2d 578, 588 (7th Cir. 1993); *Maynard*, *supra* note 12.

83 *See Securities Act of 1933* § 2(10), 15 U.S.C. § 77b(10) (1988).

84 *See LOSS*, *supra* note 3, at 119.

85 *See, e.g. Diskin v. Lomasney & Co.*, 452 F.2d 871, 873 (2d Cir. 1971) (in which

For example, in *Ballay*, Legg Mason, the defendant-seller, disseminated false and misleading information both orally⁸⁶ and through the distribution of research reports prepared by the firm's research department, which presumably fell within the statute's definition of "prospectus." Legg Mason representatives used the research reports generated by its securities analysts to induce Legg Mason customers to purchase Wickes securities. As such, the customers relied on these reports and Legg Mason received a benefit from this reliance in the form of the commissions paid as a result of its customers' purchases of Wickes securities in secondary market transactions executed by Legg Mason on its customers' behalf.⁸⁷ In these situations, section 12(2) obligates the secondary market seller, here, the Legg Mason firm, to make truthful statements in its research reports used in connection with the firm's efforts to dispose of Wickes securities in the post-distribution trading markets.⁸⁸

Thus, at a minimum, section 12(2) obligates the seller to fully disclose any material facts necessary to make statements made by the seller during the course of the trading transaction not misleading. In *Ballay*, the curative research reports (containing the firm's accurate calculation of the book value of Wickes' securities) are consistent with this understanding of the burdens imposed on Legg Mason under section 12(2) since the curative research reports were necessary in order to make the firm's prior incorrect statements of book value not misleading.⁸⁹

the issuer sent a letter along with the prospectus/traditional offering circular to prospective investors, apparently in an effort to pique their interest; the court found that the letter constituted a "prospectus"). See also Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 916-17 (1992).

86 On at least one occasion, misleading oral communications regarding Wickes securities were made over the firm's "squawk box," thereby disseminating Legg Mason's misleading calculation of the book value of Wickes securities, excluding good will. See *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 685 (3d Cir. 1991).

87 On the other hand, if it turns out that in reporting the transaction to its customer, Legg Mason indicated that it had acted in a dealer capacity, then the financial benefit flowing to Legg Mason on this transaction generally would be referred to as a markup.

88 In *Ballay*, the defendant-seller, a securities broker-dealer made affirmative misstatements about a material fact, *i.e.*, the value of the underlying security. In such cases, section 12(2) is clear on its face in its prohibition of such affirmative misrepresentations. As to omissions, on the other hand, the analysis is less clear. At the outset, it seems clear that the defendant-seller inherits an obligation akin to the doctrine of half-truths at common law. See 9 LOSS & SELIGMAN, *supra* note 32, at 4200-01; HAMILTON, *supra* note 4, at 933-34.

89 The question arises, however, as to the scope of Legg Mason's disclosure obliga-

In addition to a misleading oral or written communication, the purchaser also must show that the seller misrepresented or omitted a "material fact" in her prospectus or oral communication. The modern test for determining materiality is whether "there is a substantial likelihood that a reasonable [investor] would consider it important in deciding" whether to purchase the security.⁹⁰ This test is widely used under the federal securities laws⁹¹ and includes reference to whether the "fact" involves "soft information," such as estimates of revenues, earnings per share, future value, and other types of forward-looking information not readily susceptible to precise calculation.⁹²

tion to its customers if it had not disseminated the materially misleading research reports. In other words, does section 12(2) by itself impose an affirmative obligation on the part of the seller to disclose material facts to the buyer? It seems as though "section 12(2) does not impose liability for omissions *per se*—although here again the Section presumably goes at least as far as the common law in imposing an affirmative duty to speak in special situations, as when the seller occupies a fiduciary relationship to the buyer . . ." 9 LOSS & SELIGMAN, *supra* note 32, at 4201-02. See also *Pacific Dunlop Holdings v. Allen & Co.*, 993 F.2d 578, 587 (7th Cir 1992), wherein the Seventh Circuit suggested that section 12(2) applies to a particular subset of fraud—that committed by way of fraudulent prospectus or oral communication.

Although section 12(2) in and of itself does not appear to be the source of an affirmative disclosure obligation, it is likewise clear that the section 12(2) defendant-seller cannot ignore the circumstances surrounding her sale to the buyer, including her relationship to the buyer, in deciding whether the seller must make disclosure in order to avoid section 12(2) liability for making misleading communications to the buyer. Assuming, therefore, that Legg Mason is in possession of information that is material to its customers' proposed trading transactions, the scope of its affirmative disclosure obligation to its customers under section 12(2) must of necessity depend in substantial part on the nature of this defendant-seller and her relationship to the plaintiff-buyer, factors that are also crucial to defining the scope of the seller's burden to establish her exercise of reasonable care. See *infra* Part IV. Thus, analysis of the seller's disclosure obligation under section 12(2) is interwoven with the analysis of the seller's standard of reasonable care, and cannot be fully examined without evaluating the criteria that define the seller's exercise of reasonable care. The scope of this disclosure obligation is more fully addressed in section IV of this Article, which sets forth the framework for analyzing the exercise of reasonable care as to each respective class of potential section 12(2) defendant-seller, and incorporates relevant common law doctrines—including fiduciary duty principles—in refining this analysis.

90 *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

91 Although the Court originally formulated this definition in the context of a Rule 14a-9 implied cause of action for violations of the SEC's proxy solicitation rules, courts generally have followed it in interpreting the concepts of "materiality" under other provisions of the federal securities laws. See *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 919-20 (8th Cir. 1977) (applying the TSC standard of materiality to a section 12(2) suit); LOSS, *supra* note 3, at 550-55.

92 See JENNINGS, *supra* note 6, at 204-06; 9 LOSS & SELIGMAN, *supra* note 32, at 4200; 17A HICKS, *supra* note 76, at 6-255 to -256.

In *Ballay*, the material fact related to the book value of Wickes securities. The research department of the Broker-Dealer Seller published a report, including its analysis of the book value of Wickes securities. This analysis led the firm to recommend the security to its customers as an undervalued security. Relying on the integrity of this advice, many buyers entered the secondary market to purchase Wickes securities. The materiality of this book value calculation, and the firm's recommendations based on it, were undoubtedly important to the buyers' investment decisions, and therefore material.⁹³

The nature of the "fact" misrepresented in *Ballay* related to the nature of the issuer or its business and thus is one that affected the intrinsic value of the company's securities.⁹⁴ However, the nature of statements (or of misleading omissions) made by defendant-sellers can vary widely and may relate to almost any aspect of the underlying trading transaction. Such variations may range from the amount of commission that the plaintiff-purchaser will pay the defendant-seller to the value of the securities that the plaintiff-buyer will purchase. Analytically, the nature of the statements made (or facts omitted) can be broadly categorized as follows:⁹⁵

- i. the nature of the issuer's business or operations, or other factors affecting the intrinsic value of the security;
- ii. the customer's investment objectives and/or needs;⁹⁶

93 The broker-dealer's book value calculation also involves the question of whether it was properly prepared. This aspect of establishing the defendant-seller's liability under section 12(2) is addressed in the context of analyzing the seller's affirmative defense of reasonable care. See *infra* notes 261-62 and accompanying text.

94 Representations about the nature of the issuer or the value of its securities clearly raise an issue as to the scope of the seller's obligation to make an affirmative investigation of the facts that form the basis for such representations and, as such, is properly analyzed as part of the seller's defense of reasonable care. However, not all types of material misrepresentations or omissions trigger an analysis of whether the section 12(2) defendant-seller must undertake an investigation in order to ascertain the completeness and/or truthfulness of the misrepresented or omitted facts. See *infra* notes 97-101 and accompanying text.

95 In developing this analytical framework, the author is indebted to Prof. Lipton's excellent treatise, 15 DAVID A. LIPTON, *BROKER-DEALER REGULATION* (1989), and to the authoritative treatise, NICHOLAS WOLFSON ET AL., *REGULATION OF BROKERS, DEALERS, AND SECURITIES MARKETS* (1977).

96 This type of fraudulent statement necessarily involves discussion of the shingle theory and the suitability doctrine and, therefore, most particularly relates to the prospective liability of broker-dealers as seller-defendants under section 12(2). See *infra* notes 227-

- iii. the terms of either the proposed securities transaction or the instrument itself (*i.e.* commission charges or other aspects of brokerage compensation, or the yield on a debt instrument, etc.); and
- iv. the nature of the seller or other participants in the offering (*i.e.* the broker-dealer's status as a market-maker, etc.).

As to statements falling within the first two categories, a further issue arises as to whether the defendant-seller incurs a duty to investigate the facts in order to ensure the accuracy and completeness of any statements made by the seller. For example, the nature of the statements made in *Ballay* regarding the book value of Wickes securities falls within category (i). Assuming that as part of its recommendation of Wickes securities, Legg Mason made a completely truthful disclosure to the prospective buyers of all material facts known to it, the critical issue then becomes whether Legg Mason, as the defendant-seller, had an affirmative duty to investigate to ascertain all relevant facts (and the accuracy thereof) that impact the basis of its recommendation, including its estimate of the book value of the securities. However, the analysis of the scope of Legg Mason's obligation, if any, to conduct a reasonable investigation properly falls within the analysis of the seller's burden to show that she exercised reasonable care.⁹⁷

On the other hand, statements falling within categories (iii) and (iv) do not generally, in and of themselves, trigger an inquiry into whether the defendant-seller has satisfied an obligation to conduct a reasonable investigation. Instead, the analysis of these types of statements properly focuses on whether there has been full and adequate disclosure of all material facts. For example, in a transaction involving the sale of a debt instrument, the prospective buyer may demand to know the effective yield. Section 12(2)

39 and accompanying text.

97 Similarly, statements falling within category (ii) trigger an analysis of whether the defendant-seller incurs a duty to make a reasonable investigation before recommending a particular security for purchase by an investor. In order to recommend particular securities to a particular customer, the broker-dealer must ascertain the customer's investment objectives, financial resources, etc. Obtaining this information necessarily entails an investigation of the customer's situation. This application of the suitability doctrine is properly taken up in analyzing the nature of the defendant-seller and her obligation to exercise reasonable care in order to establish her affirmative defense. *See infra* notes 241-43 and accompanying text.

would forbid the Broker-Dealer Seller from misleading the buyer as to the stated yield. Thus, the broker-dealer may be required to familiarize herself with the terms of the debt instrument at issue to ensure that her statements will meet the full disclosure obligation of section 12(2) by providing the buyer with all the information necessary to make the seller's statements to the buyer not misleading. In familiarizing herself with the instrument so as to be in a position to make full and accurate disclosure to the prospective buyer, the seller presumably need not undertake any independent investigation beyond a careful reading of both the terms of the instrument and any related offering materials. As this analysis of statements falling into category (iii) demonstrates, the exercise of reasonable care under section 12(2) imposes, at a minimum, an obligation of full candor,⁹⁸ requiring the seller to be completely truthful, but does not necessarily trigger as a threshold matter any obligation to make a reasonable investigation.

Similarly, statements falling within category (iv) relating to the nature of the seller—for example, a Broker-Dealer Seller's representations about her status as a market-maker in the underlying security⁹⁹—do not, in and of themselves, trigger an affirmative obligation to make an investigation of any underlying facts in order for the Broker-Dealer Seller to be in a position to make full and adequate disclosure of *all* material facts about her market-maker

98 17A HICKS, *supra* note 76, at 6-252, -303 to -304.

99 In *Prawer v. Dean Witter Reynolds, Inc.*, 626 F. Supp. 642 (D. Mass. 1985), the plaintiff was a customer that maintained an account with Dean Witter, a broker-dealer. The plaintiff purchased stock pursuant to the recommendation of a Dean Witter agent. Both the agent and Dean Witter owned stock in the company in which the agent recommended that his customer invest. The agent did not disclose either his own or Dean Witter's holdings in the company. The agent apparently executed the transaction as a broker. After the customer lost \$250,000 on the investment, he brought a section 12(2) claim against Dean Witter. In determining whether or not there had been a material misrepresentation or omission, the court focussed on the agent's failure to disclose his own holdings in the stocks. The court also observed: "It would certainly have been material if Dean Witter was making a market in the securities, acting in the transactions as a principal rather than simply as an agent for Prawer." *Id.* at 644.

In *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970), the plaintiff brought a Rule 10b-5 action against Smith, Barney, a broker-dealer. A Smith, Barney agent had recommended that the plaintiff invest in a stock in which Smith, Barney made a market. The agent, however, did not disclose to the plaintiff that Smith, Barney was a market-maker for the stock in question. The plaintiff accepted the agent's recommendation and purchased the stock, unaware that Smith, Barney was dealing as a principal in the transaction. The court held that "[i]n this situation failure to inform the customer fully of its possible conflict of interest, in that it was a market maker in the securities which it strongly recommended for purchase by him, was an omission of material fact in violation of Rule 10b-5" *Id.* at 1172.

status. As such, litigated cases involving broker-dealers' statements that fall into categories (iii) and (iv) generally raise threshold issues of whether the defendant-seller made *full and adequate* disclosure of *all* material facts in her communications with the buyer.¹⁰⁰ Fulfillment of this disclosure obligation is distinct from the defendant-seller's duty to exercise "reasonable care," however, including any subsidiary obligation to make an affirmative investigation to put the seller in *possession* of all material facts. As such, statements that fall into categories (iii) and (iv) do not, in and of themselves, impose the same threshold question of whether the seller is required at the outset to undertake a reasonable investigation in order to establish the seller's section 12(2) defense of reasonable care, unlike the statements that fall within categories (i) and (ii).

As to future cases involving material misrepresentations or omissions not falling within the above four-part classification of statements, any such future alleged misstatement or omission presumably would be classifiable as to whether a reasonable investigation would be required at the outset (thus akin to the analysis of statements falling within categories (i) and (ii)). Alternatively, the misstatement or omission would be classifiable as a statement requiring the seller to satisfy an obligation of full candor, thereby triggering a duty to make full and adequate disclosure of all facts known to the seller (similar to the threshold analysis required by statements falling within categories (iii) and (iv)).¹⁰¹

F. *Plaintiff Buyer's Knowledge of Misrepresentation or Omission*

The only duty that section 12(2) imposes on the plaintiff as part of his case-in-chief is to show¹⁰² that, at the time of sale, he

100 Or, alternatively, whether the disputed "fact" was "material" and thus subject to the disclosure requirements of section 12(2).

101 A particular fact pattern may involve facts and circumstances that give rise to a claim of constructive notice to the defendant-seller, which may create an obligation to conduct a reasonable investigation in order to resolve any underlying concerns that are raised as a result of notice to the seller of these suspicious circumstances. The analysis of whether the section 12(2) defendant-seller must make such an investigation to preserve her section 12(2) affirmative defense, or alternatively, whether the seller may satisfy her section 12(2) obligation of exercise of reasonable care through *full disclosure of all* facts to the buyer—including disclosure of any suspicious facts and circumstances that give rise to the constructive notice to the seller—should depend on the nature of the seller and the flexible analysis of reasonable care described in Part IV of this Article.

102 See 17A HICKS, *supra* note 76, at 6-257 to -258 ("Thus, a court will deny recovery unless a section 12(2) plaintiff can prove that he did not know of the alleged omission

did not know of the alleged misrepresentations or omissions.¹⁰³ The section 12(2) cause of action, however, places no duty of investigation on the purchaser;¹⁰⁴ the duty to investigate, if any, falls exclusively on the seller.¹⁰⁵

Furthermore, the buyer need not establish any reliance on the seller's misstatement or omission.¹⁰⁶ The courts and commentators have consistently rejected defendants' attempts to introduce some type of causation requirement into plaintiffs' case-in-chief.¹⁰⁷ Thus, once the plaintiff-buyer demonstrates his igno-

or misrepresentation at the time of sale.").

103 See *Mayer v. Oil Field Sys. Corp.*, 611 F. Supp. 635, 638 (S.D.N.Y. 1985), *aff'd*, 803 F.2d 749, 755-56 (2d Cir. 1986); Kaminsky, *supra* note 49, at 266; Theresa A. Gabaldon, *Causation, Courts, and Congress: A Study of Contradiction in the Federal Securities Laws*, 31 B.C. L. REV. 1027, 1056-60 (1990).

104 *Mayer v. Oil Field Sys.*, 803 F.2d 749 (2d Cir. 1986); *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1034 (2d Cir. 1979); *Alton Box Board Co. v. Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977); *Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680, 696 (5th Cir. 1971); *Gilbert v. Nixon*, 429 F.2d 348, 356-57 (10th Cir. 1970); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1129-30 (4th Cir. 1970); *Barnebey v. E.F. Hutton & Co.*, 715 F. Supp. 1512, 1524 (M.D. Fla. 1989). At least one commentator has observed that "where the misrepresentation or omission is contained in a writing and relates to a widely held security, purchasers apparently need not even demonstrate their receipt of the misleading writing." Gabaldon, *supra* note 103, at 1057 (citing to *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1225-26 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981)). A different result may obtain, however, where the security is not widely held. See Gabaldon, *supra* note 103, at 1058 n.161.

105 The seller's duty to investigate generally will arise as part of the seller's burden to establish that she acted with reasonable care and therefore may properly claim the statute's affirmative defense. See 17A HICKS, *supra* note 76, at 6-260 to -261.

