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J. Dormer Stephen III

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GUSTAFSON: ONE SMALL STEP (BACKWARD) FOR PRIVATE PLAINTIFFS, ONE GIANT LEAP (BACKWARD) FOR THE SECURITIES BAR

J. DORMER STEPHEN III*

In law, the moment of temptation is the moment of choice, when a judge realizes that in the case before him his strongly held view of justice, his political and moral imperative, is not embodied in a statute or in any provision of the Constitution. He must then choose between his version of justice and abiding by the American form of government. Yet the desire to do justice, whose nature seems to him obvious, is compelling, while the concept of constitutional process is abstract, rather arid, and the abstinence it counsels unsatisfying. To give in to temptation, this one time, solves an urgent human problem, and a faint crack appears in the American foundation. A judge has begun to rule where a legislator should.[1]

Introduction

The United States government is a system "of laws and not of men."[2] In situations where the legislature has spoken through the enactment of a statute, the judiciary is relegated to interpreting that law.[3] However, as history has shown, the judiciary does not always reserve the power to enact law to the legislature.[4]

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* Associate in the corporate finance group of Hebb & Gitlin in Hartford, Connecticut. J.D., 1996, Albany Law School of Union University; Editor-in-Chief, *Albany Law Review*. This article has benefitted from the comments of Chester L. Fisher III, Gary S. Hammersmith and Professor James D. Redwood. The author would like to thank Hebb & Gitlin for its promotion of legal scholarship. The opinions expressed in this article are solely those of the author and do not necessarily reflect the opinions of Hebb & Gitlin.

1. ROBERT H. BORK, THE TEMPTING OF AMERICA 1 (1990).

2. Marbury v. Madison, 5 U.S. (1 Cranch) 137, 163 (1803); *see also* DONALD E. LIVELY, JUDICIAL REVIEW AND THE CONSENT OF THE GOVERNED 75-76 (1990) (suggesting that courts are "attuned and responsive . . . to majoritarian preferences").

3. The Constitution of the United Sates of America grants "all legislative Powers" to Congress, U.S. CONST. art. I, § 1, while reserving "all judicial Powers" to the Supreme Court and all inferior courts created by Congress, U.S. CONST. art. III, § 1. "Legislative Powers" has been construed to mean the power to enact statutes and does not include the power to control their implementation or interpretation. The Supreme Court has expressly construed the judiciary's power under article III as limited. "Judicial power is never exercised for the purpose of giving effect to the will of the Judge; always for the purpose of giving effect to the will of the Legislature; or, in other words, to the will of the law." Osburn v. Bank of the United States, 22 U.S. (9 Wheat.) 738, 866 (1824) (Marshall, C.J.).

4. *See* BORK, *supra* note 1, at 5 ("[J]udges must consider themselves bound by law that is independent of their own views of the desirable. They must not make or apply any policy not fairly to

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The courts will occasionally take it upon themselves to render decisions that are contrary to relevant statutory language or legislative intent, in order to reach what they perceive as the correct result from a policy standpoint.[5]

This was recently exemplified in the Supreme Court's decision in *Gustafson v. Alloyd Co.*[6] when the Court interpreted the language of section 12(2) of the Securities Act of 1933[7] (Securities Act) as only applying to public offerings. The *Gustafson* decision furthers the apparent trend to restrict the availability of federal securities law remedies for private plaintiffs.[8] Unfortunately for private plaintiffs,

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be found in the Constitution or a statute. It is of course true that judges to some extent must make law every time they decide a case, but it is minor interstitial lawmaking."); GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 31-43 (posing the theory that judicial activism is a vehicle for validating anachronistic laws); EDWARD H. LEVI, AN INTRODUCTION TO LEGAL REASONING 30-32 (1949) (discussing the occasional abuse of power utilized by a court by imposing a different meaning upon the statutory intention of Congress); *see also* LIVELY, *supra* note 2, at 49-70 (suggesting that judicial activism is an inevitable fact of political reality since the text, legislative history, and structure of the law are often equivocal or uncertain). *See generally* REED DICKERSON, THE INTERPRETATION AND APPLICATION OF STATUTES (1975) (advocating the need for developing an adequate theory on how to read and apply statutes, thus minimizing the extent of judicial lawmaking); Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405 (1989).

5. *See* Michael P. Kenny & Theresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 141 (1995) ("The *words* of a statute must necessarily constrain courts when they engage in this process, otherwise, they simply substitute arbitrary normative expressions of personal preference for any semblance of legislative intent."); *see also* ALEXANDER M. BICKEL, THE LEAST DANGEROUS BRANCH 18 (1962) (stating that "judicial review is a deviant institution in the American democracy"); LIVELY, *supra* note 2, at 30-32; BORK, *supra* note 1, at 262 (opining that "law is being seduced by politics and is thereby losing its integrity as a discipline. If it continues on this course, law will cease to be what Holmes named it, calling for thinkers, and become merely the province of emoters and sensitives.") (citing Oliver Wendell Holmes, Profession of the Law, *in* SPEECHES BY OLIVER WENDELL HOLMES 22 (1st ed. 1913)); LAURENCE H. TRIBE, CONSTITUTIONAL CHOICES 30 (1985) (stating that "it seems axiomatic that the *words* of a statute — and *not* the legislators' intent as such — must be the crucial elements both in the statute's legal force and in its proper interpretation"); Frank H. Easterbrook, *The Role of Original Intent in Statutory Construction*, 11 HARV. J.L. & PUB. POL'Y 59, 63 (1988) (opining that the judicial interpretation of statutes can often result in the creation of "laws" that could not have been passed by the legislature"); Richard A. Posner, *Statutory Interpretation — in the Classroom and in the Courtroom*, 50 U. CHI. L. REV. 800, 809-10 (1983) (noting that disagreement during the legislative drafting process can result in vague legislative intent).

6. 115 S. Ct. 1061 (1995).

7. Securities Act of 1933, Pub. L. No. 73-38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)).

8. *See, e.g.*, Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.) (providing for certain restrictions on private rights of action under the federal securities laws); Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1455 (1994) (holding that private plaintiffs may not maintain an aiding and abetting action under rule 10b-5); Santa Fe Indus. v. Green, 430 U.S. 462, 473-74 (1977) (holding that private plaintiffs must prove manipulation and deception to maintain an action under rule 10b-5); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that private plaintiffs must prove scienter to maintain an action under rule 10b-5); *see also* Douglas C. Buffone, *Predatory Attorneys and Professional Plaintiffs: Reforms Are Needed to Limit Vexatious Securities Litigation*, 23 HOFSTRA L. REV. 655 (1995) (advocating the reform of vexatious private lawsuits against American corporations); Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961 (1994)

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section 12(2) is the latest provision in the federal securities laws to be scaled back.

Section 12(2) of the Securities Act creates a cause of action or recision where the offer or sale of a security through the means of a prospectus or oral communication contains a materially false statement or an omission of a material fact.[9] A division among the circuit courts had developed concerning the interpretation of "prospectus or oral communication" as it relates to section 12(2). One line of case law, led by *Ballay v. Legg Mason Wood Walker, Inc.*,[10] held that the scope of section 12(2) was limited to public offerings.[11] The *Ballay* court stated that the primary purpose of the Securities Act was to regulate public offerings, not secondary market transactions.[12] The second line of case law, led by *Pacific Dunlop Holdings, Inc. v. Allen & Co.*,[13] extended the scope of section 12(2) beyond public offerings.[14] The *Pacific Dunlop* court stated that the term "prospectus" should be defined via section 2(10), which includes a broad category of communications rather than restricting liability solely to an offering prospectus.[15] The Supreme Court recently resolved this dispute in *Gustafson v. Alloyd Co.*,[16] by holding that section 12(2) liability only applies to public offerings.[17]

This landmark decision severely limits the scope of section 12(2). The decision leaves section 10(b) of the Securities Exchange Act of 1934[18] (Exchange Act) and Rule 10b-5,[19] promulgated thereunder, as the only private remedies available

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(urging the Securities and Exchange Commission to disimply private rights of action under the federal securities laws); *cf.* Joel Seligman, Comment, *The Merits Do Matter*, 108 HARV. L. REV. 438, 439 (1994) (arguing that there is "insufficient evidence to justify significant rule or legislative changes that would further burden private federal securities legislation").

9. Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(2) (1994).

10. 925 F.2d 682 (3d Cir. 1991).

11. *See id.* at 693; *see infra* notes 36-54 and accompanying text.

12. *See Ballay*, 925 F.2d at 693. Secondary market transfers are transactions that occur in the marketplace of buyers and sellers of *existing* securities. *See* 3 THE NEW PALGRAVE DICTIONARY OF MONEY & FINANCE 411 (Peter Newman et al. eds., 1992).

13. 993 F.2d 578 (7th Cir. 1993).

14. *See id.* at 582; *see infra* notes 55-74 and accompanying text.

15. *See Pacific Dunlop*, 993 F.2d at 582. "The term "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 . . . ." Securities Act of 1933 § 2(10), 15 U.S.C. § 77b(10) (1994).

16. 115 S. Ct. 1061 (1995).

17. *See id.* at 1071.

18. Securities Exchange Act of 1934, Pub. L. No. 73-404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78*ll* (1994)). Section 10(b) states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994).

19. Rule 10b-5 states:

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for misrepresentations made in connection with a private placement or secondary market transaction. Section 10(b) of the Exchange Act is not an attractive cause of action for private plaintiffs because it requires the plaintiff to prove the additional elements of scienter,[20] reliance,[21] and causation.[22]

Although *Gustafson* reaches the correct result from a policy standpoint, the analysis behind the result is flawed. The Court's misguided interpretation of the statutory language could pose irreconcilable conflicts within the federal securities laws that will have a lasting effect on practitioners.

This article begins with a discussion of the court decisions that have interpreted the scope of section 12(2) up to *Gustafson*. Part II provides a critical examination of the *Gustafson* analysis. Part III discusses the effect and implications of the *Gustafson* decision on the securities industry.

I. The "Pre-Gustafson" Scope of Section 12(2)

The "roaring" 1920s, as far as the securities industry was concerned, came to an abrupt halt when the stock market crashed on Black Monday, October 29,

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> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit 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 (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1995).

20. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197-200 (1976). Justice Ginsburg noted in her dissent in *Gustafson* that "§ 12(2) did not become prominent in Securities Act litigation until this court held in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), that an action for civil damages under § 10(b) . . . requires proof of scienter." *Gustafson*, 115 S. Ct. 1061, 1083 n.8 (1995) (Ginsburg, J., dissenting); *see also* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 101, 109 Stat. 737, 747 (requiring the plaintiff to state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind).

