

1995

## *Gustafson v. Alloyd Co.*: The Continued Shrinking of Private-Plaintiff Remedies under the 1933 Securities Act

Laura K. Bancroft

Follow this and additional works at: <http://lawcommons.luc.edu/lucj>

 Part of the [Securities Law Commons](#)

---

### Recommended Citation

Laura K. Bancroft, *Gustafson v. Alloyd Co.: The Continued Shrinking of Private-Plaintiff Remedies under the 1933 Securities Act*, 27 Loy. U. Chi. L. J. 149 (1995).

Available at: <http://lawcommons.luc.edu/lucj/vol27/iss1/6>

This Note is brought to you for free and open access by LAW eCommons. It has been accepted for inclusion in Loyola University Chicago Law Journal by an authorized administrator of LAW eCommons. For more information, please contact [law-library@luc.edu](mailto:law-library@luc.edu).

# *Gustafson v. Alloyd Co.*: The Continued Shrinking of Private-Plaintiff Remedies Under The 1933 Securities Act

LEGISLATION is not anticipation. It is a response, too often a laggard response, to serious need. The new Federal Securities Act is a belated and conservative attempt to curb the recurrence of old abuses which, through failure of adequate legislation, had attained disastrous proportions. How to draw the savings of people into great streams of investment and at the same time to protect those savings from recklessness has been a problem for statesmanship ever since the advent of large corporate enterprise. Particularly exigent has this problem been in periods of crisis following speculative debauches. Man's memory is short and hope of gain is an obdurate motive. When, however, confidence takes flight, it can be coaxed to return permanently only by prudent safeguards against future devastation.<sup>1</sup>

## I. INTRODUCTION

As a response to the 1929 Stock Market crash, securities<sup>2</sup> are now

---

1. Felix Frankfurter, *The Federal Securities Act: II*, FORTUNE, Aug. 1933, at 53. See *infra* part II (discussing the background of the 1933 Securities Act).

2. Congress defined a "security" in the definitional provision of the Securities Act of 1933 (the "1933 Act"). Securities Act of 1933, Pub. L. No. 22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77b(1) (1994)). Section 2(1), as amended in 1934, provides:

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interests in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.

Securities Exchange Act of 1934, Pub. L. No. 291, 48 Stat. 881, 905 (codified as amended at 15 U.S.C. § 77b(1) (1994)). In 1982, Congress inserted the following language into 15 U.S.C. § 77b, after "mineral rights": "any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency . . ." An Act of October 13, 1982, Pub. L. No. 97-303, 96 Stat. 1409 (codified as amended at 15 U.S.C. § 77b(1) (1994)). This definition allows for "sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933), *reprinted in* 1 FED. BAR ASS'N SECURITIES LAWS

regulated by legislation at both the state and federal level.<sup>3</sup> The sale of stock<sup>4</sup> often occurs after the distribution of a prospectus to the public, offering information about the stock and the entity issuing the stock.<sup>5</sup> Generally, a prospectus is a selling document or advertisement, usually for the sale of a security, which provides information about that security and the company issuing the security.<sup>6</sup> Securities laws, however, offer a more precise meaning of the term "prospectus". Specifically, the Securities Act of 1933 (the "1933 Act")<sup>7</sup> defines the term "prospectus" in the definitional section of the Act.<sup>8</sup> Section 2(10) provides: "'prospectus' means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security," unless the context provides otherwise.<sup>9</sup>

Federal appellate courts, however, differed in their interpretation of the proper scope of this definition in other provisions of the 1933

LEGISLATIVE HISTORY 1933-1982, at 148 (1983).

3. Basically, these laws "reflect the regulatory procedures required to be followed by a company seeking to raise funds from both public and private sources." WILLIAM M. PRIFTI, *SECURITIES: PUBLIC & PRIVATE OFFERINGS* § 1:01 (1994). For a discussion of the beginnings of security regulation at the federal level, see *infra* part II.

4. The following general scenario depicts the way in which securities are often sold to the public:

In a typical . . . public offering, the marketing of securities occurs much as the marketing of most consumer products. The securities are created by the issuer (the manufacturer), which sells them to "underwriters" (wholesalers), which in turn sell them to "dealers" (retailers), which then sell them to investor-shareholders (consumers). The process of getting securities from the issuer to the investing public is known as a *public distribution*.

LEWIS D. SOLOMON AND ALAN R. PALMITER, *CORPORATIONS: EXAMPLES AND EXPLANATIONS* § 10.1.1 (2d ed. 1994).

5. Perhaps the best way to define a public offering is through negative inference, defining first a private offering, and then noting that "[a] private offering is the opposite of a public offering." PRIFTI, *supra* note 3, § 1:07. The Securities Exchange Commission ("SEC") limits private offerings by the number of participants that may be involved, but generally does not limit the amount of money that may be raised. *Id.* See also Regulation D of the 1933 Act, Sec. Act. Rel. No. 6389 (March 8, 1982) (establishing safe-harbor exemptions for certain qualifying transactions). In addition, § 4(2) of the 1933 Act exempts private offerings from many of the requirements of the Act itself. See 15 U.S.C. § 77d(2) (1994).

In contrast to private offerings, in which the sale of securities occurs through a private agreement, a public offering is commonly accomplished through the use of securities exchanges, or through broker-dealer relationships. PRIFTI, *supra* note 3, § 1:06.

6. A prospectus is "a description of a new security issue supplied to prospective purchasers." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1821 (1986). See *infra* note 122.

7. 15 U.S.C. § 77a (1994).

8. 15 U.S.C. § 77b(10) (1994).

9. *Id.*

Act.<sup>10</sup> When the sale of stock is accomplished through the use of a prospectus, section 12(2) of the Act provides the buyers with an express cause of action for rescission of the sale when the sellers make material misstatements or omissions in the prospectus.<sup>11</sup> Disagreement on the meaning and scope of the term “prospectus” in section 12(2) led to a circuit split.<sup>12</sup> Specifically, the courts could not agree on whether section 12(2) applied to aftermarket or secondary market transactions.<sup>13</sup>

In *Gustafson v. Alloyd Co.*,<sup>14</sup> the Supreme Court resolved this circuit split, deciding in a five to four ruling that the term “prospectus” as used in section 12(2) does not apply to a private agreement for the sale of securities.<sup>15</sup> The Court therefore held that no cause of action

---

10. While § 2(10) provides the general definition of the term prospectus, courts disagreed on the meaning of prospectus as used in § 12(2), in light of the restrictive definition of prospectus in § 10. See *infra* notes 31-62 and accompanying text for a discussion of the courts’ concerns with this contradictory language.

11. Section 12(2) provides:

Any person who . . . offers or sells a security (whether or not exempted by the provisions of [section 3], other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77I(2) (1994). Professor Louis Loss once noted that since “[s]ection 12(2) is not too happily drafted, . . . it is best not to attempt a paraphrase.” 3 LOUIS LOSS, *SECURITIES REGULATION* 1699 (2d ed. 1961).

12. For a complete discussion on the nature of this circuit split, see *infra* part II.

13. It is undisputed that when an issuer makes an initial distribution or an offering of a security, the issuer can be subject to liability under § 12(2). Catherine Zucal, Comment, *Does Section 12(2) of the Securities Act of 1933 Apply to Secondary Trading?: Ballay v. Legg Mason Wood Waler, Inc.*, 65 ST. JOHN’S L. REV. 1179 (1991) (citing *Kaplan v. Pomerantz*, 131 F.R.D. 118, 126 (N.D. Ill. 1990)). These transactions generate proceeds for corporate use. 3A HAROLD S. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* § 6.03 (1988). In comparison, a secondary market transaction, broadly defined, is made on behalf of some person or company other than the original issuer. *Id.* Additionally, the notion of a secondary market transaction can refer to a control person’s sale of securities. See generally RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION* 469-491 (7th ed. 1992) (defining aftermarket transactions).

14. 115 S. Ct. 1061 (1995).

15. *Id.* at 1073-74. See *infra* part III.C for a discussion of the Court’s holding.

exists for misrepresentations made in such contracts under section 12(2) of the 1933 Act.<sup>16</sup>

This Note first traces the background of the federal securities laws and the posture of the circuits prior to the decision in *Gustafson*.<sup>17</sup> This Note then discusses the majority and dissenting opinions in *Gustafson*.<sup>18</sup> Next, this Note analyzes the decision in *Gustafson*, concluding that the majority unnecessarily considered factors outside the statute, rather than looking at the plain language of the statute itself.<sup>19</sup> Finally, this Note anticipates that *Gustafson* will limit the rights of private parties involved in securities trading that seek remedies under the 1933 Act.<sup>20</sup>

## II. BACKGROUND

The Great Depression began on Black Monday, October 29, 1929. The crash of the stock market in New York not only signaled the beginning of the Great Depression, but also marked the impetus for the development of the federal securities laws.<sup>21</sup> The devastating impact of the stock market crash highlighted the need for change. In response to the financial crash, President Franklin D. Roosevelt instituted a program to return stability to the American economic system, with considerable focus on stock markets, the issuance of securities, and securities trading.<sup>22</sup> To achieve stability, Congress enacted the Securities Act of 1933.<sup>23</sup> This new legislation, President Roosevelt stressed, would ensure that "every issue of new securities . . . [would] be accompanied by full publicity and information" with the burden of truthful disclosure on those that issued securities.<sup>24</sup> The 1933 Act protected the public through disclosure requirements and created remedies for violations of the Act.<sup>25</sup>

---

16. *Gustafson*, 115 S. Ct. at 1074. See *infra* note 131 and accompanying text.

17. See *infra* part II.

18. See *infra* part III.

19. See *infra* part IV.

20. See *infra* part V.

21. Arthur H. Dean, *The Federal Securities Act: I*, FORTUNE, Aug. 1933, at 50 (1933). "[W]hen President Roosevelt signed . . . [the 1933 Act], he not only put an end to a series of promotional practices which had played their part in precipitating the Stock Market Crash of 1929: he altered the whole technique of American finance." *Id.*

22. President's [Roosevelt] Message to Congress, 77 CONG. REC. 937 (1933), reprinted in 1 FED. BAR ASS'N, SEC. L. COMM., FEDERAL SECURITIES LAW: LEGISLATIVE HISTORY 1933-1982, at 20 (1983) [hereinafter President's Message].

23. Elliott J. Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 BUS. LAW. 1, 8 (1992).

24. President's Message, *supra* note 22.

25. 15 U.S.C. §§ 77a-77bbb (1994).

One of these remedies can be found in section 12(2).<sup>26</sup> Section 12(2) creates civil liability when the seller of a security makes a misrepresentation in the offering of that security.<sup>27</sup> The scope of this section, however, remained undefined and in flux.<sup>28</sup> Legislative history on the provision was "sparse," shedding little light on the intended scope of section 12(2).<sup>29</sup> Specifically, scholars<sup>30</sup> and courts<sup>31</sup> questioned whether section 12(2) could be applied to transactions other than initial offerings. Federal district courts also disagreed on the scope of section 12(2), with some courts finding that this section applied to secondary market transactions,<sup>32</sup> and other courts holding that

26. See *supra* note 11 for the text of § 12(2). Damages and rescission are available under § 12(2) where a purchaser can establish that the seller:

(1) offered to sell or sold a security, (2) through the use of interstate commerce, (3) by means of a prospectus or oral communication, (4) which included a misstatement or omission of material fact, (5) of which the purchaser did not have knowledge, unless the seller did not know nor could reasonably have known of the misstatement or omission.

Kevin N. Peter, Comment, *Section 12(2) of the Securities Act of 1933: Does it Apply to the Secondary Market? The Circuits are Fighting*, 31 HOUS. L. REV. 1205, 1209 (1994); 15 U.S.C. § 77I(2) (1994).

27. 15 U.S.C. § 77I(2) (1994). See *supra* note 11. Section 12(2) provides an express private right of action, unlike some of the other statutory provisions. Compare § 12(2) (providing an express private right of action) with § 17 (15 U.S.C. § 77q(a)) (failing to explicitly create a private right of action). For the text of § 17, see *infra* note 125.

28. See *infra* notes 30-62 and accompanying text.

29. *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986). For an extended discussion on the legislative history of the 1933 Act, see James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959). Significantly, Congress has not, to this date, substantively amended § 12. Adam D. Hirsch, Comment, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. CHI. L. REV. 955, 965, 984 (1990).

30. See generally Hirsch, *supra* note 29, at 984 (arguing that § 12(2) should apply to an aftermarket only where that market is inefficient); Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 917 (1992) (arguing that § 12(2) applies to the sale of all securities); Louis Loss, *Securities Act Section 12(2): A Rebuttal*, 48 BUS. LAW. 47 (1992) (finding that public policy supports the application of § 12(2) to private transactions); Therese H. Maynard, *The Future of Securities Act Section 12(2)*, 45 ALA. L. REV. 817, 822 (1994) (arguing that the general understanding of § 12(2) requires its application to secondary market transactions); Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 WM. & MARY L. REV. 847, 849 (1991) (concluding that a "§ 12(2) cause of action is available to any defrauded buyer"); Peter, *supra* note 26 (examining the circuit split prior to *Gustafson* and advocating a broad interpretation of § 12(2)); Robert A. Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 ALB. L. REV. 97, 140 (1991) (supporting a limitation of § 12(2) to initial offerings); Weiss, *supra* note 23, at 4 (arguing that the language "by means of a prospectus" was intended to limit the scope of § 12(2)).

31. See generally Peter, *supra* note 26, at 1206-07 n.9 (citing cases holding either that §12(2) applied or did not apply to secondary market transactions).

32. The following district courts held that § 12(2) applied to secondary market

section 12(2) had no such application.<sup>33</sup> Four appellate courts deciding this issue similarly disagreed on the proper interpretation of the term "prospectus" in section 12(2).<sup>34</sup> By 1993, a circuit court split had developed.

Decisions by the Third and Seventh Circuits exemplified this split. In *Ballay v. Legg Mason Wood Walker, Inc.*,<sup>35</sup> the Third Circuit expressly considered the application of section 12(2) to a privately negotiated sale of stock. In *Ballay*, investors sued a brokerage firm for alleged oral misrepresentations made regarding the value of the securities at issue.<sup>36</sup> Plaintiffs prevailed on the section 12(2) claim against the brokerage firm, but the district court certified for appeal the issue of whether section 12(2) applied to secondary market transactions.<sup>37</sup>

---

transactions: *Farley v. Baird, Patrick & Co.*, 750 F. Supp. 1209, 1221 (S.D.N.Y. 1990); *In re Ramtek Sec. Litig.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,483 (N.D. Cal. Sept. 7, 1990); *Ballay v. Legg Mason Wood Walker, Inc.*, No. 88-6867, 1989 U.S. Dist. LEXIS 15495, at \*15 (E.D. Pa. Dec. 27, 1989), *rev'd*, 925 F.2d 682, 693 (3d Cir.), *cert. denied*, 112 S. Ct. 79 (1991); *Elysian Fed. Sav. Bank v. First Interregional Equity Corp.*, 713 F. Supp. 737, 747-51 (D.N.J. 1989); *Scotch v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 709 F. Supp. 95, 98 (M.D. Pa. 1988). For an explanation of secondary market transactions, see *supra* note 13.