106 *MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/American Express*, 886 F.2d 1249, 1256 (10th Cir. 1989) (Section 12(2) "has no requirement of justifiable reliance on the part of a purchaser."); *Woodward v. Wright*, 266 F.2d 108, 116 (10th Cir. 1959); *Aronson v. TPO Inc.*, 410 F. Supp. 1375, 1379 (S.D.N.Y. 1976); 17A HICKS, *supra* note 76, at 6-202 to -205.

107 In vigorously resisting one defendant's attempt to impose a causation requirement on the plaintiff the Fourth Circuit reasoned: "[Defendant]'s theory of 'causation' is an impermissible attempt to introduce reliance upon the misrepresentations and omissions as a necessary element of section 12(2)." *Johns Hopkins Univ.*, 422 F.2d at 1129. A similar ploy was summarily rejected in *Demarco v. Edens*, 390 F.2d 836, 841 (2d Cir. 1968), where the seller sought to defend on the ground that "the sale was not 'by means' of . . . [an offering] circular." Several commentators, as well as the courts, have struggled to give meaning to the statutory reference that the underlying sale be "by means of" a materially misleading statement without using this language to impose on the plaintiff some form of strict reliance requirement. One commentator has suggested that a fair reading of the statute's language indicates that "there must be some causal connection between the challenged communication and the plaintiff's purchase" but that this interpretation does not lead to the requirement "that the misleading communication be instrumental in effecting the sale." Kirk J. Goza, Comment, *Securities Regulation: Reliance as an Element in a Section 12(2) Action*, 30 KAN. L. REV. 599, 608 (1982) (citing to *Sanders v. John Nuveen & Co.*, 619 F.2d 1222 (7th Cir. 1980); and *Jackson v. Oppenheim*, 533 F.2d

rance of the material facts as of the time of his purchase, the burden shifts to the defendant-seller to establish her exercise of reasonable care in connection with the sale to that plaintiff-buyer.

G. *Duty Analysis Under Section 12(2): The Affirmative Defense of "Reasonable Care"*

This Article has demonstrated that where a misrepresentation or omission of a material fact is made orally or in a prospectus and the plaintiff-buyer did not know the truth, the defendant-seller in privity with such a buyer (as determined by the *Pinter* analysis) will be liable under section 12(2) for rescission or rescissory damages.¹⁰⁸ The only affirmative defense available to the defendant-seller requires the seller to prove not only that she did not know about the untruths or omissions, but also that she could not have learned the truth by the exercise of reasonable care.¹⁰⁹

826 (2d Cir. 1976)).

108 With respect to the manner of computing plaintiff's damages, the Supreme Court's decision in *Randall v. Loftsgaarden*, 478 U.S. 647, 655-60 (1986), makes clear that the Court takes a broad view of the remedial purposes underlying this express cause of action. In rejecting the defendants' claim that the amount recoverable under section 12(2) should be limited by any tax benefits that the buyer received from ownership of the security, the Court observed that, in enacting the 1933 Act, Congress had broader goals than the reimbursement of particular victims. *Id.* Therefore, it is proper that the section 12(2) seller bear "the risk of an intervening decline in the value of the security . . . whether or not that decline was actually caused by the fraud." *Id.* at 659. "The Court noted that Congress devised this risk to create an additional measure of deterrence as compared to a purely compensatory measure of damages." Gabaldon, *supra* note 103, at 1058. However, the measure of damages does not lead to potentially draconian recoveries. Where the elements of section 12(2) are established, "it is the rescission measure, along with the modified privity requirement, that brings such liability within reasonable limits. The fact that loss causation is never permitted to be raised as an issue makes it even clearer than in the case of section 11 that the cause of action is not primarily compensatory [D]eterrence is the logical, and acknowledged, congressional goal . . ." *Id.* at 1059-60 (footnotes omitted).

109 In addition to the section 12(2) affirmative defense of reasonable care, a short statute of limitations applies to section 12(2) actions. See 15 U.S.C. § 77m (1988 & Supp. IV 1992); 17A HICKS, *supra* note 76 at 6-274 to -293. The seller may also defend against liability by refuting the plaintiff's required showing on any of the elements of his section 12(2) action. For example, the seller may try to establish that the purchaser actually knew the misrepresented or omitted facts, or that the facts were not "material." 17A *Id.* § 6.07. Additionally, the defendant-seller could attack certain jurisdictional prerequisites, such as whether the instrument purchased was a "security" or whether the facilities of interstate commerce or the mails were used as part of the transaction at issue. 17A *Id.* § 6.04. Other defenses may be available to the seller as well, including waiver and estoppel. See *Pinter v. Dahl*, 486 U.S. 622, 628 n.8 (1988); *Koehler v. Pulvers*, 614 F. Supp. 829, 841 (D.C. Cal. 1985).

Congress, therefore, did not require the buyer to establish the seller's intent. Instead, in a modified form of a negligence standard, Congress left it to the seller to show that she acted with the appropriate level of care considering all the circumstances surrounding the underlying sale.¹¹⁰ Accordingly, Congress did not purport to define specifically the level of care required in any given sale; presumably, the level of care required would depend on a variety of factors including the manner of sale, the nature of the relevant security, the nature of the defendant-seller, etc.¹¹¹ By requiring proof of the exercise of the requisite level of care as the seller's affirmative defense, Congress recognized that most of the facts relevant to proof of the seller's *intent*, such as the defendant-seller's knowledge of the untruth as well as her access to truthful information relating to the proposed sale of securities, are largely within the control of the defendant-seller. Therefore, the seller's satisfaction of this burden of proof under section 12(2) should be less costly than if this burden were imposed on the plaintiff-buyer.¹¹²

Shifting this burden to the defendant-seller can also be viewed as an attempt by Congress to bolster the level of care used by sellers of securities in order to better protect the unsuspecting

110 See *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1308-09 n.105 (2d Cir. 1973) (en banc); *McLean v. Alexander*, 449 F. Supp. 1251, 1262 (D. Del. 1978), *rev'd*, 599 F.2d 1190 (3d Cir. 1979); *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089, 1093 (E.D. Pa. 1972); Epstein, *supra* note 5, at 387-92. This view of the standard required under section 12(2) has received support in the commentary on section 12(2). See 17A HICKS, *supra* note 76, at 6-298; Marc I. Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington*, 68 GEO. L.J. 163, 178 (1979) ("the standard of liability in an action brought under section 12(2) is negligence"). In formulating the Federal Securities Code, the American Law Institute characterized the standard of section 12(2) as a "basic negligence standard." ALI Federal Securities Code § 287b, at 144 n.5 (Proposed Official Draft 1978). At least two commentators, however, have expressed the view that section 12(2) imposes a standard other than that of basic negligence. See Ernest L. Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case (pt. 2)*, 55 VA. L. REV. 199, 207-14 (1969); Kaminsky, *supra* note 50, at 275-78. See also William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173-77 (1933) (comparing the section 11 due diligence defense to section 12(2) reasonable care defense, noting that both had purposes beyond being merely compensatory, but suggesting that section 12(2)'s standard "presumably is somewhat less exacting" than the requirement of section 11).

111 See 17A HICKS, *supra* note 76, at 6-296 to -297.

112 Thus, this shift can be viewed as a purposeful effort by Congress to ease the substantial burden of proof that was otherwise imposed on the buyer under the common law corollary, a suit for fraud. LOSS, *supra* note 3, at 1022. Congress justified this shift, in substantial part, on the grounds that defendant-sellers generally are closer to the facts necessary to establish their innocence. See 9 LOSS & SELIGMAN, *supra* note 32, at 4206-07.

buyer from an unscrupulous seller of securities.¹¹³ Delineation of the standard of care as applied to any particular defendant-seller, therefore, should take into account the deterrence component, as well as the compensatory purpose, that underlies the express remedy of section 12(2).¹¹⁴

In light of these policy factors, the fact that the defendant-seller may have acted honestly and in good faith is irrelevant if, with reasonable diligence, she could have discovered the truth.¹¹⁵ Therefore, the crucial issue is the scope of the seller's reasonable diligence burden, including any obligation on the seller's part to make a "reasonable investigation." The next Part examines the limited body of judicial decisions that have addressed this aspect of section 12(2).

III. JUDICIAL DECISIONS INTERPRETING THE SECTION 12(2) REASONABLE CARE DEFENSE

The discussion in Part II briefly described the elements of a section 12(2) cause of action in order to place the seller's affirmative defense into proper focus. This Part examines existing case law interpretation of the seller's statutory defense and demonstrates that judicial decisions have relied on a flexible approach which encompasses a number of different factors in applying the statute's reasonable care requirement.

A. *The Leading Case: Sanders v. John Nuveen & Co.*

The leading case addressing the scope of the reasonable care standard under section 12(2) is *Sanders v. John Nuveen & Co.*¹¹⁶ In this case, the Seventh Circuit concluded that the defendant underwriter was required to conduct a reasonable investigation in order to establish its exercise of reasonable care. However, the precise standard for determining the seller's exercise of reasonable

113 See Epstein, *supra* note 5, at 387-92.

114 See Gabaldon, *supra* note 103, at 1058-59.

115 The affirmative defense under section 12(2) therefore is comprised of two parts: the seller had no actual knowledge of the true facts, and in the exercise of reasonable care, the seller could not have known of the untruth. See 17A HICKS, *supra* note 76, at 6-308.

116 619 F.2d 1222 (7th Cir.), *cert. denied*, 450 U.S. 1005 (1981). This case was preceded by three cases of the same name, which the court referred to as *Sanders I*, *II* and *III*. This Article will also refer to *Sanders v. John Nuveen & Co.*, 524 F.2d 1064 (7th Cir. 1975) as *Sanders II*, and *Sanders v. John Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977) as *Sanders III*.

care, including any requirement that the seller make a reasonable investigation, remains unclear.¹¹⁷

The plaintiff-investor class in *Sanders* consisted of forty-two purchasers of the unsecured promissory notes of Winter & Hirsch, Inc. ("W & H"), a consumer finance company. This offering of W & H notes was exempt from the registration and prospectus delivery obligations under the commercial paper exemption of section 3(a)(3).¹¹⁸ The defendant broker-dealer firm, John Nuveen & Co. ("Nuveen"), served as the exclusive underwriter of this public offering of W & H notes,¹¹⁹ which were sold through Nuveen's branch offices in a manner similar to other commercial paper offerings in which Nuveen participated.

In connection with this offering, Nuveen prepared a report on the W & H notes.¹²⁰ The Nuveen salesmen distributed this report to prospective purchasers of the W & H commercial paper¹²¹ and made oral statements to some of the plaintiff class members about the quality of W & H commercial paper. Moreover, the head of Nuveen's commercial paper department testified

117 See *John Nuveen & Co. v. Sanders*, 450 U.S. 1005 (1981) (denial of certiorari). Justice Powell's opinion, dissenting from the Court's decision to deny review in *Sanders*, reflects this uncertainty: "Although the opinion of the Court of Appeals is not explicit, it appears to impose a duty of 'reasonable investigation' rather than section 12(2)'s requirement of 'reasonable care.'" *Id.* at 1008 (Powell, J., dissenting).

118 Securities Act of 1933 § 3(a)(3), 15 U.S.C. § 77c(a)(3) (1988). This exemption was intended to facilitate the sale of an issuer's short term promissory notes, i.e., commercial paper, the proceeds of which generally are used to provide cash to finance issuer's current operations. See *Sanders*, 450 U.S. at 1006; BLOOMENTHAL, *supra* note 4, at § 4.04[6]; HAZEN, *supra* note 3, § 1.5, at 33, and § 4.4, at 130.

119 The transaction at issue in the *Sanders* case involved an exempt public offering of commercial paper. As such, this *distribution* transaction differs from the focus of this paper, which is on transactions in the *secondary trading* markets that may create liability under section 12(2). Since *Sanders* is one of the leading cases regarding the scope of the reasonable care defense under section 12(2), its discussion of the scope of the seller's affirmative defense presents a useful starting point for analyzing the application of this defense to the seller's activities in secondary market transactions. In the underwritten offering of W & H commercial paper, Nuveen delivered to each of the plaintiff class members the usual written confirmations describing the W & H notes purchased by the plaintiffs from Nuveen, who had sold the notes as principal. *Sanders*, 524 F.2d at 1067. As such, on these facts there was no dispute whether Nuveen was a seller within the privity requirement of section 12(2). This result would be consistent with the *Pinter* formulation of seller. See *Sanders III*, 554 F.2d at 790; *Sanders II*, 524 F.2d at 1064.

120 *Sanders II*, 524 F.2d at 1067.

121 *Sanders v. John Nuveen & Co.*, 619 F.2d at 1224. Three plaintiff class members testified to receiving copies of this report prior to their purchases of W & H notes, while at least two other class members testified to receiving Nuveen's commercial paper report, although they could not swear they had received the report prior to making their purchases.

that the firm sold commercial paper, including the W & H notes, "on the basis 'that there should be no question but what the paper will be paid at maturity.'"¹²²

Subsequently, W & H defaulted on its notes held by the plaintiff. As detailed by the Seventh Circuit:

[W & H's] default was the product of a fraud it perpetrated with the connivance of the certified public accountants who audited its financial statements and rendered opinions thereon. In summary, over a period of ten years [W & H] continually issued financial statements in which accounts receivable were overstated and some of its indebtedness was omitted. By 1970 [W & H's] financial statements overstated accounts receivable by some \$14,000,000 and failed to reflect some \$1,750,000 of indebtedness.¹²³

Accordingly, at the time these plaintiff-investors purchased the W & H notes from Nuveen, W & H's liabilities exceeded its assets.¹²⁴

At the time of its participation in the public offering of W & H commercial paper, Nuveen was not aware of the fraud. Rather, it held "the mistaken but honest belief that [the W & H] financial statements prepared by certified public accountants correctly represented the condition of [W & H]."¹²⁵ Nuveen relied on these false financial statements in the preparation of its commercial paper report, which was then distributed to prospective buyers of W & H notes.

Nuveen defended against section 12(2) liability¹²⁶ primarily on the grounds that it did not know and, in the exercise of reasonable care, could not have known of W & H's fraud as reflected

122 *Id.*

123 *Id.*

124 Following its default, W & H was taken over by its creditors. Ultimately, W & H was liquidated and the proceeds were distributed to creditors of W & H, including plaintiff class members who received back approximately two-thirds of the amounts they originally paid to Nuveen for the W & H notes. The plaintiff class members then sued Nuveen to recover the unpaid balance of the purchase price of the W & H notes and prejudgment interest thereon. *Id.*

125 *Sanders II*, 524 F.2d at 1066.

126 The plaintiff also brought a Rule 10b-5 claim against Nuveen, which was denied because of plaintiffs' failure to establish scienter on the part of Nuveen. *See Sanders III*, 554 F.2d at 790; *Sanders II*, 524 F.2d at 1064.

on its financial statements. On appeal, however, the Seventh Circuit denied Nuveen this affirmative defense because of its failure, in its capacity as underwriter of W & H notes,¹²⁷ to conduct an investigation of the financial affairs of W & H, the issuer of the commercial paper. Thus, the Seventh Circuit concluded that Nuveen, as the underwriter, was required to undertake a reasonable investigation of the issuer and its business affairs in order to establish its reasonable care defense under section 12(2). The Seventh Circuit's conclusion is notable in several respects, particularly from the perspective of the defendant sued under section 12(2) as a seller in a secondary market transaction.

The Seventh Circuit readily concluded that the "exercise of reasonable care" within the meaning of section 12(2) includes an obligation, under certain circumstances, to undertake a reasonable investigation of the facts underlying the statements the seller makes to prospective buyers. Thus, the court found that Nuveen, as seller, was under an obligation to make a reasonable investigation of the facts underlying the statements made in Nuveen's commercial paper reports that were disseminated to its customers, even though these matters may have been outside the scope of Nuveen's direct control, relating as they did to the nature of the issuer and its business and financial affairs. In imposing this burden on Nuveen to conduct a reasonable investigation of W & H and its financial affairs, the court relied heavily on Nuveen's position as an *underwriter* of W & H's public offering of its notes.¹²⁸

The court's reliance on Nuveen's status as an underwriter of W & H's public offering of commercial paper is not entirely misplaced because section 11¹²⁹ expressly imposes an investigation obligation on underwriters of offerings that are registered under section 5.¹³⁰ An underwriter of a *registered* offering is subject to

127 This case involves a broker-dealer's participation as an underwriter in a distribution transaction and therefore does not squarely address the situation presented by the participation of a broker-dealer in a secondary market transaction. Nonetheless, the *Sanders* case is instructive since it involves a broker-dealer's representations regarding the nature of the issuer, its business, and its securities. As such, it involves one of the types of material statements that is more problematic to analyze for purposes of determining the proper scope of "reasonable care" under section 12(2). See *supra* notes 82-101 and accompanying text describing various classes of statements that may create liability under section 12(2).

128 *Sanders v. John Nuveen & Co.*, 619 F.2d at 1227.