21. Reliance is required in an action based on a material misrepresentation, rather than a material omission. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-54 (1972). The reliance requirement can be satisfied in material misrepresentation situations by establishing a "fraud on the market" theory. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 243-49 (1988) ("The fraud on the market theory is based on the hypothesis that, in an open market, the price of a company's stock is determined by the available material information regarding the company and its businesses. . . . Misleading statements will therefore defraud purchases of stock even if the purchases do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations." (quoting Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

22. There are two strands contained in the causation requirement: transaction causation and loss causation. Transaction causation requires the plaintiff to prove that the misrepresentation caused the plaintiff to engage in the transaction. Loss causation requires the plaintiff to prove that the misrepresentation or omission caused the plaintiff to suffer economic damages. *See* Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 381 (2d Cir. 1974) (holding that plaintiffs asserting an action based on an omission, rather than a material misrepresentation, must only plead loss causation).

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1929. When the stock market crashed in 1929 it brought the "regulatory scheme" of the securities industry crumbling down with it. President Franklin D. Roosevelt began picking up the pieces after this devastating blow to the nation's economy by staunchly advocating reform in the stock exchanges, the issuance of securities, and securities trading.[23] Congress responded to President Roosevelt's initiatives by enacting the Securities Act in order to restore stability to the nation's financial markets.[24] The Securities Act has two basic objectives: to provide investors with material information concerning the issuance of new securities to the public and to prohibit the fraudulent sale of securities.[25] The Securities Act provides investors with protection against noncompliance with these disclosure requirements through the creation of private rights of action.[26] Section 12(2) of the

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23. *See* H.R. REP. NO. 73-85, at 2 (1933) (President's Message of March 23, 1933, to the House Committee on Interstate and Foreign Commerce). *But see* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1-8 (3d ed. 1995) (arguing that the Securities Act did not grow out of President Roosevelt's New Deal, but rather evolved from "a generation of state regulation and several centuries of legislation in England").

24. *See* Securities Act of 1933, Pub. L. No. 73-38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)). Congress continued to enact additional regulatory legislation for the securities industry. *See* Securities Exchange Act of 1934, Pub. L. No. 73-404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78jj (1994)); Public Utility Holding Company Act of 1935, Pub. L. No. 74-333, 49 Stat. 803 (codified as amended at 15 U.S.C. §§ 79 to 79z-6 (1994)); Trust Indenture Act of 1939, Pub. L. No. 76-253, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa-77bbb (1994)); Investment Company Act of 1940, Pub. L. No. 76-768, §§ 1-53, 54 Stat. 789, 789-847 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-52 (1994)); Investment Advisors Act of 1940, Pub. L. No. 76-768, §§ 201-222, 54 Stat. 789, 847-57 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21 (1994)).

25. *See* RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 1 (7th ed. 1992). For a thorough discussion on the purpose of the Securities Act and a "behind-the-scenes" look at the drafting of this legislation, see James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

26. The federal securities laws provide both express and implied private rights of action. The Supreme Court has set forth eight express liability provisions in the Securities Act and the Exchange Act. *See* Musick, Peeler & Garrett v. Employers Ins., 508 U.S. 286, 296-97 (1993). These express provisions are: Securities Act of 1933 § 11, 15 U.S.C. § 77k (1994) (imposing liability for misstatements or omissions in a registration statement); Securities Act of 1933 § 12, 15 U.S.C. § 77*l* (1994) (imposing liability for the sale of unregistered securities or fraud in the sale of securities); Securities Act of 1933 § 15, 15 U.S.C. § 77o (1994) (imposing liability on control persons); Securities Exchange Act of 1934 § 9, 15 U.S.C. § 78i (1994) (imposing liability for manipulations of exchange traded securities); Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p (1994) (imposing liability for "short-swing" profits); Securities Exchange Act of 1934 § 18, 15 U.S.C. § 78r (1994) (imposing liability for misleading statements in reports filed with the Securities Exchange Commission); Securities Exchange Act of 1934 § 20, 15 U.S.C. § 78t (1994) (imposing liability on control persons); Securities Exchange Act of 1934 § 20A, 15 U.S.C. § 78t-1 (1994) (imposing insider trader liability).

Courts have also created implied private rights of action under the federal securities laws. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 385-87 (1983); Kardon v. National Gypsum Co., 69 F. Supp. 512, 513-14 (E.D. Pa. 1946) (implying a private cause of action under the Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (1994), and Rule 10b-5, promulgated thereunder, 17 C.F.R. § 240.10b-5 (1994), which imposes liability for employing any device, scheme or artifice to defraud in connection with the purchase or sale of a security); J.I. Case Co. v. Borak, 377 U.S. 426, 430-31 (1964) (implying a private cause of action under the Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a) (1994), and Rule 14a-9, promulgated thereunder, 17 C.F.R. § 240.14a-9 (1994), which imposes liability for fraud

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Securities Act is one of these protectionist remedies.[27]

Section 12(2) provides a remedy and recessionary damages to a purchaser of a security against an offeror or seller of the security in the event that: (1) the defendant offered or sold a security, (2) through the means of interstate commerce, (3) by the use of a prospectus or oral communication, (4) which includes an untrue statement or omission of material fact; (5) the plaintiff did not know of the untruth or omission, and (6) the defendant knew, or, in the exercise of reasonable care, could have known of the untruth or omission.[28] Although this may appear to be a straightforward provision in the federal securities laws, the scope of section 12(2) has been the center of recent controversy. Courts[29] and

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in the connection with the solicitation of proxy statements); Piper v. Chris-Craft Indus., 430 U.S. 1, 24-42 (1977) (implying a private cause of action under the Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 78n(e) (1994), and Rule 14e-3, promulgated thereunder, 17 C.F.R. § 240.14e-3 (1994), which imposes liability for fraud in connection of tender offers).

27. *See* Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(2) (1994).

28. *See* Monetary Management Group v. Kidder, Peabody & Co., 615 F. Supp 1217, 1222 (E.D. Mo. 1985); Gridley v. Sayre & Fisher Co., 409 F. Supp. 1266, 1272-73 (D.S.D. 1976), *aff'd sub nom.* Gridley v. Cunningham, 550 F.2d 551 (8th Cir. 1977).

Section 12(2) states:

> Any person who . . . offers or sells a security (whether or not exempted by the provisions of section 77c of this title [(Securities Act of 1933 § 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 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.

Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(2) (1994).

29. *See generally* Robert A. Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary market?*, 55 ALB. L. REV. 97, 99 n.14 (1991) (listing cases that discuss the scope of section 12(2) to secondary market transactions).

For cases holding that section 12(2) applies to secondary market transactions, see Pacific Dunlop Holdings Inc. v. Allen & Co., 993 F.2d 578, 595 (7th Cir. 1993); Farley v. Baird, Patrick & Co., 750 F. Supp 1209, 1221 (S.D.N.Y. 1990); *In re* Ramtek Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 95,483, at 97,521 (N.D. Cal. Sept. 7, 1990); Elysian Fed. Sav. Bank v. First Interregional Equity Corp., 713 F. Supp 737, 747-51 (D.N.J. 1989); Scotch v. Mosely, Hallgarten, Estabrook & Weeden, Inc., 709 F. Supp 95, 98 (N.D. Pa. 1988).

For cases holding that section 12(2) does not apply to secondary market transactions, see First Union Discount Brokerage Servs. v. Milos, 997 F.2d 835, 843-44 (11th Cir. 1993); Metromedia Co. v. Fugazy, 983 F.2d 350 (2d Cir. 1992); Shapiro v. UJB Financial Corp., 964 F.2d 272 (3d Cir. 1992); Ryder Int'l Corp. v. First Am. Nat'l Bank, 943 F.2d 1521 (11th Cir. 1991); Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682, 693 (3d Cir. 1991); Bogart v. Shearson Lehman Bros., No. 91 CIV 1036, 1993 WL 33643, at *3 (S.D.N.Y. Feb. 3, 1993); Fujisawa Pharm. Co. v. Kapoor, 814 F. Supp. 720 (N.D. Ill. 1993); PPM America, Inc. v. Marriott Corp., 820 F. Supp. 970 (D. Md. 1993); Hedden v. Marinelli, 796 F. Supp 432 (N.D. Cal. 1992); *In re* Delmarva Sec. Litig., 794 F. Supp 1293 (D. Del. 1992); Budget Rent-A-Car

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scholars[30] have attempted to define the scope of section 12(2) to determine whether it applies to secondary market transactions.

In 1991, the Third Circuit, in *Ballay v. Legg Mason Wood Walker, Inc.*,[31] held that section 12(2) does not apply to secondary market transactions, reasoning that the Securities Act was intended to regulate offerings of public securities.[32] However, in May 1993, the Seventh Circuit threw its hat into the ring and rejected the Third Circuit's holding in *Ballay*. In *Pacific Dunlop Holdings, Inc. v. Allen & Co.*,[33] the Seventh Circuit held that section 12(2) of the Securities Act does apply to secondary market transactions.[34] This debate eventually prompted the Supreme Court to resolve the issue in *Gustafson v. Alloyd Co.*[35]

Sys. v. Hirsch, 810 F. Supp. 1253 (S.D. Fla. 1992); Newman v. Comprehensive Care Corp., 794 F. Supp. 1513, 1524-25 (D. Or. 1992); Bennet v. Bally Mfg. Corp., 785 F. Supp. 559, 562 (D.S.C. 1992); Bank of Denver v. Southeastern Capital Group, 763 F. Supp. 1552, 1559 (D. Colo. 1991); 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 Burnham Lambert, Inc., 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).

30. For articles by scholars arguing that section 12(2) applies to secondary market transactions see: Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 917 (1992); Louis Loss, *Securities Act Section 12(2): A Rebuttal*, 48 BUS. LAW. 47 (1992); Therese H. Maynard, *The Future of Securities Act Section 12(2)*, 45 ALA. L. REV. 817, 822 (1994) [hereinafter Maynard, *The Future of Securities Act Section 12(2)*]; Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933*, 32 WM. & MARY L. REV. 847, 849 (1991); Robert N. Rapp, *The Proper Role of Securities Act Section 12(2) as an Aftermarket Remedy for Disclosure Violations*, 47 BUS. LAW. 711, 714 (1992); Laura K. Bancroft, Note, Gustafson v. Alloyd Co.: *The Continued Shrinking of Private Plaintiff Remedies Under the 1933 Securities Act*, 27 LOY. U. CHI. L.J. 149, 188 (1995); Adam D. Hirsh, Note, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. CHI. L. REV. 955 (1990); 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, 1239 (1994); Catherine Zucal, Comment, *Does Section 12(2) of the Securities Act of 1933 Apply To Secondary Trading?:* Ballay v. Legg Mason Wood Walker, Inc., 65 ST. JOHN'S L. REV. 1179, 1183 (1991).

For articles by scholars arguing that section 12(2) does not apply to secondary market transactions see: Prentice, *supra* note 29, at 140; Elliott J. Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 BUS. LAW. 1, 4 (1992).

31. 925 F.2d 682 (3d Cir. 1991).

32. *See id.* at 693. In *First Union Discount Brokerage Services v. Milos*, 997 F.2d 835 (11th Cir. 1993), the Eleventh Circuit joined the Third Circuit's position.

33. 993 F.2d 578, 595 (7th Cir. 1993).

