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## Expanded Liability Under Section 12 of the Securities Act: When Is a Seller Not a Seller?

*Robert N. Rapp\**

*The language of section 12 of the Securities Act of 1933 limits the scope of potential defendants thereunder to those people who offer or sell a security. The courts have consistently expanded the class of eligible section 12 defendants to include people who do not fit the traditional notion of a "seller." The author traces that judicial expansion and suggests that the most recent cases may be developing a more realistic, though still imperfect, approach to section 12 liability.*

### I. INTRODUCTION

IN ORDER "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent fraud in the sale thereof"<sup>1</sup> Congress enacted the Securities Act of 1933. The Securities Act provides a variety of civil remedies to enforce its disclosure provisions.<sup>2</sup> Usually, attention has focused upon the scope of implied civil liability under general antifraud provisions such as section 17(a) of the Securities Act<sup>3</sup> and section 10(b) of the Securities Exchange Act of 1934,<sup>4</sup> including rule 10b-5 promulgated thereunder.<sup>5</sup> However, the express alternative afforded by section 12(2) of the Securities Act should not be overlooked. Section 12<sup>6</sup> imposes civil liability upon any per-

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1. Securities Act of 1933, Preamble, 48 Stat. 74 (1933) [hereinafter cited as Securities Act].
2. 15 U.S.C. §§ 77a-77aa (1970).
3. 15 U.S.C. § 77q(a) (1970).
4. 15 U.S.C. § 78j(b) (1970) [hereinafter cited as Exchange Act].
5. 17 C.F.R. § 240. 10b-5 (1976).
6. 15 U.S.C. § 77l (1970).

son who offers or sells a security in violation of the Act's registration and prospectus delivery requirements<sup>7</sup> and upon any person who offers or sells by means of a prospectus or oral communication which contains an untrue or misleading statement of material fact.<sup>8</sup> Unlike the other antifraud provisions, section 12(2) offers a right to rescission or damages<sup>9</sup> that is virtually free of common law shackles.<sup>10</sup>

7. Securities Act § 12(1), 15 U.S.C. § 77l(1) (1970). The requirements of a filed and effective registration statement are respectively set forth in sections 5(c) and 5(a) of the Act, 15 U.S.C. §§ 77e(c), 77e(a) (1970), while the prospectus delivery requirements are set forth in section 5(b), 15 U.S.C. § 77e(b) (1970), in conjunction with section 10, 15 U.S.C. § 77j (1970), which prescribes the form and content of permissible communications to potential purchasers during the critical periods of a distribution of securities.

8. Securities Act § 12(2), 15 U.S.C. § 77l (2) (1970).

9. Section 12 provides that a successful plaintiff is entitled "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 . . . damages if he no longer owns the security." In the latter case, the measure to be applied—the difference between the purchase price and the amount received on resale, plus interest, less any return—results in the substantial equivalent of rescission. See *Gerity v. Cable Funding Corp.*, 372 F. Supp. 679 (D. Del. 1973); 3 L. LOSS, SECURITIES REGULATION 1721 (2d ed. 1961).

10. Indeed, the recent decision by the United States Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), holding that in order to recover under rule 10b-5, a private plaintiff must allege and prove scienter, dramatically illustrates the common law origins of the implied cause of action it provides. The elements of the common law tort of fraud or deceit have been stated as follows:

1. A false representation made by the defendant. In the ordinary case, this representation must be one of fact.
2. Knowledge or belief on the part of the defendant that the representation is false—or, what is regarded as equivalent, that he has not a sufficient basis of information to make it. This element often is given the technical name of "scienter."
3. An intention to induce the plaintiff to act or refrain from action in reliance upon the misrepresentation.
4. Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.
5. Damage to the plaintiff resulting from such reliance.

W. PROSSER, THE LAW OF TORTS § 105, at 685-86 (4th ed. 1971) (footnotes omitted).

The principal available remedy at equity for misrepresentation, the equivalent of the tort of deceit, was rescission of the transaction tainted by the misstatement. One major difference between the two actions was that, in an action for misrepresentation, the courts of equity, being more concerned with unjust retention of benefits, permitted recovery for innocent misrepresentation, thereby eliminating the need for proof of scienter. See 3 J. POMEROY, EQUITY JURISPRUDENCE §§ 885-88a (5th ed. 1941). Another distinction was that "[t]he buyer need not show any causal connection between the misrepresentation and his damage; indeed, he need not even show that he [was] damaged." 3 L. LOSS *supra* note 9, at 1627. Of course, because the action for rescission was principally an equitable one, it was subject to all equitable defenses and restrictions.

The plaintiff [seeking equitable relief] must himself do equity by restoring whatever he had received, unless excused by special circumstances; and he must do nothing inconsistent with the relief demanded, so that the right to rescind a sale, for example, would be lost by any conduct affirming the transaction, or even by non-action for an unreasonable length of time after discovery of the facts.

Nevertheless, section 12 is not entirely free from restrictions. Principal among its limitations<sup>11</sup> is the restriction of potential defendants to those who offer<sup>12</sup> or sell and of possible plaintiffs to those who purchase from them.<sup>13</sup>

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W. PROSSER, *supra*, at 688 (footnotes omitted).

Section 12(2) of the Securities Act and rescission are much the same in requiring that buyers prove "misrepresentations" of "fact." However, section 12(2) affords purchasers of securities several additional advantages. First, purchasers need not prove "reliance" on the misstatement or omission; they must only prove that they did not know of it. Second, if the buyer has sold the securities so as to make impossible the tender required for restitution, he may obtain damages. Finally, as this article points out in detail, section 12(2) and section 15, 15 U.S.C. § 77o (1970), relating to the liability of "controlling persons," expand the scope of potential liability to persons other than the seller in the contractual privity sense. 3 L. LOSS, *supra* note 9, at 1700-04.

11. In addition to the requirement of some degree of privity, with which this article is concerned, other limitations apply to all section 12 plaintiffs. First, the most significant limitation is the seller's due care defense—a defense unavailable to him in actions for rescission. Section 12 expressly provides that the defendant may not be found liable if he can "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." Second, the short statute of limitations found in section 13, 15 U.S.C. § 77m (1970), is an important restriction. The statute provides:

No action shall be maintained to enforce any liability created under section [11 or 12(2)] unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section [12(1)], unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section [11 or 12(1)] more than three years after the security was bona fide offered to the public, or under section [12(2)] more than three years after the sale.

Third, the jurisdictional requirement that the seller must use the mails or interstate facilities constitutes another possible limitation. This limitation is embodied in section 12. *See* 15 U.S.C. § 77l (1970).

And fourth, the relatively obscure provision found in section 11(e), which applies to all actions commenced under the Act, provides:

In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit. . . .

15 U.S.C. § 77k(e) (1970).

12. 15 U.S.C. § 77l (1970). The words "offers or" were added by the Act of August 10, 1954, Pub. L. No. 577, § 9, 68 Stat. 686, because of the exclusion of the "offer" type activities from the definition of "sell" in section 2(3) made to complement the changes in section 5 permitting certain offers to be made after a registration statement has been filed but before it has become effective. This formal amendment was therefore necessary in order to preserve existing law. H.R. REP. NO. 1542, 83d Cong., 2d Sess. 26 (1954). Throughout the remainder of this article persons directly subject to section 12 liability will simply be referred to as "persons who sell" or "sellers."

13. The privity requirement arises from the introductory language to both sections 12(1) and 12(2), 15 U.S.C. § 77l(1), (2) (1970), which refers to "[a]ny person who offers or sells" and from the language which provides that those found in violation "shall be liable to the person purchasing . . . from [them]." For the meaning of the terms offer and sell, see the text accompanying note 23 *infra*.

Until the decade of the 1960's the federal courts strictly interpreted this privity requirement. Other than the actual transferor of title of securities and "controlling persons" within the meaning of section 15,<sup>14</sup> only brokers and agents of the seller who solicited purchases for him or her were subjected to liability.<sup>15</sup> Although some courts still adhere to the narrow view of the privity concept,<sup>16</sup> others have sought to expand it in one of two ways.

14. 15 U.S.C. § 77o (1970). Section 15 provides:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections [11 or 12], shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

There are no precise determinants of "control" for purposes of section 15. Securities and Exchange Commission Rule 405, 17 C.F.R. § 230.405(f) (1976), defines the term to mean "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

15. See PART II *infra* (notes 22-42 and accompanying text). Indeed, Professor Loss observed:

Subject to these exceptions involving controlling persons and agents, it seems quite clear that § 12 contemplates only an action by a buyer against *his immediate seller*. That is to say, in the case of the typical "firm-commitment underwriting," the ultimate investor can recover only from the dealer who sold to him.

3 L. Loss, *supra* note 9, at 1719 (footnote omitted) (emphasis original). He did note, however, that respectable authority among state courts existed in support of granting rescission, the touchstone of section 12, "against an officer or agent of a corporation who *brought about* the corporation's fraudulent sale of securities or other property . . ." *Id.* at 1715 (emphasis added). And he further observed that in light of the law as it had developed regarding the liability of a broker under section 12 that "it is hard to distinguish the case of an officer or director or employee or other non-broker agent of the seller who actively participates in the sale." *Id.* at 1716. Both of these notions—bringing about a sale and actively participating in it—became key concepts in the expansion of section 12 to include a variety of persons other than the actual transferor of title.

Concerning the expansion of section 12 liability to broader categories of persons, specifically participating officers and other agents, Professor Loss concluded:

There would still be a distinction under § 12 between the liability of the seller proper and the liability of these other persons, in that the seller proper would have the burden under the statute of proving his innocence but the plaintiff obviously would have the burden of proving that the other persons had participated in an unlawful sale, a burden which (at least under § 12(2) as distinguished from § 12(1)) would almost inevitably involve proof by the plaintiff of some sort of *scienter* on their part.

*Id.* (emphasis original). It is this *scienter* element which became the focal point in *Sandusky Land, Ltd. v. Uniplan Groups, Inc.*, 400 F. Supp. 440 (N.D. Ohio 1975), which is considered in depth in PART IV *infra* (notes 88-125 and accompanying text).

16. Indeed, in the course of dismissing the plaintiff's complaint in *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089 (E.D. Pa. 1972), Judge Lord observed that "[t]he plaintiff's complaint [did] not allege that the direct seller sold securities to the plaintiffs in violation of § 12(2) nor [did] the complaint allege that the named defendants controlled the direct seller." *Id.* at 1093. Apparently, the judge was of the opinion that section 15 prescribed the outer limits of liability for violations of section 12, a position which is not without a fair measure of support. See, e.g., *Jackson Tool & Die, Inc. v. Smith*, 339 F.2d 88 (5th Cir. 1964); *Russell v. Travel*

Some decisions have sought to expand liability beyond the actual transferor of title through an examination of the role played by the proposed defendant in the sale transaction. Other courts have broadened the section 12 seller concept to render directly or primarily liable persons whose relatively passive conduct would be found violative in other securities law contexts only under theories of secondary liability.<sup>17</sup>

The traditional view focused upon the role which a particular defendant played vis-à-vis the purchase in the process of solicitation. The recent trend, however, enunciates an approach seemingly based upon the defendant's "facilitation" of the violative transaction coupled with a certain level of scienter.<sup>18</sup> A facilitation test is more flexible than the traditional approach; it allows liability to be imposed upon people who are not actually sellers, without the artificial expansion of primary seller liability.<sup>19</sup>

Courts have begun to recognize concepts of secondary liability by refusing to dismiss section 12 complaints that are based on allegations of aiding and abetting or conspiracy. The decisions have admitted that attempts to distinguish between the class of defendants who have been held primarily liable under an expansive interpretation of the section 12 seller concept and defendants chargeable as aiders and abettors or conspirators amount merely to "hair-splitting."<sup>20</sup>

The recent trend looks with objectivity at the extent of expansion which primary liability under section 12 has undergone and the fundamental considerations underlying that expansion. It must be recognized, however, that the rationale for recognizing claims based upon principles of secondary liability is contingent upon the further recognition of limitations of those principles.<sup>21</sup> Where proper limitations are recognized it does not harm either the letter or spirit of section 12 to uphold such claims. Indeed, recognition of secondary liability under section 12 of the Securities Act represents an alter-

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Concepts Corp., [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,230 (M.D. Tenn. 1975).

17. See PART III *infra* (notes 43-87 and accompanying text).

Throughout this article the author has embraced the definitional distinctions between direct or primary liability and secondary liability proffered by Professor David Ruder in his article, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972). He characterizes primary wrongdoers as those "persons owing direct duties to the public," the unlawful acts being their own. *Id.* at 600. Secondary wrongdoers, however, are "[t]hose whose liabilities arise only because another has violated the law," *id.*, and who are, in addition, attached to that violation by agreement, conduct, or otherwise. *Id.* at 628.

18. See, e.g., *Sandusky Land, Ltd. v. Unipian Groups, Inc.*, 400 F. Supp. 440 (N.D. Ohio 1975).

19. See PART IV *infra* (notes 88-125 and accompanying text).

20. See *In re Caesars Palace Securities Litigation*, 360 F. Supp. 366, 380 (S.D.N.Y. 1973).

21. See PART V *infra* (notes 126-181 and accompanying text).

native to the legal gymnastics which have marked the expansion of direct or primary liability. The emergence of secondary liability may well be a reaction to these awkward efforts to broaden the scope of "persons who sell" for purposes of section 12. Perhaps the same can be said for what may be the emerging approach to primary liability. Nonetheless, it appears certain that an orientation has emerged with respect to both areas of development under section 12 which looks at privity in a transactional sense. Rather than viewing a defendant in terms of his or her relationship with the plaintiff purchaser, the focus is upon the defendant vis-à-vis a transaction and its surrounding circumstances. This change in orientation is of no small consequence, nor is it a simplistic one.

The analysis which follows traces the erosion of the section 12 privity requirement and the consequent expansion of the scope of liability. This leads to a consideration of current approaches to the section—primary liability in the context of the expanded definition of seller, and the recent development of secondary liability—and finally, to the question of whether the courts have developed a more workable method of dealing with the expanded scope of section 12 liability.

## II. INROADS ON THE PRIVACY REQUIREMENT IN THE AGENCY SETTING

Liability for violations of either prohibition of section 12 of the Securities Act attaches to one who "offers or sells" a security—the action being brought by the "person purchasing . . . from him."<sup>22</sup> At its most basic level, this language depicts a buyer/seller relationship not at all unlike traditional contractual privity. However, section 2(3) of the Act defines "sale" or "sell" to include "every contract of sale or disposition of a security or interest in a security, for value" and the terms "offer to sell," "offer for sale," or "offer" to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."<sup>23</sup> Careful consideration of this provision reveals that *any* person can make an "attempt to dispose" of a security. Thus, in the case of a passive actual seller who sells through an active agent, the latter can also logically be deemed a "person who sells" within the contemplation of section 12.

The foregoing reasoning was embraced early in the litigative history of section 12 in *Cady v. Murphy*.<sup>24</sup> Knowing that the plaintiff Murphy, a

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22. 15 U.S.C. § 77l (1970).

23. 15 U.S.C. § 77b(3) (emphasis added).

24. 113 F.2d 988 (1st Cir. 1940), *aff'd* 30 F. Supp. 466 (D. Me. 1939), *cert. denied*, 311 U.S. 705 (1940). *See also* Wall v. Wagner, 125 F. Supp. 854 (D. Neb. 1954), *aff'd sub nom.* Whittaker v. Wall, 226 F.2d 868 (8th Cir. 1955).

broker, was looking for a stock with speculative possibilities to sell to his customers, Lynch, head trader for the brokerage firm of Rhoades & Company, informed him that certain shares in South American Utilities Corporation might soon be available. In the course of various telephone conversations with the plaintiff, Lynch later stated that South American was

[a] "nice little operating company", managed by the Chase Bank of New York and practically controlled by that bank; that the earnings of the company were twenty-five to thirty cents a share; that the Chase Bank had refused an offer of \$8 a share and was holding its stock for \$12; that the South American laws and regulations, as well as the exchange situation, were favorable; and that this information was obtained by one of the partners of the defendants from an officer of the South American Utilities Corporation while in Florida.<sup>25</sup>

Satisfied that the sale was induced by these representations, several of which were false, Judge Peters of the district court turned to the defendant's contention that the section 12 rescission remedy only contemplated a restoration of the status quo between principals to a transaction, *i.e.*, those in contractual privity. He noted that the activities used in the definition of "sell" in section 2(3)<sup>26</sup> "may be carried on by persons other than the owners of the security itself."<sup>27</sup> Thus, he concluded:

Whether the seller, being a broker, himself owns the security, or whether he is acting as the agent for the owner, or for the purchaser, or for both, is immaterial. If, in the course of an attempt to dispose of, or solicitation of an offer to buy a security, he makes false statements under circumstances referred to in Section 12, the purchaser is given a right of action to recover any damages he has suffered on account of the false representations.<sup>28</sup>

The First Circuit Court of Appeals affirmed this analysis, stating: "This is not a strained interpretation of the statute, for a selling agent in common parlance would describe himself as a person who sells, though title passes from his principal, not from him."<sup>29</sup>

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25. 30 F. Supp. at 467.

26. At the time of Judge Peters' opinion, the definition of "sell" included those activities now encompassed by the definition of "offer." See notes 12, 23 *supra* and accompanying text.

27. 30 F. Supp. at 469.