129 Securities Act of 1933 § 11, 15 U.S.C. § 77k (1988).

130 Securities Act of 1933 § 5, 77 U.S.C. § 77e (1988); see also HAROLD S. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* 284-86 (1987-88 ed.) (discussion of the standard of care section 12(2) of the 1933 Act requires).

liability under section 11 for any misrepresentations or omissions of material fact in the registration statement as of the date it becomes effective.¹³¹ Section 11(b), however, provides the underwriter with an affirmative defense, generally referred to as the "due diligence defense." Under section 11(b), the underwriter must show that it reasonably believed, and did believe, following a *reasonable investigation* of the underlying facts and circumstances, that the registration statement was completely truthful and accurate as of the date of its effectiveness.¹³²

Section 11 was intended to bolster the overall degree of involvement of underwriters in the process of preparing the issuer's registration statement.¹³³ However, as Nuveen pointed out, the statute distinguished between (i) those statements prepared by and under the authority of an acknowledged expert, such as an accountant, geologist, or other professional (the "expertised portion"), and (ii) all other portions of the registration not prepared by an expert (the "nonexpertised portion").

As to the *nonexpertised* portions of the registration statement, the underwriter has an express obligation to conduct a reasonable investigation¹³⁴ and, based on this investigation, must demonstrate his or her reasonable belief in the veracity of the statements made. With respect to the *expertised* portions, however, the statute relaxes the showing required of the defendant by eliminating any affirmative obligation to conduct a reasonable investigation. Rather, the underwriter defendant must show only that he or she "had no reasonable ground to believe and did not believe" that the information contained in the expertised portion of the registration

131 See Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1988). Although Nuveen acted as an underwriter, it was not subject to section 11 liability since the W & H offering was exempt from section 5 registration requirements by virtue of section 3(a)(3) of the 1933 Act, 15 U.S.C. § 77c(a)(3) (1988).

132 Securities Act of 1933 § 11(b), 15 U.S.C. § 77k(b) (1988).

133 BLOOMENTHAL, *supra* note 4, § 14.03, at 14-2 (describing *in terrorem* purpose of section 11); HAZEN, *supra* note 3, § 7.4, at 297 (discussing underwriter's potential conflict of interest with issuer in public offering that generally results in an almost adversarial type of relationship during the course of preparing the registration statement).

134 Section 11(c) defines "reasonable investigation": "In determining . . . what constitutes reasonable investigation . . . , the standard of reasonableness shall be that required of a prudent man in the management of his own property." 15 U.S.C. § 77k(c) (1988). The courts have interpreted this standard flexibly, looking to, among other things, the nature of the different individual defendants and his or her relationship to the process of preparing the registration statement. See *Feit v. Leasco Data Processing Equip. Co.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Escott v. BarChris*, 283 F. Supp. 643 (S.D.N.Y. 1968).

statement was false or misleading.¹³⁵ If the nonexpert defendant is put on notice of facts that tend to show that some statement made by the expert is not completely truthful, such notice presumably would trigger some obligation on the part of that nonexpert defendant to conduct a reasonable investigation in order to establish the nonexpert's reasonable belief in the accuracy of the expertised portion of the registration statement.

In *Sanders*, the defendant was not directly subject to section 11 standards because the public offering of W & H notes was exempt and therefore did not involve the preparation of a registration statement. Reasoning by analogy, the Seventh Circuit found that the same high degree of involvement of the underwriter as required by section 11 in the case of a *registered* offering should apply in the context of an unregistered, exempt public offering.¹³⁶ In the process, however, the court failed to borrow fully from the relaxed formulation of the section 11 due diligence standards as to the *expertised* portions of a registration statement. As Justice Powell forcefully pointed out in his dissent from the Supreme Court's refusal to review the Seventh Circuit's decision:

Even under § 11 of the Act, an underwriter is explicitly absolved of the duty to investigate with respect to "any part of the registration statement purporting to be made on the authority of an expert" such as a certified accountant if "he had no reasonable ground to believe and did not believe" that the information therein was misleading. This provision is in the Act because, almost by definition, it is reasonable to rely on financial statements certified by public account-

135 See Securities Act of 1933 § 11(b)(3)(C), 15 U.S.C. § 77k(b)(3)(c) (1988); see also *BarChris*, 283 F. Supp. at 685 (chief financial officer was not entitled to rely on the accountant's statements as an "expert," because he was aware of facts that suggested that the statements made by the expert in the company's financial statements were not completely truthful).

136 The *Sanders* court believed that Congress intended that the same duty of care would apply to an underwriter under section 11 for a registered distribution and under section 12(2) for an exempt distribution. *Sanders v. John Nuveen & Co.*, 619 F.2d at 1228. The difference in language between section 11's duty of "reasonable investigation" and section 12(2)'s duty of "reasonable care" is attributable to the broader class of defendants for which section 12(2) imposes liability, but that difference was not intended to reduce the underwriter's standard of care for an exempt offering. *Id.* Whether or not the offering is registered or exempt, "a greater quantity of information is 'reasonably ascertainable' by an underwriter than by a mere broker." *Sanders*, 619 F.2d at 1227 (quoting *Sanders II*, 524 F.2d at 1071).

tants. Yet, in this case, the Court of Appeals nevertheless seems to have imposed the higher duty prescribed by § 11 to investigate, but denied petitioner the right to rely on "the authority of an expert" that also is provided by § 11.¹³⁷

Implicit in the Seventh Circuit's reasoning, therefore, is the assumption that the "reasonable care" standard of section 12(2) may *require* that the defendant-seller undertake a reasonable investigation. As Justice Stevens pointed out, the language of section 12(2) is conspicuous in its omission of any *express* obligation to make such an investigation, unlike the section 11 standard.¹³⁸ Thus, he raises the threshold question of whether the exercise of reasonable care under section 12(2) requires, in the first instance, any showing that the defendant-seller conducted a reasonable investigation.

At the very least, *Sanders* demonstrates that in some situations a section 12(2) defendant may be required to show that she conducted a reasonable investigation in order to establish that she has exercised the requisite degree of care. Further, by recognizing the nature of Nuveen's involvement as an underwriter in the sale of W & H commercial paper to the plaintiff-buyers, the Court seems to acknowledge that the nature of the defendant-seller, as well as the nature of the defendant's involvement in the sale to the plaintiff, is important in defining the relevant standard of reasonable care required of that defendant-seller under section 12(2).¹³⁹

137 *Sanders*, 450 U.S. at 1010 (footnotes and citations).

138 To quote Justice Stevens:

In providing standards of care under the 1933 Act, Congress thus used different language for different situations. "Reasonable investigation" is required for registered offerings under § 11, but nothing more than "mer[e] . . . 'reasonable care'" is required by § 12(2) The difference in language is significant, because in the securities acts Congress has used its words with precision.

Id. at 1008-09.

139 The SEC likewise pointed to the nature of the underwriting activities of defendant Nuveen and emphasized that Nuveen's involvement as an underwriter did not change simply because the offering was exempt and therefore outside the scope of section 11 liability:

Since Congress has determined that registration is not necessary in certain defined situations, we believe that it would undermine the Congressional intent—that issuers and other persons should be relieved of registration—if the same degree of investigation were to be required to avoid potential liability whether or not a registration statement is required.

Sanders suggests that the reasonable care standard of section 12(2) should be interpreted flexibly and that the nature of the defendant is a crucial factor in defining the relevant standard. Moreover, *Sanders* suggests that the exercise of reasonable care may, but does not automatically, require the defendant-seller to conduct an investigation to establish her exercise of reasonable care.¹⁴⁰ Again, the nature of the defendant-seller is a critical factor in determining whether there is an affirmative obligation to make a reasonable investigation to establish the section 12(2) reasonable care defense. Finally, *Sanders* indicates that, where an investigation is required to show the defendant's exercise of reasonable care, the scope of any required investigation will be defined in substantial part by the nature of the defendant-seller and her involvement in, and relationship to, the plaintiff's purchase of the securities at issue.

B. *Other Cases Interpreting the Reasonable Care Defense of Section 12(2)*

The few other cases that have addressed the affirmative defense of section 12(2) similarly reflect the flexible nature of the reasonable care standard.¹⁴¹ This Part briefly describes the paucity of judicial authority and commentary on this aspect of the section 12(2) cause of action.¹⁴²

Id. at 1009 (quoting Brief for SEC at 69, *Sanders III*, 554 F.2d 790 (7th Cir. 1977) (Nos. 74-2047 and 75-1260)).

140 As pointed out by Justice Powell in his dissent from the Supreme Court's denial of the underwriter's petition for certiorari, the Seventh Circuit's ruling has the effect of treating the section 11 due diligence requirement (which is expressly defined to include a reasonable investigation requirement) as *in pari materia* with the "reasonable care" requirement of section 12(2). On its face, however "reasonable care" as used in section 12(2) seems to suggest a lesser showing than the section 11 due diligence defense, which expressly requires each section 11 defendant to show her reasonable belief, as formed based upon a reasonable investigation, that the registration contains no misrepresentation or omission of a material fact.

It must be emphasized, however, that the Seventh Circuit's ruling speaks only to the situation involving an exempt *distribution* where the *underwriter* of the offering is sued under section 12(2). This situation lies outside the scope of this Article, which focuses exclusively on application of the section 12(2) reasonable care standard to *post-distribution* trading, which, by definition, involves only *non-underwriter* defendant-sellers.

141 9 LOSS & SELIGMAN, *supra* note 32, at 4212 ("There is not much law on how this defense may be established.").

142 "Although the specific content of the burdens imposed by section 11 has been examined by courts and commentators in some detail, the precise issue of its relationship to the burdens of section 12(2) has been discussed very little." Epstein, *supra* note 5, at 387-88.

The few courts that have addressed the issue of the seller's affirmative defense have recognized that, in effect, section 12(2) holds the defendant-seller responsible for her negligence.¹⁴³ Thus, Congress has shifted proof of the seller's non-negligence to the defendant as the party presumably in the better position to establish the propriety of her conduct, thereby relaxing the plaintiff's required showing for recovery under section 12(2).¹⁴⁴

Since section 12(2) essentially embodies a negligence standard, the exercise of reasonable care will presumably be defined by the facts and circumstances of each case. In addition to the nature of the defendant-seller, the courts and commentators have identified the following as the most important factors in determining the defendant's exercise of reasonable care:

- i) the role of the defendant-seller in the selling process;
- ii) the relationship between the buyer and the seller;
- iii) the relationship between the seller and the issuer of the security, *i.e.*, the availability of the corporation-issuer as the seller's source of information;
- iv) the circumstances under which the statements were made; and
- v) what the representation purports to state.¹⁴⁵

For example, in *Davis v. Avco Financing*,¹⁴⁶ the court relied on these criteria in its flexible interpretation of the section 12(2) reasonable care defense. The facts of *Davis* grew out of "Dare To Be Great" ("DTBC"), the well-known fraudulent pyramid scheme.¹⁴⁷ Plaintiffs in *Davis* were customers of Avco Financing

143 See *supra* note 110 and accompanying text describing the standard required under section 12(2) as a basic negligence standard. This Article therefore assumes that section 12(2) embodies a basic negligence standard and then offers a framework for applying this standard to the secondary market activities of various types of potential section 12(2) defendant-sellers in the trading markets.

144 H.R. REP. NO. 85, 73d Cong., 1st Sess. 9, 23-24 (1933); LOSS, *supra* note 3, at 1026.

145 See 17A HICKS, *supra* note 76, at 6-205; 15 LIPTON, *supra* note 95, at 6-297.

146 739 F.2d 1057 (6th Cir. 1984).

147 Other reported decisions arising out of the same nucleus of facts include SEC v. Glenn W. Turner Enter., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); SEC

("Avco"). Each plaintiff borrowed money from Avco at the behest of defendant McCormack, the manager of Avco's office in Toledo, Ohio. These plaintiffs used the borrowed funds to purchase shares in the DTBG scheme. After Avco had made several loans to DTBG purchasers, the promoters of DTBG invited McCormack to attend several DTBG promotional meetings.¹⁴⁸ At these meetings, McCormack distributed blank Avco loan application forms to prospective DTBG investors. Several DTBG purchasers indicated that McCormack told them that DTBG "was a good quality investment."¹⁴⁹ When McCormack's supervisor learned of the office manager's activities on behalf of DTBG, he ordered the Toledo office to immediately cease making loans for investment in DTBG. McCormack's superiors at Avco promptly recognized the fraudulent nature of Avco's pyramid scheme and ordered McCormack to have nothing further to do with the DTBG scheme.

In finding that the Avco defendants had not established the section 12(2) affirmative defense of reasonable care,¹⁵⁰ the *Davis* court observed:

In fact, far from attempting clandestinely to promote a known fraudulent venture, the manager actually suggested to his superior that Avco adopt some of the DTBG promotional methods in its own public relations. This caused the manager's superiors to

v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974).

148 See *Davis*, 739 F.2d at 1061.

149 *Id.*

150 The court specifically found that the representations made by McCormack, the Avco office manager, were not made with the requisite degree of reasonable care. Moreover, Avco was found liable for the actions of its office manager under the doctrine of *respondeat superior*. See *id.* at 1062 (citing *Holloway v. Howerdd*, 536 F.2d 690, 694-95 (6th Cir. 1976)). On similar facts, the court in another case, *Quincy Coop. Bank v. A.G. Edwards & Sons*, 655 F. Supp. 78 (D. Mass. 1986), held the broker-dealer firm liable for the conduct of its employee, a broker who actually made the misrepresentations which induced the firm's customer, a bank, to buy the bonds through the broker-dealer firm. The court found that the firm was responsible for its employee's actions, reasoning that the "federal securities acts do not pre-empt the operation of common agency theories." *Id.* at 82 n.1. The court observed, however, that the language of control person liability under section 15 of the 1933 Act may complicate this analysis. See generally, Stacy D. Blank, *Section 20(a) or Respondeat Superior?: An Update*, 44 WASH. & LEE L. REV. 919 (1987); William J. Fitzpatrick & Ronald T. Carman, *Respondeat Superior & The Federal Securities Laws: A Round Peg in a Square Hole*, 12 HOFSTRA L. REV. 1 (1983); Steven R. Reininger, *Exclusive or Concurrent—The Role of Control & Respondeat Superior in the Imposition of Vicarious Civil Liability on Broker-Dealers*, 9 SEC. REG. L.J. 226 (1981). This issue, however, lies outside the scope of this Article.

make an immediate investigation. In short order, they perceived that the whole DTBG promotion was a chimera, forbade the manager to have anything further to do with it, and prohibited the making of any more loans to DTBG investors.

The fact that his supervisors so promptly perceived the inherent fallacy of the DTBG scheme indicates that its defects were obvious and that the manager, although he may have been innocent of fraudulent intent, was certainly guilty of negligence. Nor was his sincerity of any comfort to the bilked investors. One who is sold the Brooklyn Bridge by means of sincere but negligent representations is nonetheless the possessor of a worthless asset.¹⁵¹

Most importantly, in connection with its finding that Avco, as a section 12(2) "seller" of DTBG securities to these plaintiffs,¹⁵² failed to exercise reasonable care, the Sixth Circuit observed that:

We believe that the following considerations are pertinent to an analysis of whether a § 12(2) seller has established this affirmative defense: (1) the quantum of decisional (planning) and facilitative (promotional) participation, such as designing the deal and contacting and attempting to persuade potential purchasers, (2) access to source data against which the truth or falsity of representations can be tested, (3) relative

¹⁵¹ *Davis*, 739 F.2d at 1062. Consistent with this view, the Second Circuit has observed that:

The statute specifically requires the defendant to show that by the exercise of reasonable care he "could not have known" of the omission, not merely that "he had used reasonable care" to avoid or correct the omission. 15 U.S.C. § 771(2). It is true that in some cases evidence of steps taken to avoid or correct an omission in a communication would negate reasonable knowledge that an omission existed. Thus, broad, corrective publication of information might well bear on whether a defendant could reasonably have known of a continuing material omission in the knowledge of buyers with whom he has communicated. But reasonable effort to extinguish ignorance does not necessarily prove reasonable unawareness of continued ignorance.

Jackson v. Oppenheim, 533 F.2d 826, 829 n.7 (2d Cir. 1976).

¹⁵² In this pre-*Pinter* case, the Sixth Circuit relied on the proximate cause approach to the determination of whether a person is a "seller" for purposes of section 12(2). Of course, this analysis would now be controlled by the *Pinter* formulation, assuming that the Supreme Court will rely on the same test for section 12(2) purposes. See *supra* notes 63-81 and accompanying text.

skill in ferreting out the truth (for example, in this case Avco's manager had comparatively greater skill in evaluating judgments based on subsidiary facts, since he performed a similar function in the process of investigating the creditworthiness of borrowers), (4) pecuniary interest in the completion of the transaction, and (5) the existence of a relationship of trust and confidence between the plaintiff and the alleged 'seller.'¹⁵³

The few other cases specifically addressing the seller's section 12(2) affirmative defense,¹⁵⁴ including the *Davis* case, primarily have involved plaintiffs' purchases during the course of a distribution market transaction, and, therefore, they are not directly relevant to defining the parameters of the seller's exercise of reasonable care in connection with her sales activities in the *secondary* markets. But to the extent that these cases rely on a flexible standard which emphasizes the nature of the defendant-seller and her role in the sales transaction involving the plaintiff-buyer, they provide the starting point for analyzing the application of the section 12(2) reasonable care defense to sales activity occurring in the trading markets. This analysis is expanded further in the next section.