34. *See id.* The Supreme Court granted certiorari to *Pacific Dunlop Holdings* in February 1994. Subsequent to the Supreme Court's grant of certiorari, the parties agreed to a voluntary settlement and the case was dismissed. *See* Allen & Co. v. Pacific Dunlop Holdings, Inc., 510 U.S. 1160 (1994).

35. 115 S. Ct. 32 (1994). Subsequent to the dismissal of *Pacific Dunlop Holdings*, the Supreme Court, apparently anxious to define the scope of section 12(2), granted certiorari in *Gustafson*.

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A. Ballay v. Legg Mason Wood Walker, Inc.

The Third Circuit was the first federal circuit court to determine the scope of section 12(2).[36] In *Ballay*, forty-one investors asserted causes of action under section 10(b) and section 12(2) of the Securities Act against the brokerage house of Legg Mason Wood Walker, Inc. (Legg Mason).[37] The investors alleged that Legg Mason had made oral misrepresentations regarding the book value of Wickes Company securities (Wickes).[38]

The district court jury denied the investors' section 10(b) claim but found in favor of the investors on their section 12(2) claim.[39] Legg Mason moved for a judgment notwithstanding the verdict, asserting that section 12(2) should not be applied to secondary market transactions.[40] The district court denied the motion and held that section 12(2) applied to aftermarket trading, stating that the plain language of section 12(2) does not limit its application to public offerings of securities and that the broad remedial purposes of the Securities Act are not restricted to public distributions.[41]

The Third Circuit reversed the district court and held that section 12(2) did not apply to secondary market transactions.[42] The court first examined the precise language of the statute.[43] In particular, the court focused on the meaning of "oral communication" in the section 2(10) definition of "prospectus."[44] The court utilized the canon of construction principle *noscitur a sociis* and determined that the phrase "oral communication" was limited by its meaning to the more restrictive term "prospectus."[45] After the statutory language analysis, the court

36. *See* Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir. 1991).

37. *See id.* at 684, 686.

38. *See id.* at 684. According to a Legg Mason branch manager, "Legg Mason is a full service brokerage house which subscribes to a value philosophy of investing." *Id.* at 685 (footnote omitted). Operating under this investment philosophy, Legg Mason promoted undervalued stock of companies with growth potential, such as those recently emerging from bankruptcy or reorganization (i.e., Wickes). *See id.* Legg Mason used various factors in calculating the value of these companies, one of which was goodwill, an intangible asset. *See id.* The investors argued that in calculating book value of the company, goodwill should not have been included since intangible assets cannot be readily sold in the event of a liquidation, and therefore, should not be included for "purposes of estimating the downside risk." *Id.*

39. *See id.* at 686.

40. *See id.*

41. *See id.* at 686-87.

42. *See id.* at 693.

43. *See id.* at 687 (stating that statutory construction begins with the language of the statute); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).

44. *See Ballay*, 925 F.2d at 688. For a definition of "prospectus" under section 2(10), see *supra* note 15.

45. *See Ballay*, 925 F.2d at 688 (quoting Jarecki v. G.D. Searle & Co., 367 U.S. 303, 307 (1961) by stating that "[t]he maxim noscitur a sociis, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress"). The *Ballay* court noted that "[t]he fact that 'oral communication' keeps company with 'prospectus' suggests . . . that the more general term [oral communication] be limited to conform to the more restrictive term [prospectus] where consonant with the legislative intent." *Id.*

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determined that the word "prospectus" is a term of art which describes the transmittal of information with regard to a public offering.[46]

The court then examined the legislative history and structure of the Securities Act and the Exchange Act. The court noted that Congress sought to regulate public offerings with the Securities Act, while the Exchange Act was established to regulate unfair practices on securities exchanges.[47] The logical result of this presumption is that since section 12(2) is part of the Securities Act, it therefore relates solely to public offerings, unless the legislative history states otherwise, which in this case the court stated that it did not.[48]

The court concluded its analysis with a comparison of section 12(2) with section 17(a) of the Securities Act[49] and section 10(b) of the Exchange Act,[50] both of which apply to secondary market transactions. The court distinguished section 17(a) for various reasons. Unlike section 17(a), the legislative history of section 12(2) is "devoid" of any indication that Congress intended it to be broader than the limited scope of sections 11 and 12(1).[51] Furthermore, section 17(a) does not contain the phrase "prospectus or oral communication" but instead provides as unlawful conduct employed "directly or indirectly . . . to obtain money or property by means of any untrue statement . . . ."[52] The court construed this distinction in language to mean that Congress intended the reach of section 17(a) to be much broader than section 12(2).[53] The court also differentiated section 10(b) of the Exchange Act from section 12(2). The court

46. *See id.* The Third Circuit displayed typical judicial activism in its apparent attempt to restrict the scope of section 12(2) to public offerings, thus eliminating one more weapon from the private plaintiff arsenal. The court feared that a broad reading of "oral communication" would inherently provide purchasers with a cause of action under section 12(2) for negligent misrepresentations even though the purchaser could not recover under section 10(b) because of the scienter, causation and reliance requirements. *See id.* at 689. The court further noted that under its analysis, although flawed, "[i]nterpreting section 12(2) so that 'oral communication' refers to both initial and secondary trading . . . would create an anomaly in that sellers in the aftermarket would be liable only for oral and not written misrepresentations because the term 'prospectus' is limited to initial offerings." *Id.*

47. *See id.* at 690.

48. *See id.* The court made a further leap of faith when it noted that the location of section 12(2) in the Securities Act, behind sections 11 and 12(1), which relate to public offerings, and before section 13, which relates to public offerings, indicates that section 12(2) is similarly restricted to public offerings. *See id.* at 691.

49. Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1994). Section 17(a) and section 12(2) have been referred to as criminal analogues because of their similar language. *See Ballay*, 925 F.2d at 691. The Supreme Court has held section 17(a) applicable to secondary market transactions. *See* United Sates v. Naftalin, 441 U.S. 768 (1979).

50. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994). The Supreme Court has held that purchasers of securities can bring private causes of action in secondary market transactions. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195-97 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

51. *See Ballay*, 925 F.2d at 692 ("Had Congress intended section 12(2) to extend to liability for secondary transactions, it could have preceded 'oral communication' with 'any' and explicitly stated its special intent in the legislative history.").

52. *Ballay*, 925 F.2d at 691 (quoting Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1994)).

53. *See id.* at 691-92.

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focused on the fact that the elements of proof required and damages recoverable between the provisions differed substantially.[54]

The Third Circuit thus set the stage for restricting the scope of section 12(2) to public securities distributions. Shortly thereafter, the Seventh Circuit appeared on the scene in *Pacific Dunlop Holdings, Inc. v. Allen & Co.*[55] and departed from the prevailing view established in *Ballay.*

B. Pacific Dunlop Holdings Inc. v. Allen & Co.

The Seventh Circuit was presented with the task of determining the scope of section 12(2) approximately two years after the Third Circuit decided *Ballay.* Pacific Dunlop Holdings, Inc. (Pacific Dunlop) entered into a stock purchase agreement with GNB Holdings, Inc. (GNB).[56] The stock purchase agreement warranted that GNB and its subsidiaries were in compliance with all the applicable environmental rules and regulations, were not subject to any pending governmental investigation, and fully disclosed all liabilities and obligations.[57] Subsequent to the stock purchase agreement, Pacific Dunlop discovered that GNB was exposed to extensive environmental claims, liabilities regarding a government services contract, and occupational disease claims.[58] Upon this discovery, Pacific Dunlop instituted a lawsuit against GNB alleging that GNB had omitted material facts that rendered its representations in the stock purchase agreement false and misleading, constituting a violation of section 12(2) of the Securities Act.[59]

The district court, relying on the *Ballay* decision, dismissed the action stating that the stock purchase agreement was not a public offering of stock.[60] The Seventh Circuit, on appeal, examined the relevant statutory language and legislative history surrounding section 12(2), compared section 12(2) to similar fraud provisions, and concluded that section 12(2) "applies to any communication which offers any security for sale or confirms the sale of any security, including the stock purchase agreement in the present case."[61]

The Seventh Circuit did agree with the Third Circuit on one issue (albeit trivial): "The starting point in every case involving construction of a statute is the

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54. *See id.* at 692. Section 12(2) provides recisionary damages, while section 10(b) only permits recovery of actual damages. *See id.* at 693. *Compare* Pinter v. Dahl, 486 U.S. 622 (1988) *with* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). Section 12(2), unlike section 10(b), does not contain the requirements of scienter, reliance, or causation. "If it were determined that section 12(2) applies to secondary market trading, the more lenient requirements of section 12(2) would effectively eliminate the use of section 10(b) by securities purchasers." *Ballay,* 925 F.2d at 692.

55. 993 F.2d 578 (7th Cir. 1993).

56. *See id.* at 579. The defendants in this case were two principal shareholders of GNB: Allen & Co., Inc., an investment banking firm, which owned 20% of the stock, and Daniel Heffernan, who owned 6.7% of the stock. *See id.*

57. *See id.*

58. *See id.*

59. *See id.*

60. *See* Pacific Dunlop Holdings, Inc. v. Allen & Co., No. 90-C-5678, 1991 WL 348493, at *1 (N.D. Ill. May 16, 1991), *rev'd,* 993 F.2d 578 (7th Cir. 1993).

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

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language itself."[62] In examining the language of section 12(2), the court initially focused on whether the terms "prospectus or oral communication" were intended to apply to secondary market transactions.[63] The court noted the historically broad scope of the section 2(10) definition of "prospectus" and concluded that a contract of sale or any written communication that disposes of a security, such as the stock purchase agreement at hand, is included within that scope.[64]

Although the Securities Act contains only one definitional provision of prospectus, it describes more than one type of prospectus in various provisions. For example, section 10[65] prescribes additional requirements for a section 2(10) prospectus for purposes of complying with section 5(b)(1).[66] The court wrestled with the issue of which prospectus definition to apply for under section 12(2).

The Seventh Circuit adopted a broad section 2(10) definition of prospectus to include communications used to solicit investor interest in both the initial distribution and secondary trading markets.[67] The court determined that section 2(10) is the controlling definitional provision "unless the context otherwise requires."[68] The Seventh Circuit, after examining the structure of the Securities Act and the text of section 12, concluded that section 12(2) applies to secondary market transactions.[69] The court then proceeded to analyze the legislative history of section 12(2).[70]

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62. *Id.* at 582 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975)); *see supra* note 43 and accompanying text.

63. *See Pacific Dunlop*, 993 F.2d at 582-83.

64. *See id.* at 583 (citing Byrnes v. Faulkner, Dawkins & Sullivan, 550 F.2d 1303, 1309 (2d Cir. 1977) (quoting Securities Act Release No. 2623 (1941), *reprinted in* 11 Fed. Reg. 10,964 (1946) ("'[P]rospectus' include[s] 'within its meaning an ordinary confirmation,' as well as 'every kind of written communication . . . which constitutes a contract of sale or disposition of a security for value.'")).