28. *Id.*

29. 113 F.2d at 990. Notably the other sections of the statute referred to by the court for support included section 12(1) pursuant to which persons who offer or sell a security in violation of the registration requirements of section 5 may be found liable. Judge Magruder reasoned:

If the security in question had been a security required by law to be registered, but as to which no registration statement was in effect, [the broker] under the facts



Broadly speaking, the emphasis in *Cady* is upon the role of an agent in the selling process. The more specific question becomes how active the agent must be in that process. Judge Peters was careful to point out that an active role does not necessarily exist in all situations; “[t]he ordinary brokerage transaction, merely the execution of orders to buy or sell, does not appear to be affected by Section 12. It is the extra-brokerage activity—solicitations accompanied by false statements—which are made the basis for a cause of action if damage is caused thereby.”<sup>30</sup> The difficulty with this “extra-brokerage” approach is that it lacks clear guidelines or controlling principles for assessing the conduct of a particular agent.

Two recent decisions in the brokerage context have suggested that the proper inquiry is whether the broker/agent’s conduct was a “substantial factor” in bringing about the plaintiff’s purchase. These two cases, *Lewis v. Walston & Co.*<sup>31</sup> and *Canizaro v. Kohlmeyer & Co.*<sup>32</sup> reach opposite results but in so doing provide valuable insight in determining where the line between culpable and nonculpable agency conduct lies.

In *Lewis* the focal point was a Mrs. DeCasenave, a registered representative of the defendant brokerage house, whose role in the sale to plaintiffs of shares in Allied Automation, a company engaged in developing a machine for converting currency into money orders, was related by the Court of Appeals for the Fifth Circuit as follows:

From November 1968 on Mrs. DeCasenave touted Allied Automation to the plaintiffs by telephone and whenever they came in to the Walston office on business. She told them about the company, and about its plan for developing the money changing machine; in the Walston offices she showed them pictures of the machine and literature on the company; she voiced optimistic opinions about the appreciation potential of the company’s stock. . . . [S]he [touted] the stock as a “potential IBM”. She told the plaintiffs that the company would go public at a price between \$13.50 and \$15 per share, but that they could then purchase the stock at the “ground floor” because a certain number of shares could be allocated to them at a price of \$5 per share. She falsely stated that Walston would be “taking a position” in the stock.<sup>33</sup>

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of the present case would certainly have been guilty of selling a security in violation of § 5(a)(1) . . . . As a person who “sells a security in violation of section 5”, [the broker] would have been under a civil liability to Murphy under § 12(1). But the phrase “any person who sells a security” occurs both in § 12(1) and in § 12(2), and would seem to mean the same thing in both subsections . . . .

*Id.* at 990-91.

30. 30 F. Supp. at 469-70.

31. 487 F.2d 617 (5th Cir. 1973).

32. 370 F. Supp. 282 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975).

33. 487 F.2d at 619.

It also appeared that Mrs. DeCasenave arranged at least two important meetings between the plaintiffs and the management of the issuer and made further representations concerning the brokerage house's intended position in the stock. She continued to tout the stock after initial purchases by the plaintiffs and advised further purchases which were in fact made. Mrs. DeCasenave even went so far as to procure most of the purchase price for the plaintiffs by selling stocks in their respective accounts and providing them with checks from the proceeds to use in purchasing the Allied Automation securities.<sup>34</sup>

In parlance faithful to the *Cady* decision, the defendants urged that Mrs. DeCasenave could not be deemed a seller for purposes of section 12 liability because "she was not the party who parted with the securities sold and received the consideration given in the exchange."<sup>35</sup> The court, however, recognized this fact to be inconclusive under section 12(1), and instead endorsed a proximate cause test to determine the parameters of the selling concept.<sup>36</sup>

In the *Canizaro* case the plaintiff purchaser sought to impose section 12 liability upon a broker/dealer who had acted as his agent in executing a purchase order rather than as the agent of the seller. The evidence in the case demonstrated that as to the particular sale in question, the plaintiff had informed Wilkins, one of the defendant brokerage firm's registered representatives, about the proposed offering and its terms, but had not communicated his doubts concerning the brokerage firm which had contacted him on the seller's behalf. Instead, he simply asked whether Wilkins and his firm could handle the transaction on the basis proposed, and whether he (Wilkins) would "check out" the deal and find answers to certain specific questions relating to the nature of the security, the issuer, and the extent of the market in the shares. The evidence further showed that Wilkins did undertake to ascertain the requested information and communicated it to the plaintiff.

In order to characterize Wilkins as a seller, the plaintiff in *Canizaro* averred that

Wilkins advised him that he could see no reason why plaintiff should not purchase the HCF stock but failed to disclose certain information which was either known to Wilkins at the time or which Wilkins could have obtained through a more thorough investigation . . . [and] that Wilkins *had a duty to disclose* the fact that he had consulted neither the "pink sheets" for March nor HCF's offering circular.<sup>37</sup>

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34. *Id.* at 619-20.

35. *Id.* at 621.

36. 487 F.2d at 621-22.

37. 370 F. Supp. at 285-86 (emphasis added).

The court, however, found these allegations as to Wilkins' involvement in the selling process insufficient because he had done nothing more "than act solely as the buyer's agent in executing a purchase order and [he] neither solicited the order nor recommended the stock."<sup>38</sup>

The results in *Lewis* and *Canizaro* seem to suggest, as did Judge Peters in the district court opinion in *Cady*, that the "extra-brokerage activity" for which section 12 liability lies is some form of solicitation. Solicitation injects the broker directly into the selling process, and where it is accompanied by a substantive section 12 violation it is hard to contend that the broker is not a "person who sells." It would seem that the actionable involvement need not be as blatant as that in *Lewis*. Indeed, *Murphy* indicates that far less is sufficient, as does the "substantial factor" test postulated and adopted by the court in *Lewis*.

Nevertheless, limiting the inquiry to whether or not a broker or agent actually solicits a particular purchase is overly restrictive. When one analyzes particular conduct in terms of the role which it represents in the

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38. *Id.* at 287. The court added that the common thread which tied together the cases decided under section 12

is the fact that those held to be offerors or sellers either had some relationship with or connection to the actual seller or participated in some significant way in a sales effort. But "when the broker represents the buyer alone and executes a purely *unsolicited* order, it is difficult to see how he could be considered one who 'sells' even within the meaning of the Securities Act."

*Id.*, quoting 3 L. LOSS, SECURITIES REGULATION 1714 (2d ed. 1961) (emphasis original).

As for the plaintiff's allegation that Wilkins had a duty to investigate and disclose in greater detail than was requested of him, the court concluded that even if Kohlmeier & Co. were an offeror or seller, such a duty would not have been violated. The court reasoned:

A broker who recommends a security or who volunteers an "investment opinion" or makes a prediction in order to effect a sale or purchase must have a reasonable basis for what he tells his customer. The broker's obligation to his customer to investigate and disclose all material facts must surely increase in direct proportion to the degree of his participation in the sale. However, the broker who has not been engaged in attempting to effect a sale or purchase, who has neither solicited the order nor recommended the securities, but who has merely received and executed a purchase order, has a minimal duty, if any at all, to investigate the purchase and disclose material facts to a customer.

In the case at bar, Wilkins, in the course of receiving and executing an unsolicited purchase order, was asked to "check the deal out," to ascertain the answers to certain specific questions and to determine whether the deal could be handled, all within the limited time of twenty-four hours. Wilkins answered each question with accurate information. He refrained from recommending the stock or pressuring Canizaro to purchase. Wilkins knew that Canizaro was an experienced trader in speculative securities. Although he could have made a more thorough investigation which would have revealed the bid and asked prices prior to April 1 and the information in the offering circular, we do not feel that Canizaro expected one, and we hold that neither § 12(2) nor Rule 10b-5 required him to do so. To make a broker liable under these circumstances would make him a virtual insurer of his customers' purchases unless he provided them with every conceivable material fact concerning a stock before they purchased.

370 F. Supp. at 289, citing *Phillips v. Reynolds & Co.*, 294 F. Supp. 1249, 1255 (E.D. Pa. 1969) (footnotes omitted).

overall process of a sale of securities, it is entirely appropriate to conclude that more than one person may be involved in or be a party to a solicitation. For example, the agent or broker who knowingly facilitates the consummation of a violative transaction on behalf of the seller or who knowingly performs an essential role in permitting that consummation should not escape section 12-liability simply because he or she has not actively solicited the purchaser.

Still the restrictive view of solicitation continues to have judicial support. For example, in *Nicewarner v. Bleavins*<sup>39</sup> the court declined to include within the ambit of section 12(1) an attorney, one Hudson, whose involvement in the circumstances surrounding the sale of fractional interests in invention royalties was clearly "more than casual."<sup>40</sup>

From the beginning, it was contemplated that his part in the development and promotion of the timer would be substantial . . . . At every turn in the testing of the timer, in the printing of promotional literature, in the negotiation for manufacture or distribution of the timer, in Colorado, in Canada, in Florida, Hudson was present; but always in the capacity of attorney for Lingenfelter. Hudson drafted the assignment from Lingenfelter to Bleavins. The assignment [security sold] from Bleavins to Nicewarner, also a Hudson product, was adopted as the standard form and printed by Lingenfelter. Moreover, Hudson had discussed with Lingenfelter and Bleavins the tax advantages of assigning fractional interests. *In short, Hudson had reason to anticipate a public offering; he knew that no registration statement was in effect; he should have known that the assignments were securities; he knew that the Nicewarners were from Illinois and could have foreseen the use of the mails or of interstate facilities; and he could see that the Nicewarners needed the protection of the Act.*<sup>41</sup>

Nevertheless, the court was of the opinion that Hudson was not a seller because he had not actually "solicited" the sale.

In the present case, while it appears that the sale would not have been consummated without the services of some attorney, the evi-

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39. 244 F. Supp. 261 (D. Colo. 1965). The role of the lawyer, Hudson, as described by the court in *Nicewarner* (see text accompanying note 40 *infra*) should be recalled when considering *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2d Cir. 1969) (see text accompanying notes 43-52 *infra*). In *Katz*, section 12 liability was imposed upon a lawyer whom the court found had placed the purchaser in a position to be "tackled" by the seller by answering his questions and representing that the offer was a good one and that it would be all right for the plaintiff to make the investment. The principal significance of the decision is the court's recognition that one may indeed participate in or be a party to someone else's solicitation.

40. 244 F. Supp. at 266.

41. *Id.* (emphasis added).

dence fails to establish that Hudson did more than serve as an attorney. . . .

. . . Hudson did not sell the item and . . . he was not a party to the sale. . . . True, he might have prevented the sale, but failure to do so in these circumstances does not render one a seller or an offerer [*sic*].<sup>42</sup>

Accepting the court's conclusion that Hudson was not, in fact, a party to any actual soliciting, given his awareness of the plaintiff's need for the protection of the Securities Act and reason to know that it was being violated, his preparing of necessary documents, and his interaction, albeit limited, with the plaintiff, it is clear that he could easily be deemed a "substantial factor" in facilitating a violative transaction pursuant to the *Lewis* vision of section 12. This approach, focusing as it does upon the defendant's role vis-à-vis a transaction, is simply a restatement of principals of general application developed for extending liability outside the pure agency or brokerage context. In turning now to a discussion of the development of those principles, it should be recognized that they are themselves merely restatements of the basic premises laid down in *Cady* applied in a broader "extra-brokerage" context.

### III. THE EXPANSION OF PRIMARY LIABILITY UNDER SECTION 12 BEYOND THE AGENCY SETTING

The Securities Act is not concerned solely with the conduct of particular "bad" individuals, but is also quite clearly directed at eliminating evils inherent in a "distribution" of securities. A distribution "comprises the entire process by which in the course of a public offering a block of securities is dispersed and ultimately comes to rest in the hands of the investing public."<sup>43</sup> Thus, after *Cady* surmounted the contractual privity hurdle by emphasizing that any person could "attempt to dispose" of a security, it was easy for the courts to begin analyzing roles in the selling process in order to determine who was subject to direct or primary liability as a seller in a given situation.

*Katz v. Amos Treat & Co.*<sup>44</sup> is an example of such an analysis, and provides an excellent starting point for considering the expanded scope of section 12 liability. According to the plaintiff's version of the facts, he had purchased shares of Delka Research Corporation as part of a preliminary

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42. *Id.*

43. *Oklahoma-Texas Trust*, 2 S.E.C. 764, 769 (1937), *aff'd*, 100 F.2d 888 (10th Cir. 1939). See also *Wilko v. Swan*, 346 U.S. 427 (1953); *In re Ira Haupt & Co.*, 23 S.E.C. 589 (1946).

44. 411 F.2d 1046 (2d Cir. 1969).

financing effort in which it was contemplated that a later public offering would be made by the defendant as underwriter. The plaintiff purchased the shares after becoming interested by representations and assurances from the firm's president, Treat, its customer's man, Nardone, and its attorney, in connection with the proposed underwriter, Wofsey, who was also special counsel for Delka. Nardone had told Katz that "his lucky time had arrived," that he had "come across a situation which really looked tremendous," and that the firm's president, Treat, thought it was "one of the best issues that he ever had."<sup>45</sup> He had also taken Katz to a meeting of other prospective investors at Delka's plant and accompanied him on a tour. When Katz later became concerned over a delay in the underwriting and inquired about the registration statement, Treat assured him there was only " 'a little technical problem,' . . . that '[e]verything is just coming along fine,' and that he wouldn't be a bit surprised if 'this stock opens up at \$10 a share.' " <sup>46</sup> As for Wofsey, it appeared that after Katz had raised some more money at Treat's request, he had told him in response to inquiries about the registration that "everything had been worked out in principle and it was 'just a formality of going up to some law firm and just signing the name'; [and that] it would be all right for Katz to give Treat half the money."<sup>47</sup> Later, in response to inquiries about his opinion of the issue, the registration, and payment of the balance, he answered " 'I hear it is a good one and I know it is okay,' . . . 'it is just a perfunctory thing,' [and] it 'would help the registration' " respectively.<sup>48</sup>

The district court dismissed the plaintiff's claims under both section 12(1) and 12(2) against all defendants who included not only the aforementioned parties, but also James Earley and A. Thomas Ewbank, who had become officers and directors of Delka after the initial sale of shares.<sup>49</sup> At least with respect to the 12(1) claim this dismissal was apparently on the grounds that "only the issuer or immediately previous owner of the shares, in this case Delka, can 'offer or sell' a security . . . except . . . for a person controlling the issuer or previous owner."<sup>50</sup> In reversing, Judge Friendly of the Second Circuit Court of Appeals took issue with this view, stating:

So limited a construction does not accord with the language and remedial purpose of the statute or with the case law. Section 2(3) instructs that "offer" shall "include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a

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45. *Id.* at 1050.

46. *Id.* at 1051.

47. *Id.*

48. *Id.* at 1052.

49. *Id.* at 1052-53.

50. *Id.* at 1052. The Second Circuit Court of Appeals was forced to surmise this ground because of the trial judge's failure to file an opinion.

security, for value." While it is conceded on appeal that at least some of the appellees could fall within the prohibition of § 12(1) if Amos Treat & Co. acted as broker for Delka, the contention is that the firm did not do this since it received no commission and was simply helping Katz to get in on a good thing. We think a jury could have permissibly concluded that the Treat firm was acting as a broker for Delka despite the absence of a commission, particularly in light of Treat's interest in the underwriting. *Moreover under the statutory definition the firm would equally be liable if the jury found, as it could, that Treat & Co. actively solicited Katz' offers to buy. . . .* So far as this ground of decision was concerned, it was thus clear error for the court to have dismissed the complaint against Amos Treat & Co., Amos Treat and Nardone, all of whom, on Katz' testimony, pressed him to buy Delka stock.

There was also sufficient evidence that a jury could come to a similar conclusion with respect to Wofsey [the lawyer] at least with respect to the second block of 60,000 shares. To be sure there was no testimony that he had taken the initiative. On the other hand the evidence clearly warranted the inference that on both occasions in April 1961, he had not simply answered Katz' questions, but had placed Treat in a position to tackle Katz for the money. Taking into account the broad language of § 2(3) and the remedial purpose of § 12(1), *we think a jury could properly decide that Wofsey had been a party to a solicitation.*<sup>51</sup>

Emerging from the *Katz* decision is the notion that if one participates in or is a party to a solicitation which culminates in a transaction, such a role will support seller characterization under section 12. This conclusion looks to the entire selling process as opposed to the simple transfer of title which a restrictive view of section 12 mandates. Judge Friendly's opinion does not, however, expressly define the parameters of that level of participation needed to make one a "party to a solicitation." Yet the court's failure to reverse with respect to Ewbank who had signed the stock certificate for the second sale and picked up one of the payments for it on the grounds that section 12(1) "was [not] intended to embrace a corporate officer or director merely because he has knowledge of a sale of unregistered stock and plays such a minor role in facilitating it"<sup>52</sup> suggests that the role in the selling process or circumstances leading to a violative transaction must be a meaningful and perhaps even a necessary one.

There is a considerable gray area between being a party to a solicitation on the one hand and merely having some form of knowledge and playing an insignificant role on the other. Although a line must surely be drawn somewhere, its placement is not an easy task on the basis of *Katz*. The task is

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51. *Id.* at 1052-53 (emphasis added).

