

COMMENT

GUSTAFSON v. ALLOYD: SETTING LIMITS ON A POTENTIALLY POWERFUL WEAPON

I. INTRODUCTION

At the height of the Great Depression, President Franklin D. Roosevelt enacted the Securities Act of 1933.¹ This Act was the first of the President's attempts to "regulate new issues of securities, securities trading, stock exchanges, and financial institutions"² to prevent the future sale of worthless securities.³ President Roosevelt emphasized the need for legislation that would require "every issue of new securities . . . [to] be accompanied by full publicity and information."⁴ The President hoped that this legislation would "give impetus to honest dealing in securities and thereby bring back public confidence" in the securities market.⁵

Section 12(2)⁶ of this Act, one of the principal antifraud provisions,

¹15 U.S.C. § 77(a)-77(mm) (1994) [hereinafter 1933 Act or Act].

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

³Robert A. Prentice, *Section 12(2): A Remedy For Wrongs in the Secondary Market?*, 55 ALB. L. REV. 97, 110 (1991). Out of "the \$50 billion in new securities distributed during the decade preceding the great stock market crash, fully one-half were worthless." *Id.* (citing *Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 80 (1933) (statement of Walter L. Miller), reprinted in 2 J.S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, item 20, at 2 (1973) [hereinafter LEGISLATIVE HISTORY]); see also Kevin N. Peter, Comment, *Section 12(2) of the Securities Act of 1933: Does It Apply to the Secondary Market? The Circuits Are Fighting*, 31 HOUS. L. REV. 1205, 1206 (1994) (stating that the Securities Act of 1933 was enacted to regulate the issuance of new securities in hopes that it would prevent the future sale of worthless securities).

⁴President's Message (Mar. 29, 1933), House Comm. on Interstate and Foreign Commerce, A Recommendation to Congress for Federal Supervision of Traffic in Investment Securities in Interstate Commerce, H.R. DOC. NO. 12, 73d Cong., 1st Sess. 1 (1933) [hereinafter President's Message], reprinted in 2 LEGISLATIVE HISTORY, *supra* note 3, item 15, at 1. President Roosevelt also noted that this proposed legislation would add to the rule of caveat emptor, "the further doctrine [of] 'let the seller also beware,' . . . [by placing] the burden of telling the whole truth on the seller." *Id.* See Peter, *supra* note 3, at 1206; Weiss, *supra* note 2, at 9.

⁵President's Message, *supra* note 4, reprinted in 2 LEGISLATIVE HISTORY, *supra* note 3, item 15, at 1.

⁶Section 12(2) provides in pertinent part:

Any person who —

....

has been the source of much litigation. Courts have debated whether this section applies solely to initial distributions⁷ or whether it may be expanded to apply to both initial distributions and secondary market transactions.⁸ Recently, the Supreme Court has resolved this issue in *Gustafson v. Alloyd*.⁹ The Court held that the term "prospectus" as it appears in section 12(2) of the 1933 Act refers to a document that describes a public offering of securities by an issuer or controlling shareholder and not to private agreements to sell securities.¹⁰ Therefore, section 12(2)'s remedy of rescission would not apply to a transaction involving a document describing the terms of a private agreement to sell securities.¹¹

Part II of this comment discusses the background of the 1933 Act in terms of its legislative history and major provisions, both of which have been deciding factors in many courts' decisions over the years. Part III focuses on the Supreme Court's interpretation of the definition of "prospectus" in *Gustafson*, and the limitations the Court placed on section

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

15 U.S.C. § 77(l)(2) (1994).

⁷Some courts have held that § 12(2) applies solely to initial distributions. See *First Union Discount Brokerage Serv. v. Milos*, 997 F.2d 835, 843-44 (11th Cir. 1993); *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.), cert. denied, 502 U.S. 820 (1991); *Cox v. Eichler*, 765 F. Supp. 601, 609 (N.D. Cal. 1990); *T. Rowe Price New Horizons Fund, Inc., v. Preletz*, 749 F. Supp. 705, 709 (D. Md. 1990); *Mix v. E.F. Hutton & Co.*, 720 F. Supp. 8, 12 (D.D.C. 1989); *SSH Co. v. Shearson Lehman Bros.*, 678 F. Supp. 1055, 1059 (S.D.N.Y. 1987).

⁸Some courts have held that § 12(2) applies to both initial distributions and secondary market transactions. See *Pacific Dunlop Holdings Inc. v. Allen & Co.*, 993 F.2d 578, 595 (7th Cir. 1993), cert. granted, 114 S. Ct. 907 (1994), and cert. dismissed, 114 S. Ct. 1146 (1994); *Farley v. Baird, Patrick & Co.*, 750 F. Supp. 1209, 1221 (S.D.N.Y. 1990); *Elysian Fed. Sav. Bank v. First Interregional Equity Corp.*, 713 F. Supp. 737, 750-51 (D.N.J. 1989); *Scotch v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 709 F. Supp. 95, 98 (M.D. Pa. 1988).

⁹*Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995).

¹⁰*Id.* at 1067.

¹¹See *supra* note 6.

12(2) of the 1933 Act. Part IV evaluates the Court's decision by focusing on the reactions of courts and commentators to the Supreme Court's adoption of the limited view of section 12(2) rather than the expansionist view. This part also focuses on the general effects this decision will have on the securities market, in particular, its effects on the private placement of securities.

II. BACKGROUND

The Supreme Court, in the past, has consistently looked to legislative history as a primary means of interpreting both the 1933 Act,¹² and the Securities Exchange Act of 1934.¹³ The Acts are similar in that both address three common areas of investor protection: distribution, trading markets, and holding of securities.¹⁴ In addition, both Acts contain remedial provisions for claims of fraud. Such provisions include: section 12(2) and section 17(a)¹⁵ under the 1933 Act, and section 10(b) under the 1934 Act.¹⁶ Sections 17(a) and 10(b) have been applied by the

¹²See, e.g., *Pinter v. Dahl*, 486 U.S. 622, 642-47 (1988) (examining the House Report in interpreting § 12 of the 1933 Act); *United States v. Naftalin*, 441 U.S. 768, 774-778 (1979) (examining the Senate Report to determine Congress' purpose in passing the 1933 Act); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201-06 (1976) (comparing the 1933 and 1934 Acts to find that scienter is required for liability under § 10(b)).

