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MISREADING 'GUSTAFSON' COULD ELIMINATE LIABILITY UNDER § 11

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THE SECURITIES Act of 1933 was enacted principally to prevent the "exploitation of the public by the sale of unsound, fraudulent and worthless securities through misrepresentation." [FN1]

Section 11 of the Act requires full and complete disclosure in connection with public offerings by providing investors who purchase securities "sold upon a registration statement including an untrue statement or omission of material fact" with recourse against "those who have participated in such distribution either knowing of such untrue statement or omission or having failed to take due care in discovering it." [FN2]

While the aims of §11 are no less important today than they were in 1933, changes in the dynamics of public offerings, together with a misapplication of a 1995 Supreme Court decision, place investors in grave danger of losing the protections that §11 was intended to provide.

In *Gustafson v. Alloyd Co.*, a 5-4 decision, the Supreme Court held that a purchaser of securities pursuant to a private contract does not have a claim under §12(2) (currently, §12(a)(2), but, for the sake of clarity, still referred to as §12(2) in this article) [FN3] of the Act. [FN4] The decision turned on the majority finding that a private contract is not an offering document covered by the term "prospectus," the only type of offering document to which the statute applies. [FN5]

The Court reasoned that because the Act requires a prospectus to include "information contained in [a] registration statement" and since "only public offerings by an issuer of a security, or by controlling shareholders of an issuer, require the preparation and filing of registration statements," it follows that the term prospectus is "confined to documents related to public offerings." [FN6] Thus, after *Gustafson*, §12(2) claims to rescind the sale of securities can be brought only where such sales occurred in a public offering.

Although *Gustafson* dealt exclusively with §12(2), issuers and underwriters have

recently attempted to use the decision in such a way that, if successful, will insulate those who are responsible for material misstatements and omissions in registration statements from §11 liability.

Since Gustafson, defendants have advanced the argument that because §§11 and 12(2) share a "similar" legislative history, §11 claims should be available only to persons who purchase securities in a public offering, and not to those who purchase those shares in aftermarket trading. The argument seeks to eliminate the widely recognized "tracing" doctrine which enables purchasers of shares issued in connection with a false registration statement to bring a §11 claim, so long as those shares are traceable to the public offering, regardless of whether the securities were purchased in the public offering or in a subsequent aftermarket transaction from someone other than the issuer or underwriter. [FN7]

A few district courts have accepted this argument and expanded the holding of Gustafson to disallow the §11 claims of purchasers who can trace and/or show that their shares were those offered in connection with a false registration statement. [FN8] The statutory language and other distinctions between §§11 and 12(2), however, may mandate a broader interpretation of standing under §11.

Privity Requirement

Section 12(2) provides that any person who "offers or sells a security" by means of a prospectus which includes an untrue statement of a material fact or omits to state a material fact is "liable to the person purchasing such security from him" unless "he did not know, or in the exercise of reasonable care could not have known, of such untruth or omission." In other words, only those people who purchase directly from the person who sold the security by means of an alleged false prospectus, may bring a claim under §12(2).

In light of the privity requirement, even though Gustafson never addressed standing under §12(2), expanding its holding to require §12(2) claimants to have purchased their securities in a public offering and not in an aftermarket transaction (i.e., from a seller who did not sell "by means of a prospectus") is hardly controversial.

Unlike §12(2), however, §11 provides no language which can be read to limit claims only to those investors who directly purchase their shares in a public offering. Instead, §11 provides that if at the time a registration statement becomes effective, it contained an untrue statement of a material fact or omitted to state a material fact required to be stated or necessary to make the statements not misleading, "any person acquiring such security" may sue those who bear responsibility for the contents of the registration statement.

Thus, under the plain language of §11, any purchaser may bring a claim as long as he can prove that the securities acquired were issued in connection with a false registration statement (i.e., their shares can be traced to the offering).

Indeed, this conclusion finds support in the legislative history. The Committee of the House of Representatives, which recommended that the statute be passed, stated that the civil remedies afforded by §11 are to be given to purchasers

"regardless of whether they bought their securities at the time of the original offer or at some later date." [FN9]

According to Judge Henry J. Friendly, this statement "can be read to relate only to the extension of liability to open-market purchasers of the registered shares." [FN10] Judge Friendly further noted that both the House and Senate versions of the bill which ultimately became law under §11 "established a conclusive presumption of reliance upon the registration statement by 'every person acquiring any securities specified in such statements and offered to the public.'" [FN11]

Other provisions of §11 also compel the conclusion that the statute was intended to protect purchasers in the aftermarket. Section 11 was amended in 1934 to add the requirement that if a purchaser of a security "acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least 12 months beginning after the effective date of the registration statement," the right of recovery shall be conditioned on proof that he relied upon the untrue statement or omission in the registration statement. [FN12]

In approving this amendment to §11, the Speaker of the House stated that "we agree to an amendment put on by the Senate which provides that after the first financial statement of the issuer is made, then the man who buys a security in commerce after that must prove that he relied upon the statement." [FN13] Thus, although Congress placed a heavier burden upon those who purchase registered stock after the publication of the 12-month earning statement by requiring them to prove reliance, the statute contemplates relief for those who purchase shares subsequent to the public offering.

The provisions regarding the calculation of damages under §11 similarly envision relief for the broader class of purchasers. Section 11(e) provides that a purchaser of securities issued in connection with a false registration statement may sue to recover "such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public)," and the value of the security at the time that the suit was brought or the price at which the security was disposed of. Section 11(g) further states that "[i]n no case shall the amount recoverable under this section exceed the price at which the security was offered to the public."