52. *Id.* at 1053.

made even more difficult by an earlier decision by the United States District Court for the Southern District of New York in *Gould v. Tricon, Inc.*<sup>53</sup>

In *Gould*, the plaintiff purchaser sought recovery under section 12(2). He alleged that Tricon's prospectuses failed to disclose the prior association of the company's president and board chairman with a firm for which he had previously designed and begun development of a marine steering device allegedly similar to that being developed by Tricon. The plaintiff also alleged that the prospectuses misrepresented the extent to which Tricon had progressed in design and development of its device. The court had little difficulty concluding that the company had indeed omitted a material fact and had been "more optimistic about the steering mechanism than it had a right to be under the circumstances."<sup>54</sup> However, the court encountered more difficulty in trying to hold individually liable one Akers, Tricon's vice-president and secretary who also served on the board of directors. Akers' only involvement or connection with the distribution was allowing his name to appear on the prospectus. Nevertheless, on the basis of that simple fact, Judge Tenney reasoned:

When Akers became a director of Tricon, Inc. and allowed his name to appear on the prospectus, he warranted that any statements in the prospectus concerning the Tricon device were accurate. If he was uncertain as to whether the device had been fully designed and whether development work was complete, he had a duty to make further inquiry before allowing his name to appear on a prospectus setting forth such facts. His failure to do so makes him liable under section 12(2).<sup>55</sup>

Though the question of whether Akers or the other individual defendants were sellers was not specifically raised in *Gould*, there is, of necessity, a presumption of seller status in Judge Tenney's notion of a duty arising out of the circumstances.<sup>56</sup> But the *Gould* opinion does not clearly explain what it is about the extant duty, or the result of its breach, that causes one to fall within the ambit of section 12. Some insight may be obtained by reference

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53. 272 F. Supp. 385 (S.D.N.Y. 1967).

54. *Id.* at 392.

55. *Id.* at 392-93. The court did, however, decline to hold Akers liable for the omissions in the prospectus on the grounds that Akers had no duty to investigate his co-director's prior associations since his bibliography appeared in the prospectus.

56. The use of duty as a basis for imposing liability has recently taken on considerable significance in litigation under other general antifraud provisions, particularly section 10(b) of the Exchange Act, 15 U.S.C. 78j(b) (1970), and rule 10b-5 thereunder. Both major sources of rule 10b-5 opinions—the Second and Ninth Circuits—have now recognized that the proper inquiry in evaluating claimed 10b-5 liability is the duty which any particular defendant had in light of the facts and circumstances surrounding his actions, and whether that duty was breached. See *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974); *Chris Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); *Lanza v. Drexel &*



to two earlier cases, *Zachman v. Erwin*<sup>57</sup> and *Wonneman v. Stratford Securities Co.*<sup>58</sup> *Zachman* and *Wonneman* premise section 12 liability on the degree of participation in the transaction in question. It seems that the *Gould* duty concept is an outgrowth of the participation analysis set forth in these earlier cases. In other words, a certain amount of participation gives rise to a duty, the breach of which triggers section 12 liability.

Using a participation (but not a duty) analysis,<sup>59</sup> the court in *Zachman* reached the same result as the court in *Gould* in refusing to grant motions to dismiss made by members of the issuer's "Advisory Board," whose conduct was nearly as passive as that of Akers in *Gould*. Yet this approach in its broadest ramifications was seemingly rejected by the Southern District of New York in *Wonneman v. Stratford Securities Co.*

Interestingly, the participation approach advocated in *Wonneman* was not based upon section 12 or its interpretations but rather was premised upon the reference to participation in the venue provision of the jurisdictional grant found in section 22(a).<sup>60</sup> The argument was quite simply that the stat-

Co., 479 F. 2d 1277 (2d Cir. 1973). While the two circuits still differ as to what the duty is and how it is breached, they are now agreed that the basic inquiry concerns the existence of a duty. Because the language of section 10(b) and rule 10b-5 contains no apparent limitation on the scope of possible defendants comparable to that in section 12 of the Securities Act, it would be hasty to conclude that Judge Tenney was simply presaging that which was to come; the result in *Gould* is much too stark.

Note, however, the recent decision *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), which may have an effect on the notion of duty as a basis for imposing liability. In *Hochfelder*, a rule 10b-5 action, the Supreme Court demanded proof of scienter, like that required for common law fraud and deceit. Query, therefore, whether a duty analysis will survive *Hochfelder*.

57. 186 F. Supp. 681 (S.D. Tex. 1959) (rulings on motions), 186 F. Supp. 691 (S.D. Tex. 1960) (further rulings on motions).

58. [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,034 (S.D.N.Y. 1961).

59. The court concluded:

There are sufficient allegations of the participation of the Group Two defendants, members of the Advisory Board, in activities involving them in the sales and with the controlling persons. They are alleged to have willfully or negligently cooperated with the general plan or scheme to defraud plaintiffs by allowing their names to be used in connection with the selling transactions, by actual attendance at board meetings at which decisions were made and where they advised, counseled, or voted, and by the receipt or promise thereof of compensation for the use of their names, advice, and assistance given by them in the operations of the companies in their communities. Though they may not have been members of the boards of directors of the companies, the Group Two defendants are alleged to have been involved in the sales or to have been in positions that may have involved control of the sellers.

186 F. Supp. at 686.

60. Section 22(a) of the Securities Act provides in pertinent part:

The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or

ute as a whole clearly contemplated liability for those who participated in violations. In the initial *Wonneman* opinion,<sup>61</sup> Judge Cashin appeared to have at least tacitly embraced this view, for he concluded that in order to warrant dismissal the individual defendants had to show "that they did not participate in the sale and not merely that they did not actually sell the securities."<sup>62</sup> What type of participation he had in mind is far from clear; however, it appears from his refusal to grant the motion of one Pauline Lewis, a nominal officer and director of Stratford, that perhaps a control relationship of a lesser degree than that covered by section 15 was contemplated.<sup>63</sup>

Judge Murphy rendered this query purely academic in his harshly worded opinion stemming from the ensuing trial in which he challenged the notion of participation as an acceptable basis for ensnaring one within section 12. Except for Samuel Lewis, who was found to be in control of the seller, with respect to all the individual defendants he declared:

[P]laintiff does not prove or attempt to prove that any of them in any manner controlled Stratford or played any direct part in the sales or offers made to him. He seeks to hold these defendants liable upon the theory that each one of them "participated" in the sales to him within the meaning of that term as used in Section 22(a), 15 U.S.C. 77v, the venue provision of the Act. It is plaintiff's argument that "participation in an offer or sale made illegal by the Act suffices to impose liability," and further, by participation he means, "participation in any phase of the overall plan to market securities in violation of the Act."

At the outset, we find that plaintiff has failed to prove any such "overall plan" or scheme or conspiracy to make illegal sales of securities and he has failed to prove participation by any of these remaining defendants in the only illegal offers or sales for which he may maintain this suit, to wit, those made to himself. As we noted

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sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

15 U.S.C. § 77v(a) (1970) (emphasis added).

Use of the jurisdictional grant provision as a means of approaching civil remedies, and indeed as providing a basis for them under provisions of the securities laws is not unique to the *Wonneman* claims. Indeed the general jurisdictional grant found in § 27 of the Exchange Act, 15 U.S.C. § 78aa (1970), the wording of which is substantially the same as that in § 22(a) of the Securities Act, has been offered as a rationale for the implication of private rights of action for the enforcement of antifraud provisions not otherwise providing for any civil remedy. For a discussion of this rationale and its foundation, see Rapp, *An Implied Private Right of Action Under Section 16(a) of the Securities Exchange Act of 1934*, 1972 SEC. L. REV. 159, 165-67.

61. [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 90,923 (S.D.N.Y. 1959).

62. *Id.* at 92,963.

63. She "has not shown that she was not a director; that she did not attend board meetings and vote for the sale of General Oil & Industries, Inc. stock; that she was not a majority stockholder, or that she did not supervise the firm's activities." *Id.* at 92,964.

earlier, the statutes under which plaintiff sues require an element of privity between the plaintiff-purchaser and defendants. The defendant must be, for example, the actual seller or one who negotiated the sale; the owner of the securities sold or a person who in some manner controls the seller. . . . Actually, what plaintiff is contending for here is to broaden the area of liability, in accordance with his definition of the term "participated" found in the venue statute cited above. He seeks to embrace therein all persons connected with the corporation whose stock is sold in violation of the Act who he can plausibly argue have the remotest connection with facilitating, in a broad sense of causation, the ultimate sales to himself.<sup>64</sup>

Thus, the court refused to extend section 12 to an attorney who had, among other things, rendered an oral opinion to Samuel Lewis that the shares to be offered were exempt from registration even though the opinion induced, at least in part, the sale of the shares. The court also refused to extend liability to those claimed participants who were found to be merely passive officers and directors. Even the charge made against Mrs. Lewis that "her failure to act at a time when her position in Stratford imposed a duty upon her to act" <sup>65</sup> failed to move the court; she did not participate in the sales to the plaintiff nor in any way control Stratford.<sup>66</sup>

Despite the harsh treatment which the participation approach to section 12 received from Judge Murphy, it is clear from his emphasis on the defendants' complete passivity and from his declaration that the statute requires only an "element of" privity so that one who "negotiates" a sale may be liable, that participation as a basis for deeming one an offeror or seller for purposes of section 12 was not completely rejected. What Judge Murphy objected to was the plaintiff's dragnet approach based on the premise that it would suffice if there was "participation in any phase of the overall plan to market securities in violation of the Act." <sup>67</sup> There is nothing in the opinion, however, to suggest that a more restrictive view of participation than that proffered by the plaintiff would not be viable, and indeed, the implication is that it would. It is precisely this implication that was seized upon by Chief Judge Connell of the Northern District of Ohio in his highly respected decision in *Lennerth v. Mendenhall*.<sup>68</sup>

The *Lennerth* case centered on the conduct of an individual defendant, Roger, who had been instrumental in bringing the plaintiffs and the defendant/issuer together. In an initial meeting with the plaintiffs "he outlined the

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64. [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,034 at 93,459-60.

65. *Id.* at 93,461.

66. *Id.*

67. *Id.* at 93,459. See text accompanying note 85 *infra*.

68. 234 F. Supp. 59 (N.D. Ohio 1964).

details of the proposed venture," and made certain representations concerning the issuer, describing it as "a national operation, extremely successful and heavily financed."<sup>69</sup> At a later meeting, he repeated these representations and undertook financial calculations for the purpose of projecting an expected profit for the plaintiffs. At a third meeting, Roger introduced the plaintiffs to an officer of the defendant corporation who informed them that they had been confirmed as suitable investors. He thereafter played no role in the distribution of the unregistered securities.

Because Roger had not played a role in the actual consummation of the sale, Chief Judge Connell was unable to bring him within section 12 on the basis that he was "an agent for the vendor," at least in the sense given that notion by *Whittaker v. Wall*,<sup>70</sup> where "the agents had actually closed the deal and signed the agreement on behalf of the selling corporation."<sup>71</sup> Thus, the only available route to imposition of liability upon Roger, who had unquestionably played a meaningful role in the circumstances leading up to the sale, was the notion of participation. But that necessarily called for a confrontation with Judge Murphy's opinion in *Wonneman*. Chief Judge Connell responded to this challenge:

It is implicit in the [*Wonneman*] Court's reasoning, when it rejects [the contention that liability should attach to all who participate in the overall process of marketing securities] and yet states that it would hold liable one who negotiates the sale, that liability must lie somewhere between the narrow view, which holds only the parties to the sale, and the too-liberal view which would hold all who remotely participated in the events leading up to the transaction. We think that the line of demarcation must be drawn in terms of cause and effect: To borrow a phrase from the law of negligence, did the injury to the plaintiff flow directly and proximately from the actions of this particular defendant? If the answer is in the affirmative, we would hold him liable. But for the presence of the defendant Roger in the negotiations preceding the sale, could the sale have been consummated? If the answer is in the negative, and we find that the transaction could never have materialized without the efforts of that defendant, we must find him guilty.<sup>72</sup>

Using this standard, the court found Roger liable under section 12, because he had done "everything but draw and sign the contract. The hunter who seduces the prey and leads it to the trap he has set is no less guilty than the hunter whose hand springs the snare."<sup>73</sup>

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69. *Id.* at 64.

70. 226 F.2d 868 (8th Cir. 1955).

71. 234 F. Supp. at 64.

72. *Id.* at 65.

73. *Id.*

The *Lennerth* concept of participation, like that intimated in *Katz v. Amos Treat & Co.*<sup>74</sup> some years later, is based upon a consideration of the defendant's role in the circumstances of the sale. Indeed, both the attorney in *Katz* and the quasi-agent<sup>75</sup> in *Lennerth* can easily be viewed as parties to a solicitation which culminated in a violative transaction. However, these cases also suggest<sup>76</sup> that the role required to support section 12 liability must be a necessary one in terms of causing the sale. Yet the "but for" test of causation used to analyze Roger's conduct in *Lennerth* is not useful in all situations. As Dean Prosser points out in a discussion of the "but for" test in the tort law context:

If two causes concur to bring about an event, and either one of them, operating alone, would have been sufficient to cause the identical result, some other test is needed. Two motorcycles simultaneously pass the plaintiff's horse, which is frightened and runs away; either one alone would have caused the fright. A stabs C with a knife, and B fractures C's skull with a rock; either wound would be fatal, and C dies from the effects of both. The defendant sets a fire, which merges with a fire from some other source; the combined fires burn the plaintiff's property, but either one would have done it alone. In such cases it is quite clear that each cause has in fact played so important a part in producing the result that responsibility should be imposed upon it; and it is equally clear that neither can be absolved from responsibility upon the ground that the identical harm would have occurred without it, or there would be no liability at all.

[I]n a case of this type . . . a broader rule, which has found general acceptance [is applied:] The defendant's conduct is a cause of the event if it was a material factor in bringing it about . . . .

Such a formula, for it can scarcely be called a test, is clearly an improvement over the "but for" rule. It disposes of the cases mentioned above, and likewise of the difficulties presented by two other types of situations which have proved troublesome. One is . . . where a similar, but not identical result would have followed without the defendant's act; the other where one defendant has made a clearly proved but quite insignificant contribution to the result . . . .<sup>77</sup>

Had Chief Judge Connell in *Lennerth* been faced with a complex factual setting of multiple and concurrent causes, it appears certain that he would have embraced the substantial factor formula endorsed by Dean Prosser. The substantial factor test comports not only with Judge Connell's basic de-

74. 411 F.2d 1046 (2d Cir. 1969). See text accompanying notes 43-52 *supra*. Interestingly, the court in *Katz* did not cite the *Lennerth* decision in its analysis.

75. See text accompanying notes 70-71 *supra*.

76. See text accompanying notes 52, 73 *supra*.

77. W. PROSSER, *THE LAW OF TORTS* § 41, at 239-40 (4th ed. 1971) (footnotes omitted).

cision to invoke negligence law concepts, but also with his underlying inquiry—did the injury to the plaintiff flow directly and proximately from the actions of this particular defendant? More importantly, the substantial factor formula is consistent with the judge's attempt to inject some form of objectivity into analyzing roles in the gray area between being a party to the actual sale and being merely a remote participant in the events leading up to it. Thus, it appears that one can, and perhaps should, regard the "but for" language in the critical paragraph embodying that standard as surplusage. That the Fifth Circuit appears to have done so in *Hill York Corp. v. American International Franchises Inc.*<sup>78</sup> provides persuasive support. It is even more convincing that the same court, albeit in a brokerage case, *Lewis v. Walston & Co.*,<sup>79</sup> later rephrased the naked "proximate cause" test in terms of a "'substantial factor' in bringing about the plaintiffs' purchases."<sup>80</sup>

*Hill York* was an action brought pursuant to both sections 12(1) and 12(2) by purchasers of stock in a statewide franchise sales center corporation. The purchasers charged that the corporation was nothing more than part of a pyramiding scheme to funnel money to the Freemans and one Browne who comprised all the officers and shareholders of American.

Under the plan commonly used, American would seek out local investors to incorporate a state-wide or regional franchise sales center. The payment of a franchise fee to American conferred upon this sales center the exclusive right to sell Hickory Corral and Italian Den franchises within the State or region. The local investors who formed the franchise sales center corporation would sell stock in the corporation to a small number of persons who would be most likely to furnish supplies and services to the restaurants. . . . American was also in the franchise consulting business and was to assist the local investors in organizing and developing the business of the sales center.<sup>81</sup>

Florida Franchise, the corporation that was the subject of the action, was formed by Browne and one Osborne from those who responded to newspaper advertisements seeking a "Vice President of Marketing" and who appeared to be financially able. They then provided these pre-incorporation subscribers with promotional literature and advised them on how to solicit additional capital. Utilizing these instructions, Shepherd, Quinn, and McDaniel sold the remaining stock to the plaintiffs. They misrepresented Browne's experience as a capitalization consultant, failed to disclose the SEC investigation of a similar scheme years earlier, and also failed to disclose

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78. 448 F.2d 680 (5th Cir. 1971).

79. 487 F.2d 617 (5th Cir. 1973).

80. *Id.* at 620. See text accompanying notes 31-36 *supra*.

81. 448 F.2d at 684.

state investigations into certain of the other sales centers. Moreover, they failed to register the stock.

American's participation in the venture did not end when the Florida Franchise stock was sold. During the company's formative stages American required that two of the five directors be its representatives. In fact, for a short time Browne served as board chairman and chief executive officer. American continued to supply promotional material and recommended a set of by-laws which were adopted. Florida Franchise was even required to keep its minute books, accounting records, and bank statements at American's office in Missouri.

