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NEARLY A DECADE LATER: REVISITING *GUSTAFSON* AND THE STATUS OF SECTION 12(A)(2) LIABILITY IN THE COURTS—CREATIVE JUDICIAL DEVELOPMENTS AND A PROPOSAL FOR REFORM

*Natasha S. Guinan**

INTRODUCTION

In 1995 the Supreme Court determined in *Gustafson v. Alloyd Co.*[1] that rescissionary liability under the 1933 Federal Securities Act (the "'33 Act")[2] no longer applied to private or aftermarket securities transactions, but only to public securities transactions. Because rescissionary liability[3] traditionally received broad application under the '33 Act, *Gustafson* represented a policy choice by the Court to limit the number of securities lawsuits at the expense of consumer protection. The *Gustafson* decision, although popular with defendants, has been roundly criticized by academics and the securities bar alike, not only for its policy-driven result but also for its strained and illogical reading of the '33 Act.[4]

Gustafson left the lower courts with the difficult task of determining on a case-by-case basis whether a given offering of securities was public—and therefore subject to potential Section 12(a)(2) liability[5]—or private and therefore immune from Section 12(a)(2) liability. The lower courts have at times crafted creative solutions in their attempt to enable plaintiffs to recover rescissionary damages despite *Gustafson*. This Note closely examines one of these solutions, the "quasi-public" offering. This Note argues that although the quasi-

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1. 513 U.S. 561 (1995).
2. 15 U.S.C. § 77a to 77z-3 (2000).
3. In this context, rescissionary liability means that a purchaser may "recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if [the purchaser] no longer owns the security." 15 U.S.C. § 77*l* (a) (2000).
4. *See infra* Part I.C.2. and Part I.C.3.
5. 15 U.S.C. § 77*l*(a)(2).

public argument is both an interesting and creative solution to limited rescissionary recovery under *Gustafson*, it is an inadequate approach that both (1) undermines long-standing securities law that has been incorporated into the complex interrelated web of securities regulations that distinguish public transactions from private transactions, and (2) creates an unpredictable source of liability for issuers of securities that should be able to structure securities placements with foreknowledge of what liabilities could result.

Since the *Gustafson* opinion has already been written on extensively,[6] Part I offers only a brief description of *Gustafson*. Part II then examines the quasi-public argument, which is adopted by some lower courts post-*Gustafson* but rejected by other lower courts. Part III provides a critique of the quasi-public argument and support for those courts that reject this argument. Part III also offers an alternative proposal that would enable private securities purchasers to recover rescissionary damages post-*Gustafson*. This proposal does not make the applicability of Section 12(a)(2) liability dependent on exemptions from Section 5 registration requirements.[7] Rather, this solution is based on a broader understanding of a prospectus, which includes informal information that is not required to be disclosed under either Sections 5 or 10 of the '33 Act. This Note suggests that where such informal information is held out to the unsophisticated investing public and proves to be materially misleading, that information should be construed as a "prospectus"—broadly understood—and subjected to Section 12(a)(2) liability.

The proposal developed in this Note would prevent private sellers of securities from avoiding rescissionary liability by calling information that amounts to a solicitation to the unsophisticated investing public something other than a prospectus. Moreover, this proposal preserves some of the spirit of *Gustafson* by neither extending the scope of Section 12(a)(2) liability to aftermarket securities sales, nor making all private securities placements vulnerable to rescissionary liability—just those that hold fraudulent and misleading information out to the unsophisticated investing public.

I. THE LEGAL REQUIREMENT OF A PROSPECTUS FOR PUBLIC OFFERINGS OF SECURITIES

> Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman. —Justice Brandeis[8]

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6. *See infra* note 46.

7. 15 U.S.C. § 77e.

8. Cynthia A. Williams, *The Securities and Exchange Commission & Corporate Social Transparency*, 112 Harv. L. Rev. 1197, 1212 (1999) (quoting Richard M.

Part I first examines the historical background of the Federal Securities Act of 1933 and its purpose as an act of consumer protection.[9] It then explains how the registration statement and the prospectus function in securities law.[10] Finally, this part summarizes the majority[11] and dissenting[12] opinions in *Gustafson v. Alloyd Co.*,[13] and provides a brief account of typical critical responses to the case.[14]

A. *A Brief Historical Background*

The Federal Securities Act of 1933 was, in part, adopted as a congressional response to the stock market collapse of 1929 and the ensuing Great Depression.[15] The '33 Act both defines and regulates what information issuers involved in the public distribution of securities must disclose. Arguably, the '33 Act[16] has accomplished its express aim of public disclosure, since "[o]ther nations justifiably seek to implement the liquidity, transparency, integrity, and investor protection . . . that embody [U.S.] securities markets. Relatively efficient trading markets are based on a disclosure regime where transactions are expeditiously executed and competitively priced."[17]

The disclosure requirements of the '33 Act provide for consumer protection[18] by requiring that specific information—including industry-sensitive information and risk factors that make an offering speculative—about an issuing company be made public in a prospectus when that company issues securities for sale to the public.[19] As Cynthia Williams observes, "Congress adopted mandatory disclosure in the federal securities laws to advance a number of distinct purposes. One of the major purposes of disclosure was to

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Abrams, *Introduction* to Louis D. Brandeis, Other People's Money and How the Bankers Use It 62 (1967)).

9. *See infra* notes 15-22 and accompanying text.

10. *See infra* notes 23-45 and accompanying text.

11. *See infra* notes 47-78 and accompanying text.

12. *See infra* notes 79-98 and accompanying text.

13. 513 U.S. 561 (1995).

14. *See infra* notes 99-132 and accompanying text.

15. *See* James D. Cox et al., Securities Regulation: Cases and Materials 3-4 (3d ed. 2001); *see also* Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(A)(2) of the 1933 Securities Act*, 75 Wash. L. Rev. 429, 433 (2000) ("In response to the market crash of 1929, Congress enacted the Securities Act as its first attempt to create federal duties for the registration and disclosure of information in connection with securities offerings . . . ."(citation omitted)).

16. In conjunction with the 1934 Securities Exchange Act, which, among other things, created the Securities and Exchange Commission, the '33 Act provides for public disclosure for consumer protection purposes.

17. Marc I. Steinberg, *Curtailing Investor Protection Under the Securities Laws: Good for the Economy?*, 55 SMU L. Rev. 347, 347 (2002) (citation omitted).

18. Whether the disclosure requirements of the '33 Act provide adequate consumer protection is a question addressed in Part III of this Note.

19. Cheryl V. Reicin et al., An Insider's Guide to Going Public: A Guide to the Initial Offering Process and Life as a Public Company 30 (2002).

prevent fraud by corporate issuers and underwriters in the initial sale and subsequent trading of securities."[20] The '33 Act adds teeth to its mandatory disclosure requirements by making issuers who fail to comply with its requirements (for fraudulent or other reasons) liable.[21] For instance, Section 12(a)(2) of the '33 Act makes full rescissionary damages available to purchasers of securities if the prospectus for the securities contains a material omission and/or misstatement. Thus, Section 12(a)(2) provides a very broad remedy for defrauded purchasers of securities.[22]

B. *The Registration Statement and the Prospectus*

Section 5 of the '33 Act mandates that unless a security is sold pursuant to an exemption,[23] the issuer must file a registration statement in order to lawfully offer or sell a security. Section 5 states that

> Unless a registration statement is in effect as to a security, it shall be unlawful for any person,[24] directly or indirectly . . . to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security.[25]

A registration statement involves the production of a prospectus that must accompany all written offers to purchase publicly offered securities, and, at minimum, conform to the requirements for a prospectus that are listed in Section 10 of the '33 Act.[26] Section 10

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20. Williams, *supra* note 8, at 1209-10 (citations omitted).

21. See Section 12(1) of the '33 Act, which provides rescissionary damages for investors if an issuer violates registration or gun-jumping requirements, 15 U.S.C. § 77*l*(a)(1), Section 11 of the '33 Act, which creates liability for fraudulent registration statements, 15 U.S.C. § 77k, Section 15, which permits investors to recover on a joint and several basis from persons who "control" any person liable under Sections 11 or 12, 15 U.S.C. § 77o, and, the SEC itself can seek penalties and civil injunctions for violations of the '33 Act accomplished by false or misleading methods, 15 U.S.C. § 77q, 77t(b), (d).

22. *See* 15 U.S.C. § 77*l*.

> Any person who . . . offers or sells a security . . . which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . shall be liable . . . to the person purchasing such security from him . . . to recover the consideration paid for such security with interest thereon.

Id.; *see also* Peter V. Letsou, *The Scope of Section 12(2) of the Securities Act of 1933: A Legal and Economic Analysis*, 45 Emory L.J. 95, 95-96 (1996).

23. There are numerous securities transactions that are exempt or "safe harbored" from the registration requirements of the '33 Act, including those covered by Section 3, Section 4, and various SEC safe harbors.

24. The '33 Act defines "person" broadly as "an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof." 15 U.S.C. § 77b(a)(2).

25. 15 U.S.C. § 77e(a)-(c).

26. *See id.* § 77j.

empowers the Securities and Exchange Commission ("SEC") to determine which information contained in the registration statement must be included in the prospectus, and therefore enables the SEC to control the contents of a prospectus in a registered offering. In relevant part, Section 5 states: "It shall be unlawful for any person . . . to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of [Section 10]."[27]

Typically, a prospectus contains most of the information that issuers are required to provide in the detailed registration statement they file with the SEC.[28] However, parts of the prospectus must be written in plain English pursuant to Rule 421(d)[29] so that public purchasers can easily comprehend the detailed information it contains.[30] The type of information contained in a registration statement is extensive and encompasses all aspects of the issuer's business. For example, a registration statement will contain comprehensive financial information, certified financial statements, a detailed description of the rights and privileges of the offered security, management's review of the issuer's capital needs, solvency, and financial needs, and descriptions of the particular risk factors associated with this offering.[31]

A prospectus, then, must contain all the relevant material information contained in a registration statement that a prospective investor would need to assess fully the risks and benefits involved in purchasing a security. The Supreme Court defined "material information" in *TSC Industries, Inc. v. Northway, Inc.*,[32] where it found that "material information" is fact-specific, and dependent on whether a reasonable investor would find it significant if such information were withheld or misrepresented.[33] Ideally, if a

27. *Id.* § 77e(b)(1).

28. *See id.* § 77g ("Information Required in Registration Statement"); *see also* Cox, *supra* note 15, at 237 (stating that a registration statement must contain "information bearing on the registrant, information about the distribution and use of its proceeds, a description of the securities of the registrant, and various exhibits. . . . Only . . . the first three categories must be reproduced in the prospectus.").

29. Alan R. Palmiter, *Securities Regulation: Examples & Explanations* 93 (2d ed. 2002). The parts of a prospectus that must be written in plain English include the cover pages, summary, and risk factors.

30. *See* SEC, A Plain English Handbook: How to Create Clear SEC Disclosure Documents (1998) (describing the SEC plain English standards), *available at* http://www.sec.gov/pdf/plaine.pdf.

31. *See* Reicin et al., *supra* note 19, at 30.

32. 426 U.S. 438 (1976).

33. *Id.* at 449. The context of the *TSC Industries* decision was a proxy solicitation, but in 1988 the Supreme Court applied this same definition of material information in a different securities context that involved merger discussions. *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988). Therefore, it appears to be well-settled law that material information in connection with an offering of securities means information

prospectus contained all relevant material information that a reasonable investor would require to fairly assess the purchase price of a security, then the prospectus would place an individual public investor on nearly equal footing with the issuer of the security—at least in terms of their respective abilities to analyze the purchase price.