65. Securities Exchange Act of 1993 § 10, 15 U.S.C. § 77j (1994).

66. Securities Act of 1933 § 5(b)(1), 15 U.S.C. § 77e(b)(1) (1994). Section 5(b)(1) prohibits the use of any instrument or communication relating to the sale of a security unless the form of the prospectus meets the requirements set forth in section 10. The distribution of preliminary prospectus is authorized pursuant to section 10(b) after the registration statement has been filed. *See id.* § 10(b), 15 U.S.C. § 77j(b) (1994). The use of statutory prospectus is authorized pursuant to section 10(a) after the registration statement has become effective. *See id.* § 10(a), 15 U.S.C. § 77j(a) (1994) (after the registration statement becomes effective, a preliminary prospectus may be used for informational purposes pursuant to Securities Act of 1933 Rule 431).

67. *See Pacific Dunlop*, 993 F.2d at 588; *see also* Diskin v. Lomasney & Co., 452 F.2d 871, 874 (2d Cir. 1971) (holding that a letter that accompanied an offering circular sent to prospective purchasers constituted a prospectus).

68. *Pacific Dunlop*, 993 F.2d at 584 (emphasis omitted). For a discussion of this "context clause," see Maynard, *The Future of Securities Act Section 12(2)*, *supra* note 30, at 840 n.103.

69. *See Pacific Dunlop*, 993 F.2d at 595. The court, in dicta, agreed with the Third Circuit by restricting the term "oral communication" to those oral communications that relate to a prospectus. *See id.* at 588 ("The words 'oral communication' are words of form, not substance; they describe how one communicates a message, not the message content.").

70. The court noted that it could have concluded its opinion after examining the statutory language. *See id.* at 589. The court continued its analysis to rebut the Third Circuit's legislative history analysis. *See id.* at 589 n.16 ("[I]f the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary to examine the additional

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The House Report of the Securities Act focused primarily on offerings that required a registration statement.[71] The Senate Report of the Securities Act, which was apparently adopted by the Conference Report, focused on the recovery for *any* fraudulent sale of a security.[72] The court held that there is nothing contained in the legislative history to suggest a more narrow definition of prospectus than that established by the statutory language of section 2(10).[73]

Finally, the court dispensed with the notion that section 12(2) should be confined to public offerings in light of the other liability provisions established by the Securities Act and the Exchange Act.[74] The Seventh Circuit thus held that the scope of section 12(2) extends beyond the public offering and includes secondary market transactions.

The *Pacific Dunlop* decision created a division among the federal circuit courts concerning the scope of section 12(2). On one hand, the *Ballay* line of cases held that section 12(2) was restricted to public offerings.[75] On the other hand, the *Pacific Dunlop* line of cases held that section 12(2) applies to both initial offerings and secondary market transactions.[76] This conflict was promptly addressed by the Supreme Court in *Gustafson v. Alloyd Co.*[77] Although the Supreme Court addressed the conflict surrounding section 12(2), the decision itself may have created a more serious problem for the court system in the future when it is called upon to interpret the statutory language of the federal securities laws.

II. The Gustafson Debacle

A. The Facts

In 1989, the three sole shareholders of Alloyd Co. (Sellers) agreed to sell their stock to Wind Point Brothers II, L.P. (Wind Point).[78] Wind Point relied extensively on a business review of Alloyd Co. conducted by KPMG Peat

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considerations of policy that may have influenced the lawmakers in their formulation of the statute.") (quoting Aaron v. SEC, 446 U.S. 680, 695 (1980)). The Supreme Court has also noted that the legislative history behind section 12(2) is "sparse." *See* Randall v. Loftsgaarden, 478 U.S. 647, 657 (1986).

71. *See Pacific Dunlop*, 993 F.2d at 589-90 (citing H.R. REP. NO. 73-85 (1933)).

72. *See id.* at 590-92.

73. *See id.* at 592.

74. *See id.* at 592-95. The court compared section 12(2) with section 17(a) of the Securities Act and section 10(b) of the Exchange Act, both of which apply to secondary market transactions. The defendant argued, "that because Congress had intended the scope of section 17 to include initial and secondary sales, by not using the identical words 'directly or indirectly' in both sections, Congress intended to confine section 12(2) to initial offerings." *Id.* at 593. The court responded to this argument by stating that "Congress . . . can write the statute as Congress desires." *Id.* The defendant also fashioned a similar argument with regard to section 10(b). The court responded by stating that nothing in section 10(b) requires a different interpretation of section 12(2). *See id.*

75. *See supra* notes 36-54 and accompanying text.

76. *See supra* notes 55-74 and accompanying text.

77. 115 S. Ct. 1061 (1995).

78. *See id.* at 1064.

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Marwick in arriving at its decision to purchase the company.[79] The business review included an estimated inventory figure because it was the company's policy to determine inventory levels at the end of the year.[80]

Wind Point purchased all of the Alloyd stock from the Sellers through an acquisition agreement[81] which stipulated that the purchase price would be adjusted to reflect any variance between the projected estimated figures in Alloyd's financial statements and the actual year-end results.[82] The year-end audit revealed that Alloyd's actual earnings for 1989 were lower than the projected estimates relied upon by the parties in arriving at the purchase price.[83] The Sellers remitted the shortfall to Wind Point in accordance with the private offering agreement.[84]

Alloyd Co. (the newly formed company) and Wind Point, nevertheless, brought a lawsuit against the Sellers seeking to rescind the acquisition agreement under section 12(2) of the Securities Act alleging that the statements made by the Sellers regarding Alloyd's financial data were inaccurate, rendering the representations and warranties contained in the agreement untrue.[85] They further alleged that the acquisition agreement was a "prospectus," thus rendering any misstatements contained therein a violation of section 12(2).[86]

The district court, relying on the *Ballay* decision, granted the Sellers' motion for summary judgment. The court reasoned that the transaction at issue was privately negotiated and therefore did not constitute a violation of section 12(2), which the court held was only applicable to public offerings.[87] The Seventh Circuit, on appeal, vacated the district court's judgment and remanded the case for further consideration in light of its decision in *Pacific Dunlop*.[88] The Supreme Court, apparently anxious to define the scope of section 12(2), granted certiorari.

B. The Supreme Court Opinions

1. The Majority

The majority framed the issue at hand as whether the sale agreement between Alloyd and Gustafson was a prospectus as the term is used in the Securities Act.[89] The Court examined section 2(10), which sets forth the definition of a prospectus; section 10, which sets forth the information required to be included

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79. *See id.* at 1064-65.
80. *See id.* at 1065.
81. *See id.*
82. *See id.*
83. *See id.*
84. *See id.*
85. *See id.*
86. *See id.*
87. *See id.*
88. *See id.*
89. *See id.* at 1066. Alloyd argued that "prospectus" should be defined broadly, thus encompassing the agreement between the parties. *See id.* Gustafson, however, argued that "prospectus" is restricted to communications relating to public offerings. *See id.*

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in a prospectus; and section 12, which imposes liability for material misstatements or omissions contained in a prospectus.[90]

The logical starting point for interpreting the meaning of "prospectus" would have been the definitional provision found in section 2(10). However, the Court, rather curiously, began its analysis with section 10, which is a clear initial indication that the majority does not understand the structure of the federal securities laws.

Section 10 requires that certain prospectuses contain the information contained in a registration statement.[91] Although the Court observed that section 10 does not define a prospectus, it noted that section 10 instructs when a document cannot be classified as a prospectus.[92] Applying this reasoning to the facts of this case, the Court stated that the private offering agreement could not be considered a prospectus under section 10 because it did not contain all of the information required to be contained in a prospectus forming part of a registration statement.[93] The Court then concluded that if the private offering agreement was not a prospectus under section 10, it was not a prospectus under section 12(2).[94]

The Court moved to an examination of section 12(2). It began by noting that section 12(2) exempts from its coverage any prospectus used in connection with an offering exempt under section 3(a)(2) of the Securities Act.[95] The Court reasoned that if Congress had wanted to establish liability under section 12(2) for all misstatements contained in written communications, it would not have created an exception for government-issued securities.[96] The Court concluded that "[t]he

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90. *See id.* at 1066-74.

91. *See id.* at 1066. Section 10 provides in part:

> (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* . . . .

Securities Act of 1933 § 10, 15 U.S.C. § 77j (1994) (emphasis added).

92. *See Gustafson*, 115 S. Ct. at 1066-67.

93. *See id.* at 1067.

94. *See id.*

95. *See id.* at 1067-68. Section 3(a)(2) is a transaction-based exemption from the registration requirements of section 5 of the Securities Act, which applies to securities issued or guaranteed by the United States, a state, a municipality, a government instrumentality, national banks or state banks. *See* Securities Act of 1933 § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1994).

96. *See id.* at 1068. The Court further noted that the government issued securities exception is logical since it provides a precise and appropriate means of giving immunity to government authorities. *See id.* The dissent, however, refuted this argument. It offered two plausible suggestions for the exemption of government securities under section 12(2): (1) Congress thought it was unnecessary to impose liability on the secondary sellers of a government security since there is readily available information regarding the securities from the markets or the government entities; or (2) Congress chose not to burden government securities with the costs that would accrue from additional liabilities on secondary market transactions. *See id.* at 1077 (Thomas, J., dissenting).

This restrictive language can be interpreted as a clear indication that Congress intended to limit the exceptions to section 12(2)'s coverage. If Congress intended to restrict section 12(2) to public offerings,

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anomaly disappears, however, when the term 'prospectus' relates only to documents that offer securities sold to the public by an issuer."[97]

The Court then attempted a cursory review of the purpose behind the Securities Act, which, according to the Court, was the creation of registration and disclosure obligations for public offerings.[98] The Court stated that the Securities Act is limited to providing remedies for violations of registration and disclosure obligations in public offerings.[99] The Court believed that section 12(2), like the other obligations created by the Securities Act, was linked to public offerings.[100] It then rejected Alloyd's argument that any written offer is a prospectus for purposes of section 12(2), stating that this would incorrectly result in the term "prospectus" having a broader scope than the same term in section 10.[101]

The Court concluded its analysis where it should have started, the definitional provision of section 2(10). Section 2(10) defines prospectus as: "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . ."[102] Alloyd argued that any written communication that offers a security for sale is a prospectus.[103] The Court, however, quickly dispensed with this argument by manipulating two rules of statutory construction. First, the Court refused to read section 2(10) as rendering some of the words contained therein as redundant.[104] The Court added that if the term "communication" included every written communication, it would render "notice, circular, advertisement, [and] letter" redundant because each of those terms is also a form of communication.[105]

The second canon of construction utilized by the Court was the doctrine *noscitur a sociis*, which holds that no one term should be interpreted so broadly as to render its accompanying words inconsistent.[106] The Court used these two rules of construction to hold that a communication will qualify as a prospectus under section 2(10) if it is a document of wide dissemination and a public communication.[107]

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it certainly could have carved out the section 4(2) exemption, among other private offering exemptions to registration. *See infra* notes 128-29 and accompanying text.