Predictably, the focus of attention on appeal was upon the Freemans and Browne since they were clearly not sellers in the traditional sense as were Shepherd, Quinn, and McDaniel. To hold them liable under section 12(2), the court applied *Lennerth's* notion of proximate cause, without the use of any "but for" language. However, the court's conclusion that it could "deduce with certainty that the plaintiffs would not have purchased this stock had the defendants not traveled to Florida carrying their bag of promotional ideas,"<sup>82</sup> suggests that the "but for" formulation of *Lennerth* actually lay behind its decision. But the Fifth Circuit's subsequent reformulation of its *Hill York* proximate cause test in *Lewis v. Walston & Co.*,<sup>83</sup> discussed at length in Part II of this article,<sup>84</sup> indicates otherwise. That decision focused upon a registered representative of a brokerage firm who had touted a particular stock to the plaintiffs, arranged for their meeting with officers of the issuer, and informed them when additional stock became available. In sustaining the trial court's refusal to grant the defendant's motion for judgment notwithstanding the verdict, the court concluded that "[t]he jury could permissibly infer from these facts that [the representative's] actions were a 'substantial factor' in bringing about the plaintiffs' purchases, and thus the 'proximate cause' of these purchases."<sup>85</sup> This, of course, is precisely the spirit if not the letter of the workable formula advocated by Dean Prosser to accommodate the problem of multiple or concurrent causes.

The foregoing review of the cases expanding the scope of section 12 supports some generalizations. All the decisions, except *Gould*, are outwardly consistent in their broad, underlying premise—that primary liability will extend to all persons who play a direct and meaningful role in the circumstances surrounding a sale of securities. As to what constitutes a "meaningful role," these cases suggest that it is direct facilitation of the transaction, and it is this relationship—role to transaction—which has generally replaced

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82. *Id.* at 693.

83. 487 F.2d 617 (5th Cir. 1973).

84. Text accompanying notes 31-36 *supra*.

85. *Id.* at 622.

the traditional contractual privity relationship that would otherwise operate to limit the scope of permissible defendants. Even *Gould*, with its breach of duty analysis, is not inconsistent with this approach when the necessary implication of that decision is considered; failure to act under circumstances viewed as giving rise to a duty to do so can have the same impact upon the sale transaction as active participation would have. This interpretation of facilitation is certainly not foreign to securities law liability analysis.<sup>86</sup> In any event, it is clear that all of these cases turn upon what can be termed "transactional" privity in determining who in fact may be deemed a person who offers or sells for the purpose of imposing primary liability. The recent decision in *Sandusky Land, Ltd. v. Uniplan Groups, Inc.*,<sup>87</sup> however, appears to have moved away from the strictly objective transactional privity analysis of the *Lennerth/Katz* line, and focused instead on a certain level of scienter as the critical factor in determining the scope of liability. This approach is both significant and troublesome, as the ensuing portion of this article demonstrates.

#### IV. SANDUSKY LAND, LTD. v. UNIPLAN GROUPS, INC.:

##### NEW DIRECTION IN TRANSACTIONAL PRIVACY

*Sandusky Land, Ltd. v. Uniplan Groups, Inc.*, decided in September 1975 by Judge Lambros of the Northern District of Ohio, involved alleged violations of the antifraud provisions of both the Securities Act and the Exchange Act. The plaintiffs claimed that certain of the defendants had made misrepresentations in connection with the offering and sale of limited

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86. See, e.g., *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966) (motion to dismiss denied); 286 F. Supp. 702 (N.D. Ind. 1968) (on merits), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). The decision in *Brennan*, under section 10(b) and rule 10b-5 of the Exchange Act, is significant since liability for aiding and abetting was imposed upon an issuer for remaining silent after learning of improper conduct of a brokerage firm dealing heavily in its stock. For further discussion of silence and inaction as a basis for rule 10b-5 liability in the aiding and abetting context, see *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), *rev'd*, 425 U.S. 185 (1976) (contractual and statutory duties); *Fischer v. New York Stock Exch.*, 408 F. Supp. 745 (S.D.N.Y. 1976) (duty arising out of circumstances); *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967) (insiders' duty); *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963) (statutory duty); 2 A. BROMBERG, *SECURITIES LAW* § 8,5(533) (1975). *But see* *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971). Note, however, that these cases under rule 10b-5 with the possible exception of *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967), deal with a concept of secondary liability—aiding and abetting—and not with a standard of primary liability like that of offering or selling in section 12.

87. 400 F. Supp. 440 (N.D. Ohio 1975).



partnership interests to the plaintiffs.<sup>88</sup> The defendants included a national accounting firm, Haskins and Sells, that apparently had been engaged by the original general partner of the limited partnership entity to provide professional advice on tax matters. In connection with its duties as a general accountant, the defendant accounting firm had rendered an opinion on the tax consequences or benefits that would inure to the purchasers of interests in the limited partnership.

The allegations against the accounting firm were that the firm had participated in the preparation and dissemination of financial statements to the investors, most of which participation apparently occurred after the actual sale of the securities.<sup>89</sup> The court characterized the principal section 12 allegations thusly:

In sum, the allegations are that Haskins and Sells issued a written opinion violative of the requirements of § 12(2) which was disseminated to plaintiffs . . . that plaintiffs relied in making their investment on the advice of Haskins and Sells as to the flow-through of tax benefits, which flow-through was not allowed by the Internal Revenue Service . . . and that Haskins and Sells knew or should have known of the misrepresentations or omissions made concerning plaintiffs' investment yet disregarded that information, *thus aiding and abetting defendant Uniplan in the accomplishment of its unlawful conduct.*<sup>90</sup>

The court's characterization of the claim against the accounting firm was significant. It encompassed two theories of section 12 liability. First, the plaintiffs contended that Haskins and Sells was a seller for the purpose of imposing direct, or primary liability. Second, the plaintiffs alleged that the accountants aided and abetted section 12 violations allegedly committed by other defendants for the purpose of imposing secondary liability. The fascinating aspect of the decision is that the court ultimately seized upon the

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88. Another issue in the case was whether the acquisition of a *general* partnership interest could be deemed to be a security. One of the plaintiffs was an original general partner of the limited partnership entity. He claimed that although that which he purchased was ostensibly a general partnership interest, it was, in fact, an "investment contract"—a security. The court found that this particular plaintiff received his partnership interest in exchange for providing his services to the partnership enterprise. "His active involvement in the subject of his investment" persuaded the court that he did not need the special protections which the securities laws provide for investors. 400 F. Supp. at 445. Accordingly, this particular plaintiff's claims were dismissed.

89. In addition to their allegations that the accounting firm should be deemed a section 12 seller for purposes of imposing primary liability, the plaintiffs alleged that the firm had aided and abetted other violators and was thus secondarily liable. The court did not focus on this separate allegation, choosing instead to interrelate the concepts of secondary liability and aiding and abetting into primary liability.

90. 400 F. Supp. at 443-44 (emphasis added).

secondary liability allegations of aiding and abetting to establish a threshold for imposing primary liability under section 12(2). This approach to section 12 "seller" liability is a striking development which requires examination of the circumstances and arguments presented in *Sandusky Land*.

Haskins and Sells urged, in support of its motion to dismiss plaintiffs' section 12 claims, that it could not possibly be deemed a seller because it had merely performed the ordinary professional services of a tax accountant for the limited partnership and its promoter. But the plaintiffs countered that in light of the reasoning established through the *Lennerth/Katz* line of cases, section 12 liability for this particular defendant could not be determined by simply answering the question of whether or not it performed the usual function that an accounting professional performs for a client. Instead, the litigative history of section 12 compels an analysis of what role, if any, the accountants had played in the transaction in which the securities were sold to the plaintiffs. And, indeed, in the same district in which *Lennerth* was decided, such a consideration was literally mandated.<sup>91</sup>

The plaintiffs propounded, albeit within the *Lennerth* parameters, a new approach to role analysis which is similar to the analysis that was accepted by the court in *Gould v. Tricon*.<sup>92</sup> The plaintiffs argued that the real issue in the case was whether, due to the circumstances, the defendants owed a duty to the plaintiffs and whether the defendants breached that duty.<sup>93</sup> Although a particular defendant may not have been directly involved in the selling process, the breach of an extant duty owed by that defendant to the plaintiffs in the circumstances would suffice to characterize that defendant as a seller under the *Lennerth* proximate cause test.

Applying the above duty argument to *Sandusky Land*, the plaintiffs alleged that the accounting firm was either a seller, a participant in, or an aider and abettor of, conduct violative of section 12 and the other general antifraud provisions of both the Securities and the Exchange Acts. The court accepted the plaintiffs' "seller" argument:

To some extent *any* accounting firm issuing an opinion as to a particular partnership, corporation or company facilitates securities transactions in that makers of investments normally review such opinions before entering into investment transactions. Yet not all accountants will be found to be sellers under § 12(2). It is only when the evidence establishes that there was an *aiding* or *abetting* of the seller of the security or offeror of an investment that liability will be found to exist.<sup>94</sup>

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91. See text accompanying notes 68-77 *supra*.

92. 272 F. Supp. 385 (S.D.N.Y. 1967); see notes 53-56 *supra* and accompanying text.

93. Plaintiff's Complaint ¶ 15 (Civil Action No. C74-1205).

94. 400 F. Supp. at 444

The court apparently embraced the theory that secondary liability is the threshold level of *primary* liability under section 12. If one's conduct rises to the level of secondary liability based upon the aiding and abetting of a seller, then one is treated as a seller and is consequently primarily liable under section 12.

The *Sandusky Land* court did not clearly establish the level of scienter required to hold a defendant liable as an aider and abettor of a section 12(2) violation. Instead, the court appears to have adopted an approach similar to that used in *Lanza v. Drexel*,<sup>95</sup> even though *Lanza* focused not on section 12 but rather on the standard of liability under Exchange Act section 10(b) and rule 10b-5.<sup>96</sup> In *Lanza*, the Second Circuit established the threshold standard for fraud liability as a willful or reckless disregard for the truth.<sup>97</sup> In those situations in which a duty of inquiry arises, the breach of that duty would amount to willful or reckless disregard and, therefore, support the imposition of liability.

Judge Lambros cited *Lanza* for the proposition that "a defendant may be held liable under section 12(2) if it can be shown that there was either privity (as to the plaintiff) or scienter (as to the defendant to be held liable)." <sup>98</sup> The court's observation, however, must be read in conjunction with its later citation of two cases: *Hochfelder v. Midwest Stock Exchange*<sup>99</sup> and *In re Caesars Palace Securities Litigation*.<sup>100</sup> Those cases were cited in

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95. 479 F.2d 1277 (2d Cir. 1973); see note 56 *supra*.

96. The court in *Lanza* considered the applicability of section 12 and concluded that section 12 was inapposite because "[t]hat section requires privity or, in the absence of privity, scienter." 479 F.2d at 1298 (emphasis added) (footnotes omitted). It is this recognition of scienter as a basis for section 12 liability that the court in *Sandusky Land* seized upon and translated into its own aiding and abetting notion as a standard of liability. Note, however, that the authorities cited by the court in *Lanza* do not support the proposition that scienter alone is sufficient to bring a charged party within the scope of section 12 liability. See 479 F.2d at 1298 n. 67, citing *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967), and 3 L. LOSS, SECURITIES REGULATION 1716 (2d ed. 1961). The court in *Barnes* noted in dictum that both sections 12(2) and 17(a) preserve "some form of the traditional scienter requirement." 373 F.2d at 272. The court makes no reference to a limitation on the scope of section 12 liability. Indeed, the court's words can be read merely as saying that in order to impose section 12(2) liability, some form of scienter will have to be demonstrated. It clearly does not say that scienter is an alternative to the privity requirement of section 12.

The court's further reliance on Professor Loss for "the rationale for permitting actions under § 12(2) when scienter is shown," is likewise unresponsive. In the cited section, Professor Loss notes that in section 12 actions there is a distinction between the actual seller and other persons who participate in the sale transaction. As to the latter, the plaintiff would have to prove participation. Professor Loss contends that such proof would probably require a showing of scienter, but he does not argue that such a showing would be sufficient, absent a showing of privity, to invoke section 12 liability. See 3 L. LOSS, *supra*, at 1716.

97. 479 F.2d at 1306.

98. 400 F. Supp. at 443.

99. 503 F.2d 364 (7th Cir. 1974).

100. 360 F. Supp. 366 (E.D. Pa. 1973).

support of the court's proposition that section 12 liability will be imposed on a participant who aids or abets a seller in a fraudulent transaction. *Caesars Palace* is particularly significant inasmuch as it specifically discusses aiding and abetting in the context of section 12 liability. *Hochfelder*, although not a case arising under section 12, affirms the proposition that a breach of a duty of inquiry coupled with an improperly motivated failure to act would support a claim of aiding and abetting liability. Both *Caesars Palace* and *Hochfelder* conceptualize aiding and abetting as a knowing facilitation of a violation. A reading of the cases together with Judge Lambros' observation that scienter may be determinative of section 12 liability indicates that he premises section 12 liability on *knowing* conduct in a fraudulent transaction.

The plaintiffs in *Hochfelder* claimed that the Midwest Stock Exchange had aided and abetted the unlawful conduct of one of its member broker/dealers by failing to enforce, pursuant to section 6 of the Exchange Act,<sup>101</sup> compliance with the provisions of that Act. Specifically, the plaintiffs charged that the Exchange, solely by its inaction, had aided and abetted the fraudulent conduct of one of its members. The Seventh Circuit rejected the claim, observing:

[W]e would not go so far as to charge a party with aiding and abetting who somehow unwittingly facilitated the wrongful acts of another. Rather, to invoke such a rule investors must show that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure.<sup>102</sup>

*Caesars Palace* involved claims that certain defendants had aided and abetted or conspired with others in the violation of section 12 and other provisions of both the Securities Act and the Exchange Act. In his analysis, Judge Weiner also spoke of a form of knowledge, or scienter, as being sufficient, when coupled with facilitation of wrongful conduct, to invoke section

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101. 15 U.S.C. § 78f (1970). Section 6 provides in pertinent part:

(a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

(1) *An agreement* (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) *to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder . . . .*

(emphasis added).

102. 503 F.2d at 374.

12 liability. He noted:

Persons participating directly in a violation of the statute will not escape liability under the express language of the Act; similarly, those persons who are aware of and, to some lesser degree, participate in a violation of the securities laws and either enter into an agreement with or give assistance to the primary wrongdoers should not be permitted to escape the imposition of liability. . . . “[s]uch individuals will be subject to liability because they have acted knowingly or recklessly” to assist in such conduct or to be a part of a proscribed course of action.<sup>103</sup>

Neither *Hochfelder* nor *Caesars Palace* dealt with the scope of primary liability under section 12. The issue in those cases was whether the bare allegation of secondary liability stated a legally cognizable section 12 claim. The court in *Sandusky Land*, however, did not make such a distinction in its citation of *Caesars Palace* and *Hochfelder*. In fact, the court expressly disclaimed such a distinction, embracing Judge Weiner’s suggestion in *Caesars Palace* that it would amount to “hair-splitting” to attempt to do so.<sup>104</sup>

Another significant factor in the *Sandusky Land* analysis was the court’s treatment of *Lennerth v. Mendenhall*.<sup>105</sup> Although *Lennerth* should have been an influential precedent, having been decided in the same district court, Judge Lambros characterized that decision as merely “[a]n equally significant decision setting forth *another* view of liability under section 12(2).”<sup>106</sup> That view was the *Lennerth* proximate cause test for determining liability under section 12. However, in a seemingly critical tone, Judge Lambros observed that “as the Second Circuit recognized in *Lanza* . . . each case must be determined upon the facts which are established by the parties.”<sup>107</sup>

Judge Lambros did no more than refer to the *Lennerth* proximate cause test. His tandem treatment of *Lennerth* and *Katz*, however, suggests that he may have been seeking a nexus between the conduct of the defendant and the transaction at issue—transactional privity—on which to base section 12 liability. But the *Lennerth* reference was not clearly explained. In terms of the substantive section 12 issue in *Sandusky Land*—whether the accounting firm should be deemed to be a “person who sells”—*Lennerth* and its progeny are neither rejected nor followed.

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103. 360 F. Supp. at 383 (footnote omitted).

104. 400 F. Supp. at 444.

105. 234 F. Supp. 59 (N.D. Ohio 1964).

106. 400 F. Supp. at 443 (emphasis added).

107. *Id.* And as an example of such an approach the court looked to *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2d Cir. 1969), discussing the case in a manner which seems to negate any notion that a “but for” element is present.

Putting *Lennerth* aside, as the court does, and looking instead to *Lanza*, *Hochfelder*, and *Caesars Palace* as providing the real insight into the scope of section 12 liability, the significance of *Sandusky Land* emerges. Indeed, the *Sandusky Land* court effectively came full circle to the duty approach to liability that emerged in *Gould v. Tricon*,<sup>108</sup> in which the breach of a duty arising out of given circumstances rendered a defendant primarily liable under section 12. *Sandusky Land*, via the cases *Lanza*, *Hochfelder*, and *Caesars Palace*, arguably supports the conclusion that a defendant may be deemed primarily liable under section 12 if he or she willfully or recklessly disregards the misstatement or omission of a material fact of which he or she has notice. This threshold standard of liability has two parts: a scienter requirement, satisfied by willful or reckless conduct, and a facilitation requirement, satisfied by the breach of a duty of inquiry and the consequent consummation of the fraudulent transaction.

Under the *Sandusky Land* approach, the nature of transactional privity, as that concept was developed in the *Lennerth/Katz* line of cases, is changed considerably. The *Lennerth/Katz* cases seemed to contemplate liability based on both active involvement in the circumstances of a sale transaction and an implicit degree of purposefulness of the conduct. *Sandusky Land*, however, appeared to predicate section 12 liability on scienter. And the court's establishment of the breach of a duty of inquiry as the threshold level of that scienter renders immaterial the character and scope of conduct in proximity to the sale. Indeed, the only remaining inquiry is whether the breach actually facilitated the completion of the transaction.