Every registered offering of securities—that is, every offering that requires a registration statement pursuant to Section 5 of the '33 Act—must have a prospectus that, at minimum, meets the requirements of Section 10.[34] However, Section 2—the definitional section of the '33 Act—actually defines a "prospectus" much more expansively than does Section 10. Section 2 states that a prospectus is "any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security."[35]

Even though every registered offering of securities requires a prospectus that, at minimum, conforms to Section 10 requirements, not every offering of securities needs to be registered. There are many exemptions,[36] and, therefore, not every offering of securities requires a prospectus that meets the rigorous requirements of Section 10. However, even unregistered securities offerings have a "prospectus" in the sense intended by Section 2 of the '33 Act because such offerings will have some sort of sales document, consisting of either a written or oral communication, offering unregistered securities for sale or confirming the sale of that security.[37]

Prior to *Gustafson*, there was little question that references in the '33 Act to a "prospectus" included *both* the broad meaning contained in Section 2, which incorporates even non-registered non-public offerings of securities, and the narrower meaning of a prospectus created for a registered offering pursuant to Section 10.[38] Under this

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that a reasonable investor would find significant were it withheld or misrepresented to them.

34. *See supra* notes 26-27 and accompanying text.

35. 15 U.S.C. § 77b(a)(10) (2000).

36. *See supra* note 23 and accompanying text.

37. *See, e.g.*, Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 Colum. Bus. L. Rev. 1, 31-32 ("As explained by the Supreme Court, no registration is needed for investors who are 'able to fend for themselves' and thus contract for informational and veracity commitments."); *see also id.* at 11 ("Those who can 'fend for themselves,' the Securities Act supposes, will replicate regulatory protections privately through the contracting process and reliance on background antifraud standards.").

38. *See, e.g.*, Pac. Dunlop Holdings, Inc. v. Allen & Co., Inc., 993 F.2d 578 (7th Cir. 1993) (holding that Section 12(2) applies to private placements), *cert. granted*, 510 U.S. 1083 (1994), *cert. dismissed*, 510 U.S. 1160 (1994); Metromedia Co. v. Fugazy, 983 F.2d 350 (2d Cir. 1992), *cert. denied*, 508 U.S. 952 (1993); Haralson v. E.F. Hutton Group, Inc., 919 F.2d 1014 (5th Cir. 1990); Phar-Mor, Inc., v. County Natwest Global Sec., Ltd., 848 F. Supp. 46 (W.D. Pa. 1993). Before 1995, circuit courts uniformly held that 12(a)(2) liability attached to both public offering of securities and private

rationale, it followed that Section 12(a)(2) liability,[39] which can attach to a seller of a security who sells securities by means of a fraudulent "prospectus or oral communication,"[40] applied to public and private transactions, as well as aftermarket trading.[41] However, the Court's 1995 *Gustafson* decision determined—contrary to nearly fifty years of precedent[42]—that Section 12(a)(2)[43] liability no longer applied to either private transactions or aftermarket transactions.[44] At the risk of understating the reaction the *Gustafson* decision provoked, it is fair to say that its holding "came as something of a surprise"[45] to both academics and the securities bar.

C. *The* Gustafson *Decision*

Numerous commentators have written extensively about the *Gustafson* decision.[46] This section briefly summarizes the rationale of

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transactions or aftermarket trading—even when the lower courts were deciding otherwise. There was, however, one academic voice before 1995 that maintained 12(a)(2) liability should *not* attach to trading transactions, private offerings, or any securities transaction exempt pursuant to Section 4 of the '33 Act, and this voice was Professor Weiss. *See* Elliot J. Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies only to Public Offerings*, 48 Bus. Law. 1 (1992); *see also* Stephen M. Bainbridge, *Securities Act Section 12(2) After the* Gustafson *Debacle*, 50 Bus. Law. 1231, 1231 (1995) ("Professor Weiss contended [several years ago] that liability under section 12(2) arose only with respect to public offerings of securities .... At that time, Weiss' iconoclastic view had some support in the case law, but essentially no support in the academic commentary." (citation omitted)); Peter V. Letsou, *supra* note 22, 98 & n.17 ("From 1947 ... until 1995 ... the proposition that §12(2) applied to private transactions was accepted almost without question ... Professor Weiss was the exception.").

39. *See supra* note 22 and accompanying text.

40. 15 U.S.C. § 77*l*(a)(2).

41. Aftermarket trading means trading by investors who are able to "fend for themselves" without '33 Act protections. This meaning is consistent with the definition provided by *SEC. v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) ("An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

42. *See supra* note 38 and accompanying text.

43. *See supra* note 22 and accompanying text.

44. *See* Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995).

45. Letsou, *supra* note 22, at 98 n.17 (citing Therese Maynard, *The Future of Securities Act Section 12(2)*, 45 Ala. L. Rev. 817, 869 (1994)).

46. A sampling of the titles of articles written in the immediate aftermath of *Gustafson* illustrates the outpouring of academic commentary this Supreme Court decision inspired. *See, e.g.*, Laura K. Bancroft, Gustafson v. Alloyd Co.: *The Continued Shrinking of Private-Plaintiff Remedies Under the 1933 Securities Act*, 27 Loy. U. Chi. L.J. 149 (1995); Krista R. Bowen, *A Cloudy Prospectus: The Supreme Court's Problematic Reasoning in* Gustafson v. Alloyd Co., 53 Wash. & Lee L. Rev. 1041 (1996); Christie L. Gamble, Gustafson v. Alloyd: *Setting Limits on a Potentially Powerful Weapon*, 21 Del. J. Corp. L. 489 (1996); Therese Maynard, *A Requiem: Reflections on* Gustafson, 57 Ohio St. L.J. 1327 (1996); J. Dormer Stephen III, Gustafson: *One Small Step (Backward) for Private Plaintiffs, One Giant Leap (Backward) for the Securities Bar*, 49 Okla. L. Rev. 425 (1996); Elliott J. Weiss, *Some Further Thoughts on* Gustafson v. Alloyd Co., 65 U. Cin. L. Rev. 137 (1996).

the *Gustafson* Court and the dissenting opinions. This section concludes with a discussion of typical critical responses to the controversial decision.

1. The Majority Opinion

In a 5-4 decision, the *Gustafson* Court addressed the issue of whether investors who purchased all of Alloyd Company's outstanding shares from defendants, controlling shareholders of Alloyd, in a private written contract of sale agreement could seek rescission of the contract under Section 12(a)(2).[47] As Justice Kennedy wrote in the majority opinion, the question presented was "whether this right of rescission extends to a private, secondary transaction, on the theory that recitations in the purchase agreement are part of a 'prospectus.'"[48] The privately negotiated stock purchase agreement in *Gustafson* included representations and warranties concerning the financial condition of Alloyd that, after a year-end audit, proved untrue.[49] The plaintiff-purchasers were entitled to a price adjustment under the express representations and warranties contained in their stock purchase agreement,[50] but instead claimed that the contract of sale was a prospectus and sought full rescission under Section 12(a)(2) for misstatements contained in the stock purchase agreement.[51] The difference between the price adjustment and rescissionary damages amounted to nearly $20 million.[52] The critical question in this case, therefore, was whether the stock purchase agreement between Gustafson and Alloyd was a prospectus

47. *Gustafson*, 513 U.S. at 564-66.

48. *Id.* at 564.

49. Plaintiff-purchasers in *Gustafson* agreed to pay $18,709,000 in the initial sale of stock and an additional $2,122,219 to reflect the estimated net worth increase in Alloyd Corp. from the end of the previous year—the last year financial data was available—to present. *Id.* at 565. In total, plaintiff-purchasers agreed to buy nearly all the outstanding stock in the closely held Alloyd Corp. from its three controlling shareholders—Gustafson, McLean and Butler—for approximately $21 million, and plaintiff-purchasers did so through their newly formed corporation, Alloyd Holdings, Inc. *Id.* at 565-66. The stock purchase agreement included seller's representations and warranties that (i) the company's financial statements fairly stated its financial condition and that (ii) during the time between the last balance sheet and the privately negotiated stock purchase agreement, no material adverse change had occurred in Alloyd's financials. *Id.* at 565. Moreover, the stock purchase agreement contained the following warranty: "if the year-end audit and financial statements revealed a variance between estimated and actual increased value, the disappointed party would receive an adjustment." *Id.* After the end of the fiscal year, Alloyd's audit revealed that plaintiffs had the contractual right to recover an $815,000 price-adjustment from sellers pursuant to the stock purchase agreement, but plaintiffs instead sought rescission of the agreement pursuant to Section 12(2) of the '33 Act. *Id.* Indeed, even after defendants actually remitted the $815,000 price-adjustment to plaintiffs, plaintiffs continued with their 12(a)(2) lawsuit. *Id.* at 566.

50. *See supra* note 49.

51. *See supra* note 49.

52. *See supra* note 49.

within the meaning of Section 12(a)(2) of the '33 Act.[53] The majority in *Gustafson* concluded that it was not.

Justice Kennedy's majority opinion focused on definitions of the term "prospectus" found in the '33 Act in Sections 2(10), 10, and 12(a)(2).[54] Justice Kennedy wrote that, where possible, the term "prospectus" "should be construed . . . to give it a consistent meaning throughout the Act . . . [because of] our duty to construe statutes, not isolated provisions."[55] Rather than begin at the beginning of the Act with Section 2, however, Justice Kennedy's opinion first analyzed the meaning of a prospectus under Section 10.[56] Section 10 does not define the term "prospectus" per se, but requires that a prospectus provide requisite registration statement information unless an exemption obtains.[57]

On the basis of Section 10, the *Gustafson* Court reasoned that this section provides a negative definition of what a prospectus cannot be if the term "prospectus" is to be treated uniformly throughout the '33 Act[58]—namely, anything other than a document relating to a public offering by an issuer which requires a registration statement:

> [W]hatever else "prospectus" may mean, the term is confined to a document that, absent an overriding exemption, must include the "information contained in the registration statement." By and large, only public offerings by an issuer of a security, or by controlling shareholders of an issuer, require the preparation and filing of registration statements.[59]

Since the *Gustafson* majority began with Section 10 rather than Section 2, the decision effectively reasoned *backward*:[60] since, by definition, a prospectus within the meaning of Section 10 must include registration statement information, and because only public offerings require a registration statement, then according to the Court, a prospectus can only relate to public offerings of securities. That is,

53. *Gustafson*, 513 U.S. at 570.

54. *Id.* at 568.

55. *Id.* (citing Philbrook v. Glodgett, 421 U.S. 707, 713 (1975) and Kokoszka v. Belford, 417 U.S. 642 (1974)). This hermeneutic principle of construing the term as having the same meaning throughout the whole of the '33 Act received particularly harsh treatment in Justice Ginsburg's dissenting opinion, examined *infra*.

56. *Id.*

57. *See* 15 U.S.C. § 77j (2000); *Gustafson*, 513 U.S. at 569.

58. *Gustafson*, 513 U.S. at 569 (stating that Section 10 "instruct[s] us [as to] what a prospectus cannot be if the Act is to be interpreted as a symmetrical and coherent regulatory scheme . . . in which the operative words have a consistent meaning throughout").