33. However, significantly more district courts have held that § 12(2) did not apply to secondary market transactions: *Cox v. Eichler*, 765 F. Supp. 601, 609 (N.D. Cal. 1990); *T. Rowe Price New Horizons Fund, Inc. v. Preletz*, 749 F. Supp. 705, 709 (D. Md. 1990); *Grinsell v. Kidder, Peabody, & Co.*, 744 F. Supp. 931, 934 (N.D. Cal. 1990); *Leonard v. Stuart-James Co.*, 742 F. Supp. 653, 658 (N.D. Ga. 1990); *Mix v. E.F. Hutton & Co.*, 720 F. Supp. 8, 12 (D.D.C. 1989); *Panek v. Bogucz*, 718 F. Supp. 1228, 1232-33 (D.N.J. 1989); *Cheltenham Bank v. Drexel Burham Lambert Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,391, at 92,542 (E.D.N.C. Mar. 15., 1989); *Strong v. Paine Webber, Inc.*, 700 F. Supp. 4, 5 (S.D.N.Y. 1988); *Ralph v. Prudential-Bache Sec., Inc.*, 692 F. Supp. 1322, 1324 (S.D. Fla. 1988); *SSH Co. v. Shearson Lehman Bros.*, 678 F. Supp. 1055, 1059 (S.D.N.Y. 1987).

34. *First Union Discount Brokerage Servs. v. Milos*, 997 F.2d 835, 843-844 (11th Cir. 1993); *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578 (7th Cir. 1993), *cert. granted*, 114 S. Ct. 907, and *cert. dismissed*, 114 S. Ct. 1146 (1994); *Metromedia Co. v. Fugazy*, 983 F.2d 350 (2d Cir. 1992), *cert. denied*, 113 S. Ct. 2445 (1993); *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir. 1991), *cert. denied*, 112 S. Ct. 79 (1991). See *infra* notes 35-62 and accompanying text for a discussion of these decisions.

35. 925 F.2d 682 (3d Cir.), *cert. denied*, 112 S. Ct. 79 (1991).

36. *Id.* at 686. The *Ballay* court explained that the broker, Legg Mason, calculated security values in order to promote investment in undervalued securities. *Id.* at 685. The brokerage firm operated on the "value philosophy of investing" which sought to purchase securities from bankrupt or reorganized companies which theoretically presented only limited risks for the investors. *Id.* The brokerage firm determined the value of these securities by weighing various characteristics. *Id.*

37. *Id.* at 687. See also Zucal, *supra* note 13 (suggesting that the express language of § 12(2) and the legislative intent for the 1933 and 1934 Securities Acts contradict the court's narrow interpretation of the acts in *Ballay*).

The *Ballay* court began its analysis of the issue with the language of section 12(2) and consideration of the doctrine of *noscitur a sociis*,<sup>38</sup> which holds that a “word is known by the company it keeps.”<sup>39</sup> Applying this doctrine, the court found that the term “oral communication” in section 12(2) must be considered in relation to other words that accompanied it.<sup>40</sup> The *Ballay* court reasoned that the term “prospectus” restricted the definition of “oral communication”.<sup>41</sup> Similarly, the *Ballay* court found that various provisions of the 1933 Act, notably section 10, limited the scope of the term “prospectus”.<sup>42</sup> Consequently, the court concluded that the phrase “oral communication” applied only to the sale of a security in an initial distribution.<sup>43</sup>

The *Ballay* court next examined the purpose of the 1933 Act, finding that the goal of the 1933 Act also governed its interpretation of section 12(2).<sup>44</sup> The *Ballay* court reasoned that based on Congress’ intent in enacting the Securities Act, only initial offerings of securities

38. *Ballay*, 925 F.2d at 689-90.

39. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1069 (1995). See *infra* notes 120-24 and accompanying text for a discussion of the doctrine of *noscitur a sociis*.

40. *Ballay*, 925 F.2d at 687. For the text of § 12(2), see *supra* note 11.

41. *Ballay*, 925 F.2d at 688.

42. *Id.* Specifically, the *Ballay* court stated: “[i]n addition to its definition, the use of the term ‘prospectus’ in various sections of the 1933 Act supports a reading restricted to initial distributions.” *Id.*

The *Ballay* court heavily relied on § 10 of the 1933 Act in making this assertion. *Id.* Section 10 sets forth the information required in a prospectus. 15 U.S.C. § 77j (1994). Section 10 of the 1933 Act provides:

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

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

*Id.* Most importantly, a prospectus under § 10 contains essentially the same information as required in a registration statement under § 5. See 15 U.S.C. § 77j (1994) and compare with 15 U.S.C. § 77e (1994) (referencing the registration information requirements of 15 U.S.C. § 77a(a) (1994)). However, a prospectus under § 10 may “omit some documents required of registration statements.” *Ballay*, 925 F.2d at 688 (construing 15 U.S.C. § 77j(a)(i) (1994)). The *Ballay* court explained its restrictive reading by stating that “Congress repeatedly used the term ‘prospectus’ in provisions concerning registration statement requirements in initial distributions.” *Ballay*, 925 F.2d at 689.

43. *Ballay*, 925 F.2d at 688-89. In reaching this conclusion, the *Ballay* court noted that the 1933 Act did not provide a definition for the phrase “oral communication.” *Id.* at 688. However, the *Ballay* court readily limited the phrase “oral communication” to those oral communications “related to a prospectus or initial offering.” *Id.*

44. *Id.* at 690.



were to be regulated under the 1933 Act,<sup>45</sup> and that section 12(2) therefore did not apply to secondary transactions.<sup>46</sup>

In reaching this conclusion, the *Ballay* court also relied on public policy.<sup>47</sup> The *Ballay* court considered the potential conflict with other statutes that could result from the application of section 12(2) to secondary market transactions.<sup>48</sup> Specifically, the *Ballay* court noted the different damage provisions of section 12(2) of the 1933 Act and section 10(b) of the Securities Exchange Act ("1934 Act"), which allows recovery for fraud occurring in both initial and secondary securities transactions.<sup>49</sup> The court found that because section 12(2) of the 1933 Act allows a much greater remedy than section 10(b) of the 1934 Act, the application of section 12(2) should necessarily be more limited in its scope than section 10(b), and should be applied only to misrepresentations made in initial offerings of securities.<sup>50</sup>

---

45. *Id.* at 691. The *Ballay* court went on to distinguish other provisions of the 1933 Act, namely § 17, as well as the antifraud remedies of the 1934 Act. *Id.* at 691-94. The court determined that "the language and legislative history of § 12(2), as well as its relationships to §§ 17(a) and 10(b) within the scheme of the 1933 and 1934 Acts, compel our conclusion that § 12(2) applies only to initial offerings and not to aftermarket trading." *Id.* at 693.

46. *Id.*

47. *Id.* at 692-93. The *Ballay* court based much of this policy discussion on the distinctions between § 12(2) of the 1933 Act and § 10(b) of the Securities Exchange Act of 1934. *Id.* See *infra* notes 48-50.

48. The *Ballay* court expressed concern over the conflicts that could potentially arise from the application of § 12(2) to secondary market transactions at the same time that § 10(b) of the 1934 Act could be applied, since the two provisions require different elements of proof and allow different remedies. *Ballay*, 925 F.2d at 692-93. See *infra* note 49. The court explained that "the application of § 12(2) to secondary trading would permit purchasers of securities to prevail against sellers in instances where those purchasers cannot recover under section 10(b) of the Securities Exchange Act of 1934." *Ballay*, 925 F.2d at 692. The court noted that such an interpretation "would effectively eliminate the use of section 10(b) by securities purchasers." *Id.* (footnote omitted).

49. *Ballay*, 925 F.2d at 692-93. Section 12(2) allows for rescission, often viewed as necessary to compensate for fraud in initial security distributions. *Id.* at 693. On the other hand, § 10(b) allows for the recovery of only actual damages. *Id.* The *Ballay* court reasoned that these two different remedies were particularly based on the type of transaction involved. *Id.* See *supra* note 48.

In contrast to § 12(2), § 10(b) requires that a private plaintiff prove scienter, reliance, and causation in order to recover for fraud arising from a secondary market transaction. *Ballay*, 925 F.2d at 692-93 (construing § 10(b) cause of actions). See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Common law fraud actions also require that a plaintiff prove scienter, or "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 193. See also Peter, *supra* note 26, at 1208-09 (comparing the different burdens of proof under §10(b) of the 1934 Act and § 12(2) of the 1933 Act).

50. *Ballay*, 925 F.2d at 693. The court noted that purchasers of securities during the initial distribution should be allowed to recover the full measure of damages for any misrepresentations, because the sellers "are the investors' sole source of information regarding the value of the security." *Id.* The court contrasted such purchases with

Thereafter, many district courts followed *Ballay's* lead.<sup>51</sup> Notably, while in their decisions the courts expressed agreement with the basic principles articulated in *Ballay*, the courts did not expand upon the rationale for their holdings.

The Seventh Circuit, however, departed from the prevailing view expressed in *Ballay*. In *Pacific Dunlop Holdings, Inc. v. Allen & Co.*,<sup>52</sup> the court held that the language of section 12(2) indicated that the provision should be applied to all sales of securities. In *Pacific Dunlop*, the plaintiff, through a private stock purchase agreement, bought stock from a company controlled largely by the defendant, an investment banking firm.<sup>53</sup> The stock purchase agreement contained warranties and representations regarding the truth of information contained in the registration statement filed with the SEC, including assertions that the company complied with environmental regulations and had no undisclosed liabilities or obligations.<sup>54</sup> After purchasing the stock, the plaintiff discovered a multitude of claims against the company.<sup>55</sup> In its lawsuit, the plaintiff alleged that the defendant omitted material facts from the stock purchase agreement, which resulted in false representations in violation of section 12(2).<sup>56</sup>

In deciding whether the stock purchase agreement constituted a prospectus under section 12(2), the *Pacific Dunlop* court rejected the

---

aftermarket transactions, where the investors can learn of the value of the securities through other sources. *Id.*

51. *See, e.g.,* Fujisawa Pharmaceutical Co. v. Kapoor, 814 F. Supp. 720, 728 (N.D. Ill. 1993); Bogart v. Shearson Lehman Bros., No. 91 Civ. 1036 (LBS), (NG), 1993 WL 33643, at \*3 (S.D.N.Y. Feb. 3, 1993); Budget Rent-A-Car Systems, Inc. v. Hirsch, 810 F. Supp. 1253, 1257 (S.D. Fla. 1992); Hedden v. Marinelli, 796 F. Supp. 432, 435 (N.D. Cal. 1992); *In re Delmarva Sec. Litig.*, 794 F. Supp. 1293, 1309 (D. Del. 1992); Polycast Technology Corp. v. Uniroyal, Inc., 792 F. Supp. 244, 259 (S.D.N.Y. 1992); Newman v. Comprehensive Care Corp., 794 F. Supp. 1513, 1524-25 (D. Or. 1992); Bennett v. Bally Mfg. Corp., 785 F. Supp. 559, 561 (D.S.C. 1992); Bank of Denver v. Southeastern Capital Group, Inc., 763 F. Supp. 1552, 1558 (D. Colo. 1991).

52. 993 F.2d 578 (7th Cir. 1993), *cert. granted*, 114 S. Ct. 907, *cert. dismissed*, 114 S. Ct. 1146 (1994).

53. *Pacific Dunlop Holdings Inc., v. Allen & Co.*, 993 F.2d 578, 579 (7th Cir. 1993). The facts leading up to this private sale of stock are somewhat unique. The stock that the plaintiff purchased had originally been marked common stock for sale in an initial public offering. *Id.* Before any sale pursuant to this initial public offering, plaintiff and defendant entered into the private stock purchase agreement. *Id.* Thereafter, the issuing company abandoned the initial offering shortly after filing its registration statement with the Securities Exchange Commission. *Id.*

54. *Id.*

55. *Id.* The company faced claims regarding its compliance with environmental regulations, government service contracts the company had entered into and occupational disease claims. *Id.*

56. *Id.*

Third Circuit's holding in *Ballay*.<sup>57</sup> The court traced several cases in an effort to show *Ballay*'s departure from accepted understanding of the scope of section 12(2).<sup>58</sup> The *Pacific Dunlop* court reasoned that the inclusion of the term "communication" in section 2(10) of the 1933 Act (defining the term "prospectus") connoted that "prospectus" was to be interpreted "very broadly," necessarily including all written communications.<sup>59</sup> By viewing "prospectus" as a broad, encompassing term, the *Pacific Dunlop* court found the misrepresentations in the stock purchase agreement to be actionable under section 12(2).<sup>60</sup> The Seventh Circuit thus held that section 12(2)'s right of action for rescission "applie[d] to any communication which offers any security for sale . . . including the stock purchase agreement in the present

---

57. *Id.* at 582. The *Pacific Dunlop* court devoted an entire section of its opinion to the "conflict of authority" on the issue of whether the term "prospectus" can include a stock purchase agreement, subjecting a transaction to liability under § 12(2). *Id.* at 580-82. For an extensive discussion of the contrast between *Ballay* and *Pacific Dunlop*, see Therese H. Maynard, *Section 12(2)'s Availability to the Defrauded Secondary Market Buyer*, INSIGHTS, Aug. 1993, at 21.

58. *Pacific Dunlop*, 993 F.2d at 580-82. First, the *Pacific Dunlop* court noted that while the Supreme Court had yet to address the issue of whether § 12(2) applied solely to initial offerings of stock, the Supreme Court had assumed the opposite in *Wilko v. Swan*, 346 U.S. 427 (1953), *overruled by Rodriguez De Quiras v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989). In *Wilko*, the Supreme Court "held that an arbitration agreement could not waive the provisions" set forth in § 12(2) of the 1933 Act. *Wilko*, 346 U.S. at 438. Discussing the facts of the case, the *Wilko* court compared initial offerings and aftermarket sales of stock. *Id.* at 435. The *Wilko* court, in dicta, recognized that § 12(2) applied to dealers and brokers, therefore impliedly recognizing that § 12(2) applied to secondary market transactions. *Id.* at 430.

Next, the Seventh Circuit found support for its holding in *Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959). The *Woodward* court held: "the [s]ection [12(2)] remedy is applicable to the sale of all securities (with exceptions not here material) whether exempt from the registration requirements or not, or whether the sellers were issuers for the purpose of public offering or not." *Id.* at 116.

Finally, the Seventh Circuit found that the *Ballay* decision contradicted the First Circuit in *Cady v. Murphy*, 113 F.2d 988, 989 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940). In *Cady*, the court held that § 12(2) could apply to securities not required to be registered and that liability could be imposed "for misrepresentations not only upon principals but also upon brokers when selling securities owned by other persons." *Id.* at 990. Again, while the First Circuit did not expressly address whether § 12(2) applied only to initial distributions, its choice of language indicates that § 12(2) could apply to secondary market transactions. *Id.*

59. *Pacific Dunlop*, 993 F.2d at 582. The Seventh Circuit in *Pacific Dunlop* began its analysis of the issue with the text of the statute itself. *Id.* at 582. The Court noted that the term "prospectus" was defined broadly, as are other words used in § 12(2). *Id.* The Court rationalized that nothing in § 12(2) or elsewhere in the Act required a narrow reading of the term "prospectus." *Id.* at 587-88. Specifically, in reviewing the definitional section for "prospectus", the Court stated that "[s]ection 2(10) is broad enough to include initial and secondary market transactions." *Id.* at 588.