This approach can be illustrated by application to the facts of *Gould v. Tricon*.<sup>109</sup> The court in *Gould* held liable a defendant whose sole connection with the distribution at issue was the appearance of his name in the issuer's prospectus as an officer and director of the issuer. The court reasoned that the defendant, by allowing his name to appear on the prospectus, warranted the accuracy of the statements contained therein, and gave rise to a duty of inquiry. Because there were reasonable grounds under the circumstances to believe that the prospectus contained a misstatement or omission of a material fact, the defendant's failure to inquire into the accuracy of the prospectus constituted a breach of his duty. The duty analysis under *Sandusky Land* is less specific. If, in fact, there was notice of a possible violation and a failure to inquire further coupled with facilitation of the transaction, even by inaction, the duty, the breach thereof, and the facilitation would be established, with resultant primary liability under section 12(2).

The *Sandusky Land* analysis arises in the context of section 12(2) anti-fraud claims, and likewise the cases relied upon by Judge Lambros are anti-

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108. 272 F. Supp. 385 (S.D.N.Y. 1967).

109. *Id.*

fraud cases. But the approach to section 12(2) liability which emerges in *Sandusky Land* seems to be equally applicable to section 12(1) situations. Only the focus would change. A section 12(1) violation is the failure to comply with the section 5 registration provision. A potential defendant may be put on notice of the possibility of that kind of violation in the same sense that a defendant can be put on notice of a possible misstatement or omission of a material fact in the antifraud context. Arguably, section 12(1) liability may be imposed on a defendant who with notice of a possible section 5 violation fails to inquire further and thereby facilitates a sale of a security in violation of section 5. Thus, it appears that where the *Sandusky Land* tests are satisfied with respect to either form of section 12 violation, the threshold level of culpability is established.

A somewhat perplexing aspect of the *Sandusky Land* scienter approach to section 12 liability arises from the fact that the plaintiffs alleged the same set of facts to support both primary and secondary liability. The defendant accounting firm was charged with being a seller by reason of its role in the sale transaction, and in addition, or alternatively, as an aider and abettor of the primary violations of other defendants.<sup>110</sup> The court's opinion, however, conspicuously failed to focus on the sufficiency of allegations of secondary liability. Nonetheless, the court made numerous references to aiding and abetting. These references, in the very midst of the court's holding on primary liability, cause no small amount of difficulty. To determine who was a seller, the court asked whether or not there was an aiding and abetting of a seller—a rather circuitous approach.

It appears, however, that the court's references to aiding and abetting are in fact references to its notion of scienter. In other words, under certain circumstances, conduct which amounts to aiding and abetting will constitute the threshold level of scienter for the imposition of liability. But it is clear on the face of this opinion that such liability will be primary rather than secondary.<sup>111</sup>

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110. The precise secondary liability allegation of the complaint was this:

[T]hat defendants George W. Baughman, Frederick Graves, Kenneth Mlekush, Don W. Morrow, Dale Olsen, Michael Moritz and Haskins & Sells learned of the communications to plaintiff[s] or willfully and/or recklessly disregarded it and, thereby aided and abetted the unlawful conduct of Uniplan . . .

Plaintiff's Complaint ¶ 17. This allegation was, of course, made in conjunction with an allegation in the complaint relating to breach of duty as noted earlier, *see* note 111 *infra* and accompanying text.

111. The court's reference is to the elements needed to find that a defendant is a seller under section 12(2). It must be remembered that in any section 12 transaction there will always be a seller, indeed always a true seller in the strict contractual or privity sense of passing title. That true seller, however, may not be a wrongdoer in the sale transaction. Another person may carry out the active selling effort and commit the section 12 offense. Thus, from the *Cady* decision onward the concept of seller has expanded to include persons other than the actual seller. Liability under the expanded seller concept may exist even though the actual seller is

In analyzing the impact of *Sandusky Land* upon the development of expanded liability under section 12, it is perhaps most enlightening to compare its approach with that which the court regarded as an available alternative, the proximate cause approach of *Lennerth v. Mendenhall*. The proximate cause test contemplates that the role of a particular defendant was a material element and a substantial factor in bringing about the plaintiff's purchase.<sup>112</sup> Such a situation was present in *Lennerth*, where the nonprivy defendant actually procured the plaintiff for the consummation of the sale.

Another significant distinction between *Sandusky Land* and *Lennerth* is the purposefulness of the defendant's involvement in the selling process. In *Lennerth*, the defendant brought about the set of circumstances which permitted the ultimate fact—the sale—to occur. Similarly, in *Katz v. Amos Treat & Co.*,<sup>113</sup> another case cited in *Sandusky Land*, the defendant attorney had “placed [the actual seller] in a position to tackle [the purchaser] for the money.”<sup>114</sup> In both *Lennerth* and *Katz*, the nonprivy defendants had personal contact with the plaintiffs, which contact facilitated consummation of the fraudulent transaction. These characterizations clearly evoke a notion of an active, purposeful involvement in the selling process. However, in *Sandusky Land* the plaintiffs did not base their allegations on such active, purposeful involvement in selling. Instead, the accounting firm had merely rendered an opinion to the issuer on which the plaintiffs allegedly relied.

In both the *Lennerth/Katz* and the *Sandusky Land* situations, the conduct or activity of the respective defendants facilitated the completion of a sale to the plaintiffs, but the means of facilitation were not the same. Here emerges the real impact of *Sandusky Land*. The result could easily have been reached through a *Lennerth* proximate cause analysis. The court could have concluded that the allegations of the complaint, coupled with a set of facts that could be proven in support of them, would satisfy even the most restrictive *Lennerth* proximate cause analysis.<sup>115</sup> Instead the court looked to

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not guilty of fraudulent conduct. However, the *Sandusky Land* references to an aiding and abetting “of the seller” would be an anomaly if that analysis were taken too literally. To do so would require a conclusion that the true seller, or at least one other person who unquestionably qualifies as such, is the primary wrongdoer. This ignores the fact that the nonprivy seller, the accounting firm in *Sandusky Land*, could be the *only* section 12 wrongdoer. A defendant who would be liable under the *Sandusky Land* analysis should not escape section 12 liability simply because it is found that, under the circumstances, there is no other “active” seller. Thus, the only reading of the court’s “aiding and abetting of the seller” language which is consistent with the *Sandusky Land* overall analysis of section 12 liability is one which (1) incorporates the court’s notion of what rule will constitute aiding and abetting in a section 12 situation, and (2) considers that role as facilitating the transaction or the selling process.

112. See text accompanying notes 77-80 *supra*.

113. 411 F.2d 1053 (2d Cir. 1969).

114. *Id.* at 1053.

115. The matter was before the court on the defendant accounting firm’s motion to dismiss



the notion of scienter, which does not depend upon any purposeful or active role by the defendant in the actual selling process. The case stands rather clearly for the proposition that a defendant may be culpable under section 12 even though he or she was only passively involved in the actual selling process, as long as the involvement includes the requisite degree of scienter and facilitates the transaction. Where a defendant possesses no actual knowledge, the requisite scienter may be present in a breached duty of inquiry. The duty analysis requires a case-by-case determination.

Thus, the major contribution of *Sandusky Land* is that it extends, albeit by incorporation of authority rather than precise analysis, the parameters of the duty, the breach of which will trigger section 12 liability. Application of those parameters can be illustrated by projecting the court's reasoning at the preliminary motion stage in *Sandusky Land* to a trial of the case on the merits. For example, assume that at trial, the plaintiffs could produce no evidence of the defendant's actual knowledge of unlawful conduct or of purposeful involvement in the fraudulent transaction. Since there was no privity between the accountants and the purchasers, the question of whether section 12 liability would attach, according to the court, would depend on whether the defendant demonstrated the requisite scienter.

The *Lennerth* analysis would not support section 12 liability on the above facts. Despite the fact that the tax advice and opinions were rendered by the defendant to a client in the course of its business and despite the fact that the purchasers received the advice and opinions through the client, one could not conclude that the injury to the plaintiffs flowed "directly and proximately from the actions of this particular defendant."<sup>116</sup> The knowing or purposeful involvement in the selling process itself is missing. To fulfill the *Lennerth* test, the above fact pattern would necessarily require knowledge on the part of the defendant that its advice and opinions were to be disseminated to prospective investors and utilized by them to evaluate the merits of the proposed investment. This was the defendant's counterargument in *Sandusky Land*. The defendant urged that it had done nothing more than perform ordinary professional services for its client. Implicit in this argument is the ultimate evidentiary point that the defendant had no knowledge, intention, or belief that its advice or opinions would be seen and relied upon by remote offerees and purchasers. The argument apparently failed at the preliminary motion stage only because the complaint contained

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the case upon the grounds that the plaintiffs' complaint failed to state any claim upon which relief could be granted pursuant to Federal Rule of Civil Procedure 12(b)(6). On such motions the court is, of course, bound to view the complaint in the light most favorable to plaintiff and accept the well pleaded allegations as admitted for purposes of the motion. *Conley v. Gibson*, 355 U.S. 41 (1957).

116. See *Lennerth v. Mendenhall*, 234 F. Supp. 59, 65 (N.D. Ohio 1964).

ample allegations of such knowledge and involvement vis-à-vis the ultimate offerees and purchasers of the securities. But if such evidence were not adduced at trial, *Lennerth* would compel a conclusion in the defendant's favor.

The *Sandusky Land* analysis might, however, compel a conclusion different from that reached by application of the *Lennerth* rationale. Under the *Sandusky Land* test, one must look to the circumstances surrounding the conduct of a would-be section 12 seller to determine whether there was a duty of inquiry, whether such a duty was breached, and whether the fraudulent transaction was facilitated by that breach.

The defendant was involved in the transaction in question because it rendered an opinion as to the tax ramifications of the contemplated transaction. If the circumstances of the transaction were such as to put the defendant on notice of a possible section 12 violation, then there arose a duty of inquiry. Apparently, liability for breach of the duty extends to those people whose participation in the transaction may have been influenced by the defendant's opinion, notwithstanding the fact that the opinion was rendered directly only to the actual seller. The defendants could have fulfilled their duty by inquiring into the accuracy of their opinions and of the representations being made about their opinions in the actual selling process. If they made no such inquiry, then the defendants could be held liable under the *Sandusky Land* scienter approach, although they would not have been liable under a *Lennerth* analysis.

For all of its potential impact on the expansion of the scope of section 12 liability, the *Sandusky Land* opinion lacks thorough analysis. The important thesis of the opinion is not explicit but can be gleaned only from an examination of the cases cited by the court. In addition, the intermingling of the concepts of primary and secondary liability is confusing. Nevertheless, it can be discerned that the thrust of the case is a new identification of the threshold level of culpability under section 12.

The notion of a threshold level of culpability keyed to the analysis and interpretation of scienter, while well developed in other antifraud contexts, is foreign to virtually all of the previous section 12 analyses. The obvious reason for the historical lack of such analysis under section 12 is that the statute on its face contemplates liability for a particular class of defendants—those who sell. Therefore, the section 12 inquiry has focused upon the relationship between the purported defendant and the purchaser. Defendants in private actions under other antifraud provisions are determined not by reference to a particular class of persons but only by reference to particular kinds of conduct.<sup>117</sup> Furthermore, section 12, unlike the other antifraud provisions, specifically provides a defense for sellers.

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117. See, e.g., Securities Act § 17(a), 15 U.S.C. § 77q(a) (1970).

Thus, when looking at section 12, there are two distinct considerations. The first is whether the particular defendant is or is not a seller. The second is whether the statutory defense of "reasonable care" is available to the defendant who is deemed to be a seller. It is this latter consideration that renders *Sandusky Land* problematic.

To recognize, or indeed author, a new section 12 liability analysis along the scienter line that has developed under other general antifraud provisions of the securities laws is appropriate if the scienter standard comports with the provision to which it is applied. For example, neither rule 10b-5 nor the section under which it was promulgated, section 10(b),<sup>118</sup> specifies the elements or scope of liability necessary to give rise to private actions. Thus, litigants and judges, noting the common law origins of the rule, have of necessity looked to the elements of the nonstatutory actions of fraud and deceit and interpreted or modified those elements for application to rule 10b-5.<sup>119</sup> Because scienter is an integral element of the common law torts of fraud and deceit,<sup>120</sup> the requirement of at least a minimum degree of scienter to support the imposition of rule 10b-5 liability is quite appropriate.<sup>121</sup>

But section 12(2) differs markedly from rule 10b-5 in that it expressly defines the defendants against whom an action may be brought and the defense available to those defendants. Under section 12(2) the defendant may escape liability if he can demonstrate "that he did not know, and in the exercise of reasonable care could not have known, of such untruths or omissions."<sup>122</sup> The question after *Sandusky Land* then, at least with respect to section 12(2) actions, is whether the establishment of a scienter standard for determining threshold liability runs afoul of this built-in defense. If, for example, a defendant had the requisite scienter and facilitated the fraudulent transaction, he or she may, on the basis of *Sandusky Land*, be held liable. If the finding of scienter is based upon the breach of a duty of inquiry, then the consequent imposition of liability presupposes that the

118. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1976), provides simply:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate [sic] 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 the 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.

119. For an excellent analysis of the roots of Rule 10b-5, see 2 A. BROMBERG, *supra* note 86, § 2.2(100)-.2(450).

120. *See* W. PROSSER, *THE LAW OF TORTS* § 107 (4th ed. 1971).

121. *But see* discussion of *Hochfelder*, *supra* note 56 and accompanying text.

122. Securities Act § 12(2), 15 U.S.C. § 77l(2) (1970). Note that section 12(1) provides no such defense.

breach of that duty was tantamount to a failure to exercise reasonable care. Liability should be imposed only on defendants who cannot meet the reasonable care defense.

If a scienter standard is incorporated into the analysis of liability, then that standard should take the statutory defense into account. The duty may arise wholly apart from any exercise of reasonable care by a defendant if the two concepts—the seller determination and the ultimate liability determination—are treated independently. *Sandusky Land* raises the question of whether the degree of scienter required to render one a seller will also suffice to preclude the availability of the reasonable care defense. If so, then it appears that the statutory defense is read out of section 12.

Still, the defense must be reckoned with. Its presence seems to indicate that Congress intended to place some identifiable lower limit on section 12 liability. A logical reading of section 12 requires a bifurcated analysis in which step one is the determination of whether or not a seller is present and step two is the ultimate determination of liability, taking into account, at that point, the statutory defense. While the burdens of proof on these two steps are separate in the sense that the purchaser will be required to sustain the seller conclusion and the defendant/seller must then prevail on the defense, the analyses obviously cannot be separated when the conclusion on step one involves the basic question at issue in step two. It is that intertwined approach which the *Sandusky Land* decision adopts.

Perhaps there would be no problem if one could merely say that the threshold level of scienter which the *Sandusky Land* court deems sufficient to constitute a particular defendant a seller is always subject to the defendant's demonstration of the applicability of the due diligence defense. This would be to say, however, that there are really two levels of scienter, one relating to who is a seller and the other relating to who is liable, plaintiff having the burden on the first, defendant on the second. But there is absolutely no room for this kind of analysis within the confines of the statutory language. Furthermore, the scienter test used in *Sandusky Land* is simply not divisible.

The flaw in *Sandusky Land* lies in the court's separation of two elements of a section 12 claim into separate bases of liability. Instead of looking both to privity and to scienter as elements in the determination of liability, it looks to either "privity (as to the plaintiff) or scienter (as to the defendant to be held liable)"<sup>123</sup> as alternative approaches to the determination of liability. But section 12, as written, is not susceptible to this kind of alternative analysis. The statutory language unmistakably requires both privity (as to the plaintiff) and scienter (as to the defendant to be held liable). Liability

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123. 400 F. Supp. at 443 (emphasis added).

should extend only to persons who sell *and* who fail to meet the statutory defense.

If a scienter analysis is to be determinative of the scope of section 12 liability, it must, under the statute, relate to the concept of privity. The court in *Sandusky Land* appeared to be aware of the privity requirement—or, at least, of the necessity of showing some kind of link between the defendant and the fraudulent transaction. The court premised its finding that the defendant was a seller on facilitation as well as on scienter.<sup>124</sup> But, as has been noted, this conclusion should be only half of the answer to the question of liability.

In its approach to the scope of section 12 liability, the court sought to clear up the seller entanglement that has emerged over the years. It was faced with a situation different from the *Lennerth/Katz* line of cases in terms of the type of defendant involvement in the fraudulent transaction. Taking advantage of the distinction, Judge Lambros apparently sought to bring the mechanical section 12 privity analysis into the mainstream of the scienter analysis that has been so prominent in litigation under the other antifraud provisions. While the motivation is welcome, the new approach creates its own set of problems of interpretation and application which are not unlike those in the more traditional *Lennerth* approach.

Judge Lambros attempted to do away with what had become a merely semantic distinction between liability for primary and for secondary involvement in a securities transaction. His analysis, however, presented the same kind of troublesome semantic distinctions. The process of reconciling the scienter test with the statutorily granted defense may be no less troublesome than interpreting and applying the notion of proximate cause found in *Lennerth*. Indeed, on balance it seems that the *Lennerth* proximate cause test is more workable in those situations in which a possible defendant is active in the selling process. Where, however, the particular defendant alleged to be a seller is one like the accounting firm in *Sandusky Land*, the scienter analysis would be more meaningful, assuming it could be reconciled with the statutory defense.<sup>125</sup>

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124. *Id.* at 444.