59. *Id.*

60. *See infra* note 56 and accompanying text; *see also Gustafson*, 513 U.S. at 597 (Ginsburg, J., dissenting) ("The Court bypasses § 2(10) . . . . Instead of beginning at the beginning, by first attending to the definition section, the Court starts with § 10 . . . a substantive provision . . . . The Court then proceeds backward; it reads into the literally and logically prior definition section, § 2(10), the meaning 'prospectus' has in § 10."")).

rather than looking first to the definitional Section 2 of the '33 Act for what a prospectus means, the Court used the technical requirements for a prospectus in a registered offering at Section 10 to establish what the term "prospectus" means throughout the '33 Act.[61] Nonetheless, on this basis Justice Kennedy's majority opinion concluded "a prospectus under § 10 is confined to documents related to public offerings by an issuer or its controlling shareholders."[62]

The *Gustafson* Court thus determined that Section 12(a)(2) of the '33 Act must use the term "prospectus" in the same way that Section 10 does: "We conclude that the term 'prospectus' must have the same meaning under §§ 10 and 12 . . . [w]e find in § 10 guidance and instruction for giving the term a consistent meaning throughout the Act."[63] On the basis of this equivocation between Sections 10 and 12(a)(2) of the '33 Act, the *Gustafson* Court concluded that, unless a written communication offering a security for sale relates to a public offering by an issuer or its controlling shareholders, a written communication cannot be a prospectus for Section 12(a)(2) purposes.[64]

The Court bolstered its definition of a "prospectus" for Section 12(a)(2) purposes by looking to the primary purpose behind the '33 Act, which was "the creation of federal duties—for the most part, registration and disclosure obligations—in connection with public offerings."[65] On this basis, the Court reasoned that the technical definition of a prospectus found in Section 10 of the '33 Act cohered well with the overall aim of the Act to create disclosure and registration obligations in connection with public offerings.[66] Thus, the *Gustafson* majority reasoned that "[a] restrictive interpretation of the term prospectus better 'linked' section 12(a)(2) to the duties created by the Securities Act."[67]

The Court's analysis of Section 2(10)—found in the definitional section of the '33 Act, which chronologically (and logically) precedes both Sections 10 and 12(a)(2)—opposed Alloyd's contention that pursuant to Section 2(10) "any written communication that offers a security for sale is a 'prospectus'"[68] for Section 12(a)(2) purposes. The

61. This backwards analysis is something that commentators call "mystifying indeed." Bainbridge, *supra* note 38, at 1236 (citing a Letter from Elliott Weiss to Stephen M. Bainbridge (Apr. 4, 1995) (on file with The Business Lawyer, University of Maryland School of Law).

62. *Gustafson*, 513 U.S. at 569.

63. *Id.* at 570.

64. *Id.* at 584.

65. *Id.* at 571-72 (citing United States v. Naftalin, 441 U.S. 768, 777-78 (1979); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752 (1975); SEC v. Ralston Purina Co., 346 U.S. 119, 122 & n. 5 (1953); and H.R. Rep. No. 85, 73d Cong., 1st Sess., 7 (1933)).

66. *Gustafson*, 513 U.S. at 572-73.

67. Sale, *supra* note 15, at 459.

68. *Gustafson*, 513 U.S. at 574.

Gustafson Court criticized Alloyd's reliance on Section 2(10), claiming that this definitional section of the Act stands in "isolation" from other uses of the term prospectus throughout the Act.[69] As Justice Kennedy expressed: "The relevant phrase in the definitional part of the statute must be read in its entirety, a reading which yields the interpretation that the term 'prospectus' refers to a document soliciting the public to acquire securities."[70]

The *Gustafson* Court supported its reading of the term "prospectus" by using the canon of construction, *noscitur a sociis*, "a word is known by the company it keeps."[71] Using this hermeneutic principle, the majority reasoned that the broad definition given the term "prospectus" on the face of Section 2 is actually "inconsistent with its accompanying words [and would] giv[e] 'unintended breadth to the [Act].'"[72] According to the majority, because all the words listed in Section 2(10) refer to "documents of wide dissemination,"[73] there is support for the fact that when the '33 Act was adopted, a "prospectus" was already "well understood to refer to a document soliciting the public to acquire securities from the issuer."[74]

Leaning on the legislative history of the '33 Act,[75] Justice Kennedy reasoned that a "prospectus" is a term of art and that this convention explains "what might otherwise be regarded as partial circularity in the formal, statutory definition."[76] Moreover, Justice Kennedy concluded that although the list of communications enumerated in Section 2(10) of the '33 Act serves to prevent sellers of securities from calling a sales document something other than a prospectus in order to escape liability, this does not mean that any soliciting document is a prospectus.[77] Once again, the Court concluded that a prospectus for purposes of Section 12(a)(2) liability is the same as a prospectus under Section 10, requiring disclosure and registration requirements in connection with a public offering, and thereby greatly limiting the scope of 12(a)(2) liability:

> In light of the care that Congress took to justify the imposition of liability without proof of either fraud or reliance on "those whose

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69. "The flaw in Alloyd's argument . . . is its reliance on one word of the definitional section in isolation." *Id.*

70. *Id.*

71. *Id.* at 575.

72. *Id.* The majority's reasoning is evidently based on the reasoning that the '33 Act was primarily intended to create disclosure and registration requirements in connection with public offerings of securities.

73. *Id.* at 575; *see also* Bainbridge, *supra* note 38, at 1249 (arguing that the list does not, in fact, exclusively refer to documents of wide dissemination because a letter is an obvious exception).

74. *Gustafson*, 513 U.S. at 575 (citing Black's Law Dictionary 959 (2d ed. 1910)).

75. *See id.* at 579-84.

76. *Id.* at 576 (noting that 15 U.S.C. § 77b(10) reads, "The term 'prospectus' means any prospectus.").

77. *Id.*

> moral responsibility to the public is particularly heavy"—the "originators of securities"—we cannot conclude that Congress would have extended that liability to every private or secondary sale without a whisper of explanation.[78]

Because the *Gustafson* majority did not conclude that Congress intended for Section 12(a)(2) liability to apply to private and aftermarket sales of securities, the narrow requirements of Section 10—and not the broad definition of Section 2—now govern a limited form of rescissionary liability under the '33 Act.

2. The Dissenting Opinions

This section will briefly summarize two separate dissents filed by Justice Thomas[79] and Justice Ginsburg in the *Gustafson* opinion.[80] Unlike the majority opinion, Justice Thomas's dissent began with an analysis of the definition of a prospectus in Section 2(10) for purposes of 12(a)(2) liability. Justice Thomas concluded from his analysis that "the breadth of these terms [in Section 2(10)] forecloses the majority's position that 'prospectus' applies only in the context of initial distributions of securities."[81] Moreover, Justice Thomas asserted that the majority opinion's use of the doctrine of *noscitur a sociis* was not warranted because the definition provided in Section 2(10) was not ambiguous on its face and therefore did not require such a canon of construction: "The majority uses the canon in an effort to *create* doubt, not to *reduce* it."[82]

Finally, Justice Thomas's dissent noted that although the majority was correct to find that neither Sections 5 nor 10 of the '33 Act embrace the broad definition of a prospectus offered in Section 2, the term "prospectus" need not be given the same meaning when "Congress did not use the word 'prospectus' in the same sense throughout the statute."[83] Justice Thomas asserted that two distinct uses of the term "prospectus"—a broad use, such as that found in Section 2, and a narrow use involving disclosure and registration requirements, such as that found in Section 10—exist in both the '33 Act itself and in securities practice (where a broad prospectus was known as an "informal" prospectus and a registration-oriented prospectus was known as a "formal" prospectus).[84] Moreover, Justice

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78. *Id.* at 582.
79. Justices Scalia, Ginsburg, and Breyer joined in dissent. *See id.* at 584-96 (Thomas, J., dissenting).
80. Justice Breyer joined in dissent. *See id.* at 596-604 (Ginsburg, J., dissenting).
81. *Id.* at 585-86.
82. *Id.* at 586.
83. *Id.* at 588.
84. *Id.* at 586-90. As Bainbridge notes:

> This argument [of the *Gustafson* majority] ignores the long-standing distinction between the broad class of documents known as

Thomas argued that by including the very word "prospectus" as one of the types of communication that qualify as a prospectus, Congress explicitly intended that a prospectus have a broader meaning than that conveyed by either Sections 5 or 10 of the '33 Act, and that therefore there must be more than one meaning for the term "prospectus" in the statute.

Justice Thomas further noted that "[o]n its face, § 12(2) makes none of the usual distinctions between initial public offerings and aftermarket trading, or between public trading and privately negotiated sales."[85] Therefore, Justice Thomas concluded, Congress never intended to limit Section 12(a)(2) liability to prospectuses pertaining to the disclosure and registration requirements involved in a public offering: "[O]n this score, § 12(2) is notable for its silence."[86] Significantly, Justice Thomas accused the majority of being influenced by policy preferences, observing that: "[T]he majority's concern [is] that extending § 12(2) to secondary and private transactions might result in an unwanted increase in securities litigation."[87]

Justice Ginsburg's dissenting opinion endorsed Justice Thomas's statutory analysis,[88] but also bolstered his arguments with an analysis of the drafting history and traditional judicial and academic interpretations of the '33 Act.[89] First, Justice Ginsburg argued that Congress purposefully adopted a broader definition of the term "prospectus" when drafting Section 2 of the '33 Act because the British Companies Act, on which the Securities Act was based,[90] contained a narrower definition of a prospectus than that which Congress adopted in the '33 Act.[91] In relevant part, Justice Ginsburg's dissenting opinion stated that "the drafters of the Securities Act . . .

> prospectuses and the narrower class referred to as 'statutory,' 'formal,' or 'section 10(a)' prospectuses. With respect to the latter categories, the qualifying terms are used to identify that sub-group of prospectuses intended by their drafters to comply with section 10(a). This is part of the common parlance of securities lawyers, which should have been familiar to any member of the majority who has taken a securities regulation course.

Bainbridge, *supra* note 38, at 1237-38 (internal citation omitted).

85. *Gustafson*, 513 U.S. at 589-90.

86. *Id.* at 590.

87. *Id.* at 594. This Note returns to the purportedly policy-driven motives behind the *Gustafson* decision in Part I.C.3.

88. "As Justice Thomas persuasively demonstrates, the statute's language does not support the Court's reading. Section 12(2) contains no terms expressly confining the provision to public offerings, and the statutory definition of 'prospectus' . . . is capacious." *Id.* at 596.

89. "Although she joined in Justice Thomas's opinion, she wrote separately to emphasize her belief that the view of the dissenting justices was also supported by the drafting history of the 1933 Act itself and by 'the longstanding scholarly and judicial understanding of section 12(2).'" Letsou, *supra* note 22, at 108.

90. *Gustafson*, 513 U.S. at 599-600.

91. *Id.*

did not import from the British legislation the language limiting prospectuses to communications 'offering [securities] to the public' [and] [t]his conspicuous omission suggests that the drafters intended the defined term 'prospectus' to reach beyond communications used in public offerings."[92] Second, Justice Ginsburg noted that the House Conference Report contained no sign that Section 12(a)(2) was to be limited to public offerings.[93] Indeed, Justice Ginsburg emphasized that the House Conference Report never used the term prospectus, "even though one would expect that word to figure prominently if it were the significant limitation the [*Gustafson*] Court describes."[94] Justice Ginsburg further noted that commentators writing shortly after the '33 Act until 1995 understood that Section 12(a)(2) liability attaches to resales, private sales, and public offerings.[95]

Significantly, Justice Ginsburg's dissent highlighted a critical flaw in the majority's attempt to give the same term the same meaning throughout the Act.[96] Specifically, Justice Ginsburg commented that where a meaning is suitable in one context but not in another, the former meaning cannot control the latter meaning.[97] Justice Ginsburg wrote that "[a]ccording 'prospectus' discrete meanings in § 10 and § 12(2) is consistent with Congress' specific instruction in § 2 that definitions apply 'unless the context otherwise requires.'"[98] Thus, according to Justice Ginsburg's reading, the '33 Act contemplates that numerous types of communications are prospectuses, but only in specific contexts of the Act does a prospectus have its narrow meaning of a document containing the type of information required to be disclosed in a registration statement in connection with a public offering of securities.

3. Typical Critical Responses to *Gustafson*

The academic response to *Gustafson* was considerable[99] and nearly uniformly negative. The following is typical: "the [*Gustafson*] majority issued the most poorly-reasoned, blatantly results-driven securities opinion in recent memory."[100] Even Professor Elliot Weiss, who alone, prior to 1995 argued that liability under Section 12(2) was,

92. *Id.*

93. *Id.* at 600 (stating that "The House Conference Report, which explains the Act in its final form, describes § 12(2) in broad terms, and nowhere suggests that the provision is limited to public offerings" (citing H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess., 26-27 (1933))).

94. *Id.*

95. *Id.* at 601-02.