60. *Id.* at 595.

case.”<sup>61</sup>

The Second and Eleventh Circuits both followed *Ballay* without explanation.<sup>62</sup> The Supreme Court granted certiorari in *Pacific Dunlop*<sup>63</sup> in order to resolve the split. However, the parties settled and certiorari was dismissed.<sup>64</sup> The Court then granted certiorari in *Gustafson*.<sup>65</sup>

### III. DISCUSSION

#### A. Facts of the Case

In 1989, Arthur L. Gustafson, Daniel R. McLean and Francis I. Butler (collectively “Sellers”), the sole shareholders of Alloyd Co., Inc., decided to sell their company to Wind Point Partners II, L.P. (“Wind Point”) (the “Buyers”).<sup>66</sup> Wind Point, in making its decision to purchase Alloyd, relied on a formal business review of the company conducted by KPMG Peat Marwick (“KPMG”).<sup>67</sup> As part of this business review, KPMG reviewed the financial statements of Alloyd,

---

61. *Id.*

62. *First Union Discount Brokerage Serv., Inc. v. Milos*, 997 F.2d 835, 843-44 (11th Cir. 1993); *Metromedia Co. v. Fugazy*, 983 F.2d 350 (2d Cir. 1992), *cert denied*, 113 S. Ct. 2445 (1993). In *First Union*, investors counterclaimed in an action against a discount broker for material false misrepresentations, in connection with transactions that occurred in the week prior to the October 1987 stock market crash. *First Union*, 997 F.2d at 837-41. After summarizing the *Ballay* reasoning and opinion, the *First Union* court stated that: “we are persuaded by the Third Circuit’s reasoning and hold that section 12(2) of the 1933 Act does not apply to aftermarket transactions.” *Id.* at 843-44 (footnote omitted).

The *Metromedia* court did not cite specifically to *Ballay*. However, the *Metromedia* court followed *Ballay* to the extent that *Ballay* held that oral communications relating to a prospectus or initial distribution could be actionable under § 12(2). *Metromedia*, 983 F.2d at 361. The *Metromedia* court noted that “[i]n order to prevail on a claim under § 12(2) for a sale based on an oral communication, a purchaser of securities must show that the communication was ‘intended or perceived as instrumental in effecting the sale.’” *Id.* (quoting *Jackson v. Oppenheim*, 533 F.2d 826, 830 n.8 (2d Cir. 1976)). The facts of *Metromedia* include misrepresentations and omissions of material facts in connection with the issuance of stock. *Id.* at 356. Therefore, the posture of this case is different from those cases analyzing § 12(2) in light of the secondary market transaction.

63. 114 S. Ct. 907 (1994).

64. 114 S. Ct. 1146 (1994).

65. 114 S. Ct. 1215 (1994).

66. Importantly, the Respondent’s Brief noted that no evidence existed showing any previous sale or distribution of Alloyd’s stock to any person before the stock sale to Wind Point. Brief for Respondent at \*2, *Gustafson*, 115 S. Ct. 1061 (1995) (No. 93-404), 1994 WL 328995 [hereinafter Respondent’s Brief]. However, because of the Sellers’ status as controlling shareholders, the courts characterized the transaction as a secondary market transaction. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1065 (1995). See *supra* note 14 and accompanying text.

67. *Gustafson*, 115 S. Ct. at 1064-65.

noting that the inventory listing reflected only an estimate because Alloyd normally took inventory at the end of the year.<sup>68</sup> In determining the purchase price, the Sellers relied on these estimates and included a provision in the contract which allowed for adjustments to the price after the sale if the actual value of the inventory differed from the estimates.<sup>69</sup>

The Buyers purchased all of Alloyd's outstanding stock through a private stock purchase agreement ("Agreement").<sup>70</sup> The Agreement contained several warranties and representations.<sup>71</sup> The Agreement also provided that if the year-end audit revealed a discrepancy between estimated and actual increase in net worth, remuneration for that variance would be made.<sup>72</sup> Shortly thereafter, the year-end audit revealed a discrepancy between the estimated and actual earnings.<sup>73</sup> The Sellers overestimated the 1989 earnings by \$815,000.00, which they refunded to the Buyers, with interest, pursuant to the adjustment clause in the Agreement.<sup>74</sup>

Despite receiving full compensation for paying more than the actual value of the securities, the Buyers filed suit. They contended that the Sellers made misrepresentations regarding inventory and interim actual earnings, in violation of section 12(2) of the 1933 Act.<sup>75</sup> The lawsuit

---

68. *Id.* at 1065.

69. *Id.*

70. *Id.*

71. *Id.* The representations and warranties were included in Article IV of the stock purchase agreement "[a]s an inducement to Buyer to enter into this Agreement." Respondent's Brief, *supra* note 66, at \*4 (citing Joint Appendix, at \*111). Sellers represented to the Buyer that:

(1) the financial statements provided to Holdings, including the Latest Balance Sheet, "present fairly on a consolidated basis the Company's financial condition and related results of operations as of the times and for the periods referred to therein." (J. A. 115 at P 4D);

(2) between the date of the Latest Balance Sheet and the date of the Stock Purchase Agreement, there were no material adverse changes in "the business, financial condition, operating results, assets, operations or business prospects" of Alloyd (J.A. 117 at P 41); and

(3) Sellers had not failed to disclose any material facts that would adversely affect Alloyd's "business, financial condition, operating results, assets, operations or business prospects" (J.A. 140 at P 47).

*Id.* at \*4-\*5.

72. *Gustafson*, 115 S. Ct. at 1065. Specifically, "[t]he contract also provided that if the year-end audit and financial statements revealed a variance between estimated and actual increased value, the disappointed party would receive an adjustment." *Id.* For a discussion of the potential effect of this provision, see *infra* part IV.C.

73. *Gustafson*, 115 S. Ct. at 1065.

74. *Id.*

75. *Id.*

sought rescission of the Agreement pursuant to section 12(2).<sup>76</sup>

### B. Opinions Below

The District Court, relying on *Ballay*, granted Sellers' motion for summary judgment.<sup>77</sup> The court held that section 12(2) claims may arise only out of initial stock offerings, and not privately negotiated transactions.<sup>78</sup> The court explained that unlike transactions occurring during initial offerings, the Buyers had access to financial information regarding Alloyd.<sup>79</sup> On appeal, the Seventh Circuit vacated the judgment and remanded the case for additional consideration in view of its own intervening decision in *Pacific Dunlop*.<sup>80</sup>

After dismissing certiorari in *Pacific Dunlop*,<sup>81</sup> the Supreme Court swiftly granted certiorari in *Gustafson*<sup>82</sup> in order to resolve the split among the circuits regarding the proper application of section 12(2).<sup>83</sup>

---

76. *Id.* The Buyers asserted two claims in their complaint. First, Buyers alleged a violation of § 12(2) of the 1933 Act. Respondent's Brief, *supra* note 66, at \*5-6. Second, Buyers alleged a breach of the representations and warranties contained in the Agreement. *Id.*

77. *Gustafson*, 115 S. Ct. at 1065. The *Ballay* court held that § 12(2) only applied to initial offerings. See *supra* part II for a discussion of *Ballay*.

78. The dismissal of the plaintiff's § 12(2) claim took place in an unreported disposition by Judge Williams of the Northern District of Illinois, Eastern Division, in 1992. *Gustafson*, No. 91C889, Memorandum Opinion and Order (N.D. Ill. May 29, 1992). Judge Williams noted that "[w]hile plaintiffs suggest that . . . [the language of § 12(2)] supports their argument that Section 12(2) is applicable, they have provided . . . no evidence to support their claim that the sale at issue possesses the characteristics of a new offering." *Id.* at 12.

79. *Id.* Judge Williams remarked that "the transaction at issue in this case occurred approximately 30 years after the initial issuance of Alloyd's stock. Also, unlike purchasers in most initial offerings, the purchasers in this case had direct access to financial and other company documents, and had the opportunity to inspect the seller's property." *Id.* (citation omitted).

80. *Gustafson*, 115 S. Ct. at 1065. See *supra* notes 52-61 and accompanying text for a discussion of *Pacific Dunlop*.

81. 114 S. Ct. 1146 (1994). See *supra* notes 63-64 and accompanying text for a discussion of this dismissal.

82. 114 S. Ct. 1215 (1994). For an analysis of this swift grant of certiorari, see Therese H. Maynard, *Gustafson v. Alloyd Co.: The Supreme Court to Decide a Section 12(2) Case*, INSIGHTS, Aug. 1994, at 33. Opining on the focus the Court would adopt in deciding the case, Maynard notes:

By promptly granting review to *Gustafson*, the Court is seizing a second chance to review the Seventh Circuit's broader analysis of the scope of Section 12(2) relief as reflected in its *Pacific Dunlop* ruling. Moreover, by plucking the unreported case of *Gustafson* from relative obscurity and agreeing to review it[,] . . . the Court seems anxious to reach the broader question of the availability of Section 12(2).

*Id.*

83. For a discussion of the circuit split, see *supra* notes 31-62 and accompanying

The Court clearly demonstrated its concern with this issue when, after the parties and several amici curiae submitted briefs,<sup>84</sup> the Court ordered the parties to file supplemental briefs on the issue of “whether § 12(2) of the 1933 Securities Act applies to secondary transactions as well as to initial offerings of securities.”<sup>85</sup> The Supreme Court, in a five to four decision, held that section 12(2) does not apply to secondary transactions.<sup>86</sup> The Court’s decision sent shocks to the field of securities law.<sup>87</sup>

### C. Justice Kennedy’s Majority Opinion

Prior to beginning its analysis of the case, the Court stated that it would assume “that the stock purchase agreement contained material misstatements of fact made by the Sellers and that Gustafson would not sustain its burden of proving due care.”<sup>88</sup> The Buyers would therefore be entitled to rescission under section 12(2) if the Agreement fell within the scope of the statute.<sup>89</sup> The Supreme Court articulated the specific issue presented as: “whether the contract between Alloyd and Gustafson is a ‘prospectus’ as the term is used in the 1933 Act.”<sup>90</sup>

---

text.

84. Brief of Amicus Curiae Securities Industry Association, Inc. (“SIA”) in Support of Petitioners [Sellers], *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995) (No. 93-404) (LEXIS, Genfed library, SCT PLUS file) [hereinafter SIA’s Amicus Curiae Brief]; Brief of Amicus Curiae National Associations of Securities and Commercial Law Attorneys in Support of Respondents [Buyers], *Gustafson* (No. 93-404) (LEXIS, Genfed library, SCT PLUS file); Brief of Amicus Curiae Securities and Exchange Commission in Support of Respondents [Buyers], *Gustafson* (No. 93-404) (LEXIS, Genfed library, SCT PLUS file); Brief of Amicus Curiae North American Securities Administrators Association, Inc. in Support of Respondents [Buyers], *Gustafson* (No. 93-404) (LEXIS, Genfed library, SCT PLUS file).

85. *Gustafson*, 115 S. Ct. 32 (1994). The Court gave no explanation for this request. *Id.* Also, Justices Stevens and Ginsburg dissented from the entry of the order. *Id.*

86. *Id.* at 1074.

87. See *Supreme Court’s Definition of “Prospectus” Favours Rule 144A Market*, FIN. REG. REP., Mar., 1995; *Supreme Court Settles Securities Law*, VENTURE CAPITAL J., Apr., 1995; Rob Wells, *Supreme Court Decisions Make Major Strides in Litigation Reform*, J. REC. (Oklahoma City) (Mar. 4, 1995); *Supreme Court Limits Liability in Private Securities Sales*, LIABILITY WK., Mar. 6, 1995. See *infra* part V for a discussion of the impact of *Gustafson*.

88. *Gustafson*, 115 S. Ct. at 1066.

89. *Id.* With this assumption, the Court effectively narrowed the issue. See generally Maynard, *supra* note 82, at 33 (concluding that the Supreme Court should use the *Gustafson* appeal to confront the question of the scope of § 12(2), and to resolve future controversies under this section by defining the elements needed for a plaintiff-purchaser to prevail on a § 12(2) claim).

90. *Gustafson*, 115 S. Ct. at 1066. See *supra* notes 71- 72 and accompanying text for the language of the contract.

The Buyers argued that the broad definition of “prospectus” encompassed the contract between the parties, entitling them to seek rescission under section 12(2) for material misrepresentations contained in the Agreement.<sup>91</sup> In contrast, Sellers argued that the 1933 Act limited the term “prospectus” to mean only “a communication soliciting the public to purchase securities from the seller.”<sup>92</sup>

The Court found three sections of the 1933 Act to be relevant to the resolution of the issue at hand: (1) section 2(10), which defines the term “prospectus”; (2) section 10, which outlines the information which must be in a prospectus, and (3) section 12, which creates a cause of action for misrepresentations contained in a prospectus.<sup>93</sup>

The Court began its analysis with section 10 of the 1933 Act, which requires that a prospectus contain the same information that must also be included in a registration statement.<sup>94</sup> The Court explained that although section 10 does not define prospectus, it is still instructive, because it illustrates when a document cannot be considered a

---

91. *Gustafson*, 115 S. Ct. at 1066. The Buyers based their arguments on the expansive scope and nature of the entire 1933 Act. See Respondent’s Brief, *supra* note 66, at \*9. They relied on a straightforward reading of § 12(2), arguing that the remedial purpose of the Act required the application of § 12(2) to a private sale of stock. *Id.* at \*10. The Buyers asserted that “[t]he Act . . . does not draw distinctions between ‘public’ and ‘private’ purchasers when providing remedies for false or misleading statements of material fact.” *Id.* Furthermore, the Buyers explained that the SEC construed § 12(2) to apply to private sales transactions. *Id.* Therefore, “[g]iven this consistent construction by the courts of appeals and the agency responsible for administering the Act, the narrow construction of section 12(2) urged by Sellers would upset the justified expectations of the legal and investment communities.” *Id.* The Court noted that the dissents of Justices Thomas and Ginsburg supported these arguments. *Gustafson*, 115 S. Ct. at 1066. For a discussion of the dissents, see *infra* part III.D.

92. *Gustafson*, 115 S. Ct. at 1066. The Sellers relied on specific provisions of the 1933 Act and the complex interplay between the provisions of both the 1933 and 1934 Acts as the bases for their arguments. See Brief for Petitioner at \*8, *Gustafson*, 115 S. Ct. 1061 (1995), 1994 WL 178124 [hereinafter Petitioner’s Brief]. The Sellers also argued that legislative history supported a narrow construction of § 12(2). *Id.* at \*10-\*11. The Sellers maintained that because the Buyers were sophisticated and had sufficient bargaining power, the rescissionary relief available under § 12(2) would be improper. *Id.* at \*8-\*9.

93. *Gustafson*, 115 S. Ct. at 1066.