125. By approaching the scope of section 12 liability as being based upon *either* privity or scienter, the court in *Sandusky Land* failed to address the issue of the statutorily granted reasonable care defense. The court was actually faced only with a "seller" issue and not with the issue of ultimate liability. Nonetheless, its scienter analysis raises at least two significant problems. First, scienter, alone, cannot be used as an independent basis of liability under section 12, see note 96 *supra* and accompanying text. Rather it would appear that it can only bridge a gap that might otherwise exist between conduct and a transaction, so as to support a finding of transactional privity—a relationship still within the contemplation of the section 12 purchaser/seller limitation. Second, focusing on secondary liability concepts as a basis for primary liability under section 12 simply does not comport with the language of the statute. One who aids and abets a seller under section 12 may, if secondary liability is to be recognized, be liable coextensively with a seller, but that person is not in fact a seller. There is a logical dilemma here.

In yet another sense, the *Sandusky Land* decision is a hybrid. It involved allegations of both primary liability and secondary liability on the same set of facts. The court's opinion represents an attempt to combine the two concepts into a single standard or threshold of liability under section 12. Although Judge Lambros failed to opine separately on the primary and secondary liability allegations, his adoption of aiding and abetting concepts highlights the question of the propriety of holding one liable solely as an aider and abettor of, or conspirator in, a section 12 violation. Judge Lambros declined to expressly adopt the holding of the court in *Caesars Palace* that secondary liability may be imposed under section 12, opting instead to treat all section 12 liability under the scienter approach. But his use of aiding and abetting concepts and authorities in the section 12 context sets the stage for closer analysis of secondary liability as an alternative to the uncertain application and interpretation of an expanded seller notion.

While acknowledgement of secondary liability under section 12 may avoid some of the semantic hair-splitting that has plagued the expansion of the seller concept, it is not without its own uncertainty in foundation and application. The path to recognition of secondary liability is marked by disharmony, and on the basis of the analysis below it is certain that debate will continue.

## V. SECONDARY LIABILITY UNDER SECTION 12: TWO STEPS FORWARD, ONE STEP BACK

### A. *Controlling Person Liability*

All of the legal gymnastics which have emerged in the judicial development of the expanded notion of a section 12 seller are functions of the privity requirement that is built into the section 12 creation of an express right of action in favor of a purchaser of securities against one who sells. Not even an expansionist approach to the scope of section 12 liability can fail to confront this most basic point. The only statutory exception to the privity requirement is section 15<sup>126</sup> which provides for liability of the so-called "controlling person." Under section 15, one who controls a person liable under section 12 is also liable.

Controlling person liability is essentially secondary liability in the sense that a controlling person defendant is held liable to a purchaser for the acts and conduct of another who is the actual, or primary, wrongdoer. The imposition of secondary liability under section 15 depends on the existence of a control relationship. "Control" is broadly interpreted.<sup>127</sup>

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126. 15 U.S.C. § 77o (1970). See note 17 *supra*.

127. 15 U.S.C. § 77o (1970).

The principal roadblock to the use of section 15 against nonseller defendants is the express defense contained therein. The section 15 defense operates where the alleged controlling person is able to demonstrate that he or she had "no knowledge or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."<sup>128</sup> It is significant to note the distinction between the statutorily granted defense under section 15 and that under section 12. Some courts have used the "exercise of reasonable care" language in section 12 to impose on defendants an affirmative duty to investigate.<sup>129</sup> No such duty has been inferred from the "no knowledge of or reasonable ground to believe" language of section 15. Thus, the section 15 defendant may simply show that no facts came before him or her which would have caused a reasonable person to believe in the existence of the violative conduct.

Section 15 is a formidable obstacle for a plaintiff/purchaser seeking to impose liability. It requires the element of control to be present, but more importantly, the defense must be overcome, and in many section 15 situations the latter has indeed proved difficult.<sup>130</sup> Beyond controlling person liability, the notion of secondary liability has been largely absent from section 12 liability analysis, the courts looking instead to expanded primary liability. The extent to which that expansion has occurred, and the analysis employed effecting that expansion prompts a closer look at available theories of secondary liability and the extent to which the judiciary has reflected on their place in section 12 litigation.

### B. *Aiding and Abetting Liability*

Aiding and abetting theories have played an important role in the development and enforcement of responsibilities under both the Securities Act and Exchange Act from a governmental as well as from a private litigative perspective. A general recognition of aiding and abetting liability under the securities laws came quite early in their history, primarily in the development of the scope of the Securities and Exchange Commission's injunctive power in the enforcement of both securities statutes.<sup>131</sup>

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128. *Id.*

129. *See, e.g.*, *Gould v. Tricon*, 272 F. Supp. 385 (S.D.N.Y. 1967).

130. There are a number of recent decisions restrictively interpreting the scope of "controlling person" liability under section 15. *See, e.g.*, *Aid Auto Stores, Inc. v. Cannon*, 525 F.2d 468 (2d Cir. 1975); *Zweig v. The Hearst Corp.* [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,256 (9th Cir. 1975); *Gordon v. Burr*, 506 F.2d 1080 (2d Cir. 1974); *Ayers v. Wolfinger*, 491 F.2d 8 (5th Cir. 1974); *Oleck v. Fisher* [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,330 (S.D.N.Y. 1973). *But see* *Richardson v. MacArthur*, 451 F.2d 35 (10th Cir. 1971).

131. Indeed, it has been consistently recognized that the Commission's enforcement power under the extension of criminal aiding and abetting principles into the civil law, and, in particular, the securities law came with the simple recognition that there is no reason why the

The question of the propriety, or indeed the utility, of recognizing aiding and abetting as a basis for liability under section 12 comes into sharp focus when the elements of such liability are analyzed in the light of the expanded notion of seller which has emerged under section 12. As a general proposition, aiding and abetting liability involves two elements. The first is a cognitive element: an aider and abettor must have awareness—actual or constructive—of unlawful conduct.<sup>132</sup> The second element is facilitation of the unlawful conduct by the action, or in some cases the inaction, of the aider and abettor. The principle of knowing facilitation of an unlawful act of another is the key to the judicial expansion of the section 12 seller concept. Indeed, virtually all of the contemporary analyses, including the *Lennerth*, *Katz*, *Hill York*, and *Sandusky Land* decisions, turn on whether the defendant played a facilitative role in the circumstances surrounding the transaction. Note, however, that the perspective from which these analyses operate to impose section 12 liability is clearly not facilitation vis-à-vis another defendant, but rather facilitation vis-à-vis the transaction.

*Sandusky Land* is the only decision considered above that specifically linked primary liability under section 12 to the conduct of aiding and abetting the actual seller. *Sandusky Land*, however, was not, in theory, far removed from its predecessors. Some of the other decisions dealt, in some form, with the notion of facilitation that underlies liability for aiding and abetting. In *Lennerth*, for example, the nonprivity seller's liability was characterized in terms of the facilitative role that he played vis-à-vis the sale. It was he who "[seduced] the prey and [led] it to the trap."<sup>133</sup>

Closely akin to facilitation is a more general notion of participation, which has been recognized as clearly supporting the imposition of section 12 liability. In *Freed v. Szabo Food Services, Inc.*,<sup>134</sup> Judge Decker of the Northern District of Illinois upheld section 12 allegations in extremely broad terms. He observed: "The complaint states a claim under section 12(2). The fact that there is no privity will not defeat the action as long as plaintiffs'

same rule should not apply in an injunctive proceeding to restrain a violation of the same statute that may as a matter of criminal law be an offense against the United States. *See, e.g.*, *SEC v. Timetrust*, 28 F. Supp. 34 (N.D. Cal. 1939), *rev'd*, 142 F.2d 744 (9th Cir. 1944) (reversed only on the factual question). The Securities Act and the Exchange Act extend to the power to enjoin any or all individuals who play a material part in the commission of an offense, including, of course, the aider and abettor. *See, e.g.*, *SEC v. Barraco*, 438 F.2d 97 (10th Cir. 1971). The power grew from application of the more traditional criminal aiding and abetting concepts codified in federal law. *See, e.g.*, 18 U.S.C. § 2 (1970), which provides as a matter of criminal law that:

"[W]hoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal . . ."

132. *See, e.g.*, *Hochfelder v. Midwest Stock Exchange*, 503 F.2d 364, 374 (1974).

133. 234 F. Supp. 59, 65 (N.D. Ohio 1964).

134. [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,317 (N.D. Ill. 1964).



alleged purchase was in reliance upon misrepresentation and participation in these misrepresentations by the defendant."<sup>135</sup>

The plaintiffs in *Freed* alleged violations not only of section 12, but also of section 17(a) of the Securities Act and of section 10(b) of the Exchange Act and rule 10b-5. In his discussion of privity, Judge Decker made no distinction between the privity requirement under section 12 and that under the other antifraud provisions. Instead, he declared:

As regards the general question as to whether or not there has to be privity between the plaintiff and defendant as buyer and seller, I think the cases are clear that such privity is not required. The requirement of privity is no longer strictly enforced, and instead the courts are requiring rather that the plaintiff allege that he has relied upon misleading statements uttered by the defendant concerning the securities in question; that he has purchased the securities from whatever source, relying upon these misleading statements; and that through such purchase he has suffered damage.

This seems wise, as it has been held repeatedly that the securities laws are remedial and are to be construed liberally in order to achieve the congressional purpose.

. . . .

This policy, as applied to the question of privity, means that if a purchaser bought securities, relying upon misrepresentations of a third party not connected directly with his purchase, nevertheless, the third party may be held accountable if the plaintiff can show reliance and misrepresentations of the third party on which he relied. To hold otherwise would allow a corporation whose stock is issued publicly to make misrepresentations concerning the stock without any fear of liability as long as its stock was only sold to the public in the market by underwriters of others. Such a rule would ignore the realities of the public securities market, and such was certainly not the intention of Congress.<sup>136</sup>

The notion of "participation" of which Judge Decker spoke is not the same notion of "facilitation" which underlies the *Sandusky Land* secondary liability analysis. It does, however, imply a facilitative or culpable role in a transaction by one other than the actual seller, articulated at a time well before most of the major decisions expanding the seller concept. After *Freed* and *Zachman v. Erwin*,<sup>137</sup> pre-1965 decisions, the foundation for expanded liability, both primary and secondary, had been firmly planted. Aiding and

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135. *Id.* at 94,363-65.

136. *Id.* (citations omitted).

137. 186 F. Supp. 681 (S.D. Tex. 1959) (rulings on motions), 186 F. Supp. 691 (S.D. Tex. 1960) (further rulings on motions).

abetting, however, had not yet been recognized as a viable theory of liability under section 12.

The aiding and abetting question was specifically raised in *Barlas v. Bear, Stearns & Co.*<sup>138</sup> With respect to some of the defendants, the plaintiffs alleged liability only for aiding and abetting under section 12, not alleging section 12 "seller" liability or section 15 "controlling person" liability. The court dismissed the claims against those defendants, holding that the bare aiding and abetting allegation was an insufficient basis for imposing section 12 liability. Judge Marovitz declared:

Such an allegation is not sufficient, inasmuch as plaintiff has failed to invoke the "control" provisions of section [15], and the Securities Act makes no provision for liability of parties on conspiracy grounds.

We must therefore rely on the clear language of the statute at issue, and the prevailing case law which holds that, in the absence of "control" allegation, a defendant shall only be liable "to the person purchasing such security from him."<sup>139</sup>

The court in *Barlas* could have used the *Freed* decision as some justification for imposing liability against aiders and abettors. Instead, Judge Marovitz strictly interpreted the earlier decision as only referring to the situation in which an issuing corporation might seek to avoid liability for its misstatements by working through an underwriter.<sup>140</sup> The court found that the *Freed* decision "did not entirely do away with the privity requirements of section 12(2), but rather applied them more liberally to reach the principals, the parties actually responsible for both the misrepresentations and the sales."<sup>141</sup>

The flaw in the *Barlas* court's interpretation of *Freed* is that in *Freed* the issue was not whether the issuer/defendant had sought to use the device of a strawman or underwriter to avoid section 12 liability. Indeed, the allegation was far simpler. The plaintiffs in *Freed* charged that the issuer was a culpable wrongdoer in that it had induced the plaintiffs' purchases of securities from others unrelated and uninvolved with it. The limited "concern" attributed to the court in *Freed* by Judge Marovitz was not at all so clear.

Even if the court in *Barlas* had been inclined to interpret *Freed* broadly, the plaintiff's bare allegation of aiding and abetting would likely still have been considered insufficient pleading. The concept of civil aiding and abetting in the securities law setting and the expansion of the section 12 privity element were simply not sufficiently developed at that time to permit their

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138. [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,674 (N.D. Ill. 1966).

139. *Id.* at 95,478 (emphasis original) (citations omitted).

140. *See* text accompanying note 136 *supra*.

141. *Id.* at 95,477 (emphasis added).

transfer to the section 12 analysis. *Freed*, it must be remembered, involved a culpable, nonprivity defendant as the principal wrongdoer. All of the court's liberal analysis of the general privity question must be considered in that context, even though it apparently concluded that everyone who participates in a violation may be held.<sup>142</sup>

The early rejections of purely secondary liability under section 12 probably contributed to the expansion of primary liability under that section through the expanded definition of seller. It seems that a real impetus for that intensified development was the recognition that a basic privity element would remain in section 12. Without a recognition of secondary liability, a broadened interpretation of privity became the only way for the courts to enlarge the scope of section 12 liability.

It was not until 1973 that the issue of secondary liability was confronted again. In *In re Caesars Palace Securities Litigation*,<sup>143</sup> Judge Weiner reviewed the development of section 12 liability and concluded that liability for aiding and abetting and/or conspiracy should be recognized.

*Caesars Palace* is a complex case that raises a number of significant issues under provisions of both the Securities and the Exchange Acts. The issue that is pertinent to this discussion was the plaintiffs' allegation that certain defendants conspired with or aided and abetted other persons in violation of section 12. The case arose out of the acquisition of Caesar's World, Inc. by Lum's, Inc., which involved the registration and distribution of securities. In connection with that distribution, the various plaintiffs alleged *inter alia* that two registration statements and an annual report contained false and misleading information about the financial status of Caesars Palace. Further, the alleged dissemination by the defendants of a prospectus issued by Caesar's World in connection with the registration and distribution of debentures in 1969 gave rise to claims of liability under section 12.<sup>144</sup>

The defendant group included major shareholders, employees, an officer, directors, and/or partners or others who were connected with the corporation and partnership which had previously sold the Caesars Palace Hotel and Casino to the issuer, Caesar's World. The plaintiffs alleged that many of these defendants had conspired with or aided and abetted Caesar's World in the violation of antifraud provisions, including section 12(2). Claiming, as a matter of law, that they could not be held liable as conspirators or as aiders and abettors under section 12, the defendants moved to dismiss the claims.

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142. It would have been a significant step indeed to go from the participation notion in *Freed* to the bare aiding and abetting allegation in *Barlas*. The foundation for that step simply was not present. In any case, it may be futile speculation given the court's clear position in *Barlas* on the enforcement of a strict privity requirement.

143. 360 F. Supp. 366 (S.D.N.Y. 1973).

144. Plaintiffs further alleged violations of section 11 of the Act, claiming that the registration statement covering the securities misstated or omitted material facts. *Id.* at 375.

Judge Weiner refused. Instead, he accepted the rule of *Katz v. Amos Treat & Co.*<sup>145</sup> as controlling, noting: "The *Katz* decision . . . appears to adopt an extremely liberal standard of privity on § 12(2) situations, essentially requiring only some indicia of participation or solicitation on the part of an individual to warrant the imposition of liability."<sup>146</sup>

Therefore, on the basis of *Katz*, *Hill York*, and other decisions that expanded the traditional seller notion, Judge Weiner was willing to include conspirators and aiders and abettors in the class of potential section 12 defendants. He contended that an attempt to delineate a distinction between the expanded recognized class of defendants under section 12 and those before him charged with aiding and abetting or conspiracy would only amount to "semantic hair-splitting."<sup>147</sup> Indeed, Judge Weiner observed:

Persons participating directly in a violation of the statute will not escape liability under the express language of the Act; similarly, those persons who are aware of and, to some lesser degree, participate in a violation of the securities laws and either enter into an agreement with or give assistance to the primary wrongdoers should not be permitted to escape the imposition of liability. As one commentator has pointed out, "[s]uch individuals will be subject to liability because they acted knowingly or recklessly" to assist in such conduct or to be a part of a proscribed course of action.<sup>148</sup>

*Katz*, *Hill York*, *Lennerth*, and the other cases that expanded the concept of a section 12 seller do indeed hold that knowing involvement in and facilitation of a violative transaction will support section 12 primary liability. Those cases simply deem the knowing participant to be a person who sells within the meaning of section 12. One must ask whether there should be a legally cognizable distinction between a participant's knowingly assisting a primary wrongdoer in a transaction and a participant's role vis-à-vis the transaction itself. Consider, for example, *D* who is a member of the Board of Directors of *X* corporation. *D* sells stock of *X* corporation to *P*. In connection with that sale, *D* enlists the aid of *F*, a financial analyst, in the preparation of a report which is to be, and in fact is, sent to *P*. The report contains false or misleading statements of which *F* has knowledge, or the existence of which he has willfully or recklessly disregarded. *F* takes no action with respect to those statements. *D* proceeds to make the sale to *P* using the report. *F* and *P* have no direct contact whatever. In this example, *F* has knowledge of, or

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145. 411 F.2d 1046 (2d Cir. 1969).