96. *See supra* note 55 and accompanying text.

97. *See Gustafson*, 513 U.S. at 597-98; *see also* Bainbridge, *supra* note 38, at 1236.

98. *Gustafson*, 513 U.S. at 598 (citing 15 U.S.C. § 77b).

99. *See supra* note 46 and accompanying text.

100. Bainbridge, *supra* note 38, at 1231-32.

in fact, limited to public offerings,[101] and therefore agreed with the *Gustafson* result, would not endorse the *Gustafson* opinion. As he said, "the route the Court took to get [to my position] strikes me, as it struck the four dissenting Justices, as highly problematic."[102] Academic discontent with the *Gustafson* opinion is not limited to the fact that on the face of Section 12(a)(2) nothing limits liability for omissions and misstatements to public offerings, but it is certainly the touchstone for dissatisfaction with this Supreme Court opinion.

One particular source of academic discontent with the *Gustafson* opinion is the Court's reliance on Section 10 for its narrow definition of what qualifies as a prospectus for the sake of consistency throughout the Act when Section 2—the definitional section—expressly defines a prospectus more broadly at the very outset of the '33 Act. There is ample support for this assessment on the face of the '33 Act, which appears to treat numerous documents as prospectuses, even those documents that need not contain registration statement information.[103] Despite Justice Kennedy's disclaimer that the majority did not "make the mistake of treating § 10 as a definitional section [but instead found] in § 10 guidance and instruction for giving the term a consistent meaning throughout the Act,"[104] it nonetheless appears as though the majority erroneously treated Section 10 as a definitional section. As Janet Kerr notes:

> [T]he Court conceded that Section 10 is not the definitional section for the term "prospectus," and vigorously denied it was using it in such a way. Yet regardless of this hollow protestation, the Court's reliance on this section and upon no other for its interpretation of the term "prospectus" was demonstrated.[105]

Another source of discontent with the *Gustafson* opinion among academic commentators—and one that Justice Ginsburg anticipated in her dissenting opinion[106]—is the notion that in order to interpret the '33 Act as a "coherent regulatory scheme," the majority had to give

101. *See supra* note 38 and accompanying text.

102. Elliot J. Weiss, *Securities Act Section 12(2) After* Gustafson v. Alloyd Co.: *What Questions Remain?*, 50 Bus. Law. 1209, 1210 (1995).

103. *See* 15 U.S.C. § 77b(a)(10) (2000). Moreover, some documents are exempt from Section 10, and others, which violate Section 5(b)(1) because of their failure to comply with Section 10, will be deemed a statutory prospectus.

104. *Gustafson*, 513 U.S. at 570.

105. Janet E. Kerr, Ralston *Redux: Determining Which Section 3 Offerings Are Public Under Section 12(2) After* Gustafson, 50 SMU L. Rev. 175, 183 (1996). *See* Bainbridge, *supra* note 38, at 1238-39 ("[D]espite Justice Kennedy's protestations to the contrary, he cannot easily escape being charged with having improperly substituted section 10 for section 2(10) as the statutory definition of a prospectus .... By limiting the definition of prospectus to the meaning he believes is contemplated by section 10, he effectively makes section 10 the working definition of a prospectus.").

106. *See Gustafson*, 513 U.S. at 597-98 (noting that "[o]ur decisions ... constantly recognize that 'a characterization fitting in certain contexts may be unsuitable in others'" (citations omitted)).

"operative words" in the Act "a consistent meaning throughout."[107] Because the '33 Act, on its face, contemplates different meanings for the word "prospectus,"[108] the *Gustafson* majority arguably should have followed a different canon of judicial construction such as that which Kerr helpfully suggests: "[W]hen a word within a statute has different meanings, and the meaning in one context is unsuitable in another, the statutory intent must be honored and the presumption of uniformity disregarded."[109]

Not only is the canon of judicial construction of applying a consistent meaning to operative words throughout a statute criticized by *Gustafson* commentators, so too is the majority's use of the doctrine of *noscitur a sociis*. Recall that Justice Kennedy appealed to *noscitur a sociis* in order to justify the majority's understanding that a "prospectus" in the '33 Act is a document related to a public offering. The majority used this doctrine to support its reading of the list of terms defining a prospectus in Section 2(10), concluding that because the list of terms all refer to documents of "wide dissemination,"[110] a prospectus is a widely disseminated selling document made in connection with a public offering. The majority claimed that Section 2(10) supported the notion that a seller of securities could not escape liability for a fraudulent or misleading prospectus by claiming that it was not a prospectus per se but something else, such as a notice or circular: "The list of terms in § 2(10) prevents a seller of stock from avoiding liability by calling a soliciting document something other than a prospectus."[111] However, Bainbridge notes that "it is hornbook law that *noscitur a sociis* is merely an *aid* to interpretation, not a hard and fast rule. It must not be used to thwart the legislature's intent."[112]

But the *Gustafson* majority appears to have indeed thwarted the legislature's intent by invoking *noscitur a sociis* to support a narrow reading of the term "prospectus" as a document related to a public offering instead of reading it broadly as any written selling device. The majority thereby "let the tail wag the dog."[113] Not only did the *Gustafson* Court use *noscitur a sociis* to produce an unintended result, it also contradicted long-settled securities case law holdings that even offerings involving few individuals or entities are public if the purchasers require the protection of the '33 Act because they cannot fend for themselves.[114] Indeed, as Kerr notes, concluding from Section

107. *Id.* at 569.

108. Compare the difference between the use of the term "prospectus" in 15 U.S.C. § 77b and § 77j.

109. Kerr, *supra* note 105, at 185.

110. *Gustafson*, 513 U.S. at 575.

111. *Id.* at 576.

112. Bainbridge, *supra* note 38, at 1250 (emphasis added).

113. *Id.*

114. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (holding that exemption from registration should turn on whether the class of persons affected

2(10) that a public communication involves wide dissemination "directly opposes long-standing authority that public offerings are not necessarily defined by the number of participants and, thus, neither by the number of documents disseminated .... The focus on documents and their dissemination is imperfect, if not wrong altogether."[115]

On a substantive rather than purely interpretive basis, there are at least two common criticisms of *Gustafson*. One relates to the complex interrelated mechanics of the '33 Act itself and Section 12(a)(2) liability, and the other involves the purportedly policy-driven basis for this decision.

First, Section 12(a)(2) liability expressly attaches to Section 3 offerings by referring to: "Any person who... offers or sells a security (whether or not exempted by the provisions of [Section 3])."[116] However, Section 3 offerings are statutorily exempt from the prospectus requirements of Section 10 in the '33 Act.[117] This means that Congress intended Section 12(a)(2) liability to encompass a broader meaning than the prospectus requirements of Section 10 alone entail. Further, such a meaning supports the general consensus that Congress intended 12(a)(2) liability to attach to a broader understanding of the term "prospectus."[118] The *Gustafson* majority circumnavigates this difficulty by stating that 12(a)(2) liability attaches if a Section 10 prospectus is required for the sale of the security, or would have been required but for a Section 3 exemption: "a document is not a prospectus within the meaning of that section [10] if, absent an exemption, it need not comply with § 10's requirements in the first place."[119] Yet simply by conceding that exemptions exist, the *Gustafson* Court implicitly conceded that a prospectus has a meaning that is not captured by Section 10.

Second, the *Gustafson* decision was, arguably, a policy-based result, the express aim of which was to decrease securities litigation by facilitating fewer lawsuits.[120] Indeed, the *Gustafson* majority appears to admit as much when Justice Kennedy wrote: "We are reluctant to conclude that § 12(2) creates vast additional liabilities that are quite independent of the new substantive obligations the Act imposes.... It is not plausible to infer that Congress created this extensive liability for every casual communication between buyer and seller in the

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needs the protection of the Act and "[a]n offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'").

115. Kerr, *supra* note 105, at 188-89.

116. 15 U.S.C. § 77*l*(a)(2) (2000).

117. *See id.* § 77c.

118. *See* Kerr, *supra* note 105, at 186.

119. *Gustafson*, 513 U.S. at 569.

120. Bainbridge, *supra* note 38, at 1254 ("Stated most crudely, the policy preference that seems to run through this opinion is the desire to have fewer securities lawsuits.").

secondary market."[121] The *Gustafson* opinion is not unique in this regard because in the past decade the Supreme Court has both narrowed and limited securities liability.[122]

Prior to *Gustafson*, there had, according to Bainbridge, been "a substantial upswing . . . in the number of cases brought under Section 12(2)."[123] This increase in Section 12 litigation may be attributable to Supreme Court cases restricting the applicability of 10b-5 liability under the 1934 Exchange Act,[124] and the Court may have attempted to frustrate such an upswing in securities lawsuits with *Gustafson*.[125] Indeed, Hillary Sale concedes that "[w]hen *Gustafson* is applied . . . it eliminates Aftermarket Shareholders, arguably those most likely to make a claim [making] it increasingly difficult for plaintiffs to obtain their remedies under . . . 12(a)(2)."[126]

The holding in *Gustafson* has likely forced potential plaintiff-shareholders who did not purchase in connection with a public offering to seek remedies for fraud through Section 11 of the '33 Act and Rule 10b-5 of the 1934 Exchange Act. However, Section 12(a)(2) has at least two distinct advantages over these other two remedies. First, the rescissionary damages available to plaintiffs under Section 12(a)(2) will often be greater than the actual damages available under either Section 11 or Rule 10b-5.[127] Second, while causation and reliance are required for an actionable Rule 10b-5 claim and affirmative defenses as to causation and reliance are available under a Section 11 claim, neither are involved in a Section 12(a)(2) action.[128]

If the policy goal that informed the majority opinion in *Gustafson* was to reduce securities lawsuits in general, and Section 12(a)(2) suits in particular, then it is questionable whether the decision was made with the integrity of the '33 Act in mind. Indeed, precisely because the '33 Act is an interrelated and highly technical statute, it is worth questioning whether courts should, as Bainbridge put it, "make hash

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121. *Gustafson*, 513 U.S. at 572, 578.

122. Bainbridge, *supra* note 38, at 1252-53. Bainbridge cites *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994) (overturning an implied private right of action under Rule 10b-5 for aiding and abetting in the commission of securities fraud), and *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) (adopting a short federal common law limitations period for private party claims under Rule 10b-5)).

123. Bainbridge, *supra* note 38, at 1234.

124. *See supra* note 122 and accompanying text.

125. *See also* Letsou, *supra* note 22, at 108.

126. Sale, *supra* note 15, at 483.

127. *Id.* at 440 ("Section 11(e) allows shareholders to recover damages amounting to the difference between the amount they paid for the security and the value of the security at the time of suit or sale not to exceed the offering price. In contrast, section 12(a)(2) shareholders can sue for rescission or, if they no longer hold a security, damages."). However, Section 12(a)(2)'s privity requirement may be a disadvantage to plaintiffs who would have no such burden under Section 11 or Rule 10b-5. *Id.*

128. *See* Bainbridge, *supra* note 38, at 1234.

out of" it,[129] as the *Gustafson* majority appears to have done, merely to advance a policy goal. Not only may *Gustafson* have resulted in making hash of the '33 Act, it may have actually resulted in more securities litigation.[130] Because the majority opinion problematized whether a particular offering of securities is private or public, such problems are left for the lower courts to determine at their discretion. Accordingly, Part II of this Note examines the approaches adopted by lower courts in the post-*Gustafson* era.