94. *Id.*; see *supra* note 42. While the meaning of a prospectus under § 10 was not disputed by the courts, the courts disagreed about the implications of § 10 relating to the scope of § 12(2). *Gustafson*, 115 S. Ct. at 1067. The relationship between “prospectus” as used in § 10 and in § 12(2) was contemplated by both *Ballay* and *Pacific Dunlop*. See *Ballay*, 925 F.2d at 688-89 (submitting that “prospectus” has a consistent meaning in both sections), and *Pacific Dunlop*, 993 F.2d at 588 (rejecting the notion of a uniform definition of “prospectus” throughout the Act). In fact, in *Pacific Dunlop*, the court noted that § 10 contemplates a “prospectus” as “an isolated, distinct document—a prospectus within a prospectus.” *Pacific Dunlop*, 993 F.2d. at 584.



prospectus.<sup>95</sup> The Court further noted that section 12(2) must be considered in light of section 10 in order to promote a uniform interpretation of "prospectus" throughout the Act.<sup>96</sup>

Based upon this reasoning, the Court in *Gustafson* found that the agreement at issue could not be considered a prospectus under section 10, because the law does not require such contracts to contain all information found in a registration statement.<sup>97</sup> The Court stressed that "whatever else 'prospectus' may mean, the term is confined to a document that, absent an overriding exemption, must include the 'information contained in the registration statement.'"<sup>98</sup> The Court noted that, generally, the preparation and filing of a registration statement is required only for a public offering of a security.<sup>99</sup> The Court then observed that "a prospectus under § 10 is confined to documents relating to public offerings by an issuer or its controlling shareholder."<sup>100</sup> Based on this interpretation, the Court concluded that, if

---

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

96. *Id.* The Court stated: "[a]lthough § 10 does not define what a prospectus is, it does instruct us what a prospectus cannot be if the Act is to be interpreted as a symmetrical and coherent regulatory scheme, one in which the operative words have a consistent meaning throughout." *Id.* See *supra* note 42 for excerpted text of § 10.

To support its conclusion that the term "prospectus" has the same meaning throughout the 1933 Act, the Court examined the structure of the 1933 Act. *Gustafson*, 115 S. Ct. at 1067. In doing so, the Court considered other sections of the Act. *Id.* For instance, § 4 of the 1933 Act provides an exemption for transactions by "any person other than an issuer, underwriter or dealer" and those "transactions by an issuer not involving any public offering" from the registration requirements of § 5. 15 U.S.C. § 77d(1) and (2) (1994). Section 5 prohibits the sale of unregistered securities. 15 U.S.C. § 77e (1994); see *infra* note 98. Section 10 sets forth information required in prospectuses. 15 U.S.C. § 77j (1994). Next, the Court declared that "[s]ection 11 provides for liability on account of false registration statements; § 12(2) for liability based on misstatement in prospectuses." *Gustafson*, 115 S. Ct. at 1067 (citations omitted). The Court reasoned that liability under § 12(2) could not therefore attach unless the seller was required to distribute the prospectus. *Id.*

97. *Gustafson*, 115 S. Ct. at 1067. The court noted that § 10 did not require that the Agreement contain information that would have been contained in a registration statement. *Id.*

98. *Id.* (quoting 15 U.S.C. § 77j (1994)). Sections 5 and 6 of the Act require the filing of a registration statement with the Securities Exchange Commission in certain circumstances. 15 U.S.C. §§ 77e, 77f (1994). Section 2(8) defines a registration statement as "the statement provided for in section 6, and includes any amendment thereto and any report, document, or memorandum filed as part of such statement or incorporated therein by reference." 15 U.S.C. § 77b(8) (1994). Section 7 sets forth the information required in a registration statement. 15 U.S.C. § 77j (1994).

99. *Gustafson*, 115 S. Ct. at 1067. See SOLOMON & PALMITER, *supra* note 4. See also 15 U.S.C. §§ 77d, 77e, and 77b(11) (1994) (requiring registration of public offerings by an issuer or controlling shareholder).

100. *Gustafson*, 115 S. Ct. at 1067. This conclusion provided the foundation for the Court's later analysis of the scope of "prospectus" under § 12(2). See *infra* notes 101-05

the contract was not a prospectus under section 10, it could not be one under section 12(2) either.<sup>101</sup>

The Court then turned to section 12(2).<sup>102</sup> The Court focused on a portion of section 12(2) that exempts from coverage any prospectuses for the sale of government-issued securities.<sup>103</sup> The Court reasoned that if Congress had intended to create liability in section 12(2) for any misrepresentations made in any written communication, then Congress would not have provided an exemption for government-issued securities.<sup>104</sup> The Court concluded that any existing conflicting interpretation of “prospectus” disappears if the term is limited to only those documents which an issuer uses to offer a security to the public.<sup>105</sup>

After reaching this conclusion, the Court briefly examined the original purposes of the 1933 Act.<sup>106</sup> Congress primarily intended to create federal duties or requirements, including registration and disclosure obligations, for public offerings.<sup>107</sup> The Court determined that the provisions of the 1933 Act provided remedies only for violations of these requirements,<sup>108</sup> rather than creating broad additional liabilities

---

and accompanying text.

101. *Gustafson*, 115 S. Ct. at 1067.

102. *Id.* The Court stated: “[o]ur interpretation [of the scope of § 12(2)] is further confirmed by a reexamination of § 12 itself. The section contains an important guide to the correct resolution of the case.” *Id.* For an analysis of the Court’s reasoning here, see *infra* notes 103-05 and accompanying text.

103. *Gustafson*, 115 S. Ct. at 1067. See 15 U.S.C. § 77a(2) (1994) (exempting from § 12(2) government issued securities).

104. *Gustafson*, 115 S. Ct. at 1068. See *infra* part IV.A for a discussion of the Court’s emphasis on “any written communication” in this part of its analysis. The Court questioned: “[w]hy would Congress grant immunity to a private seller from liability in a rescission suit for no reason other than that the seller’s misstatements happen to relate to securities issued by a governmental entity?” *Gustafson*, 115 S. Ct. at 1068.

105. *Gustafson*, 115 S. Ct. at 1068. The Court further reasoned that “[t]he exemption for government-issued securities makes perfect sense on that view, for it then becomes a precise and appropriate means of giving immunity to governmental authorities.” *Id.*

106. *Id.* For a discussion of the legislative history and purposes of the 1933 Act, see *supra* part II.

107. *Gustafson*, 115 S. Ct. at 1068. In examining the federal duties imposed by the Act, the Court looked to the purposes of the 1933 Act, namely registration of securities and disclosure requirements for public offerings, as interpreted in prior cases. *Id.* The Court relied on *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975); and *SEC v. Ralston Purina Co.*, 346 U.S. 119, 122 n.5 (1953), each of which noted the 1933 Act as affecting public or initial offerings of securities.

108. *Gustafson*, 115 S. Ct. at 1068. Specifically, the Court maintained: “[i]t is more reasonable to interpret the liability provisions of the 1933 Act as designed for the primary purpose of providing remedies for violations of the obligations it had created.” *Id.*

independent of those requirements.<sup>109</sup> In maintaining this position, the Court used its interpretation of the term "prospectus" to connect section 12(2) to the duties created in the 1933 Act.<sup>110</sup>

In so doing, the *Gustafson* Court explicitly rejected the Buyers' argument that "a written offer is a prospectus under § 12."<sup>111</sup> The Court noted that under the Buyers' argument, the term "prospectus" would encompass a "broader set of communications in section 12 than in section 10."<sup>112</sup> The Court expressed its disagreement with the conclusion that Congress would define the term "prospectus" differently in section 10 and section 12 of the 1933 Act.<sup>113</sup>

The Court next examined section 2(10), which provides the definition of "prospectus."<sup>114</sup> The Buyers argued that, based on the word "communication" contained in section 2(10), "any written communication that offers a security for sale is a 'prospectus'."<sup>115</sup> The Court, however, dismissed this argument as flawed.<sup>116</sup>

109. *Id.* The Court recognized that liability under § 12(2) could only attach for wrongdoing in violation of the expressed purposes of the Act. *Id.* See *supra* notes 94-101 and accompanying text. Thus, effectively, the Court limited the scope of § 12(2) to those acts which affected registration of a security and/or the public disclosure of information about the offering.

110. *Gustafson*, 115 S. Ct. at 1068. See *supra* notes 94-101 and accompanying text. The Court never fully explained the link created between § 12(2) liability and the obligations of registration and disclosure, other than to state, as an introduction to this analysis, that liability under § 12(2) "cannot attach unless there is an obligation to distribute the prospectus in the first place (or unless there is an exemption)." *Gustafson*, 115 S. Ct. at 1067. The Court, however, supported this conclusion by illustrating the links of §§ 11 and 12(2) with obligations imposed by the 1933 Act. *Id.* The Court noted that § 11 afforded a "remedy for untrue statements in registration statements" and that § 12(1) provided a "remedy for sales in violation of § 5, which prohibits the sale of unregistered securities." *Id.* at 1068.

111. *Gustafson*, 115 S. Ct. at 1068. The Court also noted that this position was embraced by both dissents. *Id.* For a discussion of the *Pacific Dunlop* court's reasoning, see *supra* notes 58-61 and accompanying text.

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

113. *Id.* at 1069. The Court reasoned that:

Had Congress meant the term 'prospectus' in § 12(2) to have a different meaning than the same term in § 10, that is when one would have expected Congress to have been explicit. Congressional silence cuts against, not in favor of, Alloyd's argument. The burden should be on the proponents of the view that the term 'prospectus' means one thing in § 12 and another in § 10 to adduce strong textual support for that conclusion. And Alloyd adduces none.

*Id.* See *infra* part IV.A for an analysis of this conclusion.

114. *Gustafson*, 115 S. Ct. at 1069. See *supra* text accompanying note 9 (discussing excerpts of § 2(10)). The Court noted that Alloyd relied heavily on this section to argue that any offer to sell a security by means of a written communication was the equivalent of a prospectus. *Gustafson*, 115 S. Ct. at 1069.

115. *Id.*

116. *Id.* This flaw emanated from the Buyers' dependence on the word

Instead, relying on rules of statutory interpretation, the Court reasoned that “the definitional part of the statute must be read in its entirety, a reading which yields the interpretation that the term prospectus refers to a document soliciting the public to acquire securities.”<sup>117</sup> Using that definition, the Court found that the Buyers’ argument was defeated by two rules of statutory construction. Under the first rule, any interpretation which would render some words redundant should be avoided.<sup>118</sup> The Court addressed this rule by noting that, if the word “communication” as used in section 2(10) encompassed every written communication, this construction would render “notice, circular, advertisement, [and] letter” redundant because each of those terms can also be forms of written communication.<sup>119</sup>

The *Gustafson* Court resolved this constructional problem by applying a second rule of statutory construction, the doctrine of *noscitur a sociis*,<sup>120</sup> which requires that no single word in a list of words be given such a broad meaning that would be inconsistent with its accompanying words.<sup>121</sup> In so doing, the Court offered a “better” interpretation of section 2(10); a communication can be a prospectus under section 2(10) if it is “of wide dissemination” and is a “public communication.”<sup>122</sup> The Court noted that the numerous terms used in section

---

“communication” in § 2(10) for its argument that “prospectus” should be broadly interpreted. *Id.* The Court stated:

[t]o be sure, § 2(10) defines a prospectus as, *inter alia*, a “communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.” The word “communication,” however, on which Alloyd’s entire argument rests, is but one word in a list, a word Alloyd reads altogether out of context.

*Id.* (citation omitted).

117. *Id.* The Court labeled this definition, incorporating a public sale requirement into the meaning of “prospectus,” as controlling the interpretation of § 2(10). *Id.*

118. *Id.* at 1068-70. *See supra* note 116.

119. *Gustafson*, 115 S. Ct. at 1069.

120. *Id.* *See infra* notes 121-23 and accompanying text for an explanation of this doctrine.

121. *Gustafson*, 115 S. Ct. at 1069 (citing *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307 (1961)). This doctrine loosely means: “It is known from its associates.” BLACK’S LAW DICTIONARY 956 (5th ed. 1979). The Supreme Court has relied on this doctrine in other instances. *See, e.g.*, *Dole v. United Steelworkers*, 494 U.S. 26, 36 (1990) (analyzing “reporting and recordkeeping requirements”); *Reves v. Ernst & Young*, 494 U.S. 56, 63 (1990) (interpreting the phrase “any note” in the 1934 Securities Act); *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 8 (1985) (interpreting the term “manipulative”). Specifically, in *Reves*, the Supreme Court held that “any note” could not hold its literal meaning, but rather, needed to be interpreted in light of Congress’ intent in enacting the federal securities acts. *Reves*, 494 U.S. at 63.

122. *Gustafson*, 115 S. Ct. at 1070. The Court also relied on the accepted and understood definition of “prospectus” at the time the 1933 Act was drafted and enacted. *Id.* Specifically, the Court relied on the 1910 Black’s Law Dictionary, which defined

2(10) prevent a seller of stock from using a term other than "prospectus" in order to avoid liability, but concluded that "the term 'written communication' must be read in context to refer to writings that, from a functional standpoint, are similar to the terms 'notice, circular, [and] advertisement'."<sup>123</sup> The Court thus labeled "prospectus" as a term of art which, in order to fall within the purview of section 12(2), must be a communication to the public.<sup>124</sup>

The Court found further support for its holding by making an analogy to section 17(a) of the 1933 Act,<sup>125</sup> and to the Court's interpretation of that section in *United States v. Naftalin*.<sup>126</sup> The Court relied on its earlier decision in *Naftalin*, where it held that section 17(a) "was intended to cover any fraudulent scheme in the offer or sale of securities, whether in the course of an initial distribution, or in the

prospectus as a "document published by a company . . . or by persons acting as its agents or assignees, setting forth the nature and objects of an issue of shares . . . and inviting the public to subscribe to the issue." *Id.* (quoting BLACK'S LAW DICTIONARY 959 (2d ed. 1910)).

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

124. *Id.* The court in *Ballay* also found "prospectus" to be a term of art. *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 689 (3d Cir.), *cert. denied*, 112 S. Ct. 79 (1991).

125. 15 U.S.C. § 77q(a) (1994). Section 17(a) of the 1933 Act provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly -

- (1) to employ any device, scheme, artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

*Id.*

126. 441 U.S. 768 (1979). In *Naftalin*, the Court held that § 17(a)(1) prohibits fraud against brokers as well as investors. *Id.* at 776. The *Naftalin* Court found support for its conclusion in the legislative history of the 1933 Act and its demonstrated breadth. *Id.* at 774-76. According to this legislative history:

The purpose of this bill is to protect the investing public and honest business . . . . The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933).

course of ordinary market trading.”<sup>127</sup> The Court reasoned that section 17(a) could be broadly applied, rather than limited only to public offerings, because section 17(a) did not contain the limiting words “by means of prospectus or oral communication.”<sup>128</sup> Furthermore, the expansive reading of section 17(a) by the *Naftalin* Court was supported by clear legislative history.<sup>129</sup> The Court contrasted this provision with section 12(2), which does contain limiting language, and which does not possess legislative history supporting a broader reading of its language to include anything other than public offerings.<sup>130</sup>

Considering these arguments, the *Gustafson* Court concluded that the term “prospectus” in section 12(2) does not apply to a private agreement for the sale of securities, and that the plaintiffs therefore could not seek to rescind the Agreement under section 12(2).<sup>131</sup> Based upon its holding, the Supreme Court reversed the Seventh Circuit’s opinion, remanding the case for further proceedings.<sup>132</sup>

---

127. *Gustafson*, 115 S. Ct. at 1070 (quoting *Naftalin*, 441 U.S. at 778).