IV. APPLICATION OF SECTION 12(2) REASONABLE CARE STANDARD TO VARIOUS CATEGORIES OF DEFENDANT-SELLERS IN SECONDARY MARKET TRANSACTIONS

Based on the judicial analysis described in the preceding Part, this Part of the Article creates an analytical framework for interpreting and applying the reasonable care standard of section 12(2) to sellers' transactions in the secondary trading markets. Consistent with the flexible approach reflected in prior judicial interpretations, this Part focuses initially on the nature of the defendant-seller and classifies prospective section 12(2) sellers into three

¹⁵³ *Davis*, 739 F.2d at 1068.

¹⁵⁴ See, e.g., *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 507 (5th Cir. 1990); *Anderson v. Aurotek*, 774 F.2d 927, 930 (9th Cir. 1985); *Junker v. Crory*, 650 F.2d 1349, 1361 (5th Cir. 1981); *Franklin Sav. Bank of New York v. Levy*, 551 F.2d 521, 526-27 (2d Cir. 1977); *Wilson v. Great Am. Indus.*, 661 F. Supp. 1555, 1575-76 (N.D.N.Y. 1987), *rev'd*, 855 F.2d 987 (2d Cir. 1988); *Stone v. Fossil Oil & Gas*, 657 F. Supp. 1449, 1460 (D.N.M. 1987); and *University Hill Found. v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 898 (S.D.N.Y. 1976).

distinct groups: Ordinary Sellers, Control Person Sellers, and Broker-Dealer Sellers. With respect to each of these classes of prospective section 12(2) secondary market defendant-sellers, this Part will describe the factors that determine whether the seller has exercised the requisite degree of reasonable care and thus established an affirmative defense against secondary market buyers in privity with the seller.

The potential liability of prospective section 12(2) defendant-sellers can be thought of as lying on a continuum. Within this continuum, Ordinary Sellers generally bear the least onerous burden in establishing their exercise of reasonable care. Thus, liability of the Ordinary Seller should be the most remote of the various categories of potential defendant-sellers; this makes sense because the Ordinary Seller is usually quite removed from the sources of any relevant information that would impact her trading in the secondary market. Accordingly, she is unlikely to come into possession of material facts that may trigger obligations under section 12(2), including any obligation to make a reasonable investigation in order for the Ordinary Seller to establish her exercise of reasonable care. Conversely, the highest burden will generally fall on those sellers who are the parties closest to this information: the issuer¹⁵⁵ and its officers, directors, and affiliates, generally referred to as Control Person Sellers.¹⁵⁶

155 Issuer liability under section 12(2) lies outside the scope of this Article. Issuers' sales involve "distribution transactions" for purposes of the 1933 Act. Accordingly, the section 4(1) registration exemption, available to other secondary market sellers for their ordinary trading activity, is unavailable to the issuer. JENNINGS, *supra* note 6, at 459, 480; 1 LOSS & SELIGMAN, *supra* note 32, at 433. Any analysis of issuers' section 12(2) liability presumably must take into account the due diligence standards of section 11, which apply on their face only in the context of registered distributions but which should influence the standard of reasonable care required of issuers engaged in unregistered distributions that become subject to liability under section 12(2). See DeMarco v. Edens, 390 F.2d 836, 841-43 (2d Cir. 1968) (discussing issuer's exercise of reasonable care in a suit under section 12(2) arising out of an exempt public offering conducted pursuant to the Regulation A exemption).

156 The statute does not contain any definition of the concept of control. "The absence of a definition, however, has not prevented the [SEC] by rule, ruling and releases from [setting forth] the outlines of a definition and it has not mitigated the vital importance of determining the meaning of 'control.'" A.A. Sommer, Jr., *Who's "In Control?"*—S.E.C. 21 BUS. LAW. 559, 560 (1966). Although the concept of control cannot be fixed with any precision, substantial share ownership will generally cause the shareholder to be treated as a control person of the issuer even though that person may hold no other position with the company. Similarly, "unless a person or identifiable group clearly is in control by reason of possession and use of voting power, all directors and policy-making officers are presumptively members of the control group and only compelling evi-

The most complex burden, however, falls on the Broker-Dealer Seller. As will be demonstrated in the last subpart of this Part, the threshold question of classifying a seller as a broker or dealer is often itself a complex question. Once classified as a broker-dealer, the scope of obligations owed by the Broker-Dealer Seller to the buyer in a post-distribution trading transaction, including the nature of any relevant fiduciary duties, requires further analysis. This fiduciary duty analysis further refines the scope of the Broker-Dealer Seller's affirmative defense under section 12(2), including any obligation she has to undertake a reasonable investigation of, among other things, the facts underlying statements made by her during the course of a secondary market transaction, even without any evidence of constructive notice of suspicious facts and circumstances.

This Part focuses on each of these three classes of prospective sellers in turn and describes the manner in which the reasonable care standard should be interpreted and applied to them.¹⁵⁷ This

dence to the contrary should remove them from the group." *Id.* at 577. See also Rule 405, 17 C.F.R. § 230.405 (1992) (reflecting the SEC's definition of control). Further elaboration on the concept of control lies outside the scope of this Article.

157 The relative burdens of proof required to establish the section 12(2) affirmative defense according to the various categories of prospective sellers in the secondary market that have been identified in this Article can be thought of as laying on a continuum. On this continuum, the ordinary investor can be identified as bearing the lowest burden, while issuers can be identified as bearing the highest burden. Between ordinary investors and issuers, and in relative placement of burden from lowest to highest, are broker-dealers, underwriters and control persons. The placement of any particular class of sellers on this continuum will likely change in those situations where the nature of the misrepresentation or omission does *not* relate to the intrinsic value of the issuer's security. See *supra* notes 89-98 and accompanying text. A substantial portion of the situations that would give rise to section 12(2) liability based on post-distribution trading activity are likely to involve misrepresented or omitted facts relating to the nature of the issuer's business or some other aspect that goes fundamentally to the intrinsic value of the security to be bought by the plaintiff-investor; this continuum will provide, therefore, the focus of this Part's analysis of the flexible approach to be used in defining the relevant standard of reasonable care to be exercised by a section 12(2) defendant-seller in the context of post-distribution trading. Obviously, if the nature of the misrepresented or omitted fact more properly relates to one of the other categories of material misstatements or omissions, then the dispersion of prospective section 12(2) defendant-sellers along this continuum will change to reflect the changes in the nature of the defendants' relationship to the underlying wrongful conduct, *i.e.*, the corresponding change in the defendant-seller's relationship to the nature of the fraudulent misrepresentation or omission. For example, where the material fact relates to allegations of overcharges for commissions on a plaintiff's purchase of stock in a secondary market transaction, the burden on the Broker-Dealer Seller should be the heaviest, and the burden on the other two classes of prospective section 12(2) defendant-sellers in the trading markets, *i.e.*, Ordinary Sellers and Control Person Sellers, should be limited as a threshold matter to showing only their lack of knowledge of any such mistaken representations in order to establish the

will provide guidance to the future seller of securities in the trading markets so that she may properly arrange for the sale in order to preserve the basis for her section 12(2) affirmative defense of the exercise of reasonable care, and thereby prevent section 12(2) liability.¹⁵⁸

A. *Ordinary Investors as Secondary Market Sellers*

As the Supreme Court has emphasized on numerous occasions, the starting point in any analysis of the federal securities laws is the statutory language itself.¹⁵⁹ The language of section 12(2) suggests that "any person" who is a "seller" is a potential defendant.¹⁶⁰ Nothing in the statute's language, nor in the Court's *Pinter* analysis of the term "seller," suggests that the ordinary lay investor is *not* a proper defendant; yet, at the same time, this individual seller may also be viewed as among the intended beneficiaries of the protections of the 1933 Act.¹⁶¹ As a policy matter, therefore, the vexing question is: Under what circumstances should this ordinary lay investor be moved out of the class of intended beneficiaries of the protections created under the 1933 Act and into a category of individuals who may be regarded as potential defendants under section 12(2)?

section 12(2) affirmative defense. *See, e.g.,* Farley v. Baird Patrick & Co., 750 F. Supp. 1209 (S.D.N.Y. 1990).

158 Understanding the basis for the reasonable care standard becomes an important guide to sellers in deciding how to conduct their future trading activity in the secondary markets. Although important in the litigation context, the scope of this defense likewise is an important influence for shaping future behavior so that prospective sellers know what is expected of them as they engage in their secondary market activities in order to preserve their section 12(2) defense.

159 *See, e.g.,* Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1985); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206-11 (1976).

160 Section 2(2) of the 1933 Act defines the term "person" broadly to mean "an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof. As used in this paragraph the term 'trust' shall include only a trust where the interest or interests of the beneficiary or beneficiaries are evidenced by a security." Securities Act of 1933, 15 U.S.C. § 77b(2) (1988).

161 *See* Loss, *A Rebuttal*, *supra* note 8, at 48-49. There is at least one other place where a person who otherwise may be presumed to be an intended beneficiary of the protections of the 1933 Act nonetheless is held to the section 5 registration and prospectus delivery obligations by virtue of that person's relationship to the underlying transaction: the statutory underwriter analysis of a first-tier buyer who acts as conduit for a "distribution" and, therefore, cannot rely on the section 4(1) exemption for this buyer's subsequent resales of the securities. *See* HAZEN, *supra* note 3, at 460-62.

The apparent policy behind section 12(2)'s regulation of secondary market transactions is to prevent fraud in the sense of prohibiting any *person* from misleading a prospective buyer through fraudulent communications in the form of affirmative misrepresentations or omissions of material facts necessary to prevent the statements from being misleading. "Section 12(2) is a regulatory statute whose purpose is to ensure that potential purchasers are given correct, material information before purchasing securities."¹⁶² The deterrence policy of this anti-fraud provision should extend to secondary market transactions involving ordinary lay person investors who act as defendant-sellers. The use of the term "person"¹⁶³ in section 12(2) further supports this interpretation of section 12(2).¹⁶⁴ In sum, the broad regulatory purpose underlying section 12(2) presumably does not disappear in the case of transactions involving Ordinary Sellers.

Accordingly, the Ordinary Seller, by virtue of the express language of section 12(2), must make truthful disclosures to any buyer she deals with.¹⁶⁵ Moreover, the Ordinary Seller is also precluded from taking advantage of an unsuspecting buyer in a trading transaction by failing to reveal material facts necessary to make the seller's prior statements not misleading or by otherwise misrepresenting facts to the buyer.¹⁶⁶ Thus, assuming section 12(2) in and of itself imposes no further affirmative disclosure obligation on the Ordinary Seller,¹⁶⁷ the Ordinary Seller should easily satisfy

162 Quincy Coop. Bank v. A.G. Edwards & Sons, 655 F. Supp. 78, 84 (D. Mass. 1986) (citing to Croy v. Campbell, 624 F.2d 709, 713 (5th Cir. 1980)).

163 This broad definition indicates a willingness to impose fraud liability on individuals who are not securities professionals provided that the other statutory prerequisites for liability are established. See 17A HICKS, *supra* note 76, at 6-12 to -13, -18.3 to -21. This interpretation is further supported by examining the registration obligation of section 5, which is imposed on *all* persons although most ordinary lay investors are permitted to rely on the section 4(1) exemption. *Id.*; see also JENNINGS, *supra* note 6, at 110-11.

164 Quincy Coop. Bank, 655 F. Supp. at 84.

165 See LOSS, *supra* note 3, at 888-89.

166 In this sense, section 12(2) draws on the application of common law fraud principles to commercial transactions. In commercial dealings (*i.e.*, arms-length, bargained for transactions), the seller cannot lie, *even* in the absence of any fiduciary duty. Likewise, section 12(2) incorporates the common law doctrine of half-truths, and therefore the Ordinary Seller cannot mislead a prospective buyer by failing to reveal material information necessary to make her statements not misleading. See 9 LOSS & SELIGMAN, *supra* note 32, at 4200-01.

167 Since this class of sellers is defined to exclude control persons of the issuer, no fiduciary duty (which may otherwise create an affirmative disclosure obligation) is imposed on the Ordinary Seller as the result of some important relationship to the issuer. In certain cases, however, a special fact situation may exist that gives rise to a claim of

the disclosure requirements of section 12(2), especially given the general policy of the 1933 Act which otherwise views such persons as among the intended beneficiaries of the 1933 Act.

From the perspective of the buyer in a secondary market transaction, section 12(2) can be seen as a substantial improvement over the common law remedy of fraud with regard to the situation of actionable nondisclosure occurring during the course of a securities trading transaction.¹⁶⁸ Since section 12(2) was specifically crafted to ease the plaintiff-buyer's burden of proof, the plaintiff-buyer need only establish a material misstatement or the omission of a material fact necessary to make any statement¹⁶⁹ made by the seller not misleading; the plaintiff-buyer need not independently establish the seller's duty to disclose such information to buyer. It is enough that the plaintiff-buyer establish privity with the defendant-seller.¹⁷⁰ The burden then shifts to the seller

fiduciary duty between a prospective buyer and an Ordinary Seller (as where the secondary market sale is between related parties such as a husband and wife, or the trustee of an express trust and a named beneficiary of trust). In such cases, the language of section 12(2) presumably incorporates the common law perspective so as to create the basis for imposing an affirmative disclosure obligation under section 12(2) on such sellers. See 9 LOSS & SELIGMAN, *supra* note 32, at 4201-02. In addition, the existence of this special relationship of trust and confidence presumably will impact the analysis of the Ordinary Seller's exercise of "reasonable care," principally regarding the question of whether this Ordinary Seller now has some obligation to go beyond the standard of reasonable care otherwise applicable to Ordinary Sellers because of this factual showing of a special relationship of trust and confidence. As a result of this separate fiduciary relationship between the parties to the transaction, the Ordinary Seller may now be subject to an affirmative obligation to make a reasonable investigation as part of that seller's burden to demonstrate her exercise of reasonable care under section 12(2). Analysis of the scope of the Ordinary Seller's responsibility in these situations presumably will more closely parallel the analysis used in the situation of the Broker-Dealer Seller who, as a result of the brokerage relationship between this defendant-seller and the buyer, incurs further responsibilities in connection with proving her section 12(2) defense.

168 At early common law, the failure to disclose material facts usually was actionable only if the seller was subject to some independent source of fiduciary duty sufficient to create an affirmative obligation to make full disclosure. In the absence of such a duty, silence on the part of the seller generally was not actionable. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 737-38 (5th ed. 1984); Donald C. Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1254 (1983).

169 "Statement," as used in section 12(2), may be interpreted to include implied representations by the seller. See 9 LOSS & SELIGMAN, *supra* note 32, at 3772-98; see *infra* notes 235-36 and accompanying text.

170 From the secondary market seller's perspective, the concept of privity plays an important role in limiting the availability of this cause of action and, derivatively, in limiting the scope of the seller's affirmative disclosure obligations as well as the scope of the prospective defendant-seller's liability for money damages.

to demonstrate that she exercised "reasonable care" and that the omission of a material fact was not the result of any failure of the defendant to conduct herself properly.

The question then becomes: What is required of the Ordinary Seller to establish her exercise of reasonable care, thereby allowing her to prove her affirmative defense? In particular, does the Ordinary Seller have any obligation to make a "reasonable investigation" of the issuer or its business or other matters prior to a secondary market sale in order to preserve her section 12(2) reasonable care defense? In examining the reasonable care defense from the perspective of the Ordinary Seller, it becomes important to distinguish between two types of transactions involving the secondary trading of securities by Ordinary Sellers: (i) face-to-face sales; and (ii) exchange or over-the-counter (OTC) trading. Each of these situations will be examined separately.

1. Face-to-Face Transactions

In a face-to-face transaction, the Ordinary Seller has an affirmative duty to tell the truth in her dealings with the buyer.¹⁷¹ This obligation should be relatively easy for the Ordinary Seller to satisfy in a face-to-face transaction because the buyer is readily identifiable. In the absence of some facts suggesting an independent basis for some further disclosure obligation,¹⁷² the section 12(2) disclosure burden is thereby presumably satisfied.

A separate issue, however, focuses on whether the exercise of "reasonable care" requires the Ordinary Seller to make a "reasonable investigation" of the facts underlying any statements made by this seller. In the case of statements made by the Ordinary Seller bearing on the intrinsic value of the securities, such as opinions¹⁷³ about the issuer's business or its securities, no such additional investigation should be required of the Ordinary Seller. As to the Ordinary Seller, section 12(2) presumably is intended only

171 As previously noted, satisfaction of the anti-fraud regulatory policy underlying section 12(2) presumably also incorporates the common law doctrine of half-truths and therefore requires the Ordinary Seller to disclose any facts known to the seller that are necessary to make the statements of that seller not misleading. See *supra* notes 167-68 and accompanying text.

172 See *supra* notes 166-68 and *infra* notes 175-77 and accompanying text, which discusses the extent of the affirmative disclosure obligations imposed by section 12(2).