II. JUDICIAL RESPONSES TO *GUSTAFSON*

> [F]ederal regulation applies only to public offerings. For offerings by an issuer "not involving a public offering," the federal regime imposes neither mandatory disclosure nor agency review nor even explicit heightened liability.[131]

Part II first describes the challenge presented to lower courts that must determine the applicability of Section 12 liability post-*Gustafson*.[132] This part next describes the quasi-public argument, found in *Sloane Overseas Fund, Ltd. v. Sapiens International Corp.*[133] as one avenue for restoring the rescissionary protections of Section 12 to purchasers in ostensibly private offerings.[134] Finally, this part describes the continuing appeal of the quasi-public argument for the plaintiffs' securities bar.[135]

A. *The Courts' Challenge: Applying* Gustafson

While academic responses to the *Gustafson* decision were nearly uniformly negative,[136] the lower courts were nonetheless faced with the practical challenge of implementing this decision. Applying *Gustafson* was—and continues to be—challenging because this decision makes Section 12 liability turn on whether a given offering was private or public. *Gustafson* makes this question, in turn, depend on the existence of a Section 10-style "prospectus." As one district court opinion recently expressed:

> The Supreme Court's simple conclusion that Section 12(2) applies only to public offerings does not make the process of determining what is and is not a public offering any simpler.... The complex relationship of statutory and regulatory provisions that comprises

129. *Id.* at 1256.
130. *See infra* Part II.
131. Palmiter, *supra* note 37, at 11.
132. *See infra* notes 136-46 and accompanying text.
133. 941 F. Supp. 1369 (S.D.N.Y. 1996).
134. *See infra* notes 147-75 and accompanying text.
135. *See infra* notes 176-99 and accompanying text.
136. *See supra* Part I.C.3.

the federal securities laws insures that determining whether an offer is public, in the shadow of *Gustafson*, is more complex than ever.[137]

Prior to *Gustafson*, both courts and scholars typically concluded that buyers in a nonpublic offering could bring suit under section 12(a)(2); indeed, before *Gustafson*, many opinions where the disputed offering involved a private placement or an aftermarket purchaser nonetheless applied Section 12(a)(2) liability.[138] However, since *Gustafson*, the courts must first determine whether a given offering was public or private for purposes of Section 12(a)(2) applicability. Moreover, courts must ascertain what the following somewhat opaque language from the *Gustafson* opinion meant: "An examination of § 10 reveals that, whatever else 'prospectus' may mean, the term is confined to a document that, absent an overriding exemption, must include the 'information contained in the registration statement.'"[139] Did the *Gustafson* majority intend "overriding exemption" to include all terms of the '33 Act that exempt securities from the registration requirements of Section 5 or just some exemptions, and if so, which exemptions?

At minimum, it seems clear that the exemptions provided for in Section 3 of the '33 Act *are* subject to Section 12(a)(2) liability given the express statutory language of Section 12 itself: "Any person who . . . offers or sells a security (whether or not exempted by the provisions of [section 3]) . . . shall be liable."[140] Section 3 lists particular securities that are exempt from the registration requirements of Section 5.[141] The '33 Act also exempts particular securities transactions in Section 4(2),[142] but whether all Section 4(2) securities transactions are potentially subject to Section 12(a)(2) liability after *Gustafson* remains, to this day, an open question. Indeed, because the *Gustafson* majority never explicitly made reference to the exemptions listed in Section 4(2),[143] arguably, "overriding exemption" only includes the Section 3 exemptions.

However, because the *Gustafson* Court narrowly confined Section 12(a)(2) liability to public offerings and because the "private placements exempted by section 4(2) by definition do not involve a public offering, those transactions clearly appear to fall outside

137. Vannest v. Sage, Rutty & Co., 960 F. Supp. 651, 654 (W.D.N.Y. 1997).

138. Sale, *supra* note 15, at 439.

139. Gustafson v. Alloyd Co., 513 U.S. 561, 569 (1995) (citing 15 U.S.C. § 77d, 77e, 77b(11)).

140. 15 U.S.C. § 77*l* (2000).

141. 15 U.S.C. § 77c.

142. 15 U.S.C. § 77d.

143. The difference between Section 3 and Section 4 exemptions can be explained as follows: "The sole difference is that the latter are one-time exemptions, while most (but not all) of the former are permanent exemptions from registration." Bainbridge, *supra* note 38, at 1262.

section 12(2)'s remaining scope."[144] Since securities transactions made pursuant to Section 4(2) are statutorily exempt from registration under the '33 Act, these securities transactions must be wholly outside the realm of Section 12(a)(2) liability post-*Gustafson*. Janet Kerr observes that "Section 4(2) offerings are excluded from Section 12(2)'s scope for no other reason than by virtue of the Court's 'absent an overriding exemption' language in Gustafson, which expressly includes within Section 12(2) only those offerings that are exempted under Section 3, not Section 4."[145] If Kerr is correct, then *Gustafson* creates an anomalous result because issuers can avoid potential 12(a)(2) liability by structuring offerings of securities pursuant to Section 4(2) rather than Section 3.

What about offerings made in reliance on something other than Section 4(2)? It is not clear from the face of the *Gustafson* opinion whether ostensibly "private" offerings made on the basis of something other than Section 4(2) such as Regulation A, Regulation S, or Rule 144A can be subject to Section 12(a)(2) liability. By its silence, *Gustafson* left this question for the lower courts to determine on a case-by-case basis. Over the past eight years the lower courts have done so in a variety of ways, often reaching the same conclusion for different reasons, leading to a rather unstable panoply of decisions on various securities transactions.[146]

B. *Private Placement or Public Offering? The "Quasi-Public" Argument*

Just one year after *Gustafson*, a district court in New York concluded that notes sold pursuant to a Regulation S safe harbor, which were not subject to Section 5 registration and therefore were issued without a "prospectus" in the *Gustafson* sense,[147] nonetheless constituted a "public offering" for Section 12(a)(2) purposes. In *Sloane Overseas Fund, Ltd. v. Sapiens International Corp.*,[148] the plaintiff-purchasers bought $750,000 of private debt notes in reliance on an offering circular that allegedly contained numerous misrepresentations and omissions.[149] The offering circular in *Sloane* "stated that the Notes could be sold either (1) outside the United States pursuant to an exemption from registration under Regulation S or (2) to qualified institutional buyers in the United States pursuant to an exemption under Rule 144A."[150]

144. *Id.* at 1264-65.
145. Kerr, *supra* note 105, at 190.
146. *See infra* Part II.B.
147. *See supra* notes 54-62 and accompanying text; *see also* 17 C.F.R. § 230.901-905 (2003).
148. 941 F. Supp. 1369 (S.D.N.Y. 1996).
149. *Id.* at 1372.
150. *Id.* (citing Decl. of Michael Hammond sworn to on Feb. 21, 1996).

The plaintiffs in *Sloane* purchased under Regulation S,[151] enabling defendants to argue that because "Regulation S offerings do not require a § 10 prospectus to be filed . . . the offering is not subject to suit under § 12(2)."[152] However, the *Sloane* court specifically noted that the *Gustafson* decision said Section 12(a)(2) liability applied to offerings involving a Section 10 prospectus unless an overriding exemption applies.[153] The *Sloane* court expressly relied on the following language from *Gustafson*: "[T]he liability imposed by § 12(2) cannot attach unless there is an obligation to distribute the prospectus in the first place (or unless there is an exemption)."[154] The only exemptions that the *Sloane* court recognized were those found in Sections 3 and 4 of the '33 Act—not such SEC safe harbors as Rule 144A or Regulation S.[155]

In this way, the *Sloane* court found that an offering made pursuant to Regulation S, which is neither a Section 3 nor a Section 4 exemption, but an SEC safe harbor from registration, may be subject to Section 12(a)(2) liability "if it is a public offering."[156] Since there is no obligation to distribute a prospectus in a Regulation S offering because the registration requirements of Section 5 do not apply,[157] it appears on its face that the offering at issue in *Sloane* could not be subject to Section 12(a)(2) liability as a "public" offering at all under *Gustafson*. Indeed, even the plaintiff-purchasers in *Sloane* conceded there was no "prospectus" per se by virtue of their numerous references to the "offering circular."[158] Nonetheless, the *Sloane* court found that "the wide distribution of the Offering Circular made Sapiens' Note offering public"[159] and, consequently, the court denied defendants' motion to dismiss the Section 12(a)(2) claim under *Gustafson*.[160]

It would be wholly unclear how the *Sloane* court reached this

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151. There was some dispute in *Sloane* as to whether plaintiffs had notice of the restrictions their notes were subject to under Regulation S, as plaintiffs maintained they did not sign a participation certificate attesting to the purchaser's compliance with either 144A or Regulation S requirements. *See id.* at 1373.

152. *Id.* at 1376.

153. *Id.*

154. Gustafson v. Alloyd Co., 513 U.S. 561, 571 (1995).

155. *Sloane*, 941 F. Supp. at 1376.

156. *Id.*

157. "The Regulation [S] adopted today is based on a territorial approach to Section 5 of the Securities Act. . . . Regulation S relates solely to the applicability of the registration requirements of Section 5 of the Securities Act." *See* Cox, *supra* note 15, at 332.

158. Recall that the Section 2(10) definition of a prospectus includes the term "circular." *See* 15 U.S.C. § 77b(a)(10) (2000). But the *Gustafson* Court chose to use Section 10 (which defines the requisite content for a prospectus in a registered public offering) in order to establish what the term "prospectus" uniformly meant throughout the '33 Act.

159. *Sloane*, 941 F. Supp at 1376.

160. *Id.* at 1377.

conclusion save for an instructional footnote, which states that although Regulation S provides an "escape" from the registration requirements of the '33 Act, the Regulation S safe harbor is "intended for use in public offerings [because] [p]rivate transactions are already exempt under § 4(2) of the 1933 Act."[161] Moreover, the *Sloane* court noted that defendants neither contended that their offering was private, nor that purchasers of their debt notes had no need for the protection of the '33 Act in the *Ralston Purina* sense.[162]

Despite the *Sloane* court's conclusion, it is not clear from the *Gustafson* opinion that the only offerings that are private for Section 12 purposes are those exempt through Section 4(2) of the '33 Act. For example, *Gustafson* never addressed whether placements made pursuant to Rule 144A—a safe harbor that facilitates institutional markets for *un*registered placements—were private or public.[163] However, lower courts now routinely hold 144A placements not subject to Section 12(a)(2) liability under *Gustafson*[164] because 144A placements require no Section 10-style prospectus and are sold only to sophisticated QIBs.[165] Even the SEC has now stated that although potential 12(a)(2) liability routinely attached to private offerings such as Rule 144A placements before *Gustafson*, "the 'more likely reading' of *Gustafson* is that there is no '§ 12(a)(2) liability for the alleged misstatements in [a] Rule 144A offering memorandum.'"[166]

The *Gustafson* decision appears to strictly delimit "public offerings" for Section 12(a)(2) liability purposes to offerings involving a Section 10-type "prospectus" held out to the public for sale of securities by an issuer or controlling shareholder.[167] By holding that an offering circular that need not conform to Section 10 made a Regulation S offering "public" because it was "widely circulated," the *Sloane* court contradicted not only *Gustafson* but also long-standing securities

161. *Id.* at 1376 n.11. Therefore, the *Sloane* court appears to strictly delimit "private" offerings of securities to those made pursuant to section 4(2) of the '33 Act. *See supra* note 158 and accompanying text.

162. *See supra* note 41 and accompanying text. There was some dispute in *Sloane* as to whether plaintiff-purchasers signed a "certificate of purchase" attesting to their understanding of the Regulation S and/or Rule 144A requirements for purchase.

163. *See* 17 C.F.R. § 230.144(A) (2003).

164. *See, e.g., In re* Hayes Lemmerz Int'l, Inc. Equity Sec. Litig., 271 F. Supp. 2d 1007, 1026 (E.D. Mich. 2003) (determining that a 144A offering memorandum was not public for Section 12(a)(2) liability purposes); AIG Global Sec. Lending Corp. v. Banc of America Sec., 254 F. Supp. 2d 373, 389 (S.D.N.Y. 2003) (holding that securities sold pursuant to 144A were not subject to 12(a)(2) liability).

165. "QIBs" are Qualified Institutional Buyers with at least $100 million in assets and an audited net worth of at least $25 million. *See* Cox, *supra* note 15, at 494.