128. *Id.* at 1071. The Court found the lack of the word “prospectus” in § 17 to be important, allowing the Court to distinguish its previous holding in *Naftalin*. *Id.* The Court stated: “[j]ust as the absence of limiting language [referring to the term ‘prospectus’] in § 17(a) resulted in broad coverage, the presence of limiting language in § 12(2) requires a narrow construction.” *Id.*

129. *Id.* The legislative history for § 17 provides, in part, that “fraud or deception in the sale of securities may be prosecuted regardless of whether or not it is of the class of securities exempted under sections 11 or 12.” S. REP. No. 47, 73d Cong., 1st Sess. 4 (1933). However, the legislative history for § 12(2) makes no such clear statement, nor does the legislative history “hint” at such an intent. *Gustafson*, 115 S. Ct. at 1071.

130. *Gustafson*, 115 S. Ct. at 1071. See *supra* note 126. For a further discussion of the legislative history of § 12(2), see *supra* note 29 and accompanying text, and see *infra* note 178 and accompanying text.

131. The Court stated:

In sum, the word “prospectus” is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder. The contract of sale, and its recitations, were not held out to the public and were not a prospectus as the term is used in the 1933 Act.

*Gustafson*, 115 S. Ct. at 1073-74.

132. *Id.* at 1074. On remand, the Seventh Circuit affirmed. *Alloyd Co. v. Gustafson*, No. 92-2514, 1995 WL 258083, at \*1 (7th Cir. Apr. 28, 1995). In this unpublished opinion, the Seventh Circuit noted that, based on the Supreme Court’s holding, no federal issue remained in the case. *Id.* Although plaintiffs requested the Seventh Circuit to remand their state claims, the Seventh Circuit held that the district court’s 1992 order was correct. *Id.* That order dismissed the federal claims with prejudice but allowed the plaintiffs to pursue their state claims. *Id.*

### D. *The Dissents*

#### 1. Justice Thomas's Dissent

In a dissenting opinion, Justice Thomas, joined by Justices Scalia, Ginsburg and Breyer, found fault with the Court's holding due in part to the analysis used by the majority.<sup>133</sup> First, Justice Thomas noted that the Court should have started its analysis with the language of the statute itself, as the Court had done previously.<sup>134</sup> Justice Thomas reproached the majority for unnecessarily "turning to sources outside the four corners of the statute [in order to interpret the word 'prospectus'] rather than adopting the definition provided by Congress."<sup>135</sup> Therefore, he argued, because Congress included a broad definition within the Act, there was no need for the majority to search for the meaning of "prospectus" outside of the statute.<sup>136</sup>

Justice Thomas asserted that the majority improperly analyzed the issue. First, the majority considered the definitional section of the statute only after it reviewed the other provisions of the statute.<sup>137</sup> Additionally, Justice Thomas suggested that the majority evaluated the section 2(10) definition of "prospectus" by reading in ambiguities that were not present in the language.<sup>138</sup> He noted the majority's use of the doctrine of *noscitur a sociis* to determine that the list of words contained in section 2(10) was limited by the use of the word "prospectus," which was first in the list.<sup>139</sup> Justice Thomas, however, disagreed with the majority's proposition that all the words contained in section 2(10), such as circulars, advertisements, letters, or other communications, must be "prospectus-like," in that they must relate to

133. *Id.* at 1074 (Thomas, J., dissenting). Justice Ginsburg also wrote a separate dissenting opinion supporting Justice Thomas's dissent. *Id.* at 1079 (Ginsburg, J. dissenting). See *infra* notes 175-80 and accompanying text.

134. See *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1446 (1994); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring)). In *Landreth*, the Court stated that "[t]he starting point in every case involving construction of a statute is the language itself." *Landreth*, 471 U.S. at 685 (citation omitted). See *infra* notes 137 and 174 and accompanying text.

135. *Gustafson*, 115 S. Ct. at 1074 (Thomas, J., dissenting).

136. *Id.* (Thomas, J., dissenting).

137. The majority began its analysis with § 10. See *supra* note 94 and accompanying text. Justice Thomas explained that a better approach would have been to begin with § 12(2) itself, and the definitional section, before consulting the structure of the Act. *Gustafson*, 115 S. Ct. at 1074 (Thomas, J., dissenting).

138. *Gustafson*, 115 S. Ct. at 1075 (Thomas, J., dissenting).

139. *Id.* at 1075 (Thomas, J., dissenting). See *supra* notes 117-24 and accompanying text for a discussion of the majority's reliance on, and application of, this maxim.

an initial public offering.<sup>140</sup> Justice Thomas argued that the majority's reliance on this doctrine, ostensibly in an effort to clarify the language, only served to create doubt, because there was no ambiguity in section 2(10).<sup>141</sup> He stated that "*noscitur a sociis*, however, does not require us to construe every term in a series narrowly because of the meaning given to just one of them."<sup>142</sup>

Justice Thomas instead believed that the expansive language of section 2(10) required a broad interpretation of "prospectus."<sup>143</sup> Specifically, Justice Thomas noted that "[s]ection 2(10)'s very exhaustiveness suggests that 'prospectus' is merely the first item in a long list of covered documents, rather than a brooding omnipresence whose meaning cabins that of all the following words."<sup>144</sup> He rejected the majority's argument that such a reading created redundancy.<sup>145</sup> In support of his position, Justice Thomas relied on the "catch-all" nature of the term "communication" as used in section 2(10), noting that Congress has employed such catch-all techniques in other provisions of both the 1933 and 1934 Acts.<sup>146</sup>

---

140. *Id.* at 1075 (Thomas, J., dissenting). See *infra* note 190 and accompanying text for an example of the potential impact of this reasoning.

141. *Id.* (Thomas, J., dissenting). Justice Thomas went on to quote from *Russell Motor Car Co. v. United States*, 261 U.S. 514, 520 (1923): "[n]oscitur a sociis is a well-established and useful rule of construction, where words are of obscure or doubtful meaning, and then, but only then, its aid may be sought to remove the obscurity or doubt by reference to the associated words." *Id.* (Thomas, J., dissenting). In Justice Thomas's opinion, the majority had no reason to rely on *noscitur a sociis*, since § 2(10) contains no ambiguity. *Id.* (Thomas, J., dissenting).

142. *Id.* (Thomas, J., dissenting). Justice Thomas criticized the majority for using a constructional canon where it was unnecessary, noting that the Court should construe a statutory term in accordance with its ordinary or natural meaning. *Id.* (Thomas, J., dissenting). That canon, he stated, should be applied only "[i]n the absence of [a statutory] definition." *Id.* (Thomas, J., dissenting) (quoting *FDIC v. Meyer*, 114 S. Ct. 996, 1001 (1994)).

143. *Id.* (Thomas, J., dissenting).

144. *Id.* (Thomas, J., dissenting).

145. *Id.* (Thomas, J., dissenting). See *supra* notes 118-19 and accompanying text.

146. *Id.* at 1075 (Thomas, J., dissenting). Justice Thomas cited Congress's use of catch-all terms in the following provisions: 15 U.S.C. § 77b(1) ("term 'security' means any note, stock, treasury stock, bond, debenture, . . . or, in general, any interest or instrument commonly known as a 'security'"); 15 U.S.C. § 77b(9) ("term 'write' or 'written' shall include printed, lithographed, or any means of graphic communication"); 15 U.S.C. § 78c(a)(6) ("term 'bank' means (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution"). *Id.* (Thomas, J., dissenting). Justice Thomas criticized the majority for its failure to "account for Congress' decision to begin its definition of the term 'prospectus' with the term prospectus," which inherently suggests a "partial circularity" that the majority sought desperately to avoid. *Id.* (Thomas, J., dissenting).



Having dismissed the majority's argument regarding ambiguity, Justice Thomas then rejected the majority's view that "prospectus" must carry the same meaning in section 12 as in section 10.<sup>147</sup> He acknowledged the majority's position that certain other sections of the 1933 Act use the term "prospectus" to indicate only those documents relating to an initial public offering.<sup>148</sup> Justice Thomas, however, disagreed with the majority's use of that argument as support for the belief that "prospectus" must be given the same meaning in sections 10 and 12 of the 1933 Act.<sup>149</sup> He noted that this position would unnecessarily require the narrow use of "prospectus" in section 10, detailing the information necessary in a prospectus, to control the scope of "prospectus" as used in section 12.<sup>150</sup>

Justice Thomas examined three provisions in the 1933 Act that demonstrate the different meanings of "prospectus" in sections 10 and 12.<sup>151</sup> First, he looked to the general definition of "prospectus" as supplied in the definitional section, section 2(10).<sup>152</sup> Justice Thomas found that while the majority correctly noted the "offer a security for sale" portion of the definition, it failed to consider the "confirms the sale of any security" portion, which is a part of the definition of "prospectus" in section 2(10), but not in section 10.<sup>153</sup> He concluded that the different definitions of "prospectus" in the two provisions of the 1933 Act supported the conclusion that Congress did not intend that the term have the same meaning throughout the Act.<sup>154</sup>

---

147. *Id.* (Thomas, J., dissenting). See *supra* notes 90-101 and accompanying text. Justice Thomas recognized the general presumption that the same meaning attaches to a term throughout a statute. *Gustafson*, at 1076 (Thomas, J., dissenting). He noted, however, that "this presumption is overcome when Congress indicates otherwise." *Id.* (Thomas, J., dissenting).

148. *Gustafson*, at 1076 (Thomas, J., dissenting). See *supra* note 96. The sections that Justice Thomas and the majority refer to are § 10 of the 1933 Act, 15 U.S.C. § 77j(a)(3) (1994) (setting forth the information required in a prospectus), § 5 of the 1933 Act, and 15 U.S.C. § 77e(b) (1994) (mandating that a prospectus be sent to buyers of securities).

149. *Gustafson*, 115 S. Ct. at 1076 (Thomas, J., dissenting).

150. *Id.* at 1075 (Thomas, J., dissenting).

151. *Id.* at 1076 (Thomas, J., dissenting). Justice Thomas explained: "[s]ince § 10 assumes a narrower definition of prospectus, the majority believes that its definition must control that of § 12." *Id.* at 1075 (Thomas, J., dissenting). The majority obtained this result by considering § 10 before the language of § 12. *Id.* at 1066. See *supra* notes 94-101 and accompanying text.

152. See *supra* text accompanying note 9 for the language of § 2(10).

153. *Gustafson*, 115 S. Ct. at 1076 (Thomas, J., dissenting).

154. *Id.* (Thomas, J., dissenting). Specifically, Justice Thomas noted that:

[i]t would be radical to say that every confirmation slip must contain all the information that § 10 requires; only the documents accompanying an initial public offering must contain that information. Despite the majority's

Justice Thomas found further support for his view that “prospectus” has different meanings in the definitional section itself. He noted the preface to section 2, which states that the following definitions are to apply “unless the context otherwise requires.”<sup>155</sup> Justice Thomas argued that since there is a complete absence of a context requiring otherwise in section 12(2), the default definition should be applied.<sup>156</sup> Furthermore, he noted that “[i]f anything, it is § 10’s ‘context’ that seems to require the use of a definition which is different from that of § 2(10).”<sup>157</sup>

Additionally, Justice Thomas argued that the “dual use” of the term “prospectus” in section 2(10) clearly indicates that “prospectus” is used in at least two different ways.<sup>158</sup> He disagreed with the majority’s interpretation of “prospectus” in section 2(10) because it essentially returns to a narrow common law interpretation of “prospectus.”<sup>159</sup>

Justice Thomas then noted that section 12(2) contains none of the limitations to *initial* public offerings, as suggested by the majority.<sup>160</sup>

---

protestations, it is absolutely clear that the 1933 Act uses “prospectus” in two different ways. As a result, any justification for the majority’s twisted reading of § 2(10) disappears.

*Id.* (Thomas J., dissenting).

155. 15 U.S.C. § 77b (1994). By starting the definitions with this preface, Congress indicated that the section of definitions provided “default” definitions. *Gustafson*, 115 S. Ct. at 1076 (Thomas, J., dissenting).

156. *Gustafson*, 115 S. Ct. at 1076 (Thomas, J., dissenting).

157. *Id.* (Thomas, J., dissenting).

158. *Id.* (Thomas, J., dissenting). Specifically, “the dual use of ‘prospectus’ in § 2(10), which both defines ‘prospectus’ broadly and uses it as a term of art, makes clear that the statute is using the word in at least two different senses.” *Id.* (Thomas, J., dissenting). Thus, Justice Thomas agrees with the majority that “prospectus” can be a term of art. *Id.* (Thomas, J., dissenting). He parts with the majority, however, noting here that “prospectus,” with its provided definition, need not always be interpreted as a term of art. *Id.* (Thomas, J., dissenting).

159. *Id.* (Thomas, J., dissenting).

160. *Id.* (Thomas, J., dissenting). Specifically, “[o]n its face, § 12(2) makes none of the usual distinctions between initial public offerings and aftermarket trading, or between public trading and privately negotiated sales.” *Id.* (Thomas, J., dissenting). Moreover, while other provisions of the Act expressly mention initial public offerings, § 12(2) does not. *Id.* (Thomas, J., dissenting). Justice Thomas pointed to § 4 of the 1933 Act, which expressly creates an exemption for “transactions by an issuer not involving any public offering.” 15 U.S.C. § 77d(2) (1994). Also, § 12(2) does not limit its scope only to issuers, as does § 11 of the 1933 Act. *Gustafson*, 115 S. Ct. at 1076 (Thomas, J., dissenting). Section 11 provides civil liability for misrepresentations in registration statements. 15 U.S.C. § 77k (1994). This liability is directed toward “every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement . . . .” 15 U.S.C. § 77k(a)(2) (1994).

Rather than imposing limitations in section 12(2), Congress left the language of section 12(2) broad.<sup>161</sup> Justice Thomas stated that had Congress intended section 12(2) to be limited to public offerings, Congress would have employed words like “‘issuer,’ ‘public offering,’ or ‘private,’ or ‘resale,’ or at least discussed trading on the exchanges or the liability of dealers, underwriters, and issuers.”<sup>162</sup> The silence of section 12(2) with respect to these issues, he maintained, is noteworthy.<sup>163</sup>

Justice Thomas next suggested that the majority misread *Naftalin* by limiting that holding to its facts instead of applying it to the present case.<sup>164</sup> He added that two of the arguments the Court rejected in *Naftalin* were relevant to *Gustafson*. First, in *Naftalin*, the Court rejected the argument that the sheer structure of the 1933 Act required limiting the scope of section 17 to initial public offerings.<sup>165</sup> Second, Justice Thomas recalled that the Court in *Naftalin* declined to accept the

---

161. *Gustafson*, 115 S. Ct. at 1076 (Thomas, J., dissenting).