173 Statements of opinion, of course, are subject to a threshold analysis of whether they constitute "facts" subject to regulation by section 12(2). See *supra* note 92 and accompanying text.

to require truthful and complete disclosure at the time of sale to her secondary market buyer¹⁷⁴ but is not intended to obligate her to verify the basis of her opinions or other statements to the buyer.¹⁷⁵

A further question is whether the Ordinary Seller's knowledge of material facts triggers some independent duty to investigate. In other words, does the Ordinary Seller, by virtue of some questionable information in her possession, receive constructive notice which then triggers some obligation to make a "reasonable investigation" to preserve the statute's affirmative defense? Or, alternatively, may the Ordinary Seller rely on the full disclosure policy of the 1933 Act and shift any duty to investigate to the prospective buyer by making full disclosure to the buyer of all material facts within the Ordinary Seller's possession?¹⁷⁶ Under an approach that favors full disclosure and that recognizes the limited access the Ordinary Seller generally has to the issuer to verify facts about

174 What if the Ordinary Seller possesses knowledge of material facts, but makes no statements to the prospective buyer? In such a case, the doctrine of half-truths generally is not available to impose an obligation on the Ordinary Seller, under section 12(2), of full disclosure so that the statements made by such seller be not misleading. At common law, at least in the case of insider trading involving corporate fiduciaries, the special facts doctrine was relied on to trigger an affirmative disclosure obligation on the part of such sellers, at least in the case of certain face-to-face dealings. See HAMILTON, *supra* note 4, at 933-34. It is unclear whether this doctrine extends to trigger a similar disclosure obligation on the part of the Ordinary Seller (*i.e.*, a non-fiduciary) for purposes of section 12(2).

The express language of section 12(2), however, does not seem to impose any affirmative disclosure obligation on sellers in general since, by its terms, it only requires disclosure of those facts necessary to make the statements made by the seller not misleading. At a minimum, the nature of the face-to-face dealings between the buyer and Ordinary Seller may involve (or may, in fact, create as to that particular securities transaction) a special relationship of trust and confidence that provides an independent source of disclosure obligation on the Ordinary Seller. In any case, the scope of affirmative disclosure obligation imposed on Ordinary Sellers under section 12(2) remains unclear. See 9 LOSS & SELIGMAN, *supra* note 32, at 4200-02.

175 The doctrine of half-truths may, however, require the Ordinary Seller to disclose the basis, no matter how flimsy, of her opinions or other material statements, in order that these statements do not mislead the buyer by inferring some greater factual basis than the Ordinary Seller actually possesses.

176 In other words, in the event that the Ordinary Seller is on notice of suspicious facts or circumstances, and the transaction involves face-to-face dealings between the parties, the plaintiff-buyer presumably can establish some factual basis to support a claim that either (i) such disclosure is necessary under section 12(2) in order to make the (express or implied) statements made by the Ordinary Seller not misleading; or, alternatively, (ii) a special relationship of trust and confidence exists between this buyer and the Ordinary Seller that is sufficient to require this Seller to make full disclosure to satisfy section 12(2).

the issuer and its business, truthful disclosure of all material facts by the Ordinary Seller to the buyer during the course of their dealings should be sufficient. If the transaction proceeds following full disclosure by the Ordinary Seller, presumably the parties will negotiate a price to reflect the cost of investigation or to reflect the buyer's assumption of the risk in the event no investigation is undertaken prior to sale.¹⁷⁷

2. Exchange or OTC Transactions

In the case of sales executed over the exchanges or in the OTC market, the Ordinary Seller presumably faces the same reasonable care burden as applied in the case of the Ordinary Seller's face-to-face transactions: The Ordinary Seller must make truthful disclosures to the buyer. Similarly, the Ordinary Seller presumably has no independent duty to conduct a "reasonable investigation" to establish her exercise of reasonable care as a threshold matter.

In most anonymous trading transactions occurring on the exchanges or in the OTC market, the Ordinary Seller accesses these markets through a broker-dealer¹⁷⁸ and thus has no direct dealings with the buyer on the other side of the trade. In these anon-

¹⁷⁷ Alternatively, the parties could agree that the Ordinary Seller assume the burden to investigate, and the acquisition of further information following any such investigation would further refine the scope of the Ordinary Seller's responsibility at that point. A further issue arises, however: What would be a "reasonable" investigation for purposes of an Ordinary Seller in this situation? Presumably not as much as is required in a similar situation involving either a Control Person Seller or a Broker-Dealer Seller since the Ordinary Seller usually does not have the same accessibility to the relevant sources of information. Moreover, if the Ordinary Seller were to assume the burden of such an investigation, presumably it would be by the parties' mutual agreement, i.e., the only way the sale will go forward following the truthful disclosure of the suspicious facts by the Ordinary Seller (which should be all that is otherwise required of the Ordinary Seller to satisfy her section 12(2) obligation to exercise reasonable care) is if the Ordinary Seller conducts a further investigation into the suspicious facts and circumstances that have been disclosed to the buyer during the course of the parties' direct dealings. In this case, however, the parties presumably will have defined (either expressly or impliedly) the scope of any such investigation and the consequences to follow upon the Ordinary Seller's subsequent disclosure of the results of her further investigation.

¹⁷⁸ In executing her customer's sell order, the broker-dealer presumably acts as the seller's agent and therefore falls within the *Pinter* formulation of a seller for purposes of section 12(2). A separate set of obligations on the part of the broker-dealer may arise as a result of her activities undertaken to find a *buyer* for the Ordinary Seller's securities. The broker-dealer therefore must conduct herself in a manner sufficient to establish independently her "exercise of reasonable care" under section 12(2). See *infra* Part IV.C (discussing basis of broker-dealer's statutory defense as to section 12(2) suit brought by plaintiff-buyer).

ymous transactions, there should be relatively few opportunities for the Ordinary Seller to make statements of material fact to the buyer or to mislead the buyer by omitting material facts necessary to make the statements of the Ordinary Seller not misleading. Moreover, in the absence of any direct dealings between the Ordinary Seller and her buyer, there generally will be no factual basis for finding a common law relationship of trust and confidence that may otherwise create such an affirmative disclosure obligation.

This understanding of the requirements of section 12(2) squarely poses the question of whether section 12(2) forms the basis for an affirmative disclosure obligation on the part of the Ordinary Seller. For the reasons discussed above, section 12(2) presumably may not be treated as a separate source of an *express* disclosure obligation to be imposed on all sellers, including Ordinary Sellers, irrespective of any underlying, independent source for such an affirmative disclosure obligation.¹⁷⁹ Further, if section 12(2) were found to impose such a disclosure burden on sellers of securities, how would the Ordinary Seller satisfy this obligation in the context of an exchange or OTC transaction?¹⁸⁰ In an open-market transaction, the Ordinary Seller potentially is in privity with the whole world and thus any disclosure obligation imposed on her presumably could be satisfied only through full and adequate disclosure to all prospective buyers (*i.e.*, the whole world).¹⁸¹

179 This understanding of the scope of section 12(2)'s disclosure requirements presumably applies in the case of the Ordinary Seller's open-market transactions for the same reasons that are described above in connection with the Ordinary Seller's *face-to-face* sales to the buyer. See *supra* notes 172-78 and accompanying text. See also 9 LOSS & SELIGMAN, *supra* note 32, at 4200-02.

180 In the case of the Ordinary Seller's responsibility in a *face-to-face* transaction, the logistics of providing effective disclosure presumably are much simpler, perhaps justifying different treatment of the Ordinary Seller's *face-to-face* transactions. Moreover, as pointed out in the discussion above regarding the Ordinary Seller's direct dealings with the buyer, it is likely that sufficient facts will exist either (i) to create a claim by the plaintiff-buyer that the Ordinary Seller omitted material facts necessary to make her statements not misleading; or, alternatively, (ii) to support a claim of some special relationship of trust and confidence sufficient to support a duty to make full disclosure. It is unlikely that sufficient facts will exist in the case of open-market transactions to support such a claim by the buyer.

181 If this approach were taken, then the Ordinary Seller who is in possession of material facts presumably would be left with no choice but to hold the stock and "ride the market down." In cases where the Ordinary Seller is in possession of material, non-public facts about the issuer, these facts generally are negative (*i.e.* "bad news"). The Ordinary Seller, therefore, seeks to cut her losses by selling the shares into the market *prior* to disclosure of the bad news. As a policy matter, however, this may not be a fair result in light of the fact that, to some extent, the Ordinary Seller is a member of the

Practically speaking, this is an impossible burden for the Ordinary Seller to satisfy.¹⁸²

In light of these considerations, the prudent understanding of section 12(2), at least as to Ordinary Sellers, is to require truthful and complete communications but not to interpret section 12(2) as imposing an affirmative disclosure obligation on this class of sellers either as part of the anti-fraud, regulatory purpose of section 12(2), or as part of the seller's burden to demonstrate the exercise of reasonable care.¹⁸³

B. "Control Persons" of Issuer as Secondary Market Sellers

This Part focuses on the standard to be imposed on "control persons"¹⁸⁴ in defining their exercise of reasonable care under section 12(2) in connection with their trading of the issuer's securities in the secondary markets. In determining the scope of the Control Person Seller's obligations under section 12(2), the issuer's responsibilities under section 12(2) must be considered.

For purposes of the 1933 Act, issuers cannot engage in secondary market transactions because the statute generally treats any transaction by an issuer in its own securities as a "distribution." As such, the issuer is subject to the disclosure requirements imposed by section 5 of the 1933 Act. Alternatively, the issuer may seek to

group to be protected by the enactment of the 1933 Act. Yet, at the same time, to do otherwise is to allow this Ordinary Seller to shift the burden of loss to some other unsuspecting open-market buyer who likewise was the intended beneficiary of the 1933 Act protections.

182 And what if the Ordinary Seller possesses facts that give rise to constructive notice sufficient to trigger an obligation to make a reasonable investigation? Must the Ordinary Seller conduct such an investigation *prior* to her sale in the open market? The Ordinary Seller in an open market transaction, unlike the situation involved in the case of *direct dealings* between a buyer and an Ordinary Seller, presumably cannot readily negotiate to shift the burden to investigate to the buyer since generally the Ordinary Seller is handicapped in identifying the buyer in an exchange or OTC transaction.

183 Perhaps at this point the policies underlying the Rule 10b-5 cause of action of the 1934 Act become most directly relevant to the section 12(2) analysis. The Rule 10b-5 analytical framework seems to strongly suggest that no duty of disclosure is imposed on the Ordinary Seller, at least in the context of her open market transactions. See *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983); *HAZEN*, *supra* note 3, § 13.10, at 753-57; 7 *LOSS & SELIGMAN*, *supra* note 32, at 3517.

184 Regarding the definition of "control," see generally Rule 405, 17 C.F.R. § 230.405 (1992); 4 *LOSS & SELIGMAN*, *supra* note 32, at 1691-92; *JAMES D. COX, SECURITIES REGULATION*, 458-60. For purposes of this Article, the analysis of the section 12(2) liability of Control Person Sellers assumes that the individual satisfies the relevant standard for "control person," and therefore, any extended discussion of the determination of control person status is outside the scope of this Article.

avoid the time and expense involved in preparing a registration statement by relying on an exemption from registration, including the private placement exemption of section 4(2) for certain types of primary offerings.¹⁸⁵ However, the issuer faces a fairly substantial disclosure obligation in order to satisfy the requirements of the section 4(2) private placement exemption.¹⁸⁶ The issuer carries the burden of establishing¹⁸⁷ that all the offerees have available to them the information that registration otherwise would provide.¹⁸⁸

In the case of a *registered* offering, the issuer will face virtually strict liability for any material misrepresentation or omission in the registration statement.¹⁸⁹ In the case of a misrepresentation or omission of a material fact made during the course of an *exempt* offering, the issuer may face fraud liability under section 12(2).¹⁹⁰ At a minimum, therefore, the issuer must establish that it exercised "reasonable care" in order to avoid liability to buyers who are in privity with the issuer.¹⁹¹

In the case of either a registered or exempt offering, the issuer is involved in a *distribution* transaction.¹⁹² Once the securi-

185 See The Securities Act of 1933 § 4(2), 15 U.S.C. § 77(d)(2) (1988); JENNINGS, *supra* note 6, at 324.

186 See SEC v. Ralston Purina Co., 346 U.S. 119 (1953); see generally HAZEN, *supra* note 3, at 185-93 ("[A]ccess to information is a precondition to any section 4(2) exemption.")

187 The party claiming the exemption has the burden of proving all the elements of the exemption, thereby perfecting the claim that the section 5 registration and prospectus delivery requirements do not apply to this transaction. *Id.* at 119.

188 In general, four factors have long been identified as being particularly important in establishing the issuer's section 4(2) exemption: (1) the number of offerees and their relationship to each other and to the issuer; (2) the number of units offered; (3) the size of the offering; and (4) the manner of the offering. See General Counsel's Opinion, Securities Act Release No. 285, Jan. 24, 1935; JENNINGS, *supra* note 6, at 325-28; COX, *supra* note 184, at 375-76.

189 In this situation, liability generally lies under section 11, and there is no due diligence defense available to the issuer under section 11. See JENNINGS, *supra* note 6, at 879; Epstein, *supra* note 5, at 388.

190 See, e.g., DeMarco v. Edens, 390 F.2d 836, 842 (2d Cir. 1968).

191 In light of the failure to provide the issuer any due diligence defense under section 11, the issuer faces a very heavy burden under section 12(2) (imposing liability for fraud in the case of both registered and unregistered offerings). See DeMarco, 390 F.2d at 841. Any further discussion of the scope of the issuer's reasonable care defense is outside the scope of this Article, which focuses on transactions occurring in the trading markets. See *supra* note 156.

192 Discussion of the issuer's fraud liability under section 12(2) lies outside the scope of this Article, which focuses on section 12(2) liability for fraudulent trading in the *secondary* markets. The issuer's standard of care under section 12(2) is relevant only for

ties are issued, however, the subsequent transfer of such instruments (or any interest therein) will occur in a secondary market transaction. These post-distribution transactions involve resales by investor-owners who are either control persons¹⁹³ or non-control persons.¹⁹⁴ In determining the burdens imposed by section 12(2) on the control person in connection with her resales of the issuer's securities,¹⁹⁵ including the obligation to exercise reasonable care, a distinction must be made as to whether such resales occur in a face-to-face transaction or in an open market transaction, either on an exchange or in the OTC market.

1. Face-to-Face vs. Open Market Transactions

For purposes of the 1933 Act, the control person is generally treated as tantamount to the issuer. Indeed, one definition of "control" has suggested that a control person is any person who is in a position to cause the issuer to file a registration statement for the sale of its securities.¹⁹⁶ Such a person is in a position not only to compel the issuer to take the legal steps necessary to effectuate such a transaction but also to insist on compliance with the disclosure requirements imposed by the federal securities laws, in particular, the items of disclosure required under the relevant form of registration statement to be used in connection with the issuer's proposed offering.

Consequently, the control person who effects resales in the secondary markets that rise to the level of a distribution¹⁹⁷ is treated as an issuer for purposes of the statute's definition of an

purposes of analyzing the scope of responsibility of Control Person Sellers under section 12(2). *See also supra* note 154.

193 This discussion assumes the Control Person Seller is not a broker-dealer.

194 A non-control person may be either an Ordinary Seller or a broker-dealer.

195 By definition, a control person is a "control person" as to that issuer; thus, this Article is concerned exclusively with the control person's resales of that issuer's securities. As to any other securities that may be in the control person's investment portfolio, a separate analysis is required to determine whether the individual is a "control person" as to the issuers of these other securities, or an ordinary investor, non-control person holder of such securities. As to the latter, presumably the owner would be treated as an Ordinary Seller in connection with her disposition of these securities.

196 *See Sommer, supra* note 156, at 591.

197 The control clause language of the section 2(11) definition of a statutory underwriter is directed at the problem posed by a control person's resales in the secondary market that rise to the level of a "distribution" even though effected through regular way trading transactions in the secondary markets. *See United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969); *In re Ira Haupt & Co.*, 23 S.E.C. 589 (1946).

underwriter, and the transaction, therefore, is subject to the full panoply of registration requirements under section 5 of the 1933 Act.¹⁹⁸ The statute assumes that the control person will be in a position to provide the disclosures required to satisfy the section 5 registration obligation. This burden, therefore, is not an insurmountable obstacle to the control person's resale activity in the secondary trading markets.¹⁹⁹

In analyzing a control person's liability under section 12(2) for resales of her control securities in a trading market transaction, it is instructive to look further to the requirements for a control person's *private* resale of securities under the provision dubbed the "section 4(1½)" exemption.²⁰⁰ In general, a resale exempt under section 4(1½) must meet at least some of the criteria imposed on a private placement transaction conducted pursuant to the section 4(2) exemption.²⁰¹ As such, the control person (as the party claiming the benefit of this hybrid exemption), generally must be able to demonstrate that the purchaser(s) met the qualifications of section 4(2), including an inquiry into the prospective buyer's investment sophistication where relevant.²⁰²

The most important of the requirements for the issuer's section 4(2) exemption is that the prospective purchaser "have access to current information about the *issuer* similar to the types of information that would be made available through a registration statement."²⁰³ Similarly, the availability of current information about the issuer is generally viewed as one of the most important criteria in determining the availability of the section 4(1½) exemp-

198 See *Wolfson*, 405 F.2d at 782; HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT SECURITIES IN INTERSTATE COMMERCE, H.R. Rep. No. 85, 73d Cong., 1st Sess., 13-14 (1933).