Since investors who purchase securities on a public offering necessarily do so at the offering price and, therefore, would not have losses which exceed the offering price, §11's limitation of damages to the price at which the security was offered to the public would be unnecessary if aftermarket purchasers could not bring suit under §11. Indeed, aftermarket purchasers who pay more than the offering price for their securities are the only people who could possibly have losses which exceed the price at which the securities were offered to the public and are the only people to whom §§11(e) and (g) could logically apply.

Despite the statutory provisions and legislative history which support §11 claims for those who purchase securities issued in connection with a false registration statement subsequent to the public offering, some courts have accepted the argument that Gustafson limits standing under §11 to those persons who purchase their shares

on a public offering.

Ramifications

Given the realities of today's financial markets, if §11 liability is limited to original purchasers of securities in a public offering, those principally responsible for the issuance of false and misleading registration statements would almost never be held accountable. This is so because the majority of initial purchasers in public offerings are hedge funds and other institutional investors who often immediately sell or "flip" their shares, sometimes on the same day as the offering and, because of the momentum that typically surrounds initial public offerings, often at a profit. [FN14] Their shares are then sold to individual and smaller institutional purchasers.

If, for example, it is disclosed months after an offering that securities were issued upon a false registration statement because reported historical financial information was materially overstated, and a dramatic decline in the stock price ensues, Gustafson leaves no one with a §11 remedy.

The institutions that purchased on the offering will have no claim because they have already sold their shares and therefore could not have suffered any losses which would be causally related to the false statement. The aftermarket public investors are without a claim because they cannot trace. Effectively, the §11 remedy is thus eliminated altogether notwithstanding serious wrongdoing in connection with the issuance of newly registered shares.

Persons injured by purchasing securities issued upon a false registration statement may, of course, still pursue fraud claims under §10(b) of the Securities Exchange Act of 1934. A case in point is Murphy v. Hollywood Entertainment Corp. [FN15]

In that case, defendants issued stock in a secondary offering on the strength of a registration statement which included inflated profits and earnings projections due to improper accounting manipulation. Several corporate insiders also sold large blocks of stock at inflated prices. Once the true information about the company's financial condition came to light, the stock price plummeted. Having their §11 claims dismissed because they purchased in the aftermarket, the plaintiffs in Murphy pursued their claims under §10(b), but that remedy was a harsh substitute for the §11 claim.

In order to state a §10(b) claim, plaintiffs are required to plead and prove scienter and reliance, both of which are not elements of §11 (except that, as stated above, those who purchase securities after the release of a 12-month earnings statement must prove reliance), and carry a much greater burden, especially under new provisions of the Private Securities Litigation Reform Act of 1995 (PSLRA). [FN16]

Moreover, the PSLRA provides a safe harbor provision for §10(b) claims directed at certain forward looking statements - information which is often highly relevant to the investor's decision to purchase newly issued securities. The safe harbor completely eliminates liability for otherwise fraudulent forward looking statements

if those statements are accompanied by "meaningful cautionary language," and the investor fails to prove that the speaker actually knew that those statements were false.

In sum, by foreclosing the §11 remedy to investors who, while capable of tracing their shares to a public offering, do not buy directly on the offering, Gustafson virtually eradicates the intended protections of the statute. Indeed, the Act was enacted to provide full and complete disclosure in connection with initial and secondary offerings of securities to investors who do not stand on an equal informational footing with issuers, corporate insiders and underwriters.

FN1. S. Rep. No. 47, at 1 (1933).

FN2. H.R. Rep. No. 85, at 9 (1933).

FN3. 15 USC §771(a)(2). Section 12(2), a companion provision to §11, provides rescissory damages against a direct seller for investors who purchase securities upon a false prospectus.

FN4. 513 U.S. 561 (1995).

FN5. Id. at 569-570.

FN6. Id.

FN7. Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967); Schwartz v. Celestial Seasonings, Inc., 904 F.Supp. 1191 (D. Col. 1995); In re AES Corp. Sec. Litig., 825 F.Supp. 593 (SDNY 1993); In re Elscint, Ltd. Sec. Litig., 674 F.Supp. 374 (D. Mass. 1987); In re Data Access Systems Sec. Litig., 103 F.R.D. 130 (D.N.J. 1984).

FN8. Gannon v. Continental Ins. Co. Inc., 920 F.Supp. 566 (D.N.J. 1996); Gould v. Harris, 929 F.Supp. 353 (C.D. Cal. 1996); Murphy v. Hollywood Entertainment Corp., 1996 WL 393662 (D. Or. May 9, 1996).

FN9. H.R. Rep. No. 85, at 22 (1933).

FN10. 373 F.2d at 273.

FN11. Barnes v. Osofsky, 373 F.2d at 272, quoting S. Doc. 875, §9; H.R. Doc. 4314, §9 (1933). The House Managers that endorsed the final language of §11 "noted that the only changes to §11 from the bill were as to who was liable and their defenses." Id.

FN12. 15 USC §77k.

FN13. 78 Cong. Rec. 10266 (June 1, 1934).

FN14. See Debora Vrana, "John and Jane Q. Public and Initial Public Offerings," Los Angeles Times, July 8, 1997, Part D at 5.

FN15. 1996 WL 393662 (D. Or. May 9, 1996).

FN16. Pub. L. No. 104-67; 109 Stat. 737 (Dec. 22, 1995).

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