162. *Id.* at 1076-77 (Thomas, J., dissenting). None of these words, which would signal a limitation of § 12(2), appear in the provision.

163. *Id.* at 1077 (Thomas, J., dissenting). Justice Thomas supported his dissent in *Gustafson* by reference to *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994). *Id.* (Thomas, J., dissenting). In *Central Bank of Denver*, the Court held that § 10(b) of the 1934 Act did not impose liability on aiders and abettors. *Central Bank of Denver*, 114 S. Ct. at 1455. In reaching this holding, the Court found that “[i]f . . . Congress had intended to impose aiding and abetting liability, we presume it would have used the words ‘aid’ and ‘abet’ in the statutory text. But it did not.” *Id.* at 1448.

Relying on this rule of construction, Justice Thomas similarly reasoned that the lack of terms relating to public offerings or issuers in § 12(2) necessarily supports the application of liability to private and secondary market transactions. *Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting). Justice Thomas also found persuasive support for his position by comparing § 12(2) to § 4 of the 1933 Act. *Id.* (Thomas, J., dissenting). See *supra* note 96 for an explanation of § 4. Justice Thomas explained that had Congress intended to further limit § 12(2) to only initial public offerings, as the majority posited, Congress could have clearly provided for this by a reference to the § 4 exemptions. *Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting). Additionally, Justice Thomas noted that § 12(2) explicitly exempted government securities from the antifraud remedies, illustrating that “Congress knew how to exempt certain securities and transactions when it wanted to.” *Id.* (Thomas, J., dissenting).

164. *Gustafson*, 115 S. Ct. at 1078 (Thomas, J., dissenting). In *Naftalin*, the Court held that § 17 of the 1933 Act extended beyond the initial distributions to secondary market transactions. *United States v. Naftalin*, 441 U.S. 768, 778 (1979). For a discussion of the majority’s reliance on *Naftalin*, see *supra* notes 126-30 and accompanying text.

165. *Naftalin*, 441 U.S. at 778. Justice Thomas explained that in analyzing the statutory structure in *Naftalin*, the Court stressed that the language of § 17 “makes no distinctions between the two kinds of transactions [initial distributions and ordinary market trading].” *Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting) (quoting *Naftalin*, 441 U.S. at 778).

argument that merely because the 1934 Act applies specifically to fraud in secondary market transactions, the 1933 Act could only apply to new offerings.<sup>166</sup> Therefore, Justice Thomas argued, had “the majority wished to remain faithful to *Naftalin*,” it would have applied a similar analysis in *Gustafson*, and would have found that section 12(2) applies to both secondary and private transactions.<sup>167</sup>

Lastly, Justice Thomas examined the public policy motives behind the majority decision, stating that “[t]he majority’s analysis of § 12(2) [was] motivated by its policy preferences.”<sup>168</sup> He added that the majority acted upon an assumption “that Congress could never have intended to impose liability on sellers engaged in secondary transactions.”<sup>169</sup> Justice Thomas argued that the Court should have applied the policies articulated by Congress rather than question Congress’ intent.<sup>170</sup> He concluded that the majority’s pervasive reliance on public policy overshadowed and disrupted the norms of statutory inter-

---

166. *Gustafson*, 115 S. Ct. at 1078 (Thomas, J., dissenting). In fact, in *Naftalin*, the Court stated “[t]he fact that there may well be some overlap is neither unusual nor unfortunate.” *Naftalin*, 441 U.S. at 778 (quoting *SEC v. National Sec., Inc.*, 393 U.S. 453, 468 (1969)). See *infra* notes 206-11 and accompanying text for a discussion of the overlap between the 1933 Act and the 1934 Act.

167. *Gustafson*, 115 S. Ct. at 1078 (Thomas, J., dissenting). In reaching this assumption, Justice Thomas pointed out that nowhere else in the Securities Acts does a cause of action for private or secondary sales of securities exist: “[o]nly § 12(2) explicitly provided a broad remedy for private or aftermarket sales.” *Id.* (Thomas, J., dissenting). Justice Thomas concluded that “[i]f anything, *Naftalin* implements the opposite rule [of the majority reading]: that a provision of the 1933 Act extends to both initial public offerings and secondary trading unless the text makes a ‘distinction] between the two kinds of transactions.’” *Id.* (Thomas, J., dissenting) (citing *Naftalin*, 441 U.S. at 778).

168. *Id.* (Thomas, J., dissenting). Justice Thomas noted that “[u]nfortunately, the majority’s decision to pursue its policy preferences comes at the price of disrupting the process of statutory interpretation.” *Id.* at 1079 (Thomas, J., dissenting). See *infra* part IV.A.

169. *Gustafson*, 115 S. Ct. at 1078 (Thomas, J., dissenting). Justice Thomas noted that while the majority was “reluctant to conclude that § 12(2) creates vast additional liabilities that are entirely independent of the new substantive obligations that the Act enumerates,” Congress did just that in § 17(a) of the 1933 Act, as well as in § 10(b) of the 1934 Act. *Id.* (Thomas, J., dissenting).

170. *Id.* at 1078-79 (Thomas, J., dissenting). Justice Thomas suggested that:

[t]he majority is concerned that a contrary reading would have a drastic impact on the thousands of private and secondary transactions by imposing new liabilities and new transaction costs. But the majority forgets that we are only enforcing *Congress’* decision to impose such standards of conduct and remedies upon sellers. If the majority believes that § 12(2)’s requirements are too burdensome for the securities markets, it must rely upon other branches of government to limit the 1933 Act.

*Id.* at 1079 (Thomas, J., dissenting).

pretation,<sup>171</sup> arguing that “[t]he majority does not permit Congress to implement its intent unless it does so exactly as the Court wants it to.”<sup>172</sup> In further analyzing the underlying public policy concerns, Justice Thomas accepted and shared the majority’s concern that an application of section 12(2) to private and secondary market transactions might potentially increase the amount of litigation.<sup>173</sup> He maintained, however, that such a concern was clearly the province of Congress, not the Court.<sup>174</sup>

## 2. Justice Ginsburg’s Dissent

In Justice Ginsburg’s separate dissent, joined by Justice Breyer, she strongly supported Justice Thomas’s analysis. Justice Ginsburg focused on the language of section 2(10), finding that the definition provided did not “confine the § 12(2) term ‘prospectus’ to public offerings.”<sup>175</sup> She described the majority decision as a “backward reading,” with the analysis beginning in the wrong place.<sup>176</sup> Further-

171. *Id.* (Thomas, J., dissenting). Specifically, Justice Thomas summarized the flaws in the majority opinion:

The majority’s method turns on its head the common-sense approach to interpreting legal documents. The majority begins by importing a definition of “prospectus” from beyond the four corners of the 1933 Act that fits the precise use of the term in § 10. Initially ignoring the definition of “prospectus” provided at the beginning of the statute by Congress, the majority finally discusses § 2(10) to show that it does not utterly preclude its preferred meaning. Only then does the majority decide to parse the language of the provision at issue.

*Id.* (Thomas, J., dissenting).

172. *Id.* (Thomas, J., dissenting). In this statement, Justice Thomas seems to be suggesting that any changes in the meaning of “prospectus” under § 12(2) should be left to Congress, rather than being imposed by judicial fiat. *Id.* (Thomas, J., dissenting).

173. *Id.* (Thomas, J., dissenting).

174. *Id.* (Thomas, J., dissenting). Justice Thomas added specifically that “it is for Congress, and not for this Court, to determine the desired level of securities liability.” *Id.* (Thomas, J., dissenting). He relied on the 1994 decision of the Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1442 (1994). *Id.* (Thomas, J., dissenting). In that case, the Court weighed public policy considerations and stated that those considerations “cannot override our interpretation of the text and structure because such arguments do not show that adherence to the text and structure would lead to a result ‘so bizarre’ that Congress could not have intended it.” *Central Bank of Denver*, 114 S. Ct. at 1442 (citing *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991)). See *supra* note 163 and accompanying text.

175. *Gustafson*, 115 S. Ct. at 1080 (Ginsburg, J., dissenting). Justice Ginsburg noted that “[t]he items listed in the defining provision [§ 2(10)], notably ‘letters’ and ‘communications,’ are common in private and secondary sales, as well as in public offerings.” *Id.* (Ginsburg, J., dissenting). She also criticized the majority for bypassing § 2(10). *Id.* (Ginsburg, J., dissenting).

176. *Id.* (Ginsburg, J., dissenting). Justice Ginsburg explains: “[t]o justify its backward reading—proceeding from § 10 to § 2(10) and not the other way round—the Court

more, Justice Ginsburg criticized the majority's reasoning, which enabled it to find consistency in the different definitions of "prospectus" in section 10 and section 12(2).<sup>177</sup>

Additionally, Justice Ginsburg examined the legislative history of the 1933 Act<sup>178</sup> and other scholarly works,<sup>179</sup> finding support for a broad reading of "prospectus," without limitation. Based upon those findings, Justice Ginsburg, like Justice Thomas, suggested that this issue would best be resolved through Congressional action.<sup>180</sup>

#### IV. ANALYSIS

The *Gustafson* Court found that the term prospectus in section 12(2)

---

states that it 'cannot accept the conclusion that [the operative word prospectus] means one thing in one section of the Act and something quite different in another.'" *Id.* (Ginsburg, J., dissenting). Justice Ginsburg noted that the Court's past decisions "constantly recognize[d] that 'a characterization fitting in certain contexts may be unsuitable in others.'" *Id.* (Ginsburg, J., dissenting) (quoting *Nations Bank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 115 S. Ct. 810, 816 (1995)). Therefore, any presumption that the same word used throughout a statute has the same meaning need not be rigid and unyielding, especially where common sense warrants a different conclusion. *Id.* (Ginsburg, J., dissenting). Furthermore, Justice Ginsburg noted that "[i]t is not unusual for the same word to be used with different meanings in the same act, and there is no rule of statutory construction which precludes the courts from giving to the word the meaning which the legislature intended it should have in each instance." *Id.* (Ginsburg, J., dissenting) (quoting *Atlantic Cleaners & Dyers, Inc. v. United States*, 286 U.S. 427, 433 (1932)).

177. Much of Justice Ginsburg's criticism stems from the order in which the majority considered the various statutory provisions. *Id.* (Ginsburg, J., dissenting). See *supra* note 171. Justice Ginsburg also attacks the majority on its consistent meaning analysis: "[a]ccording 'prospectus' discrete meanings in § 10 and § 12(2) is consistent with Congress' specific instruction in § 2 that definitions apply 'unless the context otherwise requires.'" *Gustafson*, 115 S. Ct. at 1080 (Ginsburg, J., dissenting) (quoting 15 U.S.C. § 77b (1994)). See *supra* text accompanying note 9 for the relevant text of § 2(10).

178. See *Gustafson*, 115 S. Ct. at 1081-1083. (Ginsburg, J., dissenting). In examining the legislative history, Justice Ginsburg found support for her argument from the British Companies Act, 19 & 20 Geo. 5, ch. 23 (1929). The drafters of the 1933 Act used this British Act as a base for the 1933 Act's structure and scope. See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 123 (1953); James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 34 (1933).

179. Justice Ginsburg emphasized that scholars and commentators discussing the Act's passage understood the Act to encompass secondary market transactions and private transactions, as well as public offerings. *Gustafson*, 115 S. Ct. at 1082 (Ginsburg, J., dissenting) (relying on Frankfurter, *supra* note 1, at 108; and William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 183 (1933)).

180. *Gustafson*, 115 S. Ct. at 1083 (Ginsburg, J., dissenting). Specifically, Justice Ginsburg stated that "[i]f adjustment [to the scope of § 12(2)] is in order, as the Court's opinion powerfully suggests it is, Congress is equipped to undertake the alteration." *Id.* (Ginsburg, J., dissenting) (citations omitted).

of the 1933 Act does not apply to a privately negotiated agreement for the sale of securities.<sup>181</sup> Therefore, the plaintiffs could not seek rescission of the agreement under section 12(2).<sup>182</sup> In so holding, the Supreme Court continued its trend of shrinking the remedies available to private plaintiffs under the 1933 Act.<sup>183</sup> Although the majority determined that the private plaintiff remedy of rescission under section 12(2) of the 1933 Act should be limited, such a restriction of the statutory rights does not appear to be fully supported by the Court's analysis. Thus, *Gustafson* manifests a further willingness of the Court to depart from a broad, expansive interpretation of the federal securities laws.

This Part reviews the majority's departure from traditional methods of statutory analysis.<sup>184</sup> This Part also analyzes the problems in the majority's decision, focusing on underlying public policy concerns and the majority's goal-oriented approach to *Gustafson*.<sup>185</sup> Finally, this Part notes that the underlying facts of *Gustafson* may have influenced the Court's final decision, evidencing a holding that may be limited to its facts in the future.<sup>186</sup>

A. *The Use of Canons of Statutory Interpretation to Depart from a Broad, Expansive View of the 1933 Securities Act*

Established law provides that the beginning point for any analysis regarding the interpretation of a statute must be the language of the statutory provision itself.<sup>187</sup> Additionally, courts may not look past the language of the statute for interpretative guidance unless, first, the

---

181. *Id.* at 1073-74.

182. *Id.*

183. The trend of shrinking private plaintiff remedies under the federal securities acts is notable in Supreme Court cases such as *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994) (eliminating the right of private plaintiffs to bring suit against attorneys, accountants, and others who indirectly assisted a securities fraud); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) (shortening the time in which private plaintiffs can file suit); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Commentators have noted that these types of decisions represent a departure from the broad and expansive view of the securities laws envisioned in 1933. See, e.g., Rob Wells, *Supreme Court Decisions Make Major Strides in Litigation Reform*, ASSOCIATED PRESS, March 3, 1995, 1995 WL 6374096 (noting that "[t]he court is almost systematically restricting private rights under the securities laws," quoting David Mahaffey, special counsel for a Washington, D.C. law firm, and a former Securities and Exchange Commission attorney).

184. See *infra* notes 187-211 and accompanying text.

185. See *infra* notes 212-25 and accompanying text.

186. See *infra* notes 226-32 and accompanying text.

187. See *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756. (1975).

plain meaning of the statute is ambiguous, or second, an application of the plain meaning would yield a bizarre result.<sup>188</sup> Instead of starting with the language of section 12(2) itself, however, the Court began with section 10 to determine the proper scope of the term “prospectus.”<sup>189</sup> Nonetheless, starting with a section other than the language of section 12(2) allowed the majority to reach its desired result, a restriction on private-plaintiff securities litigation.<sup>190</sup>

Normally, when determining the proper interpretation of a specific term in a statute, courts will first examine the definitional section of that statute.<sup>191</sup> Congress provided a series of definitions in section 2 of the 1933 Act, including the definition of “prospectus.”<sup>192</sup> The majority, however, did not review the definitional section of the 1933 Act until well into its opinion.<sup>193</sup> Moreover, when the Court finally decided to discuss section 2(10), the Court relied on the doctrine of *noscitur a sociis* for its interpretation of that provision, without sufficient justification.<sup>194</sup> Basing many of its conclusions on this doctrine involving the relationship between words, the majority managed to take a fairly straightforward provision of the 1933 Act and turn it into a circular and, therefore meaningless, provision. Thus, the Court’s decision, for the most part, renders ineffective the explicit definition of “prospectus” in section 2(10), which includes the

---

188. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1442 (1994). See *supra* notes 134, 163, and 174 and accompanying text for a discussion of these rules of statutory construction.