199 Moreover, where a control person's resales in the secondary market rise to the level of a "distribution," such resales usually must be conducted on a registered basis. See JENNINGS, *supra* note 6, at 239-40, 486-87. Further analysis of section 12(2) as it applies to "secondary distributions" by control persons is provided in the author's article, *The Future of Securities Act Section 12(2)*, to be published in ALA. L. REV. (Fall 1993).

200 See JENNINGS, *supra* note 6, at 507-14.

201 Accordingly, the control person must avoid any general solicitation or general advertising, as well preferably limit the number of offerees, or, at the very least, the number of section 4(1½) sales that occur within a narrow time frame. See generally Carl W. Schneider, *Section 4(1½)—Private Resales of Restricted or Control Securities*, 49 OHIO ST. L.J. 501, 506-07 (1988); Christopher D. Olander & Margaret S. Jacks, *The Section 4(1½) Exemption—Reading Between the Lines of the Securities Act of 1933*, 15 SEC. REG. L.J. 339, 359-62 (1988).

202 See Schneider, *supra* note 201, at 509; Hazen, *supra* note 3, at 222-23.

203 HAZEN, *supra* note 3, at 224 (emphasis added) (footnote omitted).

tion for the control person's resale activity.²⁰⁴ Indeed, at least one commentator has suggested that the scope of the seller's disclosure obligations under the section 4(1½) exemption "should depend upon the Holder's status as an insider [*i.e.*, control person] and also upon access to material information that is unavailable to the Purchaser."²⁰⁵ Accordingly, the control person, who seeks to make a private resale of her control securities, inherits a fairly heavy burden to provide full disclosure to the prospective buyer of her securities.²⁰⁶

The implications of this analysis of the exemptions available to avoid the section 5 registration and disclosure obligations²⁰⁷ for a control person's resales are fairly clear. For purposes of section 12(2), the Control Person Seller must be completely truthful and careful not to omit any facts necessary to make her statements to a buyer in the secondary market not misleading.²⁰⁸ In addition, as a result of the direct dealings between a Control Person Seller and a prospective buyer (as would usually occur in the case of a private resale exemption under section 4(1½)), the plaintiff-buyer may be able to establish the factual basis for a relationship of trust and confidence sufficient to create an independent basis for imposing an affirmative disclosure obligation on the Control Person Seller under section 12(2).²⁰⁹ In sum, consistent with the strong 1933 Act policy favoring *full* disclosure of all material facts, section 12(2) presumably imposes a heavy burden on the Control Person Seller (who after all is treated as the issuer under the statutory definition of underwriter) to come forward and dis-

204 *Id.* at 225; Olander & Jacks, *supra* note 201, at 359-60.

205 Schneider, *supra* note 201, at 507.

206 See HAZEN, *supra* note 3, at 226 ("[A] selling shareholder who is an insider or control person may have certain additional disclosure obligations."). This disclosure burden is imposed as a condition to the availability of the section 4(1½) exemption for the resale activity in the secondary market.

207 As an alternative to relying on the section 4(1) exemption for her resale activity in the secondary markets, the Control Person Seller may opt to register her shares in compliance with the section 5 registration burden. The shelf registration procedures developed by the SEC facilitate this registered secondary distribution on behalf of a control person. See Rule 415, 17 C.F.R. § 230.415 (1992); JENNINGS, *supra* note 6, at 239-49.

208 In addition, as a control person, there may be state law fiduciary duties that apply in the context of the control person's resale activity that create an independent disclosure obligation, such as the fiduciary duties of a director or dominant shareholder. See *e.g.*, Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471-74 (Cal. 1969); ROBERT CLARK, CORPORATE LAW, 486-94 (1986).

209 This interpretation of the section 12(2) disclosure burden is further reinforced by reference to the control person's registration obligations under section 5 of the 1933 Act. See *supra* notes 197-202.

close *all* material facts in scrupulously fair fashion so as to avoid section 12(2) liability for misleading statements or omissions of material fact.

By contrast, in the case of the control person's resale activity in open market trading transactions, the SEC usually maintains that the Control Person Seller can sell only within the quantity limitations and other restrictions of Rule 144 for these activities to be treated as a nondistribution. Not coincidentally, Rule 144 imposes disclosure obligations on this resale activity as well by requiring the control person to demonstrate *inter alia* the issuer's full compliance with its 1934 Act reporting obligations.²¹⁰ Thus, Rule 144 treats all open market resales by control persons as requiring fairly substantial disclosure by the Control Person Seller. In sum, the requirements of Rule 144, as applied to the control person's open market resales, further buttress the fairly significant disclosure burden otherwise imposed on the Control Person Seller under section 12(2).²¹¹

2. The Control Person's Exercise of Reasonable Care

The remaining question is: What is required of a Control Person Seller to demonstrate her exercise of reasonable care for purposes of her section 12(2) defense, including any burden she may have to undertake a "reasonable investigation"? In light of the preceding discussion, it seems clear that the Control Person Seller must make full and adequate disclosure of all material facts in order to demonstrate that she conducted herself in compliance with the mandate of section 12(2). To do otherwise is to allow the control person to sell securities to an unsuspecting buyer in the trading markets, knowing that this buyer cannot be as knowledgeable as the Control Person Seller about the issuer and the issuer's business operations and financial affairs.

210 See 17 C.F.R. § 230.144(e) (1992).

211 Policy considerations are consistent with this interpretation of the control person's section 12(2) burden. As set forth above, *see supra* notes 197-208 and accompanying text, the Control Person Seller is treated as an "issuer" under the section 2(11) definition of underwriter; as such, the control person is closest to the facts necessary to determine the truthfulness of any statements made or that underlie any suspicious circumstances that may exist regarding the issuer and its business. Therefore, any scaling back of the disclosure or investigative burden imposed on the Control Person Seller would seem only to significantly increase transaction costs and the risk of fraud contrary to the purposes of the 1933 Act, and more particularly the anti-fraud purpose of section 12(2) of the 1933 Act. See also Olander & Jacks, *supra* note 201, at 359-63.

Since prior interpretations of section 12(2) have incorporated common law principles into the analysis of the statute's reasonable care standard, it seems that the dominant position of the control person with respect to the issuer must be taken into account. Accordingly, the Control Person Seller's exercise of reasonable care should require, at a minimum, that she make full and adequate disclosure of all material facts known to her about the issuer and its business.²¹² Moreover, the Control Person Seller should be required to show that she had some reasonable basis for any statements or representations she may have made to the buyer, including any information about the issuer and its business operations and financial affairs.²¹³ In the absence of any such reasonable basis, the Control Person Seller presumably will not be able to sustain the burden of demonstrating her exercise of reasonable care.²¹⁴ The statute's recognition of the special status of control persons justifies treating their burden under section 12(2) differently than that of the Ordinary Seller.

In circumstances involving suspicious facts or circumstances regarding the nature of the issuer and its business, the Control Person Seller presumably must conduct a fairly thorough investigation in order to establish her exercise of reasonable care. Unlike the Ordinary Seller, the Control Person Seller should have ready access to the issuer and its operations and key personnel sufficient

212 Although fairly heavy, this should not be an insurmountable burden, particularly in the case of resales involving a Control Person Seller and a buyer who is also a control person of the issuer. See, e.g., *Jackson v. Oppenheim*, 533 F.2d 826 (2d Cir. 1976); *Heffernan v. Pacific Dunlop GBN Corp.*, 767 F. Supp. 913 (N.D. Ill. 1991) (illustrating that the course of dealing, and the relationship of the Control Person Seller to the transaction, as well as to the plaintiff-buyer, are also important factors in defining the relevant standard for the defendant's exercise of reasonable care, consistent with prior case law interpretation of the section 12(2) affirmative defense). Further discussion of other aspects of these section 12(2) cases involving secondary distributions by Control Person Sellers is provided in the author's article, *The Future of Securities Act Section 12(2)* to be published in ALA. L. REV. (Fall 1993).

213 Thus, the buyer could reasonably assume that the Control Person Seller has investigated the relevant facts necessary to support any assertions made by this seller and further, that the Control Person Seller is not aware of any suspicious facts or circumstances that would cast doubt on the veracity of her statements to the buyer.

214 As with Ordinary Sellers, resales by control persons are most likely to involve "bad news." In other words, the Control Person Seller is likely to be "dumping" the issuer's stock to cut her losses by selling to unsuspecting members of the investing public in advance of public disclosure of the bad news. The policy of the 1933 Act, as described above, see *supra* notes 197-202 and accompanying text, provides support for imposing an obligation on the control person to make full disclosure of the "bad news" before engaging in any resale activity in the secondary markets.

to ascertain the true nature of the facts. Thus, where suspicious circumstances put the Control Person Seller on constructive notice, she should be required to undertake a thorough investigation of these circumstances. Mere disclosure to the prospective secondary market buyer should not be enough to establish the Control Person Seller's exercise of reasonable care.²¹⁵ The strong disclosure policy underlying the 1933 Act, and the regulatory purpose underlying section 12(2), should preclude the Control Person Seller—unlike the Ordinary Seller—from shifting the burden of investigation to the prospective buyer.

This analysis of the Control Person Seller's exercise of reasonable care should remain the same regardless of whether her trading occurs in a face-to-face transaction or in an anonymous, open market transaction. In each case, the section 12(2) policy remains the same: full and adequate disclosure of all material facts, including an affirmative obligation to conduct a thorough investigation of any suspicious facts or circumstances and an obligation to make full disclosure of all material facts learned as a result of the Control Person Seller's investigation. As a control person, with access to the financial press, this seller presumably does not face any practical obstacles to making effective disclosure of such material information to either the face-to-face, readily identifiable buyer or to the anonymous buyers in the open markets. The control person's position with respect to the issuer distinguishes her from the Ordinary Seller and eliminates the logistical problems that the Ordinary Seller would face if this disclosure obligation were made part of the Ordinary Seller's exercise of reasonable care under section 12(2).²¹⁶

215 Where the prospective buyer is himself a control person of the issuer, however, the Control Person Seller, following full disclosure of all material facts, presumably should be able to negotiate to shift to this prospective buyer any burden to investigate these suspicious circumstances. In this situation, each side to the transaction presumably has equivalent access to the underlying source of information (i.e., the issuer and its key personnel) necessary to conduct a reasonable investigation of the suspicious circumstances. As to the non-control person buyer, however, this assumption does not hold and therefore a fundamental question of fairness is involved. In other words, under what set of circumstances is it reasonable for the Control Person Seller to shift this burden of investigation to the buyer and yet claim that she has satisfied her exercise of reasonable care? Presumably, it will be difficult, if not impossible, for the Control Person Seller to shift responsibility for such an investigation to the non-control person buyer.

216 See *supra* notes 169-70, 173-74 and accompanying text.

C. *Securities Professionals as Sellers: Broker-Dealers as Secondary Market Sellers*

Section 12(2) liability has been imposed on broker-dealers for their sales activity during the course of distribution transactions²¹⁷ or secondary trading transactions.²¹⁸ Historically, the courts have taken into account the nature of the underlying transaction in analyzing the broker-dealer's exercise of reasonable care for purposes of section 12(2).²¹⁹ Most of the prior cases, however, have involved *exempt* distribution transactions. As a result, the analysis of the section 12(2) reasonable care defense has been heavily influenced by the section 11 due diligence criteria that apply in the case of *registered* distributions.

In the case of secondary market, post-distribution transactions, the analysis shifts away from the section 11 due diligence criteria and properly focuses instead on the nature of the underlying *trading* activity. Consequently, as this Part has demonstrated with respect to other secondary market sellers, the nature of the defendant-seller and her relationship to the buyer are crucial to determining the appropriate standard for the seller's exercise of reasonable care. With respect to the Broker-Dealer Seller involved in a secondary market transaction, however, a new and important dimension is added to the analysis of the defendant's exercise of reasonable care. The scope of the Broker-Dealer Seller's affirmative defense under section 12(2) must account for any fiduciary duties owed by that Broker-Dealer Seller to that buyer in connection with the execution of that trade.

This Part first describes the criteria that influence the section 12(2) reasonable care standard as applied to Broker-Dealer Sellers. Once a brokerage relationship is found to exist between the Broker-Dealer Seller and the buyer, certain well-established doctrines arising under both common law agency principles as well as the federal securities laws become important in establishing the nature

217 See 17A HICKS, *supra* note 76; 15 LIPTON, *supra* note 95.

218 See 17A HICKS, *supra* note 76; *supra* notes 7-14 and accompanying text.

219 See 17A HICKS, *supra* note 76, at 6-299. Unlike Professor Kaminsky, who advocates a rule of almost absolute equivalency between the section 11 due diligence standard and the section 12(2) reasonable care standard, see KAMINSKY, *supra* note 109, Professor Hicks advocates a flexible application of the section 12(2) reasonable care standard that recognizes that the section 11 due diligence standards may be relevant to defining the scope of reasonable care under section 12(2), depending on the nature of the underlying transaction and the broker-dealer's relationship to it. See 17A HICKS, *supra* note 76, at 6-299.

of the obligations owed by the Broker-Dealer Seller to the prospective buyer. These established doctrines include the SEC-developed shingle theory and the suitability doctrine. Application of these principles to a particular secondary market transaction will be further influenced by the nature of the misrepresented or omitted fact, as well as by the nature of the broker-dealer's involvement in the underlying trading transaction, such as whether the broker-dealer acted exclusively as the agent of the seller or acted in a dual agency capacity representing both the buyer and the actual owner of the securities.

After providing an overview of the criteria that define the scope of the brokerage relationship and any related fiduciary duties, the last subpart of this Part illustrates the application of these established principles to the trading activity at issue in the *Ballay* case. In this manner, the Article will demonstrate that the incorporation of these well-accepted principles into the analysis of the broker-dealer's exercise of reasonable care under section 12(2) should not bring the securities brokerage industry to its knees. Rather, these doctrines already guide the broker-dealer in the secondary markets. Consequently, to avoid section 12(2) liability, broker-dealers need only conduct their activities in the secondary markets in accordance with familiar standards that have previously been relied on to define the obligations and responsibilities arising out of the brokerage relationship.

1. The Nature of the Relationship Between the Broker-Dealer Seller and the Buyer

(a) *The Fiduciary Relationship.*—The reasonable care defense of section 12(2) must recognize that in many situations, such as in *Ballay*, the broker-dealer who acts as a seller of securities to the plaintiff-investor also stands in a fiduciary relationship with the plaintiff as a result of the brokerage relationship established between the broker-dealer and the prospective buyer. The brokerage relationship is a form of common law agency, in which the customer generally is regarded as the principal and the broker-dealer acts on behalf of the customer as his agent. As such, the common law rules governing the agency relationship, including the fiduciary duty doctrine encompassing the agent's duty of care, as well as the duty of loyalty, apply to this brokerage relationship.²²⁰ In addi-

220 William O. Douglas & George E. Bates, *Stock "Brokers" As Agents and Dealers*, 43

tion, the federal securities laws impose their own set of obligations to further flesh out the nature of the brokerage relationship.²²¹ The existence of this relationship then further refines the standard of reasonable care that the Broker-Dealer Seller must establish to sustain her section 12(2) affirmative defense.

As a threshold matter, however, it must be determined whether a fiduciary relationship between the broker-dealer and the customer has been established. Determining when a broker-dealer has assumed a fiduciary position with respect to her customer is often difficult to recognize²²² because generally, a broker-dealer can deal with a customer as either an agent (broker) or a principal (dealer).

When a broker-dealer executes a transaction for a retail customer in an exchange market, the broker-dealer almost always acts in a broker capacity, thus establishing an agency relationship and assuming some sort of fiduciary position with respect to her customer.²²³ In OTC transactions, on the other hand, a broker-dealer generally must decide whether to act as an agent or a principal in the absence of an agreement with the customer. The decision to execute a particular transaction as a principal or an agent, therefore, is usually left to the broker-dealer's discretion.²²⁴

The manner of execution of trading activity on behalf of a customer, however, is not the sole determinant of whether a fiduciary relationship between the broker-dealer and the customer has been established. Traditionally, the SEC has emphasized that the existence of a fiduciary relationship in these situations turns on whether the broker-dealer has placed herself in a position of trust

YALE L.J. 46, 59-60 (1933); Randall W. Quinn, *Deja Vu All Over Again: The SEC's Return to Agency Theory in Regulating Broker-Dealers*, 1 COLUM. BUS. L. REV. 61 (1990); WOLFSON, *supra* note 95, at 2-39 to -43, S2-64 (Supp. 1985).

221 Section 12(2) is worried about buyers only; it creates no remedy for the defrauded seller. *See supra* notes 3-4, 72 and accompanying text. Accordingly, for purposes of defining the Broker-Dealer Seller's exercise of reasonable care, the focus is on the relationship that exists between the broker-dealer and the buyer. The implications arising out of any agency relationship that may exist between the seller and a broker-dealer acting on behalf of such seller is generally outside the scope of this discussion.

222 *See* Robert T. Greene, Note, *Differential Commissions as a Material Fact*, 34 EMORY L.J. 507, 513 n.35; *see also* WOLFSON, *supra* note 95, at 2-40.

223 *See* Patricia A. O'Hara, *The Elusive Concept of Control in Churning Claims Under Federal Securities & Commodities Law*, 75 GEO. L.J. 1875, 1877 n.5 (1987); WOLFSON, *supra* note 95, at 2-40.