166. *In re Hayes*, 271 F. Supp. 2d at 1028 (citing *In re* Safety Kleen Corp. Bondholders Litig., C/A No. 3:00-1145-17 (D.S.C. Mar. 27, 2002) (where before deciding whether there could be section 12(a)(2) liability for a 144A offering, Judge Andersen solicited the views of the SEC and cited the reply from SEC General Counsel Becker, dated August 9, 2001 in the opinion)).

167. Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995).

precedent that the size of the offering does not determine whether the offering is public; rather, the sophistication of the offerees determines whether an offering is public.[168]

The *Sloane* court may have relied on the size of the particular offering when determining the applicability of Section 12(a)(2) because when discussing Section 2 of the '33 Act, the *Gustafson* majority stated that the listed terms under "prospectus" all refer to "documents of wide dissemination."[169] However, the *Gustafson* decision does not make the number of purchasers to whom a prospectus is held out critical for determining whether a given offering is public for Section 12(a)(2) purposes. Rather, *Gustafson* bases the determination as to whether an offering is public on the legally required content of the prospectus for a given offering.[170] Therefore, as Kerr noted, the *Sloane* court's rationale can, without overstating the case, be said to "fl[y] in the face of well-established authority that offerings involving only a few individuals (and/or entities) can still be public."[171]

Admittedly, it is not clear from the *Sloane* opinion whether the purchasers—a corporation organized under British Virgin Island law, a Delaware Limited Partnership, and an American citizen[172]—actually required the protection of the '33 Act or whether they were sophisticated purchasers. However, the *Sloane* court was somewhat disingenuous to say that defendants never claimed that the plaintiff-purchasers did not require the protection of the '33 Act because the defendant's offering included a participation certificate that itself "required a representation that the purchaser was in compliance with the exemption from registration requirements under either Rule 144A or Regulation S."[173] Such compliance would necessarily involve purchasers' attestations regarding both sophistication and eligibility to purchase. Moreover, it seems that, in fact, the plaintiffs in *Sloane* had knowledge of the participation certificate,[174] which itself typifies the contractual agreement involved in private securities offerings. The '33 Act presumes that sophisticated purchasers that can fend for

168. *See* SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

169. *Gustafson*, 513 U.S. at 575.

170. In fact, *Gustafson* relies on Section 10, not Section 2(10), for its understanding of what a prospectus is. *See supra* notes 54-67 and accompanying text.

171. Kerr, *supra* note 105, at 189.

172. *Sloane*, 941 F. Supp. at 1372.

173. *Id.* at 1373.

174. "The Declarations tend to show that plaintiffs must have had notice from the transfer agents and clearing agents that they were required to submit a participation certificate because the transfer agent had certified that the purchasers had delivered certificates confirming compliance with Regulation S." *Id.* There is no indication in the *Sloane* opinion that, for example, offers were made to non-QIBs to purchase pursuant to 144A or that directed selling efforts were made in the United States to entice purchasers under Regulation S—both of which would constitute obvious violations of their respective safe harbors.

themselves will privately replicate regulatory protections in contract.[175]

C. *The Lure of the Quasi-Public Argument*

Despite the shortcomings of the *Sloane* decision and its quasi-public argument—that an ostensibly "private" offering in the *Gustafson* sense, which does not require a prospectus, can nonetheless become public for Section 12 liability purposes through wide circulation of its offering circular—the plaintiffs successfully argued such a position in that case and thereby overcame the *Gustafson* policy of limiting securities liabilities.[176] No other decision has directly followed *Sloane* on point.[177] However, the *Sloane* rationale regarding wide circulation of private offering sales documents does surface in recent dicta and continues to offer plaintiff-shareholders an argument (albeit a frequently unsuccessful one[178]) with which to try to circumvent *Gustafson*.

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175. Palmiter, *supra* note 37, at 11.

176. *See supra* notes 158-62 and accompanying text.

177. The *Sloane* decision has been cited for a different proposition; namely, that a sufficient basis for pleading Section 20(a) control person liability under the '33 Act may be inferred by a defendant's status in a corporation such as an officer or director. *See, e.g.*, Rich v. Maidstone Fin. Inc., No. 00 CIV. 8100, 2001 WL 286757, at *10 (S.D.N.Y. Mar. 23, 2001) (rejecting the *Sloane* control person pleading standard); *In re* MicroStrategy, Inc. Sec. Litig., 115 F. Supp. 2d 620, 661 (E.D. Va. 2000) (using the same quasi-public standard as *Sloane* without actually citing to *Sloane* on point). The *Sloane* decision has also been cited for inquiry notice standards where a plaintiff is deemed to have constructive or inquiry notice when a misrepresentation or omission should reasonably have been discovered. *See, e.g.*, *In re* Dreyfus Aggressive Growth Mut. Fund Litig., No. 98 CIV. 4318, 2000 WL 10211, at *3 (S.D.N.Y. Jan. 6, 2000).

However, the *Sloane* decision has not been positively cited for the proposition that the wide circulation of an otherwise private placement offering circular renders the offering "public" for Section 12(a)(2) purposes.

178. Perhaps owing to both (1) the obvious conflict with *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), which definitively states that a public offering is one involving purchasers who are not able to fend for themselves, *not* simply one involving a large number of offerees or a sizeable offering; and (2) the contradiction of the rationale of *Sloane* with the express holding of *Gustafson* requiring a Section 10 style prospectus. *See, e.g.*, *In re* Hayes Lemmerz Int'l Inc. Equity Sec. Litig., 271 F. Supp. 2d 1007, 1028-29 (E.D. Mich. 2003) (rejecting Section 12(a)(2) liability under *Gustafson* despite plaintiffs' contention that a private placement memorandum was "public" owing to its wide dissemination); *In re* Sterling Foster & Co. Sec. Litig., 222 F. Supp. 2d 216, 244 (E.D.N.Y. 2002) (stating that "[c]ourts in this Circuit have applied the rationale of [*Gustafson*'s] *dicta* to reach what is now the predominant conclusion that purchasers in private or secondary market offerings are precluded from bringing actions under Section 12(a)(2)"); Laser Mortgage Mgmt., Inc. v. Asset Securitization Corp., No. 00 CIV. 8100, 2001 WL 1029407, at *9 (S.D.N.Y. Sept. 6, 2001) (dismissing Section 12(a)(2) claims where plaintiffs never alleged that the offerings were issued pursuant to a "prospectus" in the *Gustafson* sense); *In re* Musicmaker.com Sec. Litig., No. CV00-2018 CAS, 2001 WL 34062431, at *15 (C.D. Cal. June 4, 2001) (dismissing Section 12(a)(2) claims because plaintiffs did not claim that the offerings at issue were made pursuant to a "prospectus" under *Gustafson*); Emergent Cap. Inv. Mgmt., LLC v. Stonepath Group, Inc., 165 F. Supp. 2d 615, 622

For example, in *Lewis v. Fresne*,[179] although the court ultimately held that Section 12(a)(2) liability did not attach to a private bridge loan,[180] for which allegedly fraudulent information was both mailed and conveyed in a phone call, appellant argued before the Fifth Circuit that "the district court ignored the 'public' aspects of his transaction. [Appellant] cite[d] to a decision from the Southern District of New York that allowed a plaintiff to sue under § 12 even though his purchase of stock was made pursuant to a private placement memorandum."[181] Although the Fifth Circuit ultimately found appellant's "public aspect" argument unconvincing, the court did so not on the basis of *Gustafson* and the crucial role of a prospectus in establishing a public offering, but on the following grounds: "Two of the criteria for determining if a transaction is public are the size of the offering and the number of offerees."[182] Using these two criteria, the Fifth Circuit determined that because respondent's bridge loan involved only one purchaser—appellant—it was a private offering to which Section 12 liability did not attach.[183]

On the basis of the Fifth Circuit's reasoning in *Lewis*, it seems clear that had there been a large number of offerees and a sizeable offering at stake, the purportedly fraudulent mailing and telephone information would have reached a large number of offerees, as it did in *Sloane*, and this could have served as the basis for potential 12(a)(2) liability. Notwithstanding the *Lewis* court's disregard for long-standing Supreme Court precedent regarding how to determine whether a given offering is public or private,[184] the rationale of the *Sloane* court could have been used to obtain precisely such a result in *Lewis*.

(S.D.N.Y. 2001) (dismissing Section 12(a)(2) claims where plaintiffs failed to allege the offerings were issued pursuant to a "prospectus" under *Gustafson*); Walltree Ltd. v. ING Furman Selz LLC, 97 F. Supp. 2d 464, 470 (S.D.N.Y. 2000) (dismissing Section 12(a)(2) claims even though plaintiff argued that debt notes were sold in a 'public offering' because, inter alia, plaintiffs' complaint failed to allege the offering was issued pursuant to a "prospectus").

179. 252 F.3d 352 (5th Cir. 2001).

180. The bridge loan at issue was made in expectation that a private placement of the company's stock would close; however, the private placement failed, and the ice-cream company, "Mad Martha's," ultimately filed for bankruptcy. *Id.* at 355-56.

181. *Id.* at 357 (citing Fisk v. SuperAnnuities, Inc., 927 F. Supp. 718 (S.D.N.Y. 1996)). In *Fisk*, the court held that whether Section 12 liability applies to an offering that, on its face, comes within a Section 4(2) private placement exemption could not be determined in pre-trial pleadings because such a question involves a fact-intensive inquiry. *Fisk*, 927 F. Supp. at 730. Therefore, the *Fisk* court never reached the applicability of Section 12 liability to the placement at issue, in part because the issue in *Fisk* was whether the private placement was bona fide; this issue distinguishes *Fisk* from both *Sloane* and *Lewis*.

182. *Lewis*, 252 F.3d at 358 (citing Koehler v. Pulvers, 614 F. Supp. 829, 842 (S.D. Cal. 1985)). *Koehler* pre-dates *Gustafson* and is therefore of questionable relevance.

183. *Id.*

184. *See* SEC v. Ralston Purina Co., 346 U.S. 119 (1953); *see also supra* note 116 and accompanying text.

It does not appear likely, however, that courts will readily subscribe to a *Sloane* quasi-public argument. Indeed, the District Court for the Southern District of New York recently rejected a quasi-public argument by plaintiffs seeking recovery under Section 12(a)(2) in *AIG Global Securities Lending Corp. v. Banc of America Securities LLC.*[185] In *AIG Global*, the plaintiffs attempted to color private certificates purchased pursuant to Rule 144A as part of a "'public style' private offering[]."[186]

Perhaps with *Sloane* in mind,[187] the plaintiffs in *AIG Global* argued hypothetically that had defendants sold the same certificates overseas pursuant to Regulation S instead of Rule 144A, then such a sale should qualify as a public offering subject to Section 12(a)(2) liability. The *AIG Global* court did not mince words when dismissing plaintiffs' hypothetical quasi-public claim: "There is no legal or factual basis for calling the . . . offerings 'public style private offerings.'"[188] The *AIG Global* court, then underscored that the relevant inquiry under *Gustafson* is whether a given offering is a public offering or a private transaction[189] and certificates sold pursuant to Rule 144A are "private" for 12(a)(2) purposes.

It is not clear whether a different result would have obtained in *AIG Global* had defendants actually structured their placement under both Rule 144A and Regulation S given the precedent of *Sloane*. However, the *AIG Global* court's language arguably makes such a different outcome unlikely. After stating that the facts at issue in *AIG Global* did not involve a Regulation S placement, the court stated: "In any event, the Supreme Court made clear in *Gustafson* [what] the critical inquiry" is.[190] This language appears to rather strongly discount the quasi-public argument in any event.

Nevertheless, the quasi-public argument that first appeared in *Sloane* continues to appeal to the plaintiffs' securities bar, for which limiting Section 12(a)(2) liability to "public" offerings represents a lost avenue for recovery in fraudulent private securities placements. In the wake of recent corporate scandals involving WorldCom, Global Crossing, and Enron, the plaintiffs' securities bar is working hard to find ways around *Gustafson* and other Supreme Court decisions from

185. 254 F. Supp. 2d 373, 389 (S.D.N.Y. 2003).