146. 360 F. Supp. at 380.

147. *Id.*

148. *Id.* at 383, quoting Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 646 (1972).

has willfully or recklessly disregarded, the false or misleading statements, and by preparing the report has assisted *D* in making the sale to *P*. Thus, there is knowledge of a violation plus assistance to the primary wrongdoer.

In *P*'s section 12(2) lawsuit against *D* and *F*, if *P* is limited in his allegations to privity-based primary liability, he must allege that *F* is "a person who sells." *F* would not, however, be considered a seller under the *Lennerth/Hill York* definition because that definition requires solicitation or at least direct transactional involvement. *F*'s conduct does not even reach the degree of participation that sufficed for the imposition of section 12 liability in *Katz*. It appears that absent the *Sandusky Land* argument that *F* owed a duty to *P*, which duty *F* breached, it would be difficult to view *F* as a section 12 seller. Yet, on the assumption that the report used by *D* in making the sale to *P* contained facts that were material,<sup>149</sup> *F* played a facilitative role in the unlawful conduct. It seems that the policy behind the antifraud provisions would support liability for an aider and abettor as well as for a primary wrongdoer. That policy, coupled with his interpretation of the overall statutory scheme of the Securities Act, led Judge Weiner to conclude that those individuals in *F*'s position should not escape section 12 liability or, implicitly, be subjected to such liability only through a tortuous analysis of the seller concept.

Judge Weiner's analysis turns, in part, on his view of the overall statutory scheme in the Securities Act. Citing Professor Loss,<sup>150</sup> Judge Weiner noted that the Securities Act contains two major substantive provisions, sections 5 and 17(a)—the former prescribing the registration requirement, the latter prohibiting fraud in the sale of securities. Anyone who violates either section 5 or section 17 (a) may be held criminally responsible.<sup>151</sup> The corresponding civil liability for violators of sections 5 and 17(a) can be invoked pursuant to sections 11 and 12.

Judge Weiner looked only to criminal cases brought by virtue of the SEC's general enforcement power rather than to private civil actions to show

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149. See SEC Rule 405, 17 C.F.R. § 230.405 (1976), in which the SEC defines "material" as "matters as to which an average prudent investor ought reasonably to be informed before purchasing the security." The element of materiality, while the subject of numerous judicial analyses, essentially connotes probable effect, and in that sense the report in the example plays a meaningful role in the transaction since in order to make an investment decision the purchaser presumably acts on the information available.

150. 360 F. Supp. at 381, citing 3 L. LOSS, SECURITIES REGULATION 1785 (2d ed. 1961).

151. See Securities Act § 24, 15 U.S.C. § 77x (1971), providing:

Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this subchapter, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than \$5,000 or imprisoned not more than five years, or both.

statutory support for aiding and abetting liability. Nonetheless, he observed:

For example, in *SEC v. National Bankers Life Insurance Co.* . . . the Court stated that aiding and abetting or conspiracy are viable counts under §§ 5 and 17(a) of the 1933 Act . . . After establishing to its satisfaction that individual independent violations were present, the Court concluded that aiding and abetting liability was similarly present as “[c]ertain acts by persons other than issuers or underwriters are so intertwined with the acts by those persons that they are liable on the basis of aiding and abetting in the violation of section 5 of the Securities Act of 1933.”<sup>152</sup>

Judge Weiner noted that results in the cited decisions implied the recognition of liability for aiding and abetting violations of section 17(a), the general antifraud provision. Bearing in mind the fundamental purpose of the federal securities laws—“to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*, and thus to achieve a high standard of business ethics in the securities industry”<sup>153</sup>—Judge Weiner declared that aiders and abettors should not escape section 12 liability. He denied the motion to dismiss with this observation:

[T]he courts have continually recognized the broad, remedial nature of the 1933 Act and the need to adopt a liberal interpretation of the statute in order to best effectuate the congressional purpose . . . Our interpretation of § 12(2) is, we believe, wholly consistent with these ends.<sup>154</sup>

The *Caesars Palace* decision expressly rejected prior positions on strict privity under section 12. The court found that those decisions were not only without precedential significance but were, in fact, wrong in positing a strict privity requirement.<sup>155</sup>

Analyzing *Caesars Palace* and its endorsement of secondary liability under section 12, there are, it would seem, two perspectives involved. The first is the logical or legal perspective in which the court posits as a matter of law that secondary liability under section 12 is rooted in prior case law that upheld the propriety of SEC civil injunctive power with respect to aiding and abetting offenses. The second is the practical or policy perspective which reflects on whether there is a recognizable utility in including aiders and abettors within the scope of section 12 liability.

From a legal perspective, there is considerable strength in Judge Weiner’s reasoning by analogy to criminal liability and SEC enforcement

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152. 360 F. Supp. at 381 (citations omitted).

153. *Id.* at 382, quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963) (Goldberg, J.).

154. 360 F. Supp. at 382-83.

155. Judge Weiner dismissed the strict privity requirement as “neither the law of this Circuit nor the prevailing standard to be applied in the securities area.” 360 F. Supp. at 382.

power. Section 12 liability for aiders and abettors seems to be a natural extension of the expansion of the SEC enforcement power.<sup>156</sup> Thus, if it is recognized that one may be charged by the government with civilly or criminally aiding and abetting, or conspiring in contravention of sections 5 or 17(a) of the Act, it seems logical to conclude that the private right of enforcement relating to the same basic violations of the law should encompass the same class of defendants. Note, however, that section 12 creates an express private civil remedy to redress specific wrongs. It creates a remedy for a purchaser of securities in a transaction that is tainted by either of two kinds of violative conduct—a registration violation or a fraud violation. More importantly, the express right of action under section 12 is available only to purchasers as a weapon only against sellers. Section 12(2) even prescribes the elements of its private claim. One cannot automatically apply concepts supporting an expanded scope of the SEC's general enforcement power under sections 5 and 17(a) to the section 12 express private civil remedy, which, on its face, is restricted to expressly defined elements. Thus, in the realm of secondary liability, the various provisions are simply not coextensive, and the statutory scheme as envisioned in *Caesars Palace* necessarily breaks down.<sup>157</sup>

The second perspective in *Caesars Palace* is the practical or policy perspective that militates in favor of the opposite conclusion—that the seller requirement on the face of section 12 simply ought not to be restrictively interpreted and that the policy and remedial intent underlying the statute support, if not mandate, an expansion of liability free of the basic privity concept inherent in the seller requirement. Strong policy considerations can be mighty weapons in many situations where expansion of any form of liability is involved.

When Congress enacted section 12 of the Securities Act, however, it

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156. See note 131 *supra*.

157. The problem can be illustrated by consideration of a situation in an antifraud setting. If A sells securities to B using false or misleading statement, B has a section 12(2) claim against A, assuming the use of jurisdictional means. A has also violated section 17(a) of the Act and is, therefore, subject to an SEC civil enforcement action as well as to criminal prosecution. So far the *Caesars Palace* reasoning holds. A has engaged in conduct violative of section 17(a) and is accountable in the private action under section 12(2). But suppose that prior to selling securities to B, A counsels with X, a friend, concerning the scheme and how to go about it. A agrees to pay X part of the proceeds of the sale for putting together a list of potential purchasers whom A could contact. X has no contact with B or any of the circumstances of the particular transaction between A and B. When the sale is made, A, directly, and X, as an aider and abettor, are subject to liability under section 17(a). On the face of the statute, there would be no section 12 claim against X unless X were deemed a seller. The same conduct that constitutes the aiding and abetting of a section 17(a) violation is not determinative under section 12. Moreover, under section 12 there should still be the question of the reasonable care defense on X's part. Such a defense is not available against an assertion of aiding and abetting claims by the SEC in an action for violation of section 17(a).

seemed to operate from its own policy perspective. Section 12 seems to have been intended, from the purchaser's perspective, to remedy the inadequacies of the prestatutory causes of action.<sup>158</sup> By prescribing its own elements of a cause of action, by allocating its own burdens of proof and by providing its own specific remedy, section 12 created significant advantages to the plaintiff/purchaser over what was available at common law or in equity.<sup>159</sup>

Congress did, however, build limitations into this newly liberalized protection. Note, for example, the comparatively short statute of limitations for actions commenced under section 12.<sup>160</sup> Note also the privity requirement as another example of a limitation. It can be argued, as a matter of policy, that the significant advantages created by section 12, particularly in the antifraud context, were to be tempered or balanced by the restrictions consciously built into the provision.<sup>161</sup> Section 12's specification of its own elements and prescription of its own limitations seems to nullify the remedial policy—at least in reference to those limitations.

Similarly, there is no interpretative help outside of section 12 because that section is unique in its prescription of the elements of the claims brought under it. Years of expansive policy analyses under the securities laws have not focused extensively on provisions with their own express limitations, and even all of the section 12 analyses have involved interpretations of the privity requirement and not matters outside of it. Thus, at least two of Judge Weiner's reasons for including aiders and abettors within the scope of potential section 12 defendants—the statutory enforcement scheme and the remedial policy—are not without flaws.

Judge Weiner's reasoning was not based solely on the above points. His

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158. See note 10 *supra*.

159. For a detailed comparison of section 12(2) with its antecedents at common law or in equity, see 3 L. LOSS, *SECURITIES REGULATION* 1700-05 (2d ed. 1961).

160. Securities Act § 13, 15 U.S.C. § 77m (1970).

161. See, e.g., *Charney v. Thomas*, 372 F.2d 97 (6th Cir. 1967). The issue in *Charney* involved a determination of the appropriate statute of limitations applicable to a private action brought under Exchange Act section 10(b) and rule 10b-5. Rule 10b-5 contains no statute of limitations. However, the defendants argued that the short period of limitations contained in the antifraud provision of the state securities law governed the assertion of rule 10b-5 claims. Plaintiffs argued that the longer statute of limitations provision found in the general antifraud statute should control. The state securities law provision created an express right of recovery and, like section 12 of the Securities Act, gave plaintiffs an advantage over the common law by thrusting the burden of proof on the question of knowledge upon the defendant. The court found that "[t]his advantage under the statute is tempered by the relatively short statute of limitations." 372 F.2d at 99. Indeed, the court went on to observe:

Thus, the legislature may have meant to provide a potential plaintiff with a choice between the statutory action with its short limitation period and the more difficult to prove common law action with its longer limitation period as a compensation. This conclusion is all the more likely in view of the traditional maxim that statutes in derogation of the common law must be construed narrowly.



upholding of the aiding and abetting allegations was based, in part, on his reliance on *Katz* and his references to *Lennerth* and *Hill York*. It seems, however, that his analysis of the statutory scheme was the crucial determinant since none of those cases focused upon the aiding and abetting question.

Recognition of secondary liability under section 12 carries with it two practical considerations. The first consideration is that there must be a primary violator of the provision in order for liability to be imposed upon a secondary defendant. That is the essence of aiding and abetting liability. This is in contrast to the cases in which an expanded seller concept is employed to reach a defendant whose liability is primary. Both forms of section 12 liability involve analyses of the defendant's facilitative role or conduct, but under each the perspective differs. The seller notion depends on whether the knowing, facilitative conduct relates to the plaintiff/purchaser and to the violative transaction. On the other hand, the secondary liability analysis looks to the knowing or reckless conduct vis-à-vis the primary violator.

The second practical consideration is the impact of aider and abettor liability on the due diligence defense under section 12(2). There are obvious instances, the brokerage or agency settings, for examples, in which the actual seller is an innocent party; the section 12(2) violation has been committed by the intermediary. If a purchaser sues the intermediary under section 12(2) as a "person who sells," *a fortiori* that individual is not being sued as an aider and abettor. The claim is a direct one for primary liability; therefore, all elements of section 12(2), including the due diligence defense, are in full force and effect. If, however, the intermediary were sued as an aider and abettor, the availability of the due diligence defense is less clear.<sup>162</sup>

While Judge Weiner in *Caesars Palace* did not delineate a precise standard of secondary liability to be applied in section 12 cases, he did identify two elements of such liability: (1) some form of awareness; and (2) an agreement with, or assistance to, primary wrongdoers.<sup>163</sup> Judge Weiner seems to have contemplated an awareness element which was either actual or constructive in the sense of willful or reckless disregard.<sup>164</sup> This approach comports with generally accepted notions of aiding and abetting, but it does not take into account the added factor of the section 12(2) defense.

In those situations where it has been accepted, aiding and abetting liability has consistently been viewed as coextensive with the liability of the principal or primary wrongdoer.<sup>165</sup> In the context of operative statutory or reg-

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162. Section 12(1) does not pose the same problem since the due diligence defense is not available to the section 12(1) defendant. 15 U.S.C. § 77f(1) (1970).

163. 360 F. Supp. at 383.

164. *Id.*

165. While aiding and abetting liability presupposes the existence of a primary wrongdoer, where that primary violation exists, the adjudication as to the aider and abettor may proceed

ulatory provisions which merely proscribe certain conduct or declare it to be unlawful, such as section 10(b) of the Exchange Act and rule 10b-5, the notion that an aider and abettor shall be liable "as a principal" is not especially significant. But where a statutory provision prescribes who shall be liable as a principal, establishes the elements of the potential cause of action and specifies the only available defense, the concept of coextensive liability between primary and secondary offenders adds no small amount of complexity to the situation.

The immediate question is whether the due diligence defense built into section 12(2) should be available to one charged with liability as an aider and abettor. The issue is similar to that raised in the previous discussion of *Sandusky Land* in which scienter was used as a basis for imposing section 12 liability.<sup>166</sup> There, as here, one might easily conclude that if the minimum standard of liability conflicts with the requirements of the statutory defense, then the defense is merged into the initial determination of whether the defendant fits within the scope of section 12(2), thereby effecting the elimination of the statutory defense. That problem is clearly involved in a *Sandusky Land* primary liability analysis in which the defense, by statute, is operative. The same problem apparently is present in the secondary liability context, at least if the aider and abettor is considered to be liable as a principal or primary wrongdoer.

In the secondary liability context, however, there appears to be an argument that the statutory defense is inapplicable. The argument is founded upon the essential difference between the focus of aiding and abetting liability as opposed to that of primary liability. As Professor Ruder has characterized the distinction, people who breach duties that they owe directly to the public may be classified as primary wrongdoers. The secondary wrongdoer's liability, however, arises only because another has violated the law, and not by reason of a breach of a duty owed directly to the public.<sup>167</sup> If the focus is on a primary violation, and such a violation has occurred, then arguably the focus with respect to the aider and abettor is only on the facilitation of the given principal violation. In other words, because the aider and abettor's liability depends solely on the existence of a principal violation, the statutory defense is irrelevant to his liability determination. But while the logic seems sound, the fact remains that the aider and abettor of a section 12(2) violation is himself a violator of the section as a matter of law, so that the statutory defense should be a factor in the determination of liability. It is, after all, the mandate of the statute that one who sustains the burden of

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independently and even in the absence of the primary violator as a party. See, e.g., *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), *rev'd on other grounds*, 425 U.S. 185 (1976) (action brought directly against alleged aider and abettor). See also 18 U.S.C. § 2 (1970).

166. See PART IV *supra* (notes 106-49 and accompanying text).

167. See Ruder, *supra* note 148.

proof "that he did not know, and in the exercise of reasonable care could not have known" of the untruth or omission shall not be liable to a purchaser. The aider and abettor of a section 12(2) violation who is charged with facilitation of that violation by, for example, a breach of a duty of inquiry or reckless disregard for the truth might successfully argue that reasonable care was exercised under the circumstances and thus negate a finding of constructive knowledge. Were the defendant charged directly as a seller, the argument would obviously have critical importance. Should that same individual now charged with an aiding and abetting violation be subjected to liability without the benefit of the same due diligence defense available to a primary wrongdoer? Again, perhaps the only answer is the perspective of primary liability as opposed to secondary. Where secondary liability is involved, the principal violation is presumed and the statutory criteria for establishing a cause of action have no further applicability. Rather, with respect to the aider and abettor's liability, an entirely new set of principles is to be applied wholly apart from statutory analysis. But query whether this can be done in the context of section 12.

These considerations make Judge Weiner's reasoning problematic. On the one hand, the recognition of secondary liability under section 12 is a practical, rational reaction to the significant expansion of primary liability under section 12 in a manner that looks much like secondary liability as recognized in other contexts. The expansion of the notion of primary liability reaches the point of artificiality when the focus shifts to a broadened class of possible defendants by the use of facilitation and participation—the benchmarks of secondary liability analysis. One cannot help but agree with Judge Weiner that in a contemporary section 12 liability analysis it amounts to "semantic hair-splitting" to attempt to delineate a distinction between those persons now recognized as sellers and those charged with aiding and abetting in the violation of section 12.

Such reasoning fails, however, where the particular defendant plays no role vis-à-vis the transaction and has no involvement with the purchaser. At that point, one may not be able to conclude that the defendant could be deemed to be a seller under contemporary primary liability analysis regardless of whether he could also be viewed as an aider and abettor outside of that analysis. Where a defendant is clearly outside of the scope of section 12 primary liability, the problem of semantic hair-splitting is not necessarily present. Where the "hair-splitting" situation is not so apparent, it is more difficult to accept the recognition of aiding and abetting liability in the face of the statute.