224 *See* Greene, *supra* note 222, at 513; O'Hara, *supra* note 223, at 1876-79; *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172-73 (2d Cir. 1970).

and confidence with regard to her customers.²²⁵ The SEC's position thus recognizes the broker-dealer's discretion to function either as an agent or a principal in an OTC transaction. Exercise of this discretion, however, may result in conflicts of interest that may, among other things, allow broker-dealers the opportunity to conceal information from their customers. Consequently, the SEC is unlikely to accept the broker-dealer's claim that there was no agency relationship—and thus no fiduciary position assumed by the broker-dealer—simply because the transaction was executed in the OTC market with the broker-dealer acting as a principal in the sale. Instead, the SEC, and the courts, generally look to the totality of the circumstances to decide whether a fiduciary relationship of trust and confidence was established between the parties.²²⁶ Once the brokerage relationship is found to exist, the parameters of this brokerage relationship are governed by both agency law principles arising under state law and various doctrines developed under the federal securities laws. These doctrines, which are described in the remainder of this subpart of Part IV.C., form an integral part of the established legal framework that governs the brokerage relationship. As such, these principles must be incorporated into the standard for determining a broker-dealer's exercise of reasonable care under section 12(2).

(b) *The Shingle Theory.*—One of the most important principles that applies to the brokerage relationship under the federal securities laws is the SEC-developed doctrine known as the “shingle theory.”

Under the shingle theory, when a broker-dealer enters the securities business (hangs out her shingle), she implies that she will deal fairly with her customers.²²⁷ In its earliest formulation,

225 See WOLFSON, *supra* note 95, at 2-40.

226 Clearly, if a broker-dealer acts as an investment adviser to a client or manages a client's brokerage account pursuant to discretionary authority, these activities create a fiduciary relationship between the broker-dealer and her customer. See *Hughes v. SEC*, 27 S.E.C. 629, 634-39 (1948), *aff'd*, 174 F.2d 969 (D.C. Cir. 1949); WOLFSON, *supra* note 95, at 2-40 to -41.

227 For an early discussion of the shingle theory, see generally Douglas & Bates, *supra* note 110; Laylin K. James, *The Securities Act of 1933*, 32 MICH. L. REV. 624 (1934). See also Arnold S. Jacobs, *What Is a Misleading Statement Or Omission Under Rule 10b-5?*, 42 FORDHAM L. REVIEW 243 (1973). The prevention and elimination of manipulative, deceptive and fraudulent practices in the securities markets is a prime objective of the federal securities laws. Thus, section 12(2) extends civil remedies to investors who are induced to purchase securities, whether or not subject to registration under the 1933 Act, by false or

the shingle theory prevented excessive pricing of securities by holding that a broker impliedly represented that she will deal fairly with her customers, which includes the obligation to charge a fair price. Thus, the SEC's earliest application of the shingle theory prevented payment of excessive compensation to broker-dealers.²²⁸

The SEC subsequently relied on the shingle theory to address boiler room operations.²²⁹ In an early case, *Charles Hughes & Co. v. SEC*,²³⁰ the court relied on the shingle theory in concluding that high pressure sales tactics used in the broker-dealer's sales of certain OTC securities (today, such securities are generally referred to as "penny stocks"²³¹) violated the broker-dealer's implied representation to deal fairly with her customers. The shingle theory also has been extended to address cases involving unauthorized trading, including "churning" violations.²³² In addition to violating the broker-dealer's common law fiduciary duty, trading in excess of, or in absence of, customer authority is deemed fraudu-

misleading statements. Rule 10b-5, on the other hand, was adopted pursuant to section 10(b) of the 1934 Act. The implied private remedy from this later-adopted SEC rule is broader in its scope than the section 12(2) counterpart. Although there is substantial overlap between the scope of these two remedies, section 12(2) is available only where the plaintiff-investor can demonstrate that the misleading misrepresentation or omission was communicated orally or by means of a prospectus, a subset of a substantially larger range of conduct that may form the basis of a Rule 10b-5 action. See WOLFSON, *supra* note 95, at 2-40; see also *supra* notes 82-83 and accompanying text.

Rule 10b-5 and section 12(2) are not restricted to broker-dealers although broker-dealers may be held to a stricter standard of care than other persons who may be covered by these provisions. This higher standard generally results from the relationship involving trust and confidence between the Broker-Dealer Seller and her customer, which usually is not present in many of the other buyer-seller relationships that are subject to potential Rule 10b-5 liability exposure.

228 The shingle theory therefore prevents excessive compensation, whether in the form of commissions where the broker-dealer acts in a broker capacity, or in the form of excessive mark-ups or mark-downs where the broker-dealer executes the transaction as a principal. See *Merritt, Vickers, Inc. v. SEC*, 353 F.2d 293 (2d Cir. 1965); JENNINGS, *supra* note 6, at 578-80.

229 "A boiler room operation is a high-pressure selling campaign for a particular block of securities of a single issuer (frequently intrinsically worthless) usually carried out by long distance telephone." JENNINGS, *supra* note 6, at 620.

230 *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

231 For further background regarding recent history of abuses in the market for penny stocks, see generally HOUSE COMM'N ON ENERGY & COMMERCE, PENNY STOCK REFORM ACT OF 1990, H.R. Rep. 101-617, 101st Cong., 2d Sess. 7-35 (1990).

232 Mark C. Jensen, *Abuse of Discretion Claims Under Rule 10b-5: Churning, Unsuitability and Unauthorized Transactions*, 18 SEC. REG. L.J. 374 (1991); C. Edward Fletcher, *Learning to Live with the Federal Arbitration Act-Securities Litigation in a Post McMahon World*, 37 EMORY L.J. 99, 124-25 (1988).

lent, thereby creating liability for churning under Rule 10b-5 and perhaps under section 12(2) as well.²³³

For purposes of evaluating the broker-dealer's reasonable care defense under section 12(2), the most important application of the shingle theory probably has arisen in connection with the propriety of a broker-dealer's statements promoting an issuer and its securities. The SEC maintains:

[I]n his dealings with his customers, [a broker-dealer] impliedly represents that opinions and predictions about stock which he is recommending rest upon actual knowledge and careful consideration. Under the "shingle theory," the requirement of a reasonable basis extends to the recommendation itself. The Commission [has] held . . . that the antifraud provisions of the federal securities laws "contemplate, at the least, that recommendations of a security made to proposed purchasers shall have a reasonable basis and that they shall be accompanied by disclosure of known or easily ascertainable facts bearing upon the justification for the representation." Correspondingly,

233 Since section 12(2) is not generally interpreted as imposing an affirmative disclosure obligation on the defendant-seller, the churning cases that presumably would be subject to section 12(2) liability necessarily must involve oral (or written) communications between the customer and his broker-dealer that misrepresented or omitted material facts. Mere allegations of deceptive practices not involving such communications presumably would not create section 12(2) liability (even though liability may lie under Rule 10b-5) unless the shingle theory was used to establish liability based on the broker-dealer's conduct in violation of her implied representation to deal fairly with her customer. This qualification on broker-dealer liability is drawn from the fact that section 12(2) imposes liability for material omissions only where the omitted fact is necessary to make the statements made by the seller not misleading. Under the shingle theory, the broker-dealer impliedly represents that she will deal fairly with her customers. Therefore, her conduct involved in churning a customer's account may be viewed as a breach of this implied representation, thereby creating the basis for liability under section 12(2). See Hansen, *supra* note 11, at 198; *supra* notes 81-82 and accompanying text.

These more recent applications of the shingle theory have led to criticism of the theory as being too broad in creating liability by use of "implied representations." See 8 LOSS & SELIGMAN, *supra* note 32, at 3777-79. Some observers claim the theory could potentially be applied to any act or course of conduct which the SEC and the courts believe that broker-dealers should not perform. See, e.g., WOLFSON, *supra* note 95, at 2-51.

However, the shingle theory, at least for purposes of this Article's analysis of the scope of section 12(2)'s affirmative defense, should avoid the substance of these criticisms since it is being used to determine the scope of a broker-dealer's obligation to conduct a reasonable investigation for purposes of deciding whether she has exercised reasonable care. This more narrow use of the shingle theory should mitigate these criticisms.

the Commission has held that when a broker-dealer lacks adequate information to support a recommendation, it is a violation of the fraud rules to fail to disclose to customers the "lack of such information and [to fail to caution them] . . . as to the risk involved in purchasing the stock without such information."²³⁴

Furthermore, this particular application of the shingle theory "creates a concomitant duty of 'reasonable investigation' on the part of broker-dealers"²³⁵ Thus, whenever a broker-dealer recommends a security, or otherwise makes representations or expresses opinions concerning the issuer or its securities, she must have a reasonable basis for doing so.²³⁶

The extent of the investigation required of the broker-dealer to demonstrate factual support for her recommendation or opinion varies with the type of security and the nature of the representation, opinion, or recommendation that she makes to her customer. The duty of investigation is most imperative where a broker-dealer, by means of optimistic predictions and enthusiastic recommendations, seeks to persuade an investor to purchase securities of an unseasoned issuer. In such circumstances, the broker-dealer can satisfy the reasonable basis requirement, imposed as an extension of the shingle theory, only by making a searching inquiry into the affairs of the issuer.²³⁷

With regard to well-established issuers, on the other hand, the broker-dealer generally can rely on the information provided in the issuer's shareholder reports, or its other 1934 Act filings, to supply the reasonable basis for her recommendations to her customers. "Where a broker-dealer seeks to make broad dissemination of a recommendation, however, it is advisable for the broker-deal-

234 WOLFSON, *supra* note 95, at 2-26 (quoting *In re Best Sec., Inc.*, 39 S.E.C. 931, 934 (1966) and *In re Shearson, Hammill & Co.*, 42 S.E.C. 811, 834 (1965)). See also *Hanley v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969).

235 See WOLFSON, *supra* note 95, at 2-30; Denis Rice, *Recommendations by a Broker-Dealer: The Requirement for a Reasonable Basis*, 25 MERCER L. REV. 537 (1974).

236 If a broker-dealer does not recommend or solicit the purchase but acts only as an agent for the buyer in executing an unsolicited order, at least one court has recognized that the broker-dealer has only a minimal duty, if any, to buttress her responses to the customer's inquiries by making an independent investigation. *Canizaro v. Kohlmeyer & Co.*, 370 F. Supp. 282, 289 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975). See also WOLFSON, *supra* note 95, at 2-30 to -31.

237 See WOLFSON *supra* note 95, at 2-31.

er to conduct an examination of current SEC filings and contact the issuer . . . to verify the continued reliability of this information.²³⁸ If inconsistencies or other warning signals surface during the course of this examination, further independent investigation may be required to provide accurate information to satisfy the reasonable basis requirement imposed on broker-dealers under the shingle theory.²³⁹

The shingle theory, and its extension to impose a reasonable basis requirement on the broker-dealer in connection with her dealings with her customers, has clear implications for determining the scope of the Broker-Dealer Seller's exercise of reasonable care under section 12(2). The implications of the shingle theory for this analysis are taken up below and are examined in the context of the fact pattern alleged in the *Ballay* case.

(c) *The Suitability Doctrine.*—The suitability doctrine is another important principle arising under the federal securities law that further defines the scope of a broker-dealer's responsibility to her customers.²⁴⁰ Essentially, the suitability doctrine requires that the broker-dealer recommend for purchase by her customer only those securities that are suitable for this customer in light of his investment needs, financial situation, and overall financial objectives. Moreover, the suitability doctrine has been interpreted to require the broker-dealer to undertake an affirmative investigation into her client's background so as to ascertain the information necessary to formulate appropriate recommendations.²⁴¹

238 *Id.* at 2-32.

239 *Id.* Moreover, under the shingle theory, if a broker-dealer's recommendations go beyond information provided in established, authoritative sources, the broker-dealer has the affirmative obligation to thoroughly check the basis for such information and to document its reliability for the record.

240 See JENNINGS, *supra* note 6, at 639-42; F. Harris Nichols, *The Broker's Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFF. L. REV. 435 (1977); Arvid E. Roach II, *Suitability Obligations of Brokers*, 29 HASTINGS L.J. 1067 (1978); Greene, *supra* note 222, at 522-23; Sam Miller & Robert Popper, *Discount Broker's Obligations Under the "Suitability" Doctrine*, 5 INSIGHTS 7 (Nov. 1991).

241 This obligation is clearly set forth in the NYSE's know-thy-customer-rule, Rule 405, 2 NYSE Guide (CCH) ¶ 2405, at 3696 (1984) and has been inferred from the NASD's rule obligating its members to make suitable recommendations, Article III, Section 2, NASD Manual (CCH) ¶ 2152, at 2041 (1993). See also JENNINGS, *supra* note 6, at 639-40. Although it is not clear whether there is any implied liability for violating the rules of the self-regulating organizations, it may be a moot question because most broker-dealer violations of the suitability rules could be enforced as Rule 10b-5 claims. See WOLFSON, *supra* note 95, at 2-36. Alternatively such violations will usually form the basis for a

For purposes of analyzing the Broker-Dealer Seller's affirmative defense under section 12(2), the suitability doctrine has the most relevance in situations involving the broker-dealer's representations to her customer about the appropriateness (or "suitability") of a particular security for a particular customer. In such situations, the suitability doctrine requires the broker-dealer to collect detailed information regarding her customer's investment objectives and current financial situation *before* recommending the purchase of a particular security in furtherance of that client's investment goals.²⁴²

Like the shingle theory, the suitability doctrine forms the basis for imposing a reasonable investigation burden on the Broker-Dealer Seller that must be completed *before* the customer's purchase of a particular security. Obviously, the focus of the investigative burden imposed on the Broker-Dealer Seller under the suitability doctrine is on (i) ascertaining the customer's investment objectives, and (ii) in light of this knowledge, making appropriate investment recommendations to the customer.²⁴³ In connection with any recommendations for purchase of specific securities by her customer, the shingle theory presumably will also be implicated to assure that the Broker-Dealer Seller can demonstrate a reasonable basis for any representations made by her about the recommended security. In such a situation, the basis for the Broker-Dealer Seller's reasonable care defense under section 12(2) should implicate both the shingle theory and the suitability doctrine.

(d) *The Nature of the Misrepresented or Omitted Fact.*—The suitability doctrine will be most directly relevant in those section 12(2) suits where the plaintiff-buyer sues her broker-dealer for making

breach of fiduciary claim under state law agency principles. *Id.*

242 See JENNINGS, *supra* note 6, at 640; WOLFSON, *supra* note 95, at 2-35 (quoting from Exchange Act Release No. 7984, at 2-3 (Oct. 25, 1966)). ("The suitability of [a broker-dealer's] recommendations must be judged in the light of the information available . . . at the time of the recommendation and not by reference to subsequent events.")

243 Ascertaining customers' objectives requires broker-dealers to conduct an affirmative investigation of their customers' situation and financial needs. Any such investigation involves information that is readily accessible to the parties to the transaction. This is unlike the situation presented in *Ballay*, upon which this Article focuses. In *Ballay*, the relevant issue is whether the broker-dealer must make an affirmative investigation into matters largely in control of an unrelated third party (i.e., the issuer, Wickes) in order to support its claim that it acted reasonably in the preparation and distribution of information relating to the intrinsic value of the issuer's securities.

inappropriate recommendations to the buyer in light of the plaintiff-customer's financial situation and needs.²⁴⁴

In defending against such a suit, the scope of the Broker-Dealer Seller's reasonable care defense must take into account the affirmative obligations imposed on the broker-dealer under the suitability doctrine. This includes the need to conduct a reasonable investigation into the customer's investment interests and objectives. As such, this class of statements is most likely to give rise to a section 12(2) lawsuit in those secondary market situations involving a broker-dealer as the seller-defendant because the suitability doctrine under the federal securities laws is generally implicated only in the context of the brokerage relationship.

For purposes of analyzing the section 12(2) affirmative defense of reasonable care, however, this Article has focused primarily on statements of material fact that relate to the *intrinsic value* of the issuer's securities.²⁴⁵ Where the Broker-Dealer Seller touts a particular security to her customer, she incurs an obligation to conduct a reasonable investigation of the facts necessary to support any claims that the Broker-Dealer Seller seeks to make about the issuer and its securities. The basis for this investigative burden arises out of the shingle theory. As discussed earlier, the scope of the Broker-Dealer Seller's required investigation in this situation will depend on a number of factors including the nature of the issuer, the nature of the statement to be made, and the nature of the relationship between the issuer and the Broker-Dealer Seller.²⁴⁶

(e) *The Broker-Dealer's Role in the Trading Transaction.*—The shingle theory arises out of the brokerage relationship that exists between the customer and his Broker-Dealer Seller, and accordingly further refines the scope of the Broker-Dealer Seller's reasonable care defense. The plaintiff-investor, however, may only sue a broker-dealer who qualifies as a "seller" for purposes of section 12(2) and who must satisfy the *Pinter* criteria in order to be considered

244 See *supra* notes 88-93 and accompanying text discussing concept of materiality.

245 A frequent basis for section 12(2) suits involves claims that go fundamentally to the intrinsic value of securities, and, accordingly, that has been the focus of this Article. See *supra* notes 89-92 and accompanying text. It bears emphasizing, however, that the scope of the reasonable care defense will vary according to the nature of the misrepresented or omitted fact.