¹³15 U.S.C. §§ 78a-78jj (1994) [hereinafter 1934 Act].

¹⁴Robert N. Rapp, *The Proper Role of Securities Act Section 12(2) as an Aftermarket Remedy for Disclosure Violations*, 47 BUS. LAW. 711, 711 (1992).

¹⁵See 15 U.S.C. § 77q(a) (1994), which provides:

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

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

Id.

¹⁶See 15 U.S.C. § 78j(b) (1994), which provides in pertinent part:

It shall be unlawful for any person . . .

. . . .

(b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. Pursuant to its rule-making authority conferred in § 10(b), the Securities Exchange Commission (SEC) promulgated Rule 10b-5 as a means of enforcing § 10(b). Rule 10b-5

Supreme Court in cases involving initial distribution and secondary trading.¹⁷ As a result, it has been argued by courts and commentators that section 12(2) should similarly apply to both types of transactions.¹⁸ This issue has caused a split among the circuits over the past several decades.

A. *Securities Act of 1933*

The legislative history behind the 1933 Act is critical in understanding the Court's decision in *Gustafson*. Unfortunately, the history of section 12(2) is "sparse"¹⁹ and seemingly ambiguous at times.²⁰ Thus, both proponents and opponents of the expanded view of section 12(2) have found support by focusing on the intentions of the House and Senate in enacting this bill,²¹ as well as focusing on the language used throughout the Act.

provides in pertinent part:

It shall be unlawful for any person . . .

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1995).

¹⁷See *Naftalin*, 441 U.S. at 777-78 (finding § 17(a) to cover fraud at both initial distribution and in the secondary market); *Ernst & Ernst*, 425 U.S. at 205-06 (finding that § 10(b) is a catchall provision applicable to all persons who act in bad faith).

¹⁸See *Pacific Dunlop*, 993 F.2d at 593-95 (contending that since the Supreme Court in *Naftalin* had extended the scope of §§ 17 and 10(b) to include secondary transactions, then the scope of § 12(2) should be extended as well); Adam D. Hirsh, Comment, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. CHI. L. REV. 955, 961-75 (1990); Louis Loss, Commentary, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 914-17 (1992); Peter, *supra* note 3, at 1230-35.

¹⁹Therese H. Maynard, *Section 12(2)'s Availability to the Defrauded Secondary Market Buyer*, 7 INSIGHTS 21, 24 n.27 (Aug. 1993) (citing *Pacific Dunlop*, 993 F.2d at 591 n.17 (quoting *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986))).

²⁰See, e.g., Peter, *supra* note 3, at 1224-27 (examining the legislative history of §§ 11 and 12 of 1933 Act).

²¹*Id.* at 1222.

1. The Legislative History of Section 12(2)

The legislative history of the 1933 Act does not provide clear answers to questions of congressional intent.²² The reports from both houses conflict on the intended depth of the scope.²³ The House Report expressly states that the Act was intended to affect "only new offerings of securities,"²⁴ whereas the later-released Senate Report and Conference Report, a compromise of both versions,²⁵ do not expressly limit the scope. Thus, the Act lends itself to two separate readings. Courts rely on the House Report as support for restricting the scope of the Act solely to new offerings,²⁶ whereas the Senate Report is used to expand the scope of the Act to both initial and secondary markets.²⁷

a. *The House Report*

Commentators have noted that the House Report to the 1933 Act contains "the only clear evidence of congressional intent."²⁸ The report

²²See generally Peter, *supra* note 3, at 1222-29; Rapp, *supra* note 14, at 719-22 (taking note of this conflicting legislative intent); see also Prentice, *supra* note 3, at 108 (stating that "[g]iven section 12(2)'s unfortunate phrasing, its obscure lineage, its dearth of legislative history, and its lack of attention from the Supreme Court," it should not be a surprise that it is difficult to reach conclusive answers concerning § 12(2) issues).

²³See, e.g., Rapp, *supra* note 14, at 720.

²⁴President's Message, *supra* note 4, at 5, reprinted in 2 LEGISLATIVE HISTORY, *supra* note 3, item 15, at 5.

²⁵Peter, *supra* note 3, at 1228.

²⁶Rapp, *supra* note 14, at 720. The drafters of the 1933 Act and Congress were motivated by economic tragedies stemming from the issuance of worthless or fraudulent securities. *Id.* While many courts have correctly focused on this congressional intent, they have, however, "simply fail[ed] to identify the depth of protection actually involved." *Id.* See also *infra* note 28 (providing the exact language of the House version of the Act).

²⁷Rapp, *supra* note 14, at 719; see also *infra* note 34 (providing the exact language of the Senate version of the Act).

²⁸Peter, *supra* note 3, at 1224. The final version of § 12(2) as proposed by the House Interstate and Foreign Commerce Committee stated that:

[a]ny person who . . . sells a security (whether or not exempted by section 3), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him.

H.R. 5480, 73d Cong., 1st Sess. (1933), as passed by the House on May 5, 1933, reprinted in 3 LEGISLATIVE HISTORY, *supra* note 3, item 26, at 25.

accompanying the House version of section 12(2) commented that the Act "affects only new offerings of securities."²⁹ Specifically, in its discussion of sections 11³⁰ and 12, the House Report emphasized that liabilities attach only when there has been an untrue statement or an omission of a material fact "in the registration statement or the prospectus — the basic information by which the public is solicited."³¹ Based solely on this report, the legislative history of the 1933 Act has been interpreted as focusing on offerings requiring a registration statement, and hence, initial distributions because they typically require the filing of a registration statement.³² However, when the House Report is considered in light of the Senate Report, there is conflicting evidence regarding its intended scope.³³

b. *The Senate Report*

Contrary to the House Report, the Senate Report did not expressly limit the scope of the Act to initial offerings.³⁴ The Senate Report

²⁹H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933) [hereinafter House Report], *reprinted in 2 LEGISLATIVE HISTORY*, *supra* note 3, item 18, at 5. The Act may affect the ordinary redistribution of securities only if "such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering." *Id.* The report also stated that "the bill does not affect transactions beyond the need of public protection . . ." *Id.* at 7.

³⁰15 U.S.C. § 77k (1994). This section of the Act is similar to § 12(2) in that it creates civil liability; however, it applies for false information in registration statements. *Pacific Dunlop*, 993 F.2d at 585 (referring to § 12(2), 15 U.S.C. § 77l (1994)). Section 12(2), on the other hand, also provides for false information in a "prospectus or oral communication." *Id.*

³¹House Report, *supra* note 29, at 9, *reprinted in 2 LEGISLATIVE HISTORY*, *supra* note 3, item 18, at 9; *see also* Rapp, *supra* note 14, at 719 (noting the same emphasis on §§ 11 and 12 in the House Report).

³²*Pacific Dunlop*, 993 F.2d at 590.

³³*See* Peter, *supra* note 3, at 1223-25. Legislative history shows that the House and Senate may have had different ideas about what transactions would be within the scope of the 1933 Act. *Id.*

³⁴*Id.* at 1226-27 n.152. The final Senate version of § 12(2), proposed by the Senate Banking and Currency Committee, stated that:

[e]very person acquiring any security by reason of any false or deceptive representation made in the course of or in connection with a sale or an offer for sale or distribution of such securities shall have the right to recover any and all damages suffered by reason of such acquisition of such securities from the person or persons signing, issuing, using, or causing, directly or indirectly, such false or deceptive representation, jointly or severally.

H.R. 5480, 73d Cong., 1st Sess. (1933), *reprinted in 3 LEGISLATIVE HISTORY*, *supra* note 3, item 27, at 60 (emphasis added).

utilized general words like "any security" and "sale . . . or distribution," thus it did not seem to limit the scope of this remedial provision to initial distributions.³⁵ Rather, by emphasizing that it was "imperative" for Congress to "adopt measures looking to the protection of the purchasers of securities," the Senate Report seemed to have a much broader purpose than that indicated in the House Report.³⁶ In addition to not expressly limiting its scope, the Senate rarely referenced the word "prospectus" in its version of the Act³⁷ and not at all in its version of section 12(2).³⁸ Thus, on its face, the Senate version of the 1933 Act may be read to include secondary market transactions.³⁹

In addition to the Senate Report, remarks were made by senators following the passage of the Act, clearly supporting a broad view of section 12(2). Eight years later, during Senate debates over proposed amendments to the 1933 Act, Senator Kean compared the 1933 Act to the British Companies Act of 1929, concluding that the 1933 Act covered "original *and subsequent* transactions in securities."⁴⁰ In the same debate, Senator Thomas reiterated the comments made by Senator Kean regarding liability by stating that "[a] purchaser of securities may [sue] the person named even though he purchased in the market *after the securities had been sold* several times."⁴¹ In 1941, at a congressional hearing, the SEC Commissioner gave testimony which further supported a broad interpretation of the scope of the Act.⁴² Commissioner Purcell testified that "[s]ection 12(2) . . . applies to statements made in the formal prospectus required by the Securities Act. It applies to statements by

³⁵Rapp, *supra* note 14, at 721. The Senate Report discusses the remedial provisions of the Act "in the most general terms." *Id.*

³⁶*Id.* at 720. "The need to protect purchasers of securities from information failures is not limited to the particular circumstances of a new offering of securities." *Id.* at 721.

³⁷*Pacific Dunlop*, 993 F.2d at 590; Peter, *supra* note 3, at 1225.

³⁸*Pacific Dunlop*, 993 F.2d at 590-91.

³⁹*See id.* at 591 (holding that "the differing texts [in the two versions of the Act] display a distinctive treatment on their face"); Peter, *supra* note 3, at 1225-26 (stating that from the "clearly 'differing texts' it is argued that the Senate's intent to include secondary market transactions within the coverage of section 12 is obvious from the face of the statute").

⁴⁰Rapp, *supra* note 14, at 724 (citing 78 CONG. REC. 8674 (1934) (emphasis added)). In comparison, the British Act dealt mostly "with the original offer of securities to the public and not to subsequent transactions." *Id.* With respect to liability, Senator Kean also added that the 1933 Act provides for a right of recovery not only to original purchasers, "but to all others who may subsequently purchase such securities." *Id.* Conversely, the right of recovery under the British Act is limited to original purchasers. *Id.*

⁴¹*Id.* (citing 78 CONG. REC. 8674 (1934) (emphasis added)). Senator Thomas noted this aspect of § 12(2), even though he was arguing that the amendments to the Act should limit this broad scope. *Id.* at 727 n.60.

⁴²Peter, *supra* note 3, at 1235.

individual private owners in disposing of their securities."⁴³ Thus, it appears Commissioner Purcell's testimony supports interpreting the Act more generally as was set forth in the Senate Report.⁴⁴ The Conference Report accompanying the 1933 Act attempted to explain the inconsistencies between the views of the two Houses.

c. *The Conference Report*

A joint House-Senate conference produced what eventually became the final version of the 1933 Act.⁴⁵ The House managers attached the Conference Report to the final version of the bill.⁴⁶ The report discussed the differences and the resolution between the previous versions of the bill.⁴⁷ The Conference Committee combined the two versions of section 12(2); the types of securities described in section 3(a)(2) of the 1933 Act were exempted from section 12(2) and the types of omissions leading to liability were clarified.⁴⁸

The Conference Report failed to remedy the ambiguity. It has been interpreted on the one hand as reflecting an intent to limit the scope of the provision⁴⁹ and, on the other hand, as applying to all transactions.⁵⁰

⁴³*Id.* at 1235 (quoting SEC Commissioner Purcell from the *Proposed Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934: Hearings on H.R. 4344, H.R. 5065, and H.R. 5832 Before the Comm. on Interstate and Foreign Commerce, 77th Cong., 1st Sess., pt. 1, at 806-07 (1941)*). Peter notes that Professor Prentice was the first commentator to observe that Commissioner Purcell's testimony has gone "unnoticed by modern courts." *Id.* at 1235 n.224 (quoting Prentice, *supra* note 3, at 136). Commissioner Purcell continued by stating that § 12(2) also applied to "brokers who sell securities on behalf of their customers. It may also apply to brokers' conversations with their customers which result in the customers giving them orders to buy." *Id.*

⁴⁴Peter, *supra* note 3, at 1235; Prentice, *supra* note 3, at 137.

⁴⁵Peter, *supra* note 3, at 1227.

⁴⁶*Pacific Dunlop*, 993 F.2d at 585.

⁴⁷*Id.*

⁴⁸15 U.S.C. § 77c(2) (1994). Section 3(a)(2) relates to "securities issued or guaranteed by the United States or any State, Territory, or the District of Columbia, or by a public instrumentality, or by a Federal Reserve bank or national bank, or by a supervised State bank." 77 CONG. REC. 3891-3903 (1933), reprinted in 1 LEGISLATIVE HISTORY, *supra* note 3, item 13, at 3902. See also *Pacific Dunlop*, 993 F.2d at 591; Peter, *supra* note 3, at 1228.

⁴⁹Peter, *supra* note 3, at 1228. If securities listed in § 3 are typically sold in initial distributions then the committee's approach could reflect its intent to limit the scope of § 12(2). *Id.* This is a strong argument since most § 3 securities are likely to be sold in public offerings. *Id.* at 1229. See *supra* note 48 (describing the securities included in § 3(a)(2)).

⁵⁰Peter, *supra* note 3, at 1228. If securities listed in § 3 may be sold via the secondary market or in private offerings, then the approach by the committee may indicate its intention to expand the scope of § 12(2). *Id.* In addition, courts have argued that the Conference Report follows the Senate's interpretation of the Act, in that it applies to any sale or distribution of

2. Section 12(2) vs. Other Remedial Provisions

The 1933 and 1934 Acts are similar in that both create express remedies for investors. Investors may rely on sections 12(2) or 17(a) pursuant to the 1933 Act,⁵¹ or on section 10(b) pursuant to the 1934 Act.⁵² Section 12(2) is unique, however, in that it is the only express remedy within either Act which allows purchasers the right of rescission (or its equivalent in damages) against a seller for misinformation.⁵³ Thus, section 12(2) "is a powerful weapon available to purchasers of securities for material misstatements or omissions negligently made by sellers."⁵⁴

Sections 12(2) and 17(a), the two antifraud provisions of the 1933 Act,⁵⁵ contain similar language and have been referred to as "criminal and civil analogues."⁵⁶ The primary difference between the two antifraud provisions is in their scope. Section 12(2), the Act's civil fraud provision, allows a purchaser to obtain rescission in a case involving a "prospectus or oral communication,"⁵⁷ whereas section 17(a), the criminal fraud provision, applies to "any securities" which are offered or sold either "directly or indirectly."⁵⁸ Additionally, section 17(a) does not create a private right of action, whereas section 12(2) creates an express private right of action based on misstatements or omissions.⁵⁹ Because section 17(a) can arguably apply to securities sold either through initial distribution or secondary trading, the Supreme Court has labelled it a "major departure" from the general scope of the 1933 Act.⁶⁰

a security. *Id.*; see also *Pacific Dunlop*, 993 F.2d at 592 (recognizing that the committee did not expressly limit the scope of § 12(2)).

⁵¹Rapp, *supra* note 14, at 711-12.

⁵²*Id.*

⁵³Rapp, *supra* note 14, at 712.

⁵⁴Hirsh, *supra* note 18, at 984.

⁵⁵See Loss, *supra* note 18, at 915. Professor Loss states that the scope of liability under §§ 12(2) and 17(a) is "substantially the same." *Id.*

⁵⁶*Ballay*, 925 F.2d at 693; see also Loss, *supra* note 18, at 915 (stating that § 12(2) is the "private law analogue of section 17(a), a public law provision whose violation entails injunctive, administrative, and criminal consequences"); Peter, *supra* note 3, at 1212.

⁵⁷*Pacific Dunlop*, 993 F.2d at 585.

⁵⁸*Id.* (emphasis added).

⁵⁹See Richard A. Booth, *The Scope of Section 12(2) After Gustafson*, 9 INSIGHTS 8, 12 (July 1995); Paul Vizcarrondo, Jr. & Andrew Houston, *Liability Under Sections 11, 12, 15 and 17 of the Securities Act of 1933 and Sections 10, 18, and 20 of the Securities Exchange Act of 1934*, in UNDERSTANDING THE SECURITIES LAWS 1995, at 527, 544-45 (Jeffrey S. Hoffman & Larry D. Soderquist co-chairs, 1995).

⁶⁰*Naftalin*, 441 U.S. at 778. The Court in *Naftalin* elaborated on this concept by stating that contrary to the rest of the Act, which applies solely to initial distributions, § 17(a) was "intended to cover any fraudulent scheme in an offer or sale of securities, whether in the

Sections 12(2) and 10(b) of the 1934 Act are analogous as the primary, private antifraud provisions of the federal securities laws.⁶¹ Section 10(b), and its implementing provision Rule 10b-5, are "'catchall' provisions that provide penalties for parties who engage in fraudulent schemes."⁶² Where section 12(2) seeks to compensate and deter through rescission or its equivalent in damages,⁶³ the primary purpose of section 10(b) and Rule 10b-5 is deterrence, not compensation.⁶⁴ Furthermore, unlike section 12(2), section 10(b) and Rule 10b-5 do not create express private remedies; rather, private remedies are implied by the courts.⁶⁵

Following the Supreme Court's creation of a heightened burden of proof for causes of action under section 10(b) of the 1934 Act and SEC Rule 10b-5, many plaintiffs were forced to rely upon section 12(2) of the 1933 Act.⁶⁶ Prior to the heightened burden of proof, section 12(2) of the 1933 Act was largely unnoticed by the courts.⁶⁷ A rise in the number of

course of an initial distribution or in the course of ordinary market trading." *Id.*

⁶¹Catherine Zucal, Comment, *Does Section 12(2) of the Securities Act of 1933 Apply to Secondary Trading?*: Ballay v. Legg Mason Wood Walker, Inc., 65 ST. JOHN'S L. REV. 1179, 1188 (1991). Both sections allow a purchaser to bring a private action for damages resulting from fraudulent representation or omission in the sale of securities. *Id.* at 1188-89.

⁶²Hirsh, *supra* note 18, at 972. The Court in *Ernst & Ernst* also noted the "catchall function" of § 10(b). *Ernst & Ernst*, 425 U.S. at 204.

⁶³Hirsh, *supra* note 18, at 966.

⁶⁴*Id.* at 972. Section 10(b) and Rule 10b-5 were "meant to deter insiders from manipulating the market," whereas "§ 12(2) was intended to provide purchasers a remedy against sellers for making material misstatements or omissions." *Id.* at 974.

⁶⁵*Id.* at 973. The Supreme Court has recognized in a footnote that "a private right of action is implied in § 10(b)." *Id.* at 973 n.114 (referring to the Court's holding in *Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971)); see Loss, *supra* note 18, at 916 (referring to Rule 10b-5 as "the primary vehicle for private litigation under the federal securities laws"); Rapp, *supra* note 14, at 719 (stating that the implied private remedy under the two provisions "has been applied in virtually every transactional setting, and generally, without regard to the existence of any express or contextually prescribed remedy in either statute"); Steven Thel, Essay, *Section 12(2) of the Securities Act: Does Old Legislation Matter?*, 63 FORDHAM L. REV. 1183, 1189 (1995) (noting that neither § 10(b) nor Rule 10b-5 provide for a private right of action; rather, courts have created the private right of action).

⁶⁶Rapp, *supra* note 14, at 712 (citing *Ernst & Ernst*, 425 U.S. at 215). In *Ernst & Ernst*, the Court held that plaintiffs must prove scienter in order to recover pursuant to § 10(b) of the 1934 Act, or SEC Rule 10b-5. *Ernst & Ernst*, 425 U.S. at 193; see also *Pacific Dunlop*, 993 F.2d at 594 (stating that one reason the Supreme Court restricted the scope of § 10(b) and SEC Rule 10b-5 was the existence of express civil fraud remedies available under the 1933 Act); Loss, *supra* note 18, at 910 (asserting that the severity of the heightened "standard caused the securities plaintiffs' bar to turn its affections from rule 10b-5 to section 12(2)").

⁶⁷Rapp, *supra* note 14, at 712; see also Loss, *supra* note 18, at 910-11 (maintaining that "the ball game has shifted from rule 10b-5 to section 12(2)," one of the SEC's "best kept secrets").

section 12(2) claims has led many courts to question the scope of section 12(2) as a remedial provision.⁶⁸ A split of authority had resulted among these courts as to whether section 12(2) applies to both primary and secondary market trading.⁶⁹

B. *Conflicting Opinions of the Circuit Courts*

The conflict between the circuit courts began in 1976, with the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*.⁷⁰ The Court held that a plaintiff must prove scienter to recover pursuant to section 10(b) of the 1934 Act or SEC Rule 10b-5.⁷¹ Following *Ernst & Ernst*, in *United States v. Naftalin*, the Court extended section 17(a) of the 1933 Act to apply to both initial and secondary market transactions.⁷² In *Pinter v. Dahl*,⁷³ the Court determined the meaning of "offeror" and "seller" in section 12(1) of the Act⁷⁴ and applied those meanings to section 12(2).⁷⁵ Following these cases, there was still one major question left unanswered regarding section 12(2) of the 1933 Act: whether section 12(2) was "limited to persons who have bought in the particular distribution to

⁶⁸See Thel, *supra* note 65, at 1189. "The debate over section 12(2) would not have arisen if the Supreme Court had not made it so difficult for plaintiffs to recover for violations of rule 10b-5." *Id.* (referencing the Court's decision in *Ernst & Ernst*).

⁶⁹Rapp, *supra* note 14, at 713; *see supra* notes 7 & 8 for courts and commentators supporting each view. *See also* Hirsh, *supra* note 18, at 957 (stating that "[t]he current case law on this subject is, in a word, muddled").

⁷⁰425 U.S. 185 (1976); *see also* Loss, *supra* note 18, at 909 (contending that "[t]he story started fifteen years ago with *Ernst & Ernst v. Hochfelder*").

⁷¹*Ernst & Ernst*, 425 U.S. at 212. The history of Rule 10b-5 makes it "clear that when the Commission adopted the Rule it was intended to apply only to activities that involved scienter." *Id.* The scope of the rule cannot exceed the power of the Commission as granted by Congress in § 10(b) of the 1934 Act. *Id.* at 213-14.

⁷²441 U.S. 768, 778 (1979).

⁷³486 U.S. 622 (1988).

⁷⁴15 U.S.C. § 77k(1) (1994). This section of the 1933 Act provides a civil remedy against all persons who sell securities in violation of the registration and prospectus delivery requirements as listed in § 5 of the Act. Rapp, *supra* note 14, at 718.

⁷⁵*Pinter*, 486 U.S. at 642 n.20. In *Pinter*, the Court determined that the statutory definition of "seller" as referred to in § 12(1) "includes brokers and others who solicit offers to purchase securities," and that this interpretation of the term "furthers the purposes of the Securities Act." *Id.* at 646. *See also* Hirsh, *supra* note 18, at 962 (commenting that since most secondary sales go through a broker or dealer, *Pinter* derives its importance by implying that aftermarket transactions are not always excluded from the scope of the 1933 Act). Although the Court declined to "take a position on" the meaning of "seller" in § 12(2), it agreed that the term is generally given the same meaning as in § 12(1). *Id.* (citing *Pinter*, 486 U.S. at 642 n.20).

which a statutory prospectus was directed . . . or does it apply also to ordinary trading?"⁷⁶

1. The Third Circuit in *Ballay*

The Third Circuit was the first to address the question of whether section 12(2) applied to secondary market transactions.⁷⁷ In *Ballay v. Legg Mason Wood Walker, Inc.*,⁷⁸ the plaintiffs⁷⁹ sued their brokerage firm, Legg Mason Wood Walker, Inc. (Legg Mason), for alleged oral misrepresentations regarding the book value of securities purchased in Wickes Company, Inc. (Wickes).⁸⁰ The investors relied upon section 12(2) of the 1933 Act, and section 10(b) of the 1934 Act, in stating their claim.⁸¹ The district court denied the investors' section 10(b) claim; however, it found in favor of the investors on the section 12(2) claim.⁸² The court extended the liability under section 12(2) based on its conclusion that neither the plain language of the section, nor its broad remedial purposes, restricted its application to initial distributions.⁸³ The court also relied on *United States v. Naftalin*'s extension of section 17(a) of the 1933 Act to both initial distributions and secondary market transactions.⁸⁴

On appeal, the Third Circuit disagreed with the district court's holding that liability under section 12(2) should be extended to apply to secondary transactions.⁸⁵ The first part of the court's analysis focused on the meaning of the words "by means of a prospectus or oral communication" contained in section 12(2) of the Act.⁸⁶ In reading the

⁷⁶Loss, *supra* note 18, at 914.

⁷⁷*Ballay*, 925 F.2d at 684. At the beginning of its opinion, the Third Circuit noted that this case presented "an issue not yet ruled upon by any federal appellate court." *Id.*; see also Maynard, *supra* note 19, at 21 (noting this observation by the court).

⁷⁸925 F.2d 682 (3d Cir. 1991).

⁷⁹The plaintiffs consisted of Legg Mason clients and one of its stockbrokers. *Id.* at 685.

⁸⁰*Ballay*, 925 F.2d at 684-85.

⁸¹*Id.* at 686.

⁸²*Id.*

⁸³*Id.* at 686-87.

⁸⁴*Ballay*, 925 F.2d at 687 (citing *Naftalin*, 441 U.S. at 777-78.). The court found the *Naftalin* decision "particularly persuasive" because *Naftalin* addressed § 17(a) which is the "criminal analogue" of § 12(2). *Id.*

⁸⁵*Ballay*, 925 F.2d at 684.

⁸⁶*Id.* at 687-88. Both parties to the suit agreed that the words "prospectus" and "oral communication" must be construed as "related terms." *Id.* at 688. The court noted that the 1933 Act defined "prospectus," but not "oral communication." *Id.* Absent this definition, the court "must interpret the plain meaning of [the] words in light of their context in the statute

terms "prospectus," and "oral communication" together, the court determined that "buyers may recover for material misrepresentations made in a prospectus *or* in an oral communication related to a prospectus *or* initial offering."⁸⁷ The court also concluded that the term "prospectus," as used in this provision, was a "term of art" describing "the transmittal of information concerning the sale of a security in an initial distribution."⁸⁸

In its analysis, the court addressed the objective of the 1933 Act and its legislative history in order to determine its intent.⁸⁹ The court noted that the 1933 Act was passed primarily to "establish safeguards for investors in batch offerings of securities,"⁹⁰ whereas the 1934 Act was created to "provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails."⁹¹ In addition, the court focused on the House Report accompanying the 1933 Act.⁹² The court concluded that neither the legislative history nor the objective of the Act supported Ballay's contention that section 12(2) should be broadened beyond the "principal purpose of regulating the distribution of new offerings."⁹³

The Third Circuit also noted several factors that distinguished sections 17(a) and 12(2).⁹⁴ Consequently, the court held that the

and in keeping with the intent of Congress in passing the 1933 Act." *Id.* See *supra* note 6 for the pertinent parts of § 12(2).

⁸⁷*Ballay*, 925 F.2d at 688 (emphasis added). Reading these words as related terms also comports with the doctrine of *noscitur a sociis*, a rule of construction which translates to "a word is known by the company it keeps." *Id.* (quoting *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307 (1961)). Following this rule of construction, the more general term is "limited to conform to the more restrictive term" when it is "consonant with the legislative intent." *Id.* In this instance, "oral communication" is limited to conform with "prospectus." *Id.*

⁸⁸*Id.*

⁸⁹*Ballay*, 925 F.2d at 689-90.

⁹⁰*Id.* at 690 (referring to findings in *Ernst & Ernst*, 425 U.S. at 195).

⁹¹*Id.* (citing *In re Data Sys. Sec. Litig.*, 843 F.2d 1537, 1548 (3d Cir.), *cert. denied sub nom.* Vitiello v. I. Kahlowsky & Co, 488 U.S. 849 (1988)).

⁹²*Ballay*, 925 F.2d at 690. The court noted the House Report's emphasis that the Act "affects only new offerings of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication." *Id.*; see *supra* text accompanying notes 28-33 for further discussion of the House Report.

⁹³*Ballay*, 925 F.2d at 690.

⁹⁴*Id.* at 692. The court first studied the "plain words" in § 17(a) such as "directly or indirectly" and "any device," and distinguished these words from the specific language in § 12(2), such as "prospectus or oral communication[s]." *Id.* This distinction was used to show that if Congress had intended § 12(2) to extend to liability for secondary transactions, it could have included the word "any" before "oral communication," the effect of which would be a less specific meaning similar to the language in § 17(a). *Id.* The court also contrasted §§ 17(a) and 12(2) in terms of their legislative history and found that, unlike the clear congressional mandate

"significant differences" between the two sections did not support the lower court's broad interpretation of section 12(2) nor its reliance on *Naftalin*.⁹⁵ Like its comparison of sections 12(2) and 17(a), the court also compared section 12(2) of the 1933 Act with section 10(b) of the 1934 Act, along with its implementing provision, Rule 10b-5.⁹⁶ Focusing on the requirements of each provision, the court expressed concern that an expansive interpretation of section 12(2) would allow "the more lenient requirements of section 12(2) . . . [to] effectively eliminate the use of section 10(b) by securities purchasers."⁹⁷ The court also found the different remedies available under each provision to be a further indication that section 12(2) should be limited to initial distributions.⁹⁸ In light of these findings, the court concluded that section 12(2) applies to initial offerings and should not be extended to secondary market transactions.⁹⁹

2. The Seventh Circuit in *Pacific-Dunlop*

Two years after the Third Circuit's *Ballay* decision, the Seventh Circuit addressed the scope of section 12(2) in *Pacific Dunlop Inc. v. Allen & Co.*,¹⁰⁰ reaching the opposite conclusion.¹⁰¹ Pacific Dunlop Holdings Inc. (Pacific) entered into a stock purchase agreement with GNB Holdings, Inc. (GNB) and its other shareholders, including defendants, Allen & Co., Inc.¹⁰² When representations made in the

to extend § 17(a) to secondary markets, there was "no such clear legislative mandate" in the history of § 12(2). *Id.*

⁹⁵*Id.* at 691. The court found the legislative history of § 12(2) to be "devoid of any indication that the reach of section 12(2) was intended to be broader than the limited scope of sections 11 and 12(1)" of the 1933 Act; whereas Congress had specifically stated that § 17(a) was intended to reach secondary markets as well as initial distributions. *Id.* at 692.

⁹⁶*Id.* at 692. The court noted that the elements of proof required and the damages recoverable under § 12(2) and 10(b) (and Rule 10b-5) differ, in that § 12(2) "requires no proof of scienter or reliance, and embodies a more relaxed standard of causation." *Id.*; see *supra* text accompanying notes 61-75 for further comparison of these provisions.

⁹⁷*Ballay*, 925 F.2d at 692.

⁹⁸*Id.* at 693 (referring to the right of rescissionary damages under § 12(2) as opposed to the recovery of actual damages under § 10(b)).

⁹⁹*Id.*

¹⁰⁰993 F.2d 578 (7th Cir. 1993).

¹⁰¹See Maynard, *supra* note 19, at 21. The Seventh Circuit's conclusions are similar to the district court holding in the *Ballay* case. *Id.* However, the decision of the Seventh Circuit in *Pacific Dunlop* represented a "significant break from the groundswell of judicial opinion hostile to making Section 12(2) relief available to secondary market buyers," and it "reopen[ed] the debate" surrounding the applicability of § 12(2). *Id.*

¹⁰²*Pacific Dunlop*, 993 F.2d at 579. Allen & Co., Inc. was an investment banking firm

purchase agreement proved untrue,¹⁰³ Pacific sought to rescind the deal.¹⁰⁴ Pacific asserted that the misstatements in the purchase agreement constituted fraud in violation of section 12(2) of the 1933 Act.¹⁰⁵ The district court dismissed the complaint, relying on *Ballay*.¹⁰⁶ On appeal to the Seventh Circuit, Pacific contended that the broad definition of "prospectus" as set forth in section 2(10)¹⁰⁷ should apply, thus including the purchase agreement within its meaning.¹⁰⁸

The Seventh Circuit agreed with Pacific's contentions, and held that section 12(2)'s liability applied to both initial distributions and secondary market transactions "based on the text of the 1933 Act, its legislative history, and the impact of section 12(2) on similar fraud provisions in the security laws."¹⁰⁹ Based on the language of sections 2(10) and 12(2), the court found that the 1933 Act "contemplates many definitions of a prospectus."¹¹⁰ Interestingly, the court still agreed with the Third Circuit's finding that the maxim *noscitur a sociis* should apply,

which owned approximately 20% of the stock in GNB. *Id.* In the stock purchase agreement, GNB, a holding company, "represented that [it] and its subsidiaries were in compliance with environmental laws and regulations, were not subject to any pending or threatened governmental investigation and had disclosed all liabilities or obligations." *Id.*

¹⁰³*Id.* Pacific found that GNB faced extensive environmental claims, liability regarding a government services contract, and occupational disease claims. *Id.*

¹⁰⁴*Id.* In order to avoid liability for GNB's potential problems, Pacific sought to rescind the deal, whereas Allen sought to keep the money rather than regain the stock. *Id.*

¹⁰⁵*Id.* at 579 n.4.

¹⁰⁶*Pacific Dunlop*, 993 F.2d at 579.

¹⁰⁷15 U.S.C. § 77b(10) (1994). Section 2(10) provides in pertinent part: "The term 'prospectus' means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." *Id.*

¹⁰⁸*Pacific Dunlop*, 993 F.2d at 579-80. Allen, however, contended that § 12(2) should be read narrowly and should not apply to secondary market transactions such as the one at issue. *Id.*

¹⁰⁹*Id.* at 580. In reaching its conclusion, the court acknowledged its departure from the Third Circuit's holding in *Ballay*. *Id.* at 582.

¹¹⁰*Id.* at 584. The court found that § 2(8) incorporates § 6 of the Act because the "registration statement," as provided for in § 6, "means the statement provided for in section 6, and includes any amendment thereto and any report, document, or memorandum filed as part of such statement or incorporated therein by reference." *Id.* (referring to 15 U.S.C. §§ 77b(8), 77(f) (1994)). The court extended this reasoning to prospectuses under § 2(10). *Id.* Section 2(10), unlike § 2(8), does not contain a limiting clause such as "the statement provided for in section 10," and thus allows for a broader meaning of "prospectus." *Id.* The court concluded by stating that because § 2(10) does not contain a limiting clause, then certain communications could be prospectuses under the meaning in § 2(10) without complying with the narrower requirements of § 10. *Id.*

thus restricting the term "oral communication" to "those oral communications relating to a prospectus."¹¹¹

The court analyzed the legislative history of the 1933 Act by focusing on the three congressional reports which accompanied the 1933 Act.¹¹² In studying these reports, the court found that House Report 85 was not persuasive evidence of congressional intent. The court viewed the Senate and Conference Reports as more indicative of the legislative intent regarding the 1933 Act.¹¹³

Finally, the court studied the impact of section 12(2) on other remedial provisions such as section 17 of the 1933 Act, and section 10(b) of the 1934 Act.¹¹⁴ While agreeing with Allen's argument that the two remedial provisions of the 1933 Act contain very different language,¹¹⁵ the court did not agree with Allen's subsequent argument that the two provisions should thus have different scopes.¹¹⁶ The court read both sections of the 1933 Act as having similar scopes.¹¹⁷ Based upon this analysis, as well as the language and legislative history of section 12(2), the Seventh Circuit held that "section 12(2) applies to initial offerings *and* secondary market transactions."¹¹⁸

¹¹¹*Id.* at 588. The court relied on the maxim of *noscitur a sociis* and concluded that "[t]he words 'oral communication' are words of form, not substance; they describe how one communicates a message, not the message content." *Id.* (referring to *Ballay*, 925 F.2d at 688); see *supra* note 87 for a discussion of this doctrine.

¹¹²*Pacific Dunlop*, 993 F.2d at 588-89. The Seventh Circuit felt it necessary to discuss the legislative history because the district court had addressed it in following *Ballay*, which relied extensively on such history. *Id.* at 589. Specifically, the court focused on the House and Senate Reports and Congress' compromise to both versions in the Conference Report. *Id.*

¹¹³*Id.* at 589. The court stated that although the House Report could be interpreted to focus solely on offerings pursuant to a registration statement and prospectus, the Senate Report seemed to address recovery for *any* sale of a security and rarely mentioned "prospectus." *Id.* at 589, 592. Finally, the Conference Report seemingly supported the Senate's view of § 12(2) as applying to any distribution or sale of a security. *Id.* at 591-92.

¹¹⁴*Id.* at 592-93.

¹¹⁵*Id.* at 592-93. The court agreed with Allen's argument that the two remedial sections were very different in scope; Allen contended that § 17(a) applied to securities sold "directly or indirectly," while § 12(2) applied to a "prospectus or oral communication." *Id.* at 593. While the court recognized these contentions, it declined to extend Allen's reasoning that by not using the words "directly or indirectly" in § 12(2), Congress had not intended for the two sections to have the same scope. *Id.*

¹¹⁶*Id.* at 594.

¹¹⁷*Pacific Dunlop*, 993 F.2d at 593.

¹¹⁸*Id.* at 595 (emphasis added).

III. ANALYSIS

The Supreme Court granted *certiorari* in *Gustafson v. Alloyd Co.*¹¹⁹ to settle the conflict over whether the right of rescission pursuant to section 12(2) extended to private, secondary transactions.¹²⁰

A. *The Facts*

Petitioners Gustafson, McLean, and Butler (collectively Gustafson) were sole shareholders of Alloyd, Inc. (Alloyd), a manufacturer of plastic packaging and heat sealing equipment.¹²¹ As a result of a company profile distributed by KPMG Peat Marwick (KPMG),¹²² Wind Point Partners II, L.P. (Wind Point)¹²³ agreed to purchase all issued and outstanding stock in Alloyd through a new corporation, Alloyd Holdings, Inc. (Holdings).¹²⁴

Gustafson and Holdings executed a purchase agreement which included a provision entitled "Representations and Warranties of the Sellers."¹²⁵ One of the clauses in this provision allowed an adversely affected party an adjustment in the event of a material change in the

¹¹⁹115 S. Ct. 1061 (1995).

¹²⁰*Gustafson*, 115 S. Ct. at 1065. Prior to this petition being granted, the Court granted a petition for writ of *certiorari* in *Pacific Dunlop* to settle the same issue; however, the case eventually settled and *certiorari* was voluntarily dismissed. Therese H. Maynard, *Gustafson v. Alloyd Co.: The Supreme Court to Decide a Section 12(2) Case*, 8 INSIGHTS 33 (Aug. 1994) (referencing *Pacific Dunlop*, 993 F.2d at 595, *cert. granted*, 114 S. Ct. 907 (1994), and *cert. dismissed*, 114 S. Ct. 1146 (1994)).

¹²¹*Gustafson*, 115 S. Ct. at 1064.

¹²²KPMG was the broker/dealer used by Gustafson to sell Alloyd. *Id.*

¹²³*Gustafson*, 115 S. Ct. at 1064. Wind Point was a venture capital limited partnership. *Alloyd Co. v. Gustafson*, No. 91-C889, 1994 U.S. Dist. LEXIS 3641, at *3-4 (N.D. Ill. Mar. 24, 1994) (Magistrate's Report and Recommendation).

¹²⁴*Gustafson*, 115 S. Ct. at 1064. Holdings was formed by Wind Point for the purpose of acquiring Alloyd. *Alloyd Co.*, No. 91-C889, 1994 U.S. Dist. LEXIS 3641, at *4. The shareholders of Holdings were Wind Point and individual investors. *Gustafson*, 115 S. Ct. at 1064. In order to determine the purchase price of Alloyd, Wind Point undertook an analysis of the company in which it used estimates of the inventory as listed in the profile distributed by KPMG. *Id.* at 1064-65.

¹²⁵*Gustafson*, 115 S. Ct. at 1065. This provision included assurances that Alloyd's financial condition was presented fairly, and that between the date of the last balance sheet and the execution of the agreement there had been "no material adverse change" in the company's financial position. *Id.* Under the agreement, the purchase price included payment of a certain sum plus 90% of an estimated adjustment amount. *Alloyd Co.*, No. 91-C889, 1994 U.S. Dist. LEXIS 3641, at *7-8. "The Agreement also provided that if the actual adjustment amount turned out to be less than the 90 percent paid up front, plaintiffs would be entitled to a return of their overpayment plus interest." *Id.* at *8.

financial data.¹²⁶ Alloyd's year-end audit did, in fact, show that there was a material change in its financial condition; thus Holdings was entitled to an adjustment under the warranty provision.¹²⁷ However, instead of obtaining the adjustment, Alloyd Co. (the newly formed company formerly known as Holdings), and Wind Point brought suit in the United States District Court for the Northern District of Illinois seeking rescission of the purchase agreement pursuant to section 12(2) of the 1933 Act.¹²⁸

B. *The Lower Courts*

Before the district court, the buyer, Alloyd Co., alleged that the purchase agreement was a "prospectus" as defined in section 10 of the 1933 Act.¹²⁹ It argued that section 12(2) created liability for the alleged misrepresentation of financial data in the agreement.¹³⁰ Both parties motioned for summary judgment, and the district court, in an unpublished memorandum opinion, granted Gustafson's motion.¹³¹ The court noted a division in case law on this issue;¹³² however, it relied on *Ballay* in holding that "section 12(2) claims can only arise out of . . . initial stock offerings."¹³³

The Seventh Circuit Court of Appeals vacated the district court's judgment and remanded the case for further consideration in light of its decision in *Pacific Dunlop*.¹³⁴ In *Pacific Dunlop*, the Seventh Circuit concluded that the term "communication," within the definition of "prospectus" in section 10 of the 1933 Act, indicated that the prospectus

¹²⁶*Gustafson*, 115 S. Ct. at 1065.

¹²⁷*Id.* Alloyd's actual earnings were lower than expected in earlier estimates. *Id.* Additionally, an inventory shortage was also found during the year-end audit. *Alloyd Co.*, 1994 U.S. Dist. LEXIS 3641 at *10. The year-end financial statements indicated that Alloyd's inventory was approximately \$1.2 million less than the estimated figure based on the last balance sheet. *Id.*

¹²⁸*Gustafson*, 115 S. Ct. at 1065.

¹²⁹*Id.*

¹³⁰*Id.*

¹³¹*See Alloyd Co.*, No. 91-C889, 1994 U.S. Dist. LEXIS 3641, at *1 (citing to Alloyd Co. v. Gustafson, No. 91-C889 (N.D. Ill. May 29, 1992)).

¹³²*Gustafson*, 115 S. Ct. at 1065.

¹³³*Id.* Although the investors were, in part, made up of the controlling shareholders of the original company, the district court found that the private purchase agreement was not comparable to an initial offering because the purchasers had "direct access to financial and other company documents, and had the opportunity to inspect the seller's property." *Id.*; *see also Maynard*, *supra* note 19, at 33 (discussing the lower court decisions in *Gustafson*).

¹³⁴*Alloyd Co. v. Gustafson