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

98. *See id.*

99. *See id.*

100. *See id.*

101. *See id.* The Court would not "accept the conclusion that this single operative word means one thing in one section of the Act and something quite different in another." *Id.*

102. Securities Act of 1933 § 2(10), 15 U.S.C. § 77b(10) (1994).

103. *See Gustafson*, 115 S. Ct. at 1069.

104. *See id.*

105. *See id.*

106. *See id.* This doctrine avoids "ascribing to one word a meaning so broad that it is inconsistent with its accompanying words, thus giving 'unintended breadth to the Acts of Congress.'" *Id.* (quoting Jarecki v. G.D. Searle & Co., 367 U.S. 303, 307 (1961)). The Court had used this doctrine in the past in its interpretation of "security" under the Exchange Act. *See* Reves v. Ernst & Young, 494 U.S. 56, 63 (1990).

107. *See Gustafson*, 115 S. Ct. at 1070.

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The Court garnered further support for its erratic decision through its analogy to section 17(a) of the Securities Act[108] and its decision in *United States v. Naftalin*.[109] The Court in *Naftalin* held that section 17(a) prescribed liability for both public distributions and ordinary market transactions.[110] The *Gustafson* Court distinguished section 17(a) from section 12(2) by stating that section 17(a) did not contain the limiting language "by means of prospectus or oral communication" and its legislative history clearly indicated it was not intended to be restricted to public offerings.[111]

The Court concluded that a "prospectus" in section 12(2) is a term that describes a communication that contains all of the required information in section 10 of the Securities Act.[112] Since the private offering agreement at issue did not contain all of the required information under section 10 of the Securities Act (i.e., was not a public offering), Alloyd could not rescind the agreement under section 12(2).[113]

2. The Dissent

A dissenting opinion, written by Justice Thomas and joined by Justices Scalia, Ginsburg, and Breyer, states the proposition that section 12(2) applies to secondary transactions as well as public offerings.[114] The dissent, unlike the majority, properly maneuvered through the various sections of the Securities Act

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> The list of terms in § 2(10) prevents a seller of stock from avoiding liability by calling a soliciting document something other than a prospectus .... [T]he 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." The term includes communications held out to the public at large but that might have been thought to be outside the other words in the definitional section.

Id.

108. Section 17(a) states:

> 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, or 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 the 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.

Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1994).

109. 441 U.S. 768 (1979).

110. *See id.* at 778.

111. *See Gustafson*, 115 S. Ct. at 1071.

112. *See id.* at 1073-74.

113. *See id.* at 1074.

114. *See id.* (Thomas, J., dissenting). Justice Ginsburg, joined by Justice Breyer, offered a second dissenting opinion quite similar to Justice Thomas' dissent. Justice Ginsburg, like Justice Thomas, focused on the broad language of section 2(10) and criticized the majority for its result-oriented decision-making process. *See id.* at 1079-83 (Ginsburg, J., dissenting). Justice Ginsburg further added an examination of the legislative history of the Securities Act as well as scholarly commentary on the issue. *See id.* at 1081-83.

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in arriving at this conclusion. It started its analysis with an examination of the section at issue, section 12(2), and then proceeded to examine section 2(10), the relevant definitional provision, and concluded with an examination of the overall structure of the Securities Act.

The dissent criticized the majority's means of defining "prospectus" under the Securities Act,[115] specifically attacking the majority's use of sources outside the four corners of the statute to interpret the term "prospectus."[116] The dissent thought it was unnecessary to look further than section 2(10) to find its definition of prospectus for section 12(2).[117] In so doing, it criticized the majority's misapplication of the doctrine *noscitur a sociis*.[118] The dissent correctly noted that "[n]oscitur a sociis is a well established 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."[119] However, since the meaning of "prospectus" is neither doubtful nor obscure, there is no reason to apply this statutory canon. Justice Thomas argued that the broad language of section 2(10) required a broad interpretation of the term "prospectus."[120] In doing so, he rejected the majority's assertion that a broad definition of prospectus renders much of the section 2(10) language redundant.[121]

The dissent then moved to an examination of the use of the term "prospectus" in other provisions of the Securities Act. The dissent agreed with the majority's observation that other sections of the Securities Act employ a narrower interpretation of "prospectus."[122] It did not agree, however, that Congress intended the

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115. *See id.* at 1074-75 (Thomas, J., dissenting) ("We should use section 2(10) to define 'prospectus' for the 1933 Act, rather than, as the majority does, use the 1933 Act to define 'prospectus' for section 2(10).").

116. *See id.* at 1074 (Thomas, J., dissenting).

117. *See id.* (Thomas, J., dissenting).

118. The dissent believed that the majority sought to avoid an obvious clear meaning of prospectus under section 2(10) by introducing the maxim *noscitur a sociis* to create ambiguity. *See id.* at 1075 (Thomas, J., dissenting).

119. *Id.* (Thomas, J., dissenting) (quoting Russell Motor Car Co. v. United States, 261 U.S. 514, 519 (1923)). The dissent also argued that the majority's application of the doctrine was improper because it does not necessarily require the court to construe every term in a series narrowly because of the meaning given to one term. *See id.* (Thomas, J., dissenting).

120. *See id.* (Thomas, J., dissenting) ("Section 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."). Justice Thomas further noted that Congress' use of the phrase "communication, written or by radio or television" was intended to catch anything that had been omitted in the definition. *See id.* (Thomas, J., dissenting).

121. *See id.* (Thomas, J., dissenting).

122. *See id.* at 1075-76 (Thomas, J., dissenting) ("I agree with the majority that §§ 5 and 10 cannot embrace fully the broad definition of prospectus supplied by § 2(10) and used by § 12(2)."); *see also* Securities Act of 1933 § 10, 15 U.S.C. § 77j(a)(3) (1994) (specifying information required in a prospectus); Securities Act of 1933 § 5, 15 U.S.C. § 77e(b) (1994) (requiring a prospectus to accompany the sale of a security).

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term "prospectus" to be interpreted consistently throughout the Act.[123] In support of this argument, the dissent noted that the phrase "confirms the sale of any security" contained in the definition of prospectus in section 2(10) is not contained in section 10.[124] It found further support in the introductory language of section 2, the definitional provision of the Securities Act, which states that the definitions apply "unless the context otherwise requires."[125] The dissent believed that since there is no context requiring otherwise in section 12(2), Congress intended the default meaning of "prospectus" to apply.[126]

The dissent then maintained, contrary to the majority opinion, that section 12(2) does not contain distinctions between public offerings and aftermarket trading activity.[127] "If . . . Congress had intended to limit § 12(2) to initial public offerings, it presumably would have used words such as 'issuer,' 'public offering,' or 'private,' or 'resale,' or at least discussed trading on the exchanges or the liability of dealers, underwriters, and issuers."[128] It further contended that the absence of a reference in section 12(2) to a transaction exemption under section 4 supplements the argument that Congress did not intend to restrict section 12(2) to public offerings.[129]

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123. The dissent used a clever analogy to a hypothetical statute to clarify its position:

> 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).

124. *See id.* (Thomas, J., dissenting).

125. *See id.* (Thomas, J., dissenting) ("[N]othing in § 12(2) indicates that the 'context otherwise requires' the use of a definition of 'prospectus' other than the one provided by § 2(10). . . . [I]t is § 10's 'context' that seems to require the use of a definition which is different from that of § 2(10).").

126. *See id.* (Thomas, J., dissenting). Congress has expressly provided otherwise in other sections of the Securities Act, thus indicating it would have stated otherwise in section 12(2) if that was its intention. *See* Securities Act of 1933 § 5(b)(1), 15 U.S.C. 77e(b)(1) (1994) (referring to any prospectus relating to a security for which a registration statement has been filed unless the prospectus meets the requirements of section 10); Securities Act of 1933 § 10(a), 15 U.S.C. 77j(a) (1994) (referring to a prospectus that is required to contain the information of a registration statement); Securities Act of 1933 § 10(b), 15 U.S.C. 77j(b) (1994) (referring to a prospectus that is filed as part of a registration statement).

127. *See Gustafson*, 115 S. Ct. at 1076.

128. *Id.* at 1076-77; *see, e.g.*, Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1994) (exempting "transactions by an issuer not involving any public offering"); Securities Act of 1933 § 11, 15 U.S.C. § 77k 1994) (creating liability for false or misleading registration statements for "every person who was a director of . . . or partner in the issuer"); *see also* Central Bank v. First Interstate Bank, 511 U.S. 164, 177 (1994) (eliminating liability for aiding and abetting under section 10(b) of the Exchange Act, reasoning: "If . . . Congress 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.").

129. *See Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting). Section 4 of the Securities Act exempts transactions from the registration requirements of section 5. *See* Securities Act of 1933 § 4, 15

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The dissent then refuted the majority's misapplication of section 17(a) of the Securities Act, and the Court's analysis in *United States v. Naftalin*[130] thereunder, to section 12(2).[131] First, the dissent rejected the contention that the structure of the Securities Act restricted the application of section 17 to public offerings.[132] Second, the dissent reiterated that the Exchange Act's applicability to fraud in the secondary market does not lead to the conclusion that the Securities Act applies only to public offerings.[133] "Naftalin counsels the Court to reject arguments that we should read § 12(2) narrowly in order to avoid redundancy in securities regulation."[134]

Finally, the dissent examined the driving public policy motivations behind the majority's decision.[135] The dissent noted that the majority based its decision on the *assumption* that Congress did not intend to impose liability on sellers in the secondary market.[136] Although the dissent could relate to the majority's concern of increased securities litigation if section 12(2) was extended to secondary market transactions, it correctly noted that it was the duty of the legislature, not the Court, to rectify the situation.[137] The dissent concluded that "[i]f the majority believes that § 12(2)'s requirements are too burdensome for the securities markets, it must rely upon the other branches of government to limit the 1933 Act."[138]

C. Supplemental Arguments in Dissent Not Addressed by the Supreme Court Opinion

1. The Origin of Section 2(10) Manifests a Broad Interpretation of "Prospectus"

The foundation of section 2(10) indicates that the legislature intended the term "prospectus" to reach beyond public offering transactions. The English Companies Act has been noted as the paramount source of the Securities Act.[139] The

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U.S.C. § 77d (1994). "If Congress had intended § 12(2) to govern only initial public offerings, it would have been simple for Congress to have referred to the § 4 exemptions in § 12(2)." *Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting).

130. 441 U.S. 768 (1979).

131. *See Gustafson*, 115 S. Ct. at 1077-78 (Thomas, J., dissenting).

132. *See id.* at 1077 (Thomas, J., dissenting).

133. *See id.* at 1078 (Thomas, J., dissenting) ("The fact that there may well be some overlap is neither unusual nor unfortunate.") (quoting SEC v. National Sec., Inc., 393 U.S. 453, 468 (1969)).

134. *Id.* (Thomas, J., dissenting) (citing *Naftalin*, 441 U.S. at 778).

135. *See id.* at 1078-79 (Thomas, J., dissenting).

136. *See id.* at 1078 (Thomas, J., dissenting).