246 See *supra* notes 226-37 and accompanying text.

a proper defendant in a section 12(2) suit.²⁴⁷ Thus, the reasonable care defense of section 12(2) as applied to the Broker-Dealer Seller's secondary market transactions will be further influenced by her involvement in the underlying transaction. The nature of this involvement generally falls within one of the following four characterizations:²⁴⁸

(i) *As Principal*.—If the broker-dealer owns the securities and makes fraudulent sales of the securities to her customers, then the broker-dealer is the seller of the securities and the plaintiff-buyer may sue her under section 12(2).²⁴⁹ The scope of reasonable care required to sustain the section 12(2) reasonable care defense will be further refined by examining the nature of the brokerage relationship, if any, that may exist between the plaintiff-buyer and this Broker-Dealer Seller.²⁵⁰

(ii) *As Agent for Seller*.—In this situation, a fiduciary relationship exists as between the actual owner of the securities (the principal) and the broker-dealer who acts as his agent in locating the buyer. This broker-dealer nonetheless should qualify as a section 12(2) seller even though she is selling securities owned by another person.²⁵¹ Therefore, if this broker-dealer makes material misstatements or omits facts necessary to make statements made by her during the course of locating a buyer for these securities not misleading, the broker-dealer will incur liability under section 12(2) to the buyer.²⁵² But, what if there were no misleading communications between the buyer and the broker-dealer acting *exclusively* as agent for the seller? In such a case, there may be no basis for finding a fiduciary relationship between the broker-dealer and the buyer. In light of the absence of any facts showing direct

247 See *supra* notes 59-74 and accompanying text.

248 See generally 17A HICKS, *supra* note 76, at 6-121 to -131.

249 See, e.g., *Yanceski v. E.F. Hutton*, 581 F. Supp. 88, 93 (E.D. Pa. 1983). This analysis would seem to hold true irrespective of whether the Broker-Dealer was acting as market-maker or simply selling as a principal out of an inventory she may hold. See William Fisher, *Parsing Pinter Four Years Later*, 21 SEC. REG. L.J. 46, 51 (1993). What if, however, the broker-dealer had engaged in a riskless principal transaction? In other words, the broker-dealer purchased from a market-maker and turned around and sold the securities to her customer? In both situations, the broker-dealer presumably would be treated as a seller. See 17A HICKS, *supra* note 76, at 6-121 to -122.

250 The existence and nature of the brokerage relationship will be governed by the criteria previously described in this subpart of Part IV.C.

251 See *supra* notes 60-75 and accompanying text.

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

contact between the broker-dealer and the buyer, there seems to be little support for applying the reasonable basis requirement or any other aspect of the shingle theory to this sales transaction. If there were any evidence of direct dealings between the broker-dealer (acting as agent for the seller) and the buyer, presumably this sales transaction would then shade into the next category with the broker-dealer acting in a dual agency capacity.

(iii) *As Agent for Both Buyer and Seller.*—There is at least one case which found the broker-dealer to be a “seller” in a transaction in which she acted as agent for both the buyer and the actual owner/seller of the securities involved in that transaction.²⁵³ This conclusion is entirely consistent with the *Pinter* analysis since where the broker-dealer divides her loyalty between the owner of the securities and the prospective buyer, she is still performing services for, and collecting a fee from, the seller. Thus, this broker-dealer qualifies as a seller under the *Pinter* analysis. Nevertheless, because there is factual support for finding a fiduciary relationship between the *buyer* and this Broker-Dealer Seller, the broker-dealer’s exercise of reasonable care for purposes of establishing her section 12(2) affirmative defense must be analyzed in light of the shingle theory and its reasonable basis requirement, as well as the other doctrines applicable in the context of the brokerage relationship.

(iv) *As Agent for Buyer.*—Where the broker-dealer acts as agent for the buyer, there is generally factual support for finding that the broker-dealer occupies a fiduciary relationship with the buyer. However, can this broker-dealer be treated as a “seller” for purposes of section 12(2)? At first blush, this would seem to be a case of doublespeak.²⁵⁴ Nonetheless, the policy basis of the 1933 Act suggests that some broker-dealers may be treated as sellers for purposes of section 12(2), even though they act exclusively as the buyer’s agent in connection with the transaction.²⁵⁵

253 See *id.* at 990-91; 17A HICKS, *supra* note 76, at 6-122.

254 See *Cady*, 113 F.2d at 991; *Vogel-Lorber, Inc. v. Options on Shares, Inc.*, [1974-75] Fed. Sec. L. Rep. (CCH) ¶ 94,911, at 97,108 (S.D.N.Y. 1974); 17A HICKS, *supra* note 76, at 6-123.

255 See *Boehm v. Granger*, 42 N.Y.S.2d 246 (Sup. Ct. 1943), *aff’d per curiam*, 50 N.Y.S.2d 845 (App. Div. 1944); see also *Katz v. Amos Treat & Co.*, 411 F.2d 1046, 1053 (2d Cir. 1969) (in dicta, court suggested that a broker acting exclusively as buyer’s agent in a transaction nonetheless could qualify as a seller if it was found to have actively solic-

2. Applying These Doctrines to Define the Scope of the Broker-Dealer's Section 12(2) Reasonable Care Defense: The *Ballay* Case

Where the broker-dealer acts exclusively as a principal (*i.e.* in a dealer capacity only) and renders no advice to the customer, presumably no agency relationship is established, and therefore, the fiduciary doctrines described above should not apply to define the analysis required under section 12(2) as to the Broker-Dealer Seller's exercise of reasonable care. The absence of *any* fiduciary position is important in establishing the scope of the Broker-Dealer Seller's obligation to conduct a reasonable investigation into the underlying basis for any claims the issuer may have published and which in turn form the basis for any investment advice the broker-dealer may have disseminated.

Accordingly, where the broker-dealer can establish that in a given transaction she acted only as a principal, in an arms-length, bargained-for sale, which the broker-dealer did not solicit and which was otherwise wholly devoid of any attributes of the traditional brokerage relationship, the broker-dealer should have a very narrow responsibility to take affirmative steps to substantiate her compliance with the shingle theory and the suitability doctrine.²⁵⁶ As described earlier in this Part, both of these doctrines are quite important in defining the scope of a broker-dealer's obligation to her customer under the federal securities law and in turn further

ited the plaintiff-customer's offer to buy); *Quincy Coop. Bank v. A.G. Edwards & Sons*, 655 F. Supp. 78, 84 (D. Mass. 1986). *But see* *Fischer*, *supra* note 69, at 65-66, *citing to* *Cox v. Eicheler*, 765 F. Supp. 601, 609 (N.D. Cal. 1990); *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 493 (6th Cir. 1990).

256 Even here, though, the Broker-Dealer Seller may incur an albeit more limited obligation to conduct a reasonable investigation where there are suspicious circumstances that provide constructive notice to the broker-dealer. This more narrow analysis of section 12(2) might apply in situations involving the broker-dealer's execution of a customer's *unsolicited* order although this analysis must be tempered by at least two considerations: (i) whether the broker-dealer is a market-maker in the underlying security; and (ii) whether there is some reasonable expectation created on the part of the customer simply because the seller occupies broker-dealer status. *See* Donald C. Langevoort, *Fraud & Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1279-83 (1983). However, neither of these considerations seems relevant where there is no omission or misrepresentation to form the basis for a section 12(2) complaint, as where the suit is over a complaint of market manipulation by the Broker-Dealer Seller, unaccompanied by any claims of misrepresentation or non-disclosure. *But see supra* notes 234-36 and accompanying text discussing the concept of implied misrepresentation which may provide the substantive basis for actionable misconduct under section 12(2).

refine the analysis of the Broker-Dealer Seller's exercise of reasonable care under section 12(2) in a secondary market transaction. Neither of these doctrines should apply, however, in the absence of some evidence of a relationship of trust and confidence.

In *Ballay*, Legg Mason, as the Broker-Dealer Seller, published and disseminated research reports and engaged in oral communications as well regarding the issuer and its operations to prospective buyers, ostensibly for the purpose of inducing its customers to purchase Wickes securities in the secondary markets using the services of Legg Mason for which the firm would be compensated. In situations such as this, the section 12(2) reasonable care defense imposes on the Broker-Dealer Seller some obligation to conduct a reasonable investigation of the issuer and its business operations. The remainder of this Part focuses therefore on the contours of the section 12(2) reasonable care defense as applied to Legg Mason, the Broker-Dealer Seller, for the purpose of further refining the extent of any reasonable investigation requirement that might be necessary to establish the firm's exercise of reasonable care in connection with its activities in the trading markets.

In *Ballay*, Legg Mason supplied the plaintiff-investors with information that it had prepared regarding the value of Wickes securities that it recommended for plaintiffs' purchase,²⁵⁷ consistent with its "value philosophy" of investing. At the early stage of the proceedings when the case was presented to the Third Circuit,²⁵⁸ the record was not fully developed concerning Legg Mason's reasonable care defense. Nevertheless, a framework for the appropriate analysis of Legg Mason's affirmative defense can be set forth, based on the limited record available.

Research analysts at Legg Mason apparently took the initiative in identifying Wickes securities as an undervalued investment. This analysis included an estimate of the goodwill value of Wickes. Although not specifically described in the courts' decisions, the

257 Although there are no such allegations reported in the courts' opinions, if a plaintiff could show that Wickes securities were an inappropriate investment vehicle for that plaintiff, then presumably the suitability doctrine would be relied on to further define the scope of the broker-dealer's responsibility to the plaintiff-investor. As the *Ballay* case was brought as a class action suit, presumably there was no such allegation made, as it would not seem to be the type of claim susceptible to class action treatment.

258 The case went up on appeal on the threshold issue of whether a section 12(2) cause of action was available to these secondary market buyers. The Third Circuit denied this remedy to these plaintiffs.

basis for these calculations presumably came from the issuer's published reports, including any required filings under the 1934 Act. This estimate of value, which Legg Mason broadly disseminated to its clients presumably to induce them to purchase Wickes securities, raises several subsidiary issues that need to be resolved in analyzing Legg Mason's section 12(2) affirmative defense.

Irrespective of whether Legg Mason executed these customers' orders as a dealer-principal or broker-agent, it appears that a brokerage relationship existed between Legg Mason and the plaintiff-investors. All the investors apparently received an investment recommendation from Legg Mason and relied on this investment advice to make their purchases.²⁵⁹ Since a brokerage relationship has been established, the shingle theory becomes relevant in fleshing out the scope of Legg Mason's responsibilities in connection with its dissemination of a recommendation about Wickes securities.

Relying on the shingle theory to flesh out the scope of care required of Legg Mason under section 12(2), Legg Mason should be required to demonstrate that it had a reasonable basis for its estimate of the book value of Wickes securities. To satisfy this reasonable basis requirement, Legg Mason must show the nature of the information on which it based its calculation. Although much of this information presumably is publicly available since Wickes appears to be a reporting company under the 1934 Act, Legg Mason would want to introduce *all* information that it relied on, even if some of its sources went beyond the company's public filings.²⁶⁰ Moreover, Legg Mason has the burden to show that this information basis is sufficient on which to make these calculations, raising further questions regarding the *manner* in which the Legg Mason analysts made their calculations of value. In this regard, Legg Mason should be required to show, at a minimum, that the analysts acted carefully (*i.e.*, non-negligently within industry standards) in making these calculations, presumably by showing

259 Generally, rendering investment advice is sufficient to support a finding that a brokerage relationship existed between the Broker-Dealer Seller and the plaintiff-buyer. See *supra* notes 225-26 and accompanying text.

260 It would appear to be to Legg Mason's advantage to demonstrate the thoroughness of its analysts' efforts by introducing all documentation that supports their efforts, such as information gleaned from interviews with company officials, etc. and any other non-public sources of information. These possible sources may, however, raise other concerns, such as the propriety of the firm's receipt of this information. But these other concerns, including the possibility of Rule 10b-5 liability in connection with an analyst's communications with issuer's management, lie outside the scope of this Article.

that they acted reasonably in gathering and using the appropriate amount of information on which to base these calculations.

At this point, the shingle theory, as it defines the Broker-Dealer Seller's reasonable care defense, imposes an investigative burden on Legg Mason to show that it had sufficient information upon which to make its value calculations in a non-negligent fashion. Satisfying this burden likewise may require Legg Mason to go beyond the information contained in Wickes public filings. The scope of this affirmative obligation will in turn presumably depend on a number of factors, such as the staleness of the publicly available information, the type of calculations to be performed by the analysts at Legg Mason, and the acknowledged reliability and completeness of the information possessed by Legg Mason analysts.

Finally, Legg Mason, as part of its affirmative defense, must establish that it had no reason to doubt the veracity of the information that formed the basis of the raw data used in its estimate of the value of Wickes securities. In connection with this showing, certain criteria become quite important in determining the scope of any required investigation on the part of Legg Mason, such as the nature of the issuer (well-established or unseasoned) and the nature of any relationship between the issuer and the firm (prior dealings as advisor to company or market-maker status that might give this broker-dealer greater access to, or insight about, the company and its affairs). Furthermore, if Legg Mason were aware of any suspicious facts or circumstances sufficient to give rise to constructive notice, Legg Mason would incur an obligation to go beyond the available information and investigate the continued reliability of the information used in its analysts' calculations of the value of the issuer's securities.²⁶¹

The extent of this investigative burden presumably is enhanced where, as here, the Broker-Dealer Seller intends to broadly disseminate its recommendations to its customers.²⁶² In such situations, caution dictates that the broker-dealer may want to un-

261 The scope of this investigation will be determined by the nature of the suspicious facts or circumstances that created constructive notice. If an appropriate investigation cannot be made, as where the issuer refuses to cooperate or other obstacles are encountered, the broker-dealer must at a minimum make disclosure of these difficulties and any infirmities that may be created thereby, and perhaps may even be required to refrain from disseminating any estimates of value in order that the broker-dealer be in a position to show that she exercised reasonable care for purposes of preserving her section 12(2) defense.

262 See *supra* notes 238-39 and accompanying text.

dertake a searching inquiry to verify information, even publicly available information. This burden presumably is further enhanced where, as in *Balloy*, there is some evidence suggesting that the issuer is a financially troubled entity. The reasonable basis obligation, imposed on Broker-Dealer Sellers as an extension of the shingle theory, is presumably only strengthened in cases where evidence suggests that the issuer is financially distressed.

V. CONCLUSION

Consistent with the flexible approach historically used by the courts, the nature of the seller provides the starting point in analyzing the affirmative defense expressly provided by Congress in section 12(2) of the 1933 Act. In connection with trading activity occurring in the secondary markets, prospective sellers can be divided for the most part into three classes of prospective section 12(2) defendants: Ordinary Sellers, Control Person Sellers, and Broker-Dealer Sellers.

With respect to section 12(2) claims involving materially misleading statements relating to the intrinsic value of the issuer or its securities, the liability of Ordinary Sellers under section 12(2) should be the most remote of the three prospective classes of defendant-sellers for two principal reasons. Ordinary Sellers generally are quite removed from any meaningful access to sources of material information about the issuer. Furthermore, secondary market transactions involving Ordinary Sellers usually do not create the basis for any relationship of trust and confidence that might give rise to an affirmative duty to make some investigation to establish the seller's exercise of reasonable care for purposes of section 12(2).

The Control Person Seller, on the other hand, generally will bear a heavy burden in demonstrating her exercise of reasonable care. By virtue of her control relationship with the issuer, this seller generally has superior access to information about the issuer and its business affairs. Similarly, her position may give rise to state law imposed duties, possibly including fiduciary duties, that may expand the scope of care required of the Control Person Seller to include a reasonable investigation obligation.

The most complex analysis of the reasonable care defense, however, occurs in connection with the trading activities of Broker-Dealer Sellers in the secondary markets. Generally, these sellers occupy some position of trust and confidence with respect to the secondary market buyer. As a result of this relationship, the Bro-

ker-Dealer Seller is subject to fiduciary duty principles arising under common law as well as the federal securities laws. These doctrines further refine the scope of reasonable care that a Broker-Dealer Seller must exercise to preserve her section 12(2) affirmative defense. The application of these principles, as well as other factors described in this Article that are inherent in the brokerage relationship, serve to further refine the scope of the Broker-Dealer Seller's section 12(2) affirmative defense in a manner that is entirely consistent with the established doctrines that otherwise govern the securities trading activities of Broker-Dealer Sellers.

This flexible framework for analyzing the section 12(2) reasonable care defense is consistent with the negligence standard suggested by the express language of the statute. Furthermore, the analytical approach set forth in this Article supports the view that section 12(2) relief extends to secondary market buyers. The seller's affirmative defense, along with the other required elements of a section 12(2) cause of action, will act as a meaningful barrier to unmeritorious litigation in the event that the Supreme Court ultimately concludes that defrauded secondary market buyers may sue their sellers under this provision. Indeed, the analytical framework for conceptualizing the reasonable care defense of section 12(2) described in this Article should provide meaningful guidance to secondary market sellers, especially Broker-Dealer Sellers, in structuring their trading activities to preserve their affirmative defense and thereby avoid the prospect of draconian damages awards otherwise feared to result from the extension of section 12(2) to purchasers in the secondary markets.