189. See *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1066 (1995). Both dissents discuss this flaw in the majority’s opinion. See *supra* notes 134 and 176-77 and accompanying text.

190. However, in its haste to justify its preferred end result, the majority failed to closely examine the impact of its analysis. Now, the Supreme Court has granted itself and lower courts ample ammunition for the creative interpretation of other statutory provisions certain to be reviewed in the future. This decision gives courts the leeway, in a case of statutory interpretation, to leave the language of the statute itself for consideration after the Court considers any other provision it chooses.

191. *Gustafson*, 115 S. Ct. at 1074 (Thomas, J., dissenting) (arguing that the Court should have relied on the definitional section of the 1933 Act, § 2(10), to determine the proper scope of the term “prospectus”). See *supra* note 137 and accompanying text.

192. See *supra* note 9 and accompanying text (defining “prospectus” in § 2(10)).

193. See *supra* notes 117-24 and accompanying text for a discussion of this portion of the Court’s opinion.

194. Justice Thomas aptly explained the reasons why the majority improperly employed this doctrine. See *supra* notes 139-42 and accompanying text. For instance, the doctrine of *noscitur a sociis* should generally be applied only where ambiguity exists. See *supra* notes 121-24 and accompanying text. Yet, the Supreme Court, like other lower courts before, relied on this doctrine of construction to limit the scope of § 12(2). See, e.g., *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 689-90 (1991) (discussing how the structure of the Act supports a narrow reading of §12(2)), *cert. denied*, 502 U.S. 820 (1991).



expansive term "communication."<sup>195</sup>

The majority's statutory interpretation analysis also emphasized the structure of the 1933 Act independently, as well as the overarching structure of the securities laws as a whole.<sup>196</sup> This emphasis focused on a comparison of section 12(2) to other statutory provisions. By reasoning backward,<sup>197</sup> the majority crafted an explanation for why "prospectus" could not include documents relating to private or secondary transactions.<sup>198</sup>

Specifically, the Court relied largely on section 10 of the Act and created a relationship between the term "prospectus" as used in section 10 and section 12(2).<sup>199</sup> Logically, section 10 speaks not to the definition or scope of a prospectus, but to the information which must be disseminated to the public.<sup>200</sup> Yet, the majority rejected this argument, instead finding that the use of the term "prospectus" in section 10, applying only to the information required in a prospectus, necessarily controls the scope of "prospectus" as used in section 12(2).<sup>201</sup> However, the relationship the Court created between section 10 and section 12(2) is unwarranted.<sup>202</sup>

195. On this point, Justice Thomas set forth an analogy which clearly illustrates this flaw in the majority's analysis of § 2(10):

Suppose that the Act regulates cars, and that § 2(10) of the Act defines a "car" as any car, motorcycle, truck, or trailer. Section 10 of this hypothetical statute then declares that a car shall have seatbelts, and § 5 states that it is unlawful to sell cars without seatbelts. Section 12(2) of this Act then creates a cause of action for misrepresentations that occur during the sale of a car. It is reasonable to conclude that §§ 5 and 10 apply only to what we ordinarily refer to as "cars," because it would be absurd to require motorcycles and trailers to have seatbelts. But the majority's reasoning would lead to the further conclusion that § 12(2) does not cover sales of motorcycles, when it is clear that the Act includes such sales.

*Gustafson*, 115 S. Ct. at 1076 (Thomas, J., dissenting).

196. *See supra* note 96.

197. *Gustafson*, 115 S. Ct. at 1080 (Ginsburg, J., dissenting). *See supra* note 176.

198. *Gustafson*, 115 S. Ct. at 1069. *See supra* notes 158-63 and 175-77 for Justices Thomas's and Ginsburg's criticisms of this analysis.

199. *Gustafson*, 115 S. Ct. at 1069.

200. *See supra* note 117.

201. *Gustafson*, 115 S. Ct. at 1069. *See supra* note 113.

202. *See supra* note 147 and accompanying text. The majority found further support for its analysis from the express language of § 12(2). *Gustafson*, 115 S. Ct. at 1067-68. When discussing the language of § 12(2), the Court focused almost solely on the grant of exemption for government-issued securities in § 12(2). *Id.* *See supra* notes 102-05.

However, the Court offered oblique reasoning for the inclusion of this exemption in § 12(2). The majority found that the presence of the exemption in the § 12(2) provision made "perfect sense." *Gustafson*, 115 S. Ct. at 1068; *see supra* note 105. But does it? A close examination of the structure of the Act, as Justice Thomas pointed out, reveals that the placement of an exemption in § 12(2) was probably intentional, as Congress desired

Additionally, the Court's refusal to follow the statutory reasoning of *Naftalin* further suggests that the majority was deciding the case in an outcome-oriented fashion, rather than with regard to the Court's previous interpretations of the securities acts.<sup>203</sup> In fact, Justice Thomas heavily criticized the majority for inexplicably limiting the holding of *Naftalin*.<sup>204</sup> In light of the Court's holding in *Naftalin*, which deliberately interpreted section 17(a) of the 1933 Act broadly so as not to limit its application solely to initial offerings, the Court should have similarly been willing to read section 12(2) liability broadly.<sup>205</sup>

Moreover, the overarching structure of the federal securities laws suggests that the Court may have simplified the distinctions between the 1933 and 1934 Acts.<sup>206</sup> A review of the 1934 Act reveals that Congress did not include a cause of action for these types of privately negotiated contract transactions in the 1934 Act.<sup>207</sup> Congress had the chance a year later to clarify the scope of the 1933 Act on this point and did not do so, thus suggesting that Congress saw no need because the 1933 Act already provided a rescission remedy for privately negotiated transactions.<sup>208</sup> While the legislative history on this issue is notably sparse,<sup>209</sup> shortly after the Act was passed, commentators

---

to limit the scope of § 12(2) only with regard to governmental securities. See *Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting).

If Congress intended such a limitation for all private or secondary transactions, it would seem logical that such an exemption would be expressly stated in § 12(2) or in another, more complete provision where the exemption for government securities could have also been included in the 1933 Act. Congress, however, did not choose to so limit § 12(2). By limiting § 12(2) with its holding, the majority opinion significantly deviates from the express language of the 1933 statute. On the face of the statute, § 12(2) applies to any offer or sale of security, without regard to exemptions. 15 U.S.C. § 77l(2) (1994).

203. The Court's refusal to extend the rationale of *Naftalin* to § 12(2) threatens the notion of legal precedent. Although § 12(2) is different from § 17(a), the reasoning the Court applied in *Naftalin* applies equally to the issues in *Gustafson*. See *supra* note 164 and accompanying text.

204. See *supra* note 164 and accompanying text.

205. See Hirsch, *supra* note 29, at 984. Concluding his article, Mr. Hirsch notes that the "bright line distinction" often applied to distinguish the 1933 Act from the 1934 Act was undercut by the Court's decision in *Naftalin* that "the 1933 Act's criminal counterpart to § 12(2) applies equally to the primary and secondary markets." Hirsch, *supra* note 30, at 984. For a discussion of the *Gustafson* Court's application of *Naftalin*, see *supra* notes 126-30 and accompanying text.

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

207. 15 U.S.C. § 78a-78ll (1994).

208. See Transcript of Oral Arguments before the Supreme Court at \*15, *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1994) (No. 93-404), 1994 WL 757605. See also Loss, *supra* note 30, at 914 (asserting that § 12(2) should apply to ordinary trading). See also *supra* note 174.

209. See *supra* note 29 and accompanying text.

viewed the purpose of the Act as extending beyond initial distributions.<sup>210</sup> The Court appears to have overlooked this fact, which supports the position that section 12(2) liability should be read as extending beyond initial distributions.<sup>211</sup>

*B. The Role of Public Policy Underlying Gustafson: How the Gustafson Holding Evidences Goal-oriented Decision Making*

Veiled in the majority's opinion are public policy concerns focusing on the extension of already widespread private securities litigation and the potential impact of a plaintiff-oriented decision on the securities industry.<sup>212</sup> Similar concerns about extensive private securities litigation were expressed by the Court in decisions pre-dating *Gustafson*, when the Court decided other issues under the securities laws.<sup>213</sup> The Court addressed these concerns in *Gustafson*, where it shunned a broad reading of "prospectus," interpreting it to apply only to the

210. Arthur Dean, writing in *FORTUNE* in 1933, noted that a secondary purpose of the 1933 Act "has to do with the sale of securities, old and new, subsequent to their original issue and distribution, and with respect to these its purpose is that upon any sale thereof they shall be honestly and completely represented." Dean, *supra* note 21, at 50.

211. Support for this position is drawn from the relationship of the 1933 and 1934 Acts. For example:

Congress did not repeat section 17(a) or section 12(2) in the 1934 Act for a good reason: there was no need. Although it is convenient shorthand to say that the 1933 Act relates to distributions and the 1934 Act to postdistribution trading, this distinction does not accurately describe the relationship between the two acts.

Loss, *supra* note 30, at 915. Furthermore, in this sense, the majority overlooked the Court's opinion in *SEC v. National Sec., Inc.*, 393 U.S. 453, 466 (1960), where the Court found that "the interdependence of the various sections of the [federal] securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen . . . ." Congress's silence in the 1934 Act with regard to antifraud remedies for secondary or private transactions accomplished through misstatements, speaks volumes. *SEC*, 390 U.S. at 466.

212. Justice Thomas also referenced these considerations and noted that the majority had considered the public policy ramifications of an extended scope of § 12(2). *Gustafson*, 115 S. Ct. at 1078 (Thomas, J., dissenting). Specifically, Justice Thomas noted concerns over increased private litigation, while the parties and amici curiae expressed concerns over increased transaction costs and increased burdens on security issuers. *Id.* (Thomas, J., dissenting). See *supra* note 173.

213. For instance, when approached with the issue of the required elements for a cause of action under § 10(b) of the 1934 Act, the Court narrowed the scope of the statute. In a line of cases beginning with *Ernst & Ernst v. Hochelder*, 425 U.S. 185, 199 (1976), the Court imposed a scienter requirement for § 10(b) private actions. *Ernst & Ernst*, 425 U.S. at 199. *Id.* By so doing, the Court thwarted the expansive nature of § 10(b) and narrowed the potential applications of the provision to nothing more than that provided at common law. More recently, the Court reduced the time in which investors could file an action for securities fraud. See *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 359 (1991).

“public offering of securities by an issuer or controlling shareholder.”<sup>214</sup> As a result, parties who purchase securities in a private, secondary market transaction cannot seek a remedy under section 12(2) for any misrepresentations occurring in the transaction.<sup>215</sup>

While the majority never explicitly stated in its opinion that it considered public policy in reaching its decision,<sup>216</sup> other evidence shows that the Court was attempting to address public policy concerns. During oral argument, for instance, the Court repeatedly questioned attorneys on how an encompassing definition of “prospectus” would affect certain written documents produced by the securities industry.<sup>217</sup> These questions appeared to be in response to public policy concerns that the parties expressed in briefs submitted to the Court.<sup>218</sup> However, while concerns about an expansive scope of

---

214. *Gustafson*, 115 S. Ct. at 1073-74.

215. *Id.*

216. While not explicitly mentioning many of the concerns that were expressed in oral argument, the Court did note the effects a broad reading of the scope of § 12(2) could have on the securities industry. *Id.* at 1071. The Court stated that:

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

*Id.* By implication, the Court here expressed its desire to restrict securities litigation. *Id.*

217. The Court focused on research reports prepared by analysts, as suggested in the SIA brief. *See infra* note 218. During oral argument, the Court questioned each arguing attorney about whether these types of research reports would be included under the various interpretations of “prospectus.” Transcript of Oral Argument before the Supreme Court at \*8, \*10, and \*14, *Gustafson* (No. 93-404), 1994 WL 757605.

218. *See, e.g.*, Petitioner’s Brief, *supra* note 92, at \*39. Sellers argued that a broad construction of § 12(2) would turn state contract cases into federal cases with a heavy burden of proof on defendants. *Id.* at \*41. The Buyers, on the other hand, argued, among other things, that a narrow reading of § 12(2) could not be justified merely by concerns over increased transaction costs. Respondent’s Brief, *supra* note 66, at \*41-\*42.

The SIA argued that a broad interpretation of “prospectus” could have made many of those involved in the investment industry vulnerable to heightened risks of liability. *See SIA’s Amicus Curiae Brief, supra* note 84. The SIA argued that any application of § 12(2) to secondary market transactions would discourage the communication of market research to the investing public. *Id.* The SIA explained that research and due diligence performed by stock issuers would be subject to liability under § 12(2). *Id.* The SIA noted that:

If the term “prospectus” in Section 12(2) is construed to include virtually all written communications, including research reports, securities firms will be extremely circumspect in issuing such reports in the future given their potential liability under Section 12(2) and the burden of defending such claims.

section 12(2) are perhaps justified,<sup>219</sup> the issues addressed at oral argument were not specifically before the Court.<sup>220</sup>

Undoubtedly, these considerations at least partially influenced the decision of the Court. The Court chose to rely on public policy considerations, even if they did not explicitly adopt them, that supported a restriction of the federal securities laws and restrictions on the rights of private plaintiffs. However, while public policy considerations are often reviewed in support of court decisions, review of those policy considerations is not warranted absent ambiguity in legislative intent.<sup>221</sup> As the definition of prospectus in the 1933 Act did not evidence any ambiguity, the majority improperly considered public policy to support its holding, even if that reliance never explicitly appeared in the opinion.<sup>222</sup> The majority gave unnecessary deference to public policy concerns because no bizarre outcome would result from adhering to the language of the statute.<sup>223</sup>

---

*Id.* While this may be a compelling argument, Congress could easily amend § 12(2) to prevent such a result. See also *Supreme Court—Securities Law Narrowed*, 55 FACTS ON FILE, No. 2832, at 167, 1995 WL 7732055 (stating the SIA's position that a broad interpretation of § 12(2) would have rendered all money managers, brokers, and investors vulnerable to unreasonable risk liability).

219. Scholars are currently debating, however, whether the assumption that private securities litigation is too excessive is actually evidenced by lawsuit data. See generally, Douglas C. Buffone, *Predatory Attorneys and Professional Plaintiffs: Reforms Are Needed to Limit Vexatious Securities Litigation*, 23 HOFSTRA L. REV. 655, 658-59 (1995) (noting the existence of debate regarding the extent of securities litigation); Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority"*, 108 HARV. L. REV. 438 (1994) (discussing proposed restrictions to the securities laws in the context of class action lawsuits).