137. *See id.* at 1079 (Thomas, J., dissenting) ("[I]t is for Congress, and not for this Court, to determine the desired level of securities liability"); *see also* Central Bank v. First Interstate Bank, 511 U.S. 164, 188 (1994) (stating that public policy considerations "cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it") (citing Demarest v. Manspeaker, 498 U.S. 184, 191 (1991)).

138. *Gustafson*, 115 S. Ct. at 1079 (Thomas, J., dissenting).

139. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 123 (1953) (stating that the British Companies Act was one of the "statutory antecedents" of the federal securities laws); *see also* Landis, *supra* note

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English Companies Act defined "prospectus" as "any prospectus, notice, circular, advertisement, or other invitation, *offering to the public* for subscription or purchase any shares or debentures of a company."[140] The designers of the Securities Act closely paralleled the English Companies Act in arriving at the definition of prospectus under section 2(10).[141] The Securities Act, however, did not include language limiting the scope of a prospectus to an "offering to the public."[142] This would strongly imply that the drafters intended that the term "prospectus" would apply to transactions beyond the ambit of public offerings by virtue of the excluded reference to an "offering to the public."[143]

2. The Structure and Context of the Securities Act

The structure and context of the Securities Act as a whole does not provide a basis for limiting section 12(2) to public offerings. Although a central objective of the Securities Act is to regulate public offerings, the Supreme Court has noted that it has additional functions.[144] Section 12(2), like section 17(a), prohibits misstatements in connection with the purchase or sale of securities, and the Supreme Court's observation concerning section 17(a)[145] is equally applicable to section 12(2): there is no distinction between public and private distributions.

The location of section 12(2) in the Securities Act is not indicative of an intention to limit section 12(2) to public offerings. Although section 12(2) is located after sections 11 and 12(1) and before section 13, all which relate to public offerings, their proximity to section 12(2) is unrelated to the subject of public offerings.[146] Section 11 was placed adjacent to section 12 because those provisions contain the Securities Act's only private rights of action.[147] A valid argument can be fashioned that section 12(1) was placed in the same provision

25, at 34.

140. Companies Act, 19 & 20 Geo. 5, ch. 23, § 380(1) (1929) (Eng.) (emphasis added).

141. For a definition of "prospectus" under section 2(10), see *supra* note 15.

142. *See supra* note 15.

143. In an initial draft of the House Bill, the remedy for false or misleading representations in a prospectus was contained in section 11 and was limited to prospectuses filed with a registration statement. An ensuing draft removed the restriction concerning public offerings and transferred the provision from section 11 to section 12. *See* H.R. CONF. REP. NO. 73-152, at 24 (1933); *see also* Landis, *supra* note 25, at 30-49.

144. *See* United States v. Naftalin, 441 U.S. 768, 777-78 (1979). In *Naftalin*, the Court rejected the argument that section 17(a) of the Securities Act is only applicable to public offerings. *See id.*; *see also supra* notes 108-11 and accompanying text (defining section 17(a) and comparing it section 12(2)).

145. Gustafson v. Alloyd Co., 115 S. Ct. 1061, 1070-71 (1995).

146. Section 11 imposes liability for false or misleading statements contained in a registration statement. *See* Securities Act of 1933 § 11, 15 U.S.C. § 77k (1994). Section 12(1) imposes liability for sales of securities in violation the registration requirements of section 5. *See* Securities Act of 1933 § 12(1), 15 U.S.C. § 77*l*(1) (1994). Section 13 provides the statute of limitations for private rights of action under sections 11 and 12. *See* Securities Act of 1933 § 13, 15 U.S.C. § 77m (1994). The court in *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991), considered the location of section 12(2) in the Securities Act relevant in holding section 12(2) solely applicable to public offerings. *See supra* note 48.

147. For a discussion of private rights of action under the federal securities laws, *see supra* note 26.

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as section 12(2) because both create private rights of action against the seller and provide the same ameliorative measures (rescission or, if the security has been sold, damages).[148] The obvious reason for the placement of section 13 is that it provides the statute of limitations for the preceding two provisions, sections 11 and 12.[149] There is, therefore, no merit to the argument that the location of section 12(2) lends further credence to the argument that it should be restricted to public offerings.

3. Policy Arguments in Support of a Broad Application of Section 12(2)

Although the policies of the federal securities laws are not formally permitted to transcend the language of the particular statute,[150] the overriding policy considerations favor the application of section 12(2) beyond public offerings. Congress enacted the federal securities laws to provide investors with material information concerning the issuance of new securities and to prohibit the fraudulent sales of securities.[151] Section 12(2) accomplishes this objective by providing purchasers of securities with a private cause of action for misstatements in the sale of securities.[152] The notion that Congress would not provide a protectionist remedy for false or misleading statements in connection with a private sale of securities is contrary to the legislative purpose that provoked the legislature to create the federal securities laws.[153]

III. The Effect of Gustafson's Misguided Statutory Interpretation

Gustafson held that the term "prospectus" refers to a document that relates to a public offering by an issuer or its controlling shareholders and contains the information required to be included in a registration statement.[154] It further held that a document does not cease to be a prospectus if it omits a required piece of information.[155] Furthermore, "a document is not a prospectus . . . if, absent an exemption, it need not comply with § 10's requirements."[156] This appears to limit the scope of section 12(2) to transactions registered, or required to be

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148. *See* Securities Act of 1933 § 12, 15 U.S.C. 77*l* (1994).

149. *See supra* note 146.

150. *See* Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439 (1994); Pinter v. Dahl, 486 U.S. 622 (1988).

151. *See supra* note 25 and accompanying text.

152. *See* Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(2) (1994).

153. Although purchasers of private securities have the Securities Exchange Act of 1934 section 10(b) and Rule 10b-5 available (which prohibit fraudulent conduct in connection with the purchase or sale of a security), these remedies impose more demanding requirements in order to assert a prevailing cause of action. *See supra* notes 18-22 and accompanying text (comparing section 12(2) with section 10(b) and Rule 10b-5).

154. *See Gustafson*, 115 S. Ct. at 1066, 1067.

155. *See id.* at 1067.

156. *Id.*

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registered, under section 5 of the Securities Act,[157] or transactions exempt from registration in accordance with section 3 of the Securities Act.[158]

"[T]he [*Gustafson* Court's] decision to pursue its policy preferences comes at the price of disrupting the process of statutory interpretation."[159] The Court used *Gustafson* as an opportunity to reduce the amount of securities litigation. The Court twisted the language and structure of the Securities Act to reach its result-oriented decision. The analysis used in *Gustafson* established precedent for the securities bar, at the expense of over sixty years of sound case law. As a result of *Gustafson*, the securities bar is presented with additional issues that will have to be resolved by the courts.[160]

A. Definition of a "Public Offering"

Although *Gustafson* limited the scope of section 12(2) to public offerings, it neglected to elaborate on the concept of a "public offering." Absent any evidence to the contrary, the Supreme Court's test set forth in *SEC v. Ralston Purina Co.*[161] must control for the time being. In *Ralston Purina*, the Court enunciated a standard that focused on whether all the offerees were sophisticated and had access to the information that would otherwise be required in a registration statement.[162] This, however, may not be the standard the Court had in mind

157. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1994).

158. *Id.* § 3, 15 U.S.C. § 77c.

159. *Gustafson*, 115 S. Ct. at 1079 (Thomas, J., dissenting).

160. The ensuing cases have consistently followed the *Gustafson* holding. *See* Whirlpool Financial Corp. v. GN Holdings, Inc., 67 F.3d 605, 609 n.2 (7th Cir. 1995) (holding § 12(2) inapplicable to private placements); Fisk v. Superannuities, Inc., 927 F. Supp. 718, 729-30 (S.D.N.Y. 1996); Johnson v. Mutual Sav. Bank, No. 95 C 2379, 1996 WL 79414 (E.D. Ill. Feb. 21, 1996) (dismissing a portion of the plaintiff's § 12(2) cause of action for failing to allege the purchase of shares in a public offering); *In re* Numerex Corp. Sec. Litig., 913 F. Supp. 391, 396 (E.D. Pa. 1996) (holding that § 12(2) does not apply in secondary trading or private offerings); Gannon v. Continental Ins. Co., 920 F. Supp 566, 575 (D.N.J. 1996) (holding that since there was no allegation that any of the purchases were pursuant to a public offering, the cause of action under § 12(2) should be dismissed); Baxter, v. A.R. Baron & Co., Fed. Sec. L. Rep. (CCH) ¶ 98,923 (S.D.N.Y. Oct. 6, 1995) (holding § 12(2) inapplicable since secondary market trading was at issue); Glamorgan Coal Corp. v. Ratner's Group PLC, No. 93 Civ. 7881 (S.D.N.Y. July 7, 1995); *In re* U.S.A. Classic Sec. Litig., No. 93 Civ. 6667, 1995 WL 363841, at *3 (S.D.N.Y. June 19, 1995) (denying defendants motion to dismiss because plaintiff's complaint alleged the purchase of stock pursuant to a prospectus in a public offering); ESI Montgomery County, Inc. v. Montenay Int'l Corp., 899 F. Supp. 1061, 1064-65, 1069 (S.D.N.Y. 1995) (rejecting plaintiff's argument that *Gustafson* left some room for § 12(2) to apply to private transactions, depending on the type of securities offered); De La Rue v. United States Bankr. Corp., No. 94 Civ. 7925 (S.D.N.Y. May 9, 1995); *In re* Valance Tech. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,793 (N.D. Cal. May 8, 1995); Pollack v. Laidlaw Holdings, Inc., No. 90 Civ. 5788, 1995 WL 261518, at *14 (S.D.N.Y. May 3, 1995); Komanoff v. Mabon, Nugent & Co., 884 F. Supp. 848 (S.D.N.Y. 1995) (holding § 12(2) inapplicable to secondary market transactions); Stack v. Lobo, 903 F. Supp. 1361, 1375 (N.D. Cal. 1995); Endo v. Albertine, No. 88 Civ. 1815, 1995 WL 170030, at *3 (N.D. Ill. Apr. 7, 1995) (holding § 12(2) inapplicable to private placements).

161. 346 U.S. 119 (1935). The *Ralston Purina* Court defined the scope of the section 4(2) exemption that exempts "transactions by an issuer not involving any public offering" from the registration requirements of section 5. *See id.* at 120.

162. *See id.* at 125-26. The Court chose not to focus on the quantity of offerees involved in the

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when it rendered *Gustafson*. The question of whether a transaction qualifies as a public offering has additional significance now that section 12(2) has been restricted thereto.[163] It seems inevitable that the courts will be forced to decide whether the *Ralston Purina* test will still apply in light of the Court's decision in *Gustafson*.

B. Exempt Transactions

1. Transaction Exemptions Under Section 4(2)

Section 4(2) of the Securities Act exempts any transaction by an issuer not involving a public offering from the registration requirements of section 5.[164] Furthermore, Regulation D, Rule 506 exempts from registration offers and sales of securities within the meaning of section 4(2).[165] Section 4(2), by its very definition ("not involving a public offering"), precludes the application of section 12(2) to any offerings within its ambit.[166] However, the issue may become more ambiguous if the judiciary adopts a more stringent interpretation of a "public offering."