186. *Id.* at 389.

187. It does not appear that plaintiffs in *AIG Global* cited to *Sloane* in their briefs—"[t]hese arguments . . . addressed by the plaintiffs, are not supported by any cases cited by the plaintiffs." *Id.* Perhaps this was a mere oversight by plaintiffs, given there was favorable precedent (*Sloane*) from the same district court, or perhaps this omission signals the weakness of *Sloane*'s quasi-public argument. In either event, *Sloane* was not exactly on point for *AIG Global* plaintiffs because their Regulation S argument appears to have been merely hypothetical, whereas in *Sloane* the notes were, in fact, placed pursuant to Regulation S.

188. *Id.*

189. *Id.*

190. *Id.*

the 1990s[191] that served to limit plaintiffs' right to recover in securities lawsuits.[192]

Indeed, the plaintiff-class in the Enron shareholder litigation is currently testing the boundaries of *Gustafson* in its pre-trial motions by bringing suit under Section 12(a)(2) for, inter alia, securities purchased pursuant to Rule 144A and Regulation S.[193] Plaintiffs in *Newby v. Enron Corp.* make explicit reference to *Sloane* in their Opposition Brief,[194] arguing that given the scope of the Regulation S and Rule 144A offerings at issue, these placements should qualify as public style offerings and therefore be subject to potential Section 12(a)(2) liability: "[D]ue to the widespread solicitation efforts made in connection with the Enron-related Foreign Debt Securities . . . the Court should sustain the § 12(a)(2) allegations as did the *Sloane* court."[195]

Although there is ample precedent to defeat plaintiffs' arguments in *Newby*,[196] plaintiff-shareholders today might find a more receptive judicial audience for arguments that restore plaintiffs' access to such investor protections of the '33 Act as Section 12(a)(2).[197] In the wake of successive corporate scandals over the past three years and damages wrought on investors—many of which involved pension funds—the political climate has arguably changed since the time of *Gustafson*, when the Supreme Court adhered to a policy of privileging fewer securities lawsuits at the expense of investor protection. The Supreme Court might even prove willing to revisit the issue today.

Perhaps there is no better indication that the political climate has changed than Congress's 2002 enactment of the Sarbanes-Oxley Act,[198] which seeks, among other things, to establish new disclosure requirements for public companies and provide the SEC with even greater enforcement powers. However, the failure of Sarbanes-Oxley to address the issue of rescissionary liability might indicate that the

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191. *See, e.g.*, Cent. Bank v. First Interstate Bank, 511 U.S. 164 (1994) (overturning an implied private right of action under Rule 10b-5 for aiding and abetting in the commission of securities fraud); Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (adopting a short federal common law limitations period for private party claims under Rule 10b-5).

192. *See supra* note 191.

193. Amended Complaint at ¶¶ 1016.2-1016.9, Newby v. Enron Corp., Civil Action No. H-01-3624 (S.D. Tex. May 14, 2003), *available at* http://www.enronfraud.com/pdf/MASTER1stAmd.pdf.

194. Lead Plaintiffs' Memorandum in Opposition to Motion to Dismiss at 41-44 , Newby v. Enron Corp., Civil Action No. H-01-3624 (S.D. Tex. May 14, 2003).

195. *Id.* at 42.

196. *See, e.g.*, *supra* note 180 and accompanying text.

197. The subject of 12(a)(2) applicability and quasi-private offerings in *Newby* might serve as an interesting basis of appeal to the Fifth Circuit, which recently, in dicta, demonstrated its sympathy to such arguments. *See* Lewis v. Fresne, 252 F.3d 352, 357-58 (5th Cir. 2001).

198. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

political climate has not changed enough to prompt Congress to revisit the judicially imposed limitations of 12(a)(2) liability in *Gustafson*. On one level, this omission is surprising[199] because many other liability issues pertaining to disclosure requirements were addressed in that legislation.[200] On another level, this omission from Sarbanes-Oxley is *not* surprising, given that even the Supreme Court appears to have misunderstood the mechanics of the '33 Act liability when deciding *Gustafson*. Perhaps Congress was insufficiently aware of how *Gustafson* limits rescissionary liability for plaintiff-shareholders to rectify it through legislation.

As shown in Part II, the quasi-public argument of *Sloane* is one approach adopted by the lower courts to reinstate Section 12(a)(2) liability to securities investors in ostensibly private offerings. However, the quasi-public argument of *Sloane* contradicts long-standing securities law that it is the sophistication of purchasers and not the size of the offering that determines whether an offering is public. Perhaps for this reason many lower courts have chosen not to follow the quasi-public rationale of *Sloane*. Accordingly, Part III of this Note suggests an alternative to the quasi-public argument of *Sloane*, a proposal that restores Section 12(a)(2) liability to a greater number of investors without contradicting long-standing securities case law by broadening our understanding of a prospectus while partially preserving the spirit of *Gustafson*.

III. THE QUASI-PUBLIC ARGUMENT IS NOT THE RIGHT WAY TO RESTORE 12(A)(2) INVESTOR PROTECTION TO THE '33 ACT

> U.S. securities regulation is mandatory. So goes the refrain. But is it still true? . . . The new reality is that firms, in burgeoning contexts, can raise investment capital without subjecting themselves to the Securities and Exchange Commission's . . . full blown disclosure requirements or the heightened antifraud standards of the Securities Act of 1933.[201]

Part III demonstrates why the quasi-public argument of *Sloane* is an inadequate solution for expanding Section 12(a)(2) liability post-

199. Even the SEC has indicated (as recently as August 2001) that it is at least "sympathetic to . . . plaintiffs' argument [that a placement safe-harbored from registration can be deemed "public"] on policy grounds." *In re* Hayes Lemmerz Int'l Inc. Equity Sec. Litig., 271 F. Supp. 2d 1007, 1028 (E.D. Mich. 2003) (citing letters exchanged between Judge Joseph Anderson and SEC General Counsel Becker in *In re* Safety-Kleen Corp. Bondholders Litig., C/A No. 3:00-1145-17 (D.S.C. Mar. 27, 2002) regarding plaintiffs' argument that bonds offered pursuant to Rule 144A should not be deemed "private" when followed by a registered exchange offer).

200. In particular, these requirements include mandatory CEO/CFO certification of annual and quarterly reports, the annual auditor assessment of management's report on accounting and financial controls, and enhanced disclosure of off-balance debt transactions. *See, e.g.*, 15 U.S.C. §§ 7241, 7262 (2003).

201. Palmiter, *supra* note 37, at 2-3.

Gustafson and proposes an alternative solution. First, this part explains why there is no need to continue to confuse the application of Section 12(a)(2) liability with public offerings the way both the *Gustafson* and *Sloane* decisions do.[202] Next, this part argues that *Ralston Purina* should remain authoritative when determining whether a given offering is public or private.[203] Finally, this part offers an alternative to the quasi-public argument, one that would enable private securities purchasers to recover rescissionary damages post-*Gustafson* by broadening our understanding of a prospectus—while preserving some of the spirit of *Gustafson*.[204]

A. *Why the Quasi-Public Argument Is an Inadequate Solution*

Assuming, arguendo, that expanding Section 12(a)(2) liability to its pre-*Gustafson* breadth is desirable,[205] without overturning *Gustafson* altogether,[206] the "quasi-public" argument of *Sloane* is appealing. However, this argument is not the correct rationale on which to base a restoration of Section 12(a)(2) investor protection for at least three reasons: (1) there is no need to continue to confuse the application of Section 12(a)(2) liability and "public" offerings; (2) the long-standing *Ralston Purina* standard should remain authoritative for what qualifies as a public offering; and (3) there is a simpler, more predictable way to ascertain whether Section 12(a)(2) should apply. This Note argues that a simpler way to offer investors greater protection through easier and more predictable[207] access to damages when they have suffered fraud in an investment is to make Section 12(a)(2) applicable to offerings where issuers hold fraudulent or misleading information out to the unsophisticated investing public.[208]

1. Confusing the Application of Section 12(a)(2) Liability with the Existence of a Public Offering of Securities

There is simply no need to continue to confuse the application of Section 12(a)(2) liability with public offerings as the *Gustafson* majority did. As already noted, before *Gustafson*, it was well settled that Section 12(a)(2) applied to both private and public offerings.[209]

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202. *See infra* notes 210-11 and accompanying text.
203. *See infra* notes 212-14 and accompanying text.
204. *See infra* notes 216-37 and accompanying text.
205. Because, for instance, rescissionary damages available to plaintiffs under Section 12 will often be greater than alternative remedies available to them under either Section 11 of the '33 Act or Rule 10b-5 under the '34 Act. *See supra* notes 129-30.
206. Given that overturning *Gustafson* altogether seems unlikely to happen.
207. A more predictable way to ascertain whether Section 12(a)(2) should apply from both the standpoint of purchasers and issuers.
208. *See infra* Part III.B.
209. Kerr, *supra* note 105, at 178.

The *Gustafson* majority performed a backward and illogical analysis by using Section 10 rather than Section 2(10) for a working definition of "prospectus" for Section 12 purposes.[210] The Court should rectify this problem by acknowledging that the definitional section of the '33 Act is at least relevant for Section 12 purposes, assuming that such purposes include wide-ranging consumer-shareholder protection.

2. *Ralston Purina* Should Remain Authoritative

At the same time, because a "complex relationship of statutory and regulatory provisions . . . comprise[] the federal securities laws,"[211] the *Ralston Purina* standard should remain authoritative for what qualifies as a public offering. As long-standing securities authority[212] governing whether a given offering qualifies as public, *Ralston Purina* has already been integrated into the complex relationship of statutory and regulatory provisions that constitute the securities laws. For example, Section 4(2) of the '33 Act, the exempt transactions section, is based on the concept of sophisticated purchasers who are able to "fend for themselves" and therefore do not require the registration protections of Section 5. This concept is borrowed directly from the *Ralston Purina* decision.[213] *Ralston Purina*, therefore, has become a critical basis for understanding the '33 Act, which has itself incorporated the teachings of *Ralston Purina* into its complex of interrelated provisions and regulations. It should remain the standard for defining the scope of public offerings.

Moreover, given the complex interrelationship of the securities laws and regulations, it is important to guard against gutting a foundational concept of the securities laws. This appears to be precisely what the *Sloane* court's "quasi-public" argument would accomplish—expanded investor protection at the expense of the logical coherence of the securities laws as a whole.

3. The Public-Private Distinction Should Not Control the Application of Section 12(a)(2) Liability

Finally, the idea that there remains a meaningful difference between public and private offerings of securities is arguably outdated. Therefore, the applicability of Section 12(a)(2) liability need not strictly be based on the public-private distinction in an offering of securities because exemptions from registration should not control whether the anti-fraud provisions of the '33 Act apply to a given

210. *See supra* notes 58-64 and accompanying text.
211. Vannest v. Sage, Rutty & Co., 960 F. Supp. 651, 654 (W.D.N.Y. 1997).
212. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).
213. Kerr, *supra* note 105, at 193-94.

offering of securities.[214] There is another option detailed in Part III.B. of this Note.

B. *An Alternative Solution:* Gustafson *and Securities Act Reform*

This part proposes a solution that would not make the applicability of Section 12(a)(2) liability dependent on the availability of exemptions from Section 5 registration requirements. Instead, this proposal suggests treating informal information that is already publicly available to investors[215] as part of a "prospectus"—broadly understood.[216] Finally, this part proposes that where such informal information is held out to the unsophisticated investing public and proves to be materially misleading, such information should be construed as a prospectus for purposes of Section 12(a)(2) liability.[217]

1. Media Revolution

At the level of disclosure, many differences between public offerings and private placements of securities under the Act are arguably out of date owing to easy access to an abundance of securities information through information technology and the globalization of the securities markets. Notwithstanding an increasing parity between private and public offerings at the level of information disclosure, exemptions from registration under the '33 Act remain strictly construed.[218] For example, the '33 Act prohibits such selling tactics as "general solicitations," making offers to non-QIBs, and directing selling efforts in the United States—for Regulation D, Rule 144A, and Regulation S respectively. These prohibitions exist to ensure that communications to the general public concerning securities in unregistered private transactions are restricted so that unqualified or ineligible purchasers do not attempt to purchase unregistered securities which they are ineligible to purchase.