220. See Respondent's Brief, *supra* note 66, at \*11. Alloyd noted that the research reports of securities firms that are often given to customers were not at issue in the case and that the Court had no need to resolve that issue in deciding the case. *Id.*

The Court did not specifically rely on how a broad reading of "prospectus" might adversely impact the preparation and dissemination of research reports by the securities industry in reaching its holding. However, such an issue surely played a determinative role in the outcome of the case, offering the Court an example of a profound effect of interpreting "prospectus" to include "any written communication." See Transcript of Oral Argument, at \*9-\*10, \*12, \*17, *Gustafson* (No. 93-404), 1994 WL 757605 (questioning how a broad interpretation of "prospectus" would impact research reports). Such a focus, however, seems to overlook the fact that research reports would not universally fall under the rubric of "prospectus" if the report did not offer for sale or confirm a sale of a security. See Transcript of Oral Argument at \*12, *Gustafson* (No. 93-404), 1994 WL 757605 (where counsel for the Buyers argued that brokerage research reports would not necessarily create any § 12(2) liability).

221. *Central Bank of Denver, N.A. v. First Interstate Bank, N.A.*, 114 S. Ct. 1439, 1442 (1994). For this rule of law, see *supra* note 134 and 174.

222. See *supra* note 170 and accompanying text.

223. *Gustafson v. Alloyd Co., Inc.*, 115 S. Ct. 1061, 1075 (1995) (Thomas, J.,

With this in mind, the result of *Gustafson* can perhaps be viewed as an approach taken by the majority in an effort to stem the tide of securities litigation.<sup>224</sup> Notwithstanding the Court's goal-oriented reasoning, this issue before the Court, the scope of "prospectus" under section 12(2), could have been resolved in a much more straightforward fashion, as indicated in the dissenting opinions.<sup>225</sup>

### C. The Peculiar Facts of *Gustafson*

The facts of this case reveal that the Buyers were compensated for the inadequate estimates contained in the Agreement.<sup>226</sup> In fact, the Buyers received full compensation long before the case reached the Supreme Court.<sup>227</sup> Yet, still unsatisfied, the Buyers turned to the federal securities laws for further relief, despite the existence of a viable state law contract action.<sup>228</sup> This particular fact is of extreme importance. Underlying the Supreme Court's decision seems to be some element of frustration with the case, in that the parties continued with litigation despite the availability of a contractual remedy and actual restitution.<sup>229</sup> Perhaps, had a case with a different set of facts been presented to resolve the crucial question regarding the scope of section 12(2) liability, the result would have been vastly different.<sup>230</sup>

---

dissenting).

224. See generally Wells, *supra* note 183 (commenting that *Gustafson* "effectively narrows the legal options [available] to investors who claim they've been defrauded when purchasing stocks"); Richard Carelli, *High Court Limits Legal Rights 1933 Law Gives to Stock Buyers*, HOUSTON CHRONICLE, Mar. 1, 1995, at 12 (discussing the limiting effect of *Gustafson*); Joan Biskupic, *Court Limits Stock Fraud Law; Ruling Eliminates a Recourse for Private Buyers*, WASH. POST, Mar. 1, 1995, at C2 (reporting that private buyers no longer have any recourse under § 12(2) in light of *Gustafson*); see FACTS ON FILE, *supra* note 218 (noting that "a key protection offered to investors under . . . [the 1933 Act] extended only to those who purchased stock in an initial public offering.").

225. *Gustafson*, 115 S. Ct. at 1074, 1079 (Thomas, J., dissenting and Ginsburg, J., dissenting). Seemingly, with this decision, the Court may have encroached upon Congress's powers to legislate in anticipation of future dilemmas. See *supra* note 1 and accompanying text (discussing the dangers of using legislation as anticipation). It is not the province of the Courts to legislate and, notably, "[i]t is not for the judiciary to eliminate the private action in situations where Congress has provided it . . ." *Sedima S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 499-50 (1985).

226. See *supra* text accompanying note 74.

227. See *supra* text accompanying note 74.

228. See, e.g., *Supreme Court's Definition of "Prospectus" Favors Rule 144A Market*, FIN. REG. REP., Mar. 1995, available in LEXIS, News Library, FRR file (addressing the Supreme Court's dissatisfaction with the plaintiff's decision in *Gustafson* to resort to federal law.).

229. *Id.* (stating that "[t]he Supreme Court majority was clearly put off by the plaintiff's resort to federal law.").

230. However, it appears that the Supreme Court saw an immediate need to resolve a

However, the majority could not reach its resolution of the issue at hand in a vacuum. Therefore, it is possible that the Buyers' receipt of full payment in restitution for the wrong influenced the eventual outcome, even if such was not the intent. If so, then perhaps *Gustafson* can be limited to its facts, thereby still allowing some remedy for future plaintiffs.<sup>231</sup> This fact, coupled with the Court's tendency to restrict the securities laws, may have only added to the Court's frustration with the extent of private party litigation in the securities field. As both dissents in *Gustafson* stressed, however, this litigious issue would be best left to congressional action, rather than the Court, which judicially eliminated a remedy afforded to private plaintiffs by the 1933 Congress.<sup>232</sup>

## V. IMPACT

The *Gustafson* decision further restricts the broad federal securities laws, akin to the court-created restrictions in section 10(b) of the 1934 Act.<sup>233</sup> In departing from past broad interpretations of the Securities Acts, the Supreme Court created extra insulation for sellers of securities while at the same time eliminating a remedy afforded by Congress to private plaintiffs.

This decision is certainly a boon to those working in the field of securities.<sup>234</sup> Brokers, dealers and other sellers literally have one less

---

circuit split and therefore had every intention of deciding *Gustafson* despite the fact that the Buyers had already been compensated. See Maynard, *supra* note 82.

231. The facts of *Gustafson* may easily allow for the limitation of the Court's holding. *Gustafson* clearly involved a private stock purchase agreement, completed by sophisticated buyers after the requisite due diligence. *Gustafson*, No. 91C889, Memorandum Opinion and Order (N. D. Ill. May 29, 1992). See *supra* note 78 for the lower court's discussion of the facts. Therefore, other cases, involving perhaps a private transaction without the benefit of sophisticated buyers and due diligence, could have differing results. See *infra* notes 244-46 and accompanying text.

232. See *supra* notes 170 and 180. See also Hirsch, *supra* note 29, at 975 (supporting congressional rather than judicial change to the scope of § 12(2)). Hirsch argues that "while it would be inappropriate for courts to selectively apply § 12(2)'s express statutory remedy, Congress should amend § 12(2) to apply only to those aftermarket transactions where the market for security is not efficient." *Id.* (emphasis in original).

233. Wells, *supra* note 183. This article notes that "[w]hile lobbyists and legislators have little to show from their fight [to reform private securities fraud lawsuits], substantial headway has been made by another arm of government—the Supreme Court." *Id.* In fact, *Gustafson*, along with two other recent court decision, "effectively narrows the legal options to investors who claim they've been defrauded when purchasing stocks." *Id.*

234. See, e.g., FED. SEC. L. REP., 18, No. 1653, (March 17, 1995) (stating that the Court's decision in *Gustafson* "represents a significant victory for the business and investment community). In an interview with Donald W. Jenkins, counsel for the

remedial provision of the 1933 Act with which to be concerned.<sup>235</sup> Now, not only does section 10 of the 1934 Act leave buyers with a difficult burden to prove in order to obtain relief, section 12(2) of the 1933 Act poses substantial hurdles to defrauded buyers as well.<sup>236</sup> Moreover, by limiting section 12(2), the majority merely duplicated the effect of section 11 of the 1933 Act.<sup>237</sup> Section 11 of the 1933 Act provides for civil liability for fraud in connection with a registration statement.<sup>238</sup> By holding that a prospectus is not the same thing as any written communication, the majority defined a prospectus as essentially a selling document used in conjunction with a public offering.<sup>239</sup> This definition, however, controlled by section 10, all but mimics the requirements of a registration statement.<sup>240</sup> The majority opinion effectively defines a prospectus in the terms of a registration statement. Such a definition makes all parts of section 12 superfluous, because section 11 would then be sufficient to address any issues of fraud in connection with a prospectus, as well as with a registration statement.<sup>241</sup>

---

Sellers, the journal noted that "the importance of the Court's ruling flows primarily from its prophylactic impact in barring many claims where a disappointed purchaser who cannot show fraud under Rule 10b-5 hopes to satisfy what the attorney called the 'far more lenient showing under § 12(2).'" *Id.* The Court's ruling also provides more certainty for structuring private transactions. *Id.* Moreover, had the Court found in favor of expanded remedies, transaction costs for private transactions would have surely increased. *Id.* See also FACTS ON FILE, *supra* note 218 (stating the Supreme Court's opinion that § 12(2) was not intended for every communication in the secondary market).

235. *Supreme Court Settles Securities Law*, *supra* note 87.

236. Buyers defrauded in their purchase of stock in the secondary market now must prove scienter in order to recover. See Prentice, *supra* note 30, at 100-03.

237. Credit for this argument must go to Professor Michael J. Kaufman, Loyola University Chicago School of Law. See *supra* note 160 for an explanation of § 11. For a discussion on the overlap between § 11 and § 12(2), see Weiss, *supra* note 23.

238. 15 U.S.C. § 77k (1994).

239. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1073-74 (1995).

240. Shortly after the passage of the 1933 Act, however, William O. Douglas and George E. Bates, noted that § 12(2) could provide compensation for untrue statements or omissions of material facts, whether or not the security was registered. William O. Douglas and George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 177 (1933). While this statement may not be definitive on the scope of § 12(2), clearly the registration requirements of other sections were not prerequisites to liability under § 12(2). As such, under this reading of the statute, a private transaction could create potential liability under § 12(2).

241. 15 U.S.C. § 77k (1994). Section 112 provides for civil liabilities in connection with false registration statements. *Id.* By narrowing the scope of "prospectus" as used in § 12(2), the Supreme Court seemingly attributes to a prospectus the characteristics of a registration statement. See *supra* notes 237-40 and accompanying text. Therefore, § 11 might be essentially applicable to some prospectuses as now interpreted by the Supreme Court. See *supra* note 237.



Thus, the Supreme Court's decision effectively eliminates a cause of action where the underlying transaction is based upon a private sales contract. Congress provided a remedy and the Court took that remedy away. In similar cases, the only remedy now available to plaintiffs is a fraud remedy, which requires scienter.<sup>242</sup> This holding is bound to have effects far beyond the courtroom. Indeed, by depriving private plaintiffs of this remedy, incentives to purchase stock in any secondary market transaction, or even in a privately negotiated transaction, have also been drastically reduced.<sup>243</sup> The potentially powerful weapon conferred by section 12(2) upon private plaintiffs has been greatly diminished.

Significantly, the Court did not go as far as to say that *all* private offerings were excluded from the scope of section 12(2).<sup>244</sup> The Court only maintained that the private contract at issue was not a prospectus under the meaning of section 12(2).<sup>245</sup> This specific holding may

---

242. See *supra* notes 47-50. Plaintiffs can seek relief under § 10(b) of the 1934 Act. See also Steven Thel, *Section 12(2) of the Securities Act: Does Old Legislation Matter?*, 63 FORDHAM. L. REV. 1183, 1193 (1995) (discussing legislative intent in connection with § 12(2)). Mr. Thel suggested that when the Supreme Court decides the scope of § 12(2), "it should focus on the implications of § 12(2) for the private-liability regime it has adopted under rule 10b-5. The Court should give § 12(2) the scope it believes best serves a wise coherent scheme of private liability." *Id.* Interestingly, the Court did no explicit comparison between § 12(2) remedies and § 10(b) and Rule 10b-5 remedies in its opinion. Many of the lower courts considering the scope of § 12(2) analyzed these sections contemporaneously. See, e.g., *Pacific Dunlop Holdings Inc. v. Allen & Co.*, 993 F.2d 578, 589 (7th Cir. 1993); *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 689 (3d Cir.), *cert. denied*, 502 U.S. 820 (1991).

243. See Wells, *supra* note 183, at 1. Wells notes that "[s]ome securities attorneys believe the trend is substantial enough that investors in failed savings and loans might not be able to recoup their money through private lawsuits. Others disagree, saying the real world effects of the court's [sic] decisions may not have a substantial effect on investors." Wells, *supra* note 183, at 1.

244. In fact, much of the Court's opinion focuses on secondary market transactions as well as private transactions. This dual approach to the issue could create confusion in future cases. See *supra* note 231.

245. *Gustafson*, 115 S. Ct. at 1069. This fact may have been important in creating a majority in *Gustafson*. As one commentator notes, "there are signs in this opinion that Kennedy and his side may have won the majority at the last minute. The language of Kennedy's opinion . . . suggests that Kennedy originally was writing a dissent." Joan Biskupic, *Court Limits Stock Fraud Law; Ruling Eliminates a Recourse for Private Buyers*, WASH. POST, Mar. 1, 1995, at C2.

An argument can be made for narrowing the *Gustafson* case to its facts, as the Court appeared to do here. The Buyers in this case were sophisticated and had fully researched the company before purchasing it. *Gustafson*, 115 S. Ct. at 1064-65. They evidenced their sophistication when they insisted on a remedial clause in the Agreement, and were fully compensated pursuant to this clause. *Id.* at 1065. See *supra* notes 72-74 and accompanying text. Thus, there was no need to apply § 12(2) to the Agreement, because the plaintiffs had already received full compensation. In future cases, however, with less sophisticated buyers, there may be a need to impose § 12(2) liability when the buyers

prove beneficial in the sense that other private offerings may be subject to liability under section 12(2). However, at the same time, until the *Gustafson* holding is limited to its facts, it is private buyers who may bear the brunt of its impact. The ramifications of the Court's decision are monumental.<sup>246</sup>

## VI. CONCLUSION

The Supreme Court's decision in *Gustafson* goes beyond mere statutory interpretation. This holding will affect all decisions of investors on purchases that occur outside of an initial offering. The Supreme Court should have followed its reasoning in previous cases involving the interpretation of the federal securities act. If the Court had interpreted section 12(2) consistent with past precedent, plaintiffs here, and in the future, would be afforded a stronger statutory remedy for fraud in secondary market transactions. Deviating from a broad interpretation of section 12(2), the Supreme Court manifestly changed the outlook for securities laws in an effort to curb future litigation. However, by limiting a plaintiff's right to a remedy, the ramifications of the Supreme Court's decision have yet to be fully understood or imagined.

LAURA K. BANCROFT

---

could not otherwise be compensated.

246. As of the writing of this Note, *Gustafson* has been cited in only three subsequent cases: *In re Grady*, 180 B.R. 461, 464 (E.D. Va. 1995); *In re Cohn*, 54 F.3d 1108 (3d Cir. 1995); and *Komanoff v. Mabon, Nugent & Co.*, 884 F. Supp. 848 (S.D.N.Y. 1995). In *Grady*, the court cited to *Gustafson* for the proposition that identical words used in different parts of a statute are intended to have the same meaning. *Grady*, 180 B.R. at 464. *Gustafson* was cited for the same proposition in *In re Cohn*. *Cohn*, 54 F.3d at 1115. In *Komanoff*, the court followed *Gustafson*'s holding and dismissed the plaintiffs § 12(2) claims for failure to state a cause of action. *Komanoff*, 884 F. Supp. at 857.