The application of section 12(2) to exempt offerings under Regulation D, Rule 506 is even more uncertain. Regulation D offerings "are not exempt from the antifraud, civil liability . . . provisions of the federal securities laws."[167] Although this would appear to provide an offering exempt from the registration requirements under Rule 506 with the protection of section 12(2), if the transaction would not fall within *Gustafson*'s scope of section 12(2), the transaction will not be afforded the protections of section 12(2). Since Rule 506 is premised on section 4(2) and the fact that the transaction cannot involve a public offering, it would be logical to conclude that transactions under Rule 506 are not within *Gustafson*'s scope of section 12(2). This, however, is one more issue for the judiciary to decide in the future.

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offering, but instead looked at the sophistication, or quality, of the offerees. *See id.* at 123 ("[T]o be public, an offer need not be open to the whole world.").

163. *See, e.g.*, Fisk v. Superannuities, Inc., 927 F. Supp 718, 729-31 (S.D.N.Y. 1996). In *Fisk*, the court denied the defendants' motion to dismiss a section 12(2) cause of action even though the plaintiff's purchase was made pursuant to a private placement memorandum which stated that it "constitute[d] an offer only to the person to whom [it was] delivered and only if such person is an accredited investor as such term is defined in Rule 501(a) of Regulation D . . . ." *Id.* at 730. In addition, the subscription agreement contained in the private placement memorandum required the prospective purchaser to represent that he or she was an accredited investor for purposes of obtaining a registration exemption under section 4(2). *See id.*

164. *See* Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1994).

165. *See* 17 C.F.R. § 230.506 (1995).

166. *See supra* notes 161-63 and accompanying text (discussing the definition of "public offering"); *see also* S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953).

167. 17 C.F.R. §§ 230.501-.508 (1995) (Preliminary Note 1).

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2. Transaction Exemptions Under Section 3(b)

Gustafson held that "a document is not a prospectus . . . if, absent an exemption [section 3], it need not comply with § 10's requirements in the first place."[168] This seems to indicate that "if a transaction is exempt from registration and prospectus delivery requirements only because of any of the exemptions of § 3 (other than 3(a)(2)), it will be treated under § 12(2) as if a prospectus were required and § 12(2) therefore will apply if its terms are met."[169]

There are various express exemptions under section 3(a) of the Securities Act.[170] In addition, the Securities & Exchange Commission is authorized, pursuant to section 3(b) of the Securities Act, to exempt any class of securities from registration if it determines that registration is not necessary in the public interest and for the protection of investors based on the small amount involved or the limited character of the public offering.[171] The Commission has utilized its authority under section 3(b) by promulgating, among other provisions, Regulation A[172] and Regulation D.[173]

The *Gustafson* decision appears to hold section 12(2) applicable to transactions exempt under section 3 of the Securities Act.[174] This, however, conflicts with the theory behind the Court's decision to limit the scope of section 12(2) liability to public offerings. The transactions exempted under section 3 are excluded from the registration requirements because they are already subject to other governmental regulation or adequate information is already available to potential investors.[175]

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168. Gustafson v. Alloyd Co., 115 S. Ct. 1061, 1067 (1995).

169. Ted J. Fiflis, *Significant Securities Law Decisions of the Past Year as of June 14, 1995*, A.L.I.-A.B.A. Course of Study (July 27, 1995), *available in* Westlaw, CA36 ALI-ABA *51, *68.

170. Securities Act of 1933 § 3(a), 15 U.S.C. § 77c(a) (1994).

171. *See id.* § 3(b), 15 U.S.C. § 77c(b). The maximum aggregate amount of the offering is limited to $5 million. *See id.*

172. 17 C.F.R. §§ 230.251-.263 (1995). Regulation A allows an issuer to sell securities in an unregistered offering if certain requirements are satisfied. These requirements consist of: the issuer must be a United States or Canadian entity; the amount of the offering cannot exceed $1.5 million in a twelve-month period; an Offering Statement (Form 1-A) must be filed in the Commission's regional office; and an offering circular, containing information with regard to the issuer and the securities, must be filed with the Commission's regional office. *See id.*

173. 17 C.F.R. §§ 230.501-.505, .507-.508 (1995). Regulation D provides two exemptions from registration under section 3(b): Rule 504 and Rule 505.

Rule 504 provides an exemption from registration for certain sales that do not exceed $1 million in the previous twelve months. In arriving at the $1 million limitation, all transaction exemptions under section 3(b) and all transactions in violation of section 5(a) are included in the aggregate amount. Rule 504 does not require information disclosure and is available to all issuers except investment companies and reporting companies under the Exchange Act. *See* 17 C.F.R. § 230.504 (1995).

Rule 505 provides an exemption from registration for certain sales that do not exceed $5 million in the previous twelve months and which have no more than 35 unaccredited purchasers. In arriving at the $5 million limitation, all transaction exemptions under section 3(b) and all transactions in violation of section 5(a) are included in the aggregate amount. Rule 505 is available to all issuers except investment companies. *See* 17 C.F.R. § 230.505 (1995).

174. *See supra* notes 157-58 and accompanying text.

175. *See* RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 317-21 (7th ed. 1992).

This would appear to be outside the scope of a public offering under *Gustafson*, especially in light of the Court's recent trend in severely restricting the federal securities law liability provisions.[176] This is one more issue that will create additional, unwarranted controversy as a result of the Court's flawed analysis in *Gustafson*.

3. Rule 144 and Rule 144A

Section 4(1) of the Securities Act exempts from registration a transaction "by any person other than an issuer, underwriter, or dealer."[177] Section 2(11) of the Securities Act defines the term "underwriter" as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security . . . ."[178] A person will be deemed a statutory underwriter if he purchases shares from the issuer with a view to a distribution, and the section 4(1) exemption will therefore not be available for the public resale by such affiliate.[179]

Rule 144, however, provides affiliates with the opportunity to publicly sell their shares without registration if certain requirements are met.[180] If the sale by the affiliate meets the requirements of Rule 144, the affiliate is deemed not to be an underwriter since the transaction does not involve a distribution.[181] It would therefore appear that section 12(2) would not apply to a sale protected by Rule 144, since the sale presumably does not involve a public distribution, but instead involves secondary market trading. The judiciary, however, could take exception to this presumption and hold otherwise.

Rule 144A provides affiliates with the opportunity to publicly sell their shares to "qualified institutional buyers" without registration if certain requirements are met.[182] The application of section 12(2) to resales under Rule 144A is more ambiguous than Rule 144. Rule 144A states that it applies "solely to the application of section 5 of the Act and not to antifraud or other provisions of the federal

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176. *See supra* note 8 and accompanying text.

177. Securities Act of 1933 § 4(1), 15 U.S.C. § 77d(1) (1994).

178. *Id.* § 2(11), 15 U.S.C. § 77b(11). The term "distribution" has been held to comprise "the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public." Ira Haupt & Co., 23 S.E.C. 589, 597 (1946) (quoting Oklahoma-Texas Trust, 2 S.E.C. 764, 769 (1937), *aff'd*, 100 F.2d 888 (10th Cir. 1939)).

179. *See* S.E.C. v. Guild Films Co., 279 F.2d 485 (2d Cir. 1960); S.E.C. v. Chinese Consol. Benevolent Ass'n, 120 F.2d 738 (2d Cir. 1941); Ira Haupt & Co., 23 S.E.C. 589 (1946).

180. *See* 17 C.F.R. § 230.144 (1995). An affiliate may resell the securities after a three year holding period without restriction; and engage in restricted resales after a two year holding period if (1) the issuer is subject to Exchange Act reporting requirements for at least 90 days, or other information concerning the issuer is available to the public; (2) the seller restricts the quantity of such resale during any quarter to the greatest of: 1% of the outstanding securities; the average weekly volume of trading in the securities based on reported trading on the national exchanges during a four week period preceding a notice requirement; or the average weekly volume of trading in the securities reported through the consolidated transaction reporting system; (3) the securities are sold in unsolicited brokers' transactions under section 4(4); and (4) a notice is filed with the Securities and Exchange Commission. *See id.*

181. *See id.* § 230.144(b).

182. *See id.* § 230.144A.

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securities laws."[183] However, if the requirements of Rule 144A are satisfied, the presumption is that the person is not engaged in a distribution of securities.[184] Although the judiciary will likely hold that section 12(2) is unavailable to resales qualifying under Rule 144A, it has yet to be decided after *Gustafson.*

C. Section 4(3) Prospectus Delivery Requirements for Dealers

The prospectus delivery requirements of section 5 vary depending on the classification of the party involved in a particular transaction. Absent an exemption, section 5 of the Securities Act prohibits the offer or sale of a security prior to the filing of a registration statement.[185] Once a registration statement has been filed, absent an exemption, section 5(b) of the Securities Act imposes a prospectus delivery requirement for all offers and sales of a security.[186] An issuer of securities must adhere to the prospectus delivery requirements as long as the issuer is offering the securities to the public.[187] An underwriter must obey the prospectus delivery requirements as long as it is engaged in a "distribution."[188]

The prospectus delivery requirements of section 5 also extend to dealers, regardless of whether they are engaged as participants in the initial distribution.[189] Section 4(3)(C) mandates that dealers participating in a distribution must comply with the prospectus delivery requirements of section 5(b) until they have sold their entire allotment or subscription of the distribution.[190] However, under section 4(3)(B), all dealers, regardless of whether they are participating in a distribution, must adhere to the prospectus delivery requirements of section 5(b) for either a forty or ninety day time period.[191]

183. *Id.* § 230.144A preliminary note 1.

184. *See id.* § 230.144A(b).

185. Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (1994).

186. *Id.* § 5(b), 15 U.S.C. § 77e(b) (1994). All such prospectuses must conform to the requirements of section 10 of the Securities Act. *Id.* § 10, 15 U.S.C. § 77j (1994).

187. *Id.* § 4(2), 15 U.S.C. § 77d(2) (1994).

188. *Id.* § 4(3)(c), 15 U.S.C. § 77d(3)(c) (1994).

189. "The term 'dealer' means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person." Securities Act of 1933 § 2(12), 15 U.S.C. § 77b(12) (1994).

190. *See id.* § 4(3)(C), 15 U.S.C. § 77d(3)(C).