The analysis of aiding and abetting allegations under section 12, as a practical matter, has been inconclusive on these difficult points. In *Sandusky Land*, a case in which aiding and abetting liability was strongly asserted, the

court dealt only with the primary liability allegation that the accounting firm could be deemed to be a seller. Yet in so doing, it applied notions of secondary liability. Taken alone, this might be interpreted as a tacit rejection of aiding and abetting liability under section 12, although the overall approach of the court in embracing the principles of aiding and abetting seems to indicate otherwise. The decision, however, takes no position on the legal sufficiency of aiding and abetting as a theory of liability in and of itself despite the strong invitation to do so.

Moreover, even *Caesars Palace*, the case that made substantial explicit inroads into liability for aiders and abettors,<sup>168</sup> has not been used to its full potential. In *Competitive Associates v. International Health Sciences, Inc.*,<sup>169</sup> the Southern District of New York, while not faced with aiding and abetting allegations, took the opportunity to cite *Caesars Palace* as a basis for requiring some element of privity in section 12.<sup>170</sup> On that basis, the district court denied the extension of section 12 liability to an issuer of securities in a firm commitment underwriting. Judge Briant posited that there could be no liability to the issuer of any individual defendants “[u]nder these circumstances where [*sic*] they were not plaintiff’s immediate sellers.”<sup>171</sup> The issuer and those associated with it had allegedly prepared and disseminated a prospectus which contained false or misleading statements. But the court found that because none of the actual sellers—the firm commitment underwriters—had been named in the suit, there was no basis for tracing liability to the issuer as the ultimate seller of the securities.<sup>172</sup>

A more recent decision of the Southern District of New York provides further insight into the *Caesars Palace* analysis. In *Lorber v. Beebe*,<sup>173</sup> the court held sufficient, as a matter of law, allegations of section 12(2) liability against aiders and abettors. The defendant group consisted of the issuer, five individuals who were officers and/or directors of the issuer, the issuer’s auditors, the managing underwriter in the distribution, and 36 co-underwriters. As to all of the defendants, the plaintiff alleged that they directly or indirectly “participated in or aided and abetted each other, or conspired with” one another in violating various antifraud provisions of both the Securities Act and the Exchange Act, including section 12(2) of the Securities Act.<sup>174</sup> The specific violation was the dissemination of allegedly false

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168. See text accompanying notes 143-61 *supra*.

169. [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,966 (S.D.N.Y. 1975).

170. *Id.* at 97,334.

171. *Id.*

172. *Id.*

173. [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,363 (S.D.N.Y. 1975). On rehearing, the court granted summary judgment in favor of the defendants, but only because the plaintiffs admitted that their aiding and abetting claims were factually unsupported. [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,458 (S.D.N.Y. 1976).

174. [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,363, at 98,814.

or misleading information in a registration statement and prospectus relating to the offering of common stock. The defendants sought dismissal of the section 12(2) count on two grounds. They claimed that the plaintiff had purchased his shares in an open market transaction and, therefore, could not identify his sellers or, alternatively, that if the underwriter could be deemed to be a seller vis-à-vis the plaintiff, the underwriter did not commit the violation.

Speaking for the court, Judge Knapp noted that in certain instances, the scope of section 12 liability extends beyond the immediate seller in a transaction.<sup>175</sup> One of the instances noted by the court is the situation in which a person has "actively participated in the sale, either as an aider and abettor or as a co-conspirator."<sup>176</sup> Thus he concluded:

Viewing the instant complaint most favorably to plaintiff—as we must on a motion [to dismiss]—[the plaintiff's] section 12(2) claim must be deemed to qualify under the [above] exception. [Plaintiff] alleges that all the named defendants "participated in or aided and abetted each other, or conspired with some or all of the other defendants to commit the acts or create the omissions" complained of.

Plaintiff may well find it impossible to prove these broad allegations. He does not specify which of the defendants "conspired" and which "aided and abetted." In either event, before a particular defendant could be found liable, plaintiff would have to establish that such defendant knew or should have known of the defect in the registration statement and either entered into a general scheme ("conspired") to defraud the public or deliberately assisted some other defendant ("aided and abetted") in using the misinformation in the course of a sale. Although we may entertain doubt as to plaintiff's ability to meet this burden, we cannot as a matter of law say that it is impossible.<sup>177</sup>

Judge Knapp's analysis of that which would be necessary to sustain the section 12(2) aiding and abetting claim requires evidence of "deliberate" assistance of another defendant. Apparently this means that the aider and abettor must have actual knowledge of the violative conduct. Imposing this standard rules out constructive knowledge, breaches of duty, and the like, all of which would be relevant to a lesser standard of secondary liability. This analysis could avoid the difficult problems which a general recognition of aiding and abetting liability under section 12(2) posits.

Judge Knapp relied on *Katz* to support the proposition that one may aid and abet, or conspire in a violation of section 12. *Katz*, however, was not an

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175. *Id.* at 98,816.

176. *Id.* at 98,816 n.6.

177. *Id.* at 98,816.

aiding and abetting case.<sup>178</sup> The allegations in *Katz* were of primary liability—the defendant had been a party to the solicitation of the purchaser, and thus had participated in the transaction. Yet in *Lorber*, the court now refers to that same active participation in a sale in terms of secondary liability.

The *Lorber* court's references to participation in a sale may be significant in light of the development of the scope of section 12 liability. Virtually all of the expansion of liability has been premised on a particular nonprivity defendant's facilitative role in the sale transaction. In all of those instances in which a participation notion was employed to bring a defendant within the class of sellers for section 12 purposes, such a defendant has been involved in the transaction and acting (or not acting) vis-à-vis the purchaser rather than vis-à-vis another defendant who actually committed the violation. The recognition of aiding and abetting liability must, however, look beyond this established participation notion, unless the concept of aiding and abetting under section 12 is to be different from that employed generally. That is precisely what *Lorber* stands for.

Under *Lorber*, the conduct which will amount to aiding and abetting is knowing and willful assistance or facilitation of violative conduct *in the course of a sale*. This notion of aiding and abetting does not collide with the standard of liability that has developed under section 12, inasmuch as the awareness element is actual knowledge and the facilitation element is deliberate assistance of a violation in the course of a sale. However, where this conduct is demonstrated, the standard of liability applied to the aider and abettor defendant would, *a fortiori*, preclude an assertion of the statutory defense. This approach is, in a real sense, two steps forward and one step back.

*Caesars Palace* opened the door to a general recognition of aiding and abetting liability under section 12. It did not, however, resolve the particular problems which application of aiding and abetting liability creates in the specific context of section 12(2) and the due diligence defense therein. Although Judge Knapp cites *Caesars Palace* as support for his holding in *Lorber*, the two cases are at odds in their analyses of the elements of aider and abettor liability. The *Caesars Palace* analysis looks only to the defendant's awareness, while the *Lorber* decision requires knowing and willful assistance in the violation. Judge Knapp in *Lorber* does, however, clearly take the call from Judge Weiner in *Caesars Palace* and rejects semantic hair-splitting by declaring that persons participating in a transaction to a lesser degree than the primary violators may indeed be held liable as aiders and abettors. In Judge Knapp's analysis, however, participation in the sale rather than in the violation is the determining factor.

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178. See notes 44-52 *supra* and accompanying text.

Both Judge Weiner and Judge Knapp looked to *Katz* for support of their analyses. Judge Knapp would clearly accept characterization of the conduct at issue in *Katz* as aiding and abetting the sale, given the establishment of both the actual awareness and deliberate facilitation elements. Judge Weiner's analysis in *Caesars Palace* would probably encompass more than the *Katz* situation, but query whether it can?

The net effect of *Lorber* and *Caesars Palace* is that conduct heretofore analyzed in terms of participation for the purpose of imposing primary liability may now be viewed in terms of knowing and deliberate facilitation for the purpose of imposing secondary liability. The legal manipulations necessary to impose seller status and primary liability are unnecessary under the new approach. This approach, however, necessarily assumes that an independent primary violation exists. Obviously if the particular nonprivity defendant is also the primary violator, as for example a broker or salesperson, the analysis must continue to be in terms of primary liability. But for that class of potential defendants who act in a knowing, facilitative role vis-à-vis a transaction in which a primary violator is involved, aiding and abetting liability is a viable approach. Semantic hair-splitting is avoided.

The concept of aiding and abetting which emerges in *Lorber* is not that which has become familiar in other securities law antifraud litigation. It is, to be sure, a restrictive standard, rejecting any notion that one may act recklessly to facilitate an unlawful course of action. The approach mandates that the particular defendant have some facilitative involvement in the transaction as opposed to acting solely with respect to another, primary violator.

From both *Caesars Palace* and *Lorber* one may conclude that a defendant may be charged as an aider and abettor of, or conspirator in, a violation of section 12. But it is not clear what type of conduct will suffice as the minimum to support the secondary liability allegation. That conduct which seems to be contemplated in *Caesars Palace* is considerably less than that apparently envisioned in *Lorber*. Yet *Lorber* may be the more workable approach for two reasons. First, it preserves the necessity of an alleged aider and abettor playing a more direct role vis-à-vis the transaction as opposed to vis-à-vis the conduct of the primary violator, thus preserving what even Judge Weiner recognized in *Caesars Palace* as some element of privity in section 12. Second, it is capable of application to a relatively broad range of defendants without conflict with the standard of liability contained in the statute itself. One must concede, however, that in many instances it is, or may be, merely a change in nomenclature to characterize the same conduct that has previously been regarded in some quarters as supporting the imposition of seller status, and thus primary liability, rather than any true extension into secondary liability under section 12. If this approach is accepted as the limit on the extent of aiding and abetting liability, then in all practicality

it can also be said that the lowest level of culpability under section 12 has been established.

### C. Secondary Liability Under Section 12

Two questions necessarily arise in connection with the analysis of the extension of liability under section 12 to include aiding and abetting. First, as a matter of law, can the extension be made? Second, if it can, is there utility in doing it? The preceding discussion focused upon the first question, but the second remains for consideration.

The recognition of secondary liability as portrayed by Judge Weiner in *Caesars Palace* depends upon the statutory scheme, the policy behind the statute, and the trend of earlier decisions. The statutory scheme, however, while not directly limiting the extension of liability beyond a seller, does not directly support it either. Thus, some sort of utility must provide the real impetus.

Is there utility, given the policy of the Act and the history of the seller requirement interpretations, in the rejection of the semblance of privity which an expanded seller notion necessarily retains? Or, conversely, does it make sense to preserve that seller notion as a limitation on the scope of section 12 liability? The questions are not easy ones to answer. There can be no doubt that the effectuation of the broad remedial intent of section 12 and, indeed, of the entire Securities Act, supports an expansion of the notion of a seller to encompass those persons who are so much a part of the transaction or selling process that they should be subject to the section 12 proscriptions. This is justifiable in terms of the focus of section 12—the setting in which it was intended to operate. One who purchases a security in a transaction tainted by misrepresentation or deception, or one who is denied the protections of the registration process, ought to recover against those persons who have brought about the sale and committed proscribed acts in connection with that sale. There is a transactional focus here—on a sale or on the selling process<sup>179</sup>—and the conduct at issue relates directly to that process or transaction. Thus, the expansion of the concept of seller to include people other than the actual transferor of title who are involved in the sale transaction is consistent with the focus of the statute. It seems that what the provision contemplates is that regardless of how broad the scope of potential defendants in a section 12 case is drawn, liability will be imposed only with respect to conduct in a transactional setting. This fact bears directly upon the efficacy of Judge Weiner's reasoning in *Caesars Palace*.

Fundamental to Judge Weiner's analysis in *Caesars Palace* was that it is illogical to hold that persons who participate directly in a section 12 violation

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179. The Supreme Court observed long ago that the Securities Act created the right to recover for misrepresentation *in the sale* of securities. *Wilko v. Swan*, 346 U.S. 427 (1953).



will be liable under broadened interpretations of the seller notion, but that those who knowingly participate to a lesser degree or give knowing assistance to a primary violator should escape liability. But this point is susceptible to two subtle interpretations. If the "lesser degree of participation" or the "assistance" is tied directly to the transaction at issue and is merely a different degree of participation in the violation, then Judge Weiner is correct in maintaining that recognition of secondary liability under section 12 comports with the statute and its policy and has utility in clearing the air, so to speak. If, however, the lesser degree of participation or assistance has as its only focal point the conduct of another person concededly a section 12 violator, the lesser participant has arguably been removed from the transactional setting and nothing is gained other than a host of new problems.

The difference between the approaches can be illustrated with two questions: (1) Did the conduct of the proposed defendant directly facilitate, or relate to the transaction which is the subject of the alleged violation? (2) Did that conduct facilitate the commission of a violation by another which resulted in or was directly related to the transaction which is the subject of the claim? In the former situation the conduct has as its focal point the transaction and its consummation. In the latter it is solely the conduct of another defendant which is determinative of liability. And arguably, the latter situation is not simply a matter of participation to a lesser degree because there is no direct link to the transaction. Aiding and abetting a primary violator does not necessarily mean that one has facilitated the unlawful sale. While that may be the more common case, no aspect of contemporary secondary liability analysis requires demonstration of a "but for" or proximate cause character of assistance to a primary wrongdoer in relation to the ultimate transaction between the primary wrongdoer and the wronged party. Even Judge Weiner does not reason in terms of assistance vis-à-vis the sale itself, but only vis-à-vis the commission of a violation. The fact that the participation necessary to support liability is participation directly linked to the protected transaction may be adequate justification for limiting the scope of section 12 liability to those who fit within the expanded notion of seller.

*Lorber* reflects this view while continuing to recognize secondary liability. In *Lorber* the court cited *Caesars Palace* for the proposition that one may be charged as an aider and abettor of, or conspirator in, a section 12 violation. *Lorber*, however, actually limited *Caesars Palace* by pronouncing a standard of aiding and abetting liability based upon the *deliberate assistance in disseminating misinformation in the course of a sale*.<sup>180</sup> The *Lorber* perspective clearly focuses on the sale transaction as opposed to another defendant's violation of the statute. *Lorber's* interpretation of the degree of participation required to sustain secondary liability allegations in section 12

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180. See notes 173-78 *supra* and accompanying text.

actions requires a direct link between the conduct at issue and the consummation of the transaction.<sup>181</sup> A standard of aiding and abetting liability which has as its minimum level of culpability only the knowing or reckless assistance of one who violates the section may lack a sufficient nexus to the protected transaction to invoke the *Lorber* analysis. Although not an aiding and abetting decision *per se*, the *Sandusky Land* analysis relates a *Lorber* type of direct link requirement to *any* extension of section 12 liability.

Thus, given the perspective of section 12, given the fact that it does contain some element of privity, and given the tortuous analyses which have emerged in the attempt to expand the scope of primary liability within the class of potential defendants who play facilitative roles in the offerings and sales of securities, there is utility in recognizing that knowing assistance or facilitation in those offerings and sales should be actionable. For that utility to be realized, however, the facilitation or assistance, as it was in *Lorber*, must be in the transactional sense, *i.e.*, it must truly be a "degree of participation." Only then will the recognition be consistent with the statute. It may be, as *Lorber* clearly recognizes, that the burden of establishing the elements of secondary liability under section 12 is overwhelming in some instances in which the particular conduct at issue and the particular defendant cannot be deemed to be aiding and abetting. But where conduct does amount to knowing facilitation in a transactional setting, the utility of a *Caesars Palace/Lorber* approach emerges. In a word, it makes sense.

## VI. CONCLUSION

The expansionist approach to liability under section 12 of the Securities Act began in 1940 with the recognition that the notion of a "person who sells" a security must mean something more than simply the person who transfers title. From *Cady v. Murphy* to *Sandusky Land*, *Caesars Palace* to *Lorber*, the road has been rocky and the course of development erratic at best. That development has, nevertheless, proceeded to the point that to the extent possible within the confines of its own language, section 12 has caught up with the development of liabilities under other provisions of the federal securities laws.

While it is true that some courts continue to opine that liability under section 12 may be imposed only in a strict privity setting, that position is a decidedly minority one. Three decades of interpretive analysis have clearly broadened the scope of section 12 liability. But those interpretations, par-

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181. That would also seem to be the message of *Caesars Palace* when Judge Weiner spoke of varying degrees of participation, and acting knowingly or recklessly "to be a part of a proscribed course of action" 360 F. Supp. at 382. But query whether the degree of participation that the traditional notion of aiding and abetting evokes is the same kind of participation, albeit to a lesser degree, which has supported the extension of section 12 liability.

ticularly the most recent approaches to primary and secondary liability, highlight the inherent limitation of section 12—that *some* element of privity must be maintained.

Most significantly, the privity element that has emerged is something far different from the notion of traditional contractual privity between a purchaser and a seller. Instead, section 12 litigation has fostered a notion of transactional privity that is determined by the role played by a particular individual in the circumstances surrounding a sale. The role may be active or passive and still support primary liability. Or the role may support the imposition of secondary liability under a *Caesars Palace/Lorber* rationale. Under these approaches, it makes no difference how one might label particular conduct or particular individuals sued under section 12; the element of privity will be satisfied where the particular individual is directly linked to consummation of the transaction—transactional privity as opposed to contractual privity.

To be sure, analysis of expanded liability under section 12 is far from complete. It is, perhaps, just beginning. With the expansion of the scope of potential section 12 liability to the point of adoption for the first time of contemporary concepts such as scienter on the primary liability side and a form of aiding and abetting or conspiracy on the secondary liability side, the utility of section 12 with its less burdensome, express right of action takes on new meaning. The further development of these concepts remains, and the ultimate parameters of section 12 liability cannot be predicted. The problems to be faced in any further expansion are not easily resolved, but with the emergence of transactional privity the groundwork has been laid for a rational delineation of the limits of both primary and secondary liability under section 12.