However, through the rapid increase in information technology[219] and the globalization of securities markets, publications make readily available information on private placements; for example, even the *Wall Street Journal* does not always state whether a new issue of

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214. *See infra* Part III.B.
215. *See infra* Part III.B.1.
216. *See infra* Part III.B.2.
217. *See infra* Part III.B.3.
218. Thus the failure to establish an exemption gives purchasers a one-year "put" against the seller. *See Letter from ABA Committee on Federal Regulation of Securities to David B.H. Martin, Division of Corporation Finance, U.S. Securities and Exchange Commission, RE: Securities Act Reform August 22, 2001*, 1372 Practicing L. Inst./Corp. L. & Prac. Course Handbook 539, 544 (May 8-9, 2003) [hereinafter *Letter from ABA Committee*].
219. For example, the SEC introduced EDGAR—Electronic Data Gathering Analysis and Retrieval System. *See* Cox, *supra* note 15, at 9.

securities is public or private.[220] The American Bar Association Committee on Federal Regulation of Securities recognizes that investment decisions today are typically based on multiple sources of information, such as "sell-side and buy-side analysts, traditional and electronic news services, ratings agencies, salespersons, etc."[221] Such wide-ranging sources of information inform the investment decisions of even non-institutional investors, who purchase securities in public offerings and who are likely to be ineligible purchasers of restricted private securities. Indeed, today the American Bar Association Committee on Federal Regulation of Securities acknowledges that an average "investor's decision to buy a security is [likely] not . . . based on a prospectus except possibly in the case of IPOs [and] [e]ven in the case of IPOs . . . relatively few investors actually read the preliminary prospectus."[222]

Easy access to a wide range of investment information through multiple sources is not, per se, a harmful thing for the average investor. It stands to reason that investors' interests are best served when information about issuers is made public. The disclosure requirements of the '33 Act are themselves based on precisely this premise, and according to the American Bar Association Committee on Federal Regulation of Securities, "[i]ssuers consider themselves under an obligation to inform their security holders about their private transactions."[223] Issuers already risk losing exemptions from registration in private offerings when they purposefully target, or make information available to, investors who would not qualify to purchase in the private offerings. For example, in a Rule 144A placement, if such information is construed as an offer to a non-QIB, then the issuer risks losing the 144A safe harbor. The issuer could even be subjected to rescissionary liability under Section 12 if the offer is deemed public because of a lost 144A exemption and the information at issue resembles that contained in a Section 10 prospectus.

However, although investors' interests are usually well served by information about issuers being made public, this is not an unqualified good because the quality and objectivity of such information is not guaranteed. For instance, the information made available to the public by sell-side analysts[224] in recent corporate scandals such as

220. *Letter from ABA Committee*, *supra* note 218, at 544.

221. *Id.* at 554, 550.

222. *Id.*

223. Letter from ABA Committee on Federal Regulation of Securities to David B.H. Martin, Director Division of Corporation Finance, U.S. Securities and Exchange Commission, Re: Securities Act Reform 3 (July 27, 2001) (draft copy provided by Gerald S. Backman of Weil, Gotshal & Manges LLP) (on file with the Fordham Law Review).

224. Meaning a financial analyst working for a brokerage firm, whose stock recommendations are given to customers of the brokerage firm.

Enron and Global Crossing appears to have been unreliable, if not deliberately misleading.[225] One way to deal with unreliable investor information is to broaden our understanding of the information a prospectus contains to include "informal information"[226] held out to the public.[227] If such informal information held out to the public proves to be materially misleading, then the securities laws could subject issuers to rescissionary damages under Section 12(a)(2) for a misleading prospectus. If our understanding of a prospectus were expanded beyond the narrow meaning it received in *Gustafson* to include such things as analyst reports and term sheets, then rescissionary liability would be available for a broader number of offerings.

This proposal would not reverse *Gustafson* because it does not address the issue of aftermarket trading[228] to which Section 12(a)(2) liability applied pre-*Gustafson*. If the definition of a prospectus were broadened beyond the narrow confines provided by *Gustafson*, then any strong distinction between private and public offerings of securities would be diminished, at least in terms of the disclosure of information. This result would be in keeping with the way issuers already publish information about private and public securities information. A diminished distinction between private and public distributions of securities would allow rescissionary liability to attach to more offerings of securities without thereby undermining either the securities laws or our traditional understanding of the distinction between private and public offerings.

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225. *See, e.g.*, Charles Gasparino et al., *Merrill Defends Ties to Enron Before Congress: Yet a Veteran Analyst's Perspective on the Firms' Dealings Shows Pressure from Major Clients*, Wall St. J., July 31, 2002, at C1.

> In the late 1990s Mr. Lay, the Enron Corp. chief executive, was unhappy that Mr. Olson, then at Merrill Lynch & Co., had placed a 'neutral' rating on Enron stock, and wanted him to upgrade his call, the analyst says. Mr. Olson says in an interview that Mr. Lay told him he 'just didn't get it.' . . . Mr. Olson offers an insider's view of the conflicts involved in the Wall Street research process. Wall Street firms are under enormous pressure for caving into pressure from investment bankers to publish overly optimistic ratings on stocks in a bid to win banking business from their firms' clients.

Id.; *see also* Cheryl Winokur Munk et al., *Merrill Changes Stock-Research Rating Process*, Wall St. J., June 10, 2002, at C16 ("In April, Mr. Spitzer obtained a court order requiring Merrill to overhaul the way its analysts issue stock ratings on corporate clients. How brokerage firms rate stocks and their objectivity in rating them has been under heavy fire following the technology-stock bust and high-profile debacles, such as Enron Corp.").

226. Informal information is not required to be disclosed pursuant to Sections 10 and 5 of the '33 Act. *See* 15 U.S.C. § 77j, 77e (2000).

227. "Informal information held out to the public" means information that reaches unsophisticated purchasers in the *Ralston Purina* sense. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

228. For an excellent law and economics-based discussion of why Section 12(a)(2) liability should attach to aftermarket trading in spite of *Gustafson* and, indeed, how it can do so without expressly overruling *Gustafson*, see Letsou, *supra* note 22.

2. What Is in a "Prospectus"?

In addition to the traditional prospectus requirements—such as information describing the issuer's business, selected financial data, the type of securities offered, estimated proceeds from such securities and the use they will be put to, as well as risk factors associated with the offering[229]—a "prospectus" should be understood to include term sheets and other informal offering materials on which investors already rely, and which are held out to the public. A prospectus understood broadly in this way would conform to the Section 2(10) definition of a prospectus, including any "communication" offering or confirming the sale of a security.[230]

Indeed, such a broadly-understood prospectus is arguably consistent with the reasoning of the *Gustafson* majority, which struggled to reconcile the broad Section 2 definition of a prospectus with the narrow Section 10 account of a prospectus in a registered offering.[231] Although the *Gustafson* majority ultimately confined a prospectus for 12(a)(2) purposes to Section 10, it noted that this was *consistent with* the definition offered at Section 2 because that definition "refers to documents of wide dissemination."[232] This is the same language on which the *Sloane* court hung the quasi-public argument; however, for our purposes this language is more significant when coupled with the following: "[T]he term 'prospectus' . . . refer[s] to a document soliciting the public to acquire securities from the issuer . . . § 2(10) prevents a seller of stock from avoiding [12(a)(2)] liability by calling a soliciting document something other than a prospectus."[233]

This Note's proposal conforms to the *Gustafson* Court's conclusion that a prospectus relates to a public offering of securities by issuers and controlling shareholders.[234] Moreover, this proposal understands "public" to be defined not merely by the prospectus requirements of Section 10, but also by documents that solicit the public to acquire securities from an issuer. Such documents are captured by this Note's proposal to expand what a prospectus contains to include issuer-related information held out to the unsophisticated investing public. Because this proposal does not attempt to capture aftermarket sales of securities, it is confined to issuer-based offerings of securities and issuer-produced financial or investing information held out to the public. As the *Gustafson* opinion concedes, Section 2 was intended to prevent sellers of securities from avoiding rescissionary liability by

229. *See* Reicin et al., *supra* note 19, at 30.
230. *See* 15 U.S.C. § 77b(a)(10).
231. *See* Gustafson v. Alloyd Co., 513 U.S. 573-76 (1995).
232. *Id.* at 575.
233. *Id.* at 575-76.
234. *See id.* at 576.

calling what is really a soliciting document something other than a prospectus.[235] This proposal agrees and suggests a way to prevent such liability avoidance by sellers.

This proposal for a broader understanding of a "prospectus" would not replace the mandatory disclosure requirements for public offerings that already exist in Sections 5 and 10 of the '33 Act. However, this proposal will open some private securities placements—by virtue of the soliciting information they hold out to the unsophisticated investing public—to potential rescissionary liability under Section 12(a)(2). Note that under this proposal only issuers of private securities that open themselves up to Section 12(a)(2) liability by holding broadly understood prospectus information out to the public will be potentially liable for rescissionary damages.

This proposal differs from the pre-*Gustafson* situation insofar as it applies neither to aftermarket transactions, nor across the board to all private placements, whereas pre-*Gustafson*, Section 12(a)(2) liability applied to both. Meanwhile, it differs from the quasi-public argument of the *Sloane* court because it does not render a private securities placement public by virtue of the number of offerees, contrary to *Ralston Purina*. Instead, this proposal makes issuers of private securities placements potentially liable under Section 12(a)(2) if, in the course of such a placement, the issuer holds misleading or fraudulent information out to the unsophisticated investing public. This proposal is consistent with the *Ralston Purina* standard because it does not predicate rescissionary liability on the number of offerees. Although this proposal uses a standard that may lack the bright-line clarity of the *Sloane* court's formalistic size-of-offering solution, it offsets any resultant ambiguity with a substantive rule that preserves the difference between private and public offerings based on *Ralston Purina*, which has itself been integrated into our complex interrelated securities laws over the past fifty years.

3. A New Proposal for Broader Rescissionary Damages Under the '33 Act

If the understanding of a "prospectus" for purposes of rescissionary liability were broadened to include not just materials conforming to Section 10, but also information held out by issuers (even in private securities placements) to the public, some private offerings would be subject to potential 12(a)(2) liability. However, not all private placements will be affected in this way—only those where issuers hold information concerning private placements out to the investing public.

This proposal coheres well with the consumer protection purposes

235. *Id.*

of the '33 Act. Moreover, it should not deter good business, but encourage issuers to control both the type of information they release to the average unsophisticated investing public and the quality of that information. These are both within the issuers' control.[236] Therefore, this proposal has the benefit of predictability for the issuer, who can anticipate whether promulgating information to the unsophisticated investing public about a private placement will trigger potential Section 12(a)(2) liability. Additionally, this proposal does not restore issuers to the position they occupied before *Gustafson* when all public, private, and aftermarket securities transactions across the board were potentially liable under Section 12(a)(2). Indeed, this proposal only aims to reinstate rescissionary damages under a broadened understanding of a prospectus for those private placements where an issuer has held out misleading information concerning the placement to the unsophisticated investing public.

This proposal would trigger at least one potent antifraud provision of the '33 Act where fraudulent information concerning private securities placements is held out to the unsophisticated average investor. This way, perhaps, investors would have restored to them at least part of the consumer protection *Gustafson* stripped away from the '33 Act.

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236. For this reason it might not be possible to hold an issuer subject to potential Section 12(a)(2) liability for information presented by the financial media that the issuer did not release.

Notes & Observations