191. *See id.* § 4(3), 15 U.S.C. § 77d(3). If the distribution is an initial public offering, the prospectus delivery period for dealers is 90 days after the later of (1) the effective date or (2) the date the first bona fide offer for the security is made. If the issuer has previously sold its securities pursuant to an effective registration statement, the dealer's requisite time period for prospectus delivery is reduced to 40 days. *See id.*

However, the Securities & Exchange Commission, pursuant to its authority under section 4(3), enacted Rule 174, which was created to reduce or eliminate the statutory period. *See* 17 C.F.R. § 230.174 (1995). Rule 174 eliminates the prospectus delivery requirements for a dealer that is not participating in the distribution in transactions involving (a) securities registered on Form F-6 or (b) an issuer subject to the reporting requirements of section 13 or 15(d) of the Exchange Act. *See id.* § 230.174(a), (b). Rule 174 also abbreviates the prospectus delivery period for dealers in transactions by issuers that were not reporting companies before the registration statement was filed. *See id.* § 230.174(d). In this situation, the statutory period is reduced to 25 days provided that the securities are listed on a national exchange

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Section 4(3) is a perfect example of a traditional unambiguous provision that has been transformed into a provision with additional significance as a result of the *Gustafson* decision. The courts, in another classic display of judicial activism, have interpreted section 4(3) (rather incorrectly) as extending the period of a public offering.[192] Although the statute and its legislative history are devoid of any mention of extending the time period of a public offering,[193] the courts have provided a defective foundation for this reasoning.[194] The significance of this reasoning is substantially magnified when section 12(2) is brought into the picture.

Since section 12(2) only applies to the sale of securities in a public offering as a result of *Gustafson*, the extension of the public offering time period to include the relevant section 4(3) interval broadens the scope of potential liability under section 12(2). For example, suppose Mr. X purchases 100 shares of ABC Corp. (a nonreporting company under the Securities Exchange Act and not listed on NASDAQ) in a public offering. Fifteen days after the effective date of the public offering registration, Mr. X sells the ABC securities to Laryl Mynch & Co., a dealer that did not participate in the original distribution. Twenty days after the effective date of the public offering registration, Laryl Mynch & Co. sells fifty shares of the ABC securities to Mr. Y and encloses a prospectus with the delivery of the securities in compliance with section 4(3)(B). Mr. Y discards the prospectus without ever reviewing it. One day after the prospectus delivery requirements for section 4(3) expire, Laryl Mynch & Co. sells fifty shares of the ABC securities to Mr. Z and encloses a prospectus. The value of ABC Corp. then decreases dramatically. Mr. Y and Mr. Z bring separate lawsuits against ABC Corp. for recision under section 12(2) based on an untrue statement of material fact contained in the materials which were delivered to them upon receipt of the securities. ABC Corp. moves to dismiss under Federal Rule of Civil Procedure 12(b)(6) for failure to state a cause of action. The appropriate outcome should be the court's dismissal of both lawsuits for failure to state a cause of action because both Mr. Y and Mr. Z purchased their shares in the secondary trading market. However, the recent court decisions have dictated a different result in favor of Mr. Y.[195] Since Mr. Y purchased his shares during the section 4(3)(C) period, Mr. Y can rescind his purchase of the ABC securities, even though Mr. Y purchased the securities in the secondary market.

The extension of the public offering time period to include the associated section 4(3) time frame results in an anomalous result in light of the *Gustafson* decision.

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or are authorized for participation in an interdealer quotation system governed by a registered securities association. *See id.* In addition, Rule 174 restricts the statutory period in shelf registration offerings to 90 days after the first offering of securities. *See id.* § 230.174(c).

192. *See, e.g.*, Stack v. Lobo, 903 F. Supp. 1361, 1375 (N.D. Cal. 1995); *In re* Proxima Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,236 (S.D. Cal. 1994); Wade v. Industrial Funding Corp., Fed. Sec. L. Rep. (CCH) ¶ 98,144 (N.D. Cal. 1993).

193. For a legislative history of section 4(3), see H.R. REP. NO. 83-1547 (1954), *reprinted in* 1954 U.S.C.C.A.N. 2973.

194. *See supra* note 192 and accompanying text.

195. *See supra* note 192 and accompanying text.

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Purchasers of securities in the secondary market may be afforded a recisionary remedy if the securities were acquired within the prospectus delivery time frame required by section 4(3). Securities that are acquired through the secondary market are rarely acquired as a result of the selling efforts contained in a prospectus. In fact, a substantial majority of the purchasers in the secondary market never actually receive a prospectus because it is only required in certain situations,[196] and in the event that a purchaser receives a prospectus, more often than not, the security has already been acquired.[197] Therefore, even if the purchaser does not review or rely on the requisite statutory prospectus, he or she may be able to invoke the protections of section 12(2) and rescind the transaction, even though it occurred in the secondary market, a transaction to which section 12(2) does not apply as a result of the Supreme Court's decision in *Gustafson*.

D. Regulation S Offerings

Regulation S provides a registration exemption from section 5 of the Securities Act.[198] The General Statement to Regulation S provides that the registration requirement of section 5 will not apply to the transaction if both the offers and sales of the security occur outside the United States.[199] There are two applicable safe harbors to Regulation S.[200] Rule 903 provides a safe harbor for offers and sales by issuers, distributors, and their affiliates.[201] Rule 904 provides a second safe harbor for secondary, resale transactions by persons other than issuers and distributors.[202] Any offer, sale, or resale that satisfies the requirements of either safe harbor is considered to be outside the United States for purposes of the General Statement, and the transaction, therefore, will not be subject to the registration requirements of section 5.

Although Regulation S provides an exemption from the registration requirements, it does not provide an exemption from the antifraud provisions of the federal securities laws.[203] Even though the antifraud provisions apply to Regulation S

196. *See supra* 187-91 and accompanying text.

197. *See* Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1350-51 (1966) ("[W]hile the prospectus must be the first written communication . . . in connection with a public offering, the law does not require that it be delivered before orders for the registered security may be solicited, received, or even accepted, but only that its delivery precede or accompany delivery of the security to the customer 'after sale.' Even if the customer is not legally committed to his purchase at (or before) the moment of delivery of the security to him, he is surely 'committed' in the sense of having made his investment decision well before this moment; yet this may be (and usually is) his first opportunity to see the prospectus. At this point he can hardly be said to have derived benefit from the affirmative aspect of the prospectus delivery requirements . . . ." (footnotes omitted)).

198. *See* Regulation S, 17 C.F.R. §§ 230.901-.904 (1995).

199. *See* 17 C.F.R. § 230.901 (1995).

200. For a comprehensive discussion on Regulation S and its safe harbors, see Guy P. Lander, *Regulation S — Securities Offerings Outside the United States*, 21 N.C. J. INT'L & COM. REG. 339 (1996).

201. *See* 17 C.F.R. § 230.903 (1995).

202. *See id.* § 230.904.

203. "[Regulation S] relate[s] solely to the application of Section 5 of the Securities Act of 1933 . . . and not to antifraud or other provisions of the federal securities laws." 17 C.F.R. §§ 230.901-.904 (1995)

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offerings, the issue of whether section 12(2) is applicable to such offerings is unresolved. A valid argument can be asserted that section 12(2) is inapplicable to securities issued under a Regulation S exemption. *Gustafson* held, albeit incorrectly, that in order to be classified as a "prospectus" for purposes of section 12(2), the communication at issue must contain all of the required information under section 10 of the Securities Act.[204] Since Regulation S does not require a prospectus to be delivered to the prospective investor, because it is by its nature exempt from the registration requirements of section 5 of the Securities Act, the offering will probably not involve a prospectus containing the information required by section 10 of the Securities Act. If a Regulation S offering does not involve a section 10 prospectus, it is logical to conclude that section 12(2) liability will not attach to the information communicated to the investor in connection with the offering.

At least one post-*Gustafson* court has rejected this argument. In *Sloane Overseas Fund, Ltd. v. Sapiens International Corp.*,[205] the United States District Court for the Southern District of New York held that an investor could rescind the purchase of securities issued under a Regulation S offering.[206] The defendant in *Sloane* offered the securities pursuant to an Offering Circular.[207] The plaintiffs commenced an action against the defendants for misrepresentations and omissions contained in the offering circular under various provisions of the federal securities laws, including section 12(2).[208] The court stated that "an offering issued pursuant to Regulation S is subject to liability under § 12(2) if it is a public offering."[209] However, the mere fact that the offering is public does not compel the attachment of section 12(2) liability to the communications associated with the offering. The communication in question must conform to the requirements of section 10 to qualify as a "prospectus" in order to invoke the protections of section 12(2). The court reasoned, rather incorrectly, that since the Regulation S offering at hand involved a "wide distribution of the Offering Circular [that] made [the defendants'] offering public," section 12(2) was applicable to the transaction; thus, the court denied the defendants motion to dismiss the section 12(2) cause of action.[210]

E. Free Writing

After the registration statement becomes effective, selling literature is allowed to be sent to prospective purchasers, as long as this communication has been preceded or accompanied by a section 10(a) statutory prospectus.[211] This is commonly

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(Preliminary Note 1).

204. *See supra* note 112 and accompanying text.

205. 941 F. Supp. 1369 (S.D.N.Y. 1996).

206. *See id.* at 1376-77.

207. *See id.* at 1372.

208. *See id.*

209. *Id.* at 1376.

210. *Id.* at 1376-77.

211. Section 2(10) of the Securities Act states:

> The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or

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known as "free writing." The Court in *Gustafson* stated that "a prospectus . . . is confined to a document that, absent an overriding exemption, must include 'the information contained in the registration statement.'"[212] It would therefore appear that a material misrepresentation contained in a "free writing" communication is not actionable under section 12(2) as a result of *Gustafson*.[213] However, the *Gustafson* Court also stated that "a prospectus under section 10 is confined to documents related to public offerings."[214] The selling literature that is distributed to potential purchasers under the "free writing" privilege would seem to qualify as a document relating to a public offering and therefore fall within the ambit of section 12(2). This apparent conflict will most likely be resolved by the judiciary in the future.

Conclusion

The Supreme Court's misguided statutory interpretation in *Gustafson* is one more example of the judiciary usurping the power of the legislature at the expense of securities law practitioners. The driving force behind this policy-oriented decision was an apparent attempt to curb future litigation under the federal securities laws. However, the Court's flawed analysis has created several unanswered questions that will have to be resolved by the judiciary before this objective can be accomplished. Although this may be deemed a noble effort by the Court, the confusion and ambiguity created by the decision could have been avoided if the Court had allowed Congress to amend section 12(2).[215]

> confirms the sale of any security; except that (a) a communication sent or given after the effective date of the registration statement . . . shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 77j of this title [(Securities Act of 1933 § 10)] at the time of [sic] such communication was sent or given to the person to whom the communication was made . . . .

Securities Act of 1933 § 2(10), 15 U.S.C. § 77b(10) (1994).

212. Gustafson v. Alloyd Co., 115 S. Ct. 1061, 1067 (1995).

213. This would create an anomalous scenario.

> A seller can be held liable for making a materially misleading oral statement relating to a public offering even though a statutory prospectus has been sent or given to the person to whom the seller speaks. But if the seller makes an identical misstatement in a document qualifying as free writing, no liability will result.

Elliott J. Weiss, *Securities Act Section 12(2) After* Gustafson v. Alloyd Co.*: What Questions Remain?*, 50 BUS. LAW. 1209, 1226 (1995).

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

215. Some practitioners may argue that Congress' inaction would indicate their desire to leave the issue alone or allow the judiciary to decide the issue. However, the 1994 congressional election resulted in the Republican Party regaining control of Congress. This has already resulted in greater restrictions on private rights of action under the federal securities laws. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at scattered sections of 15 U.S.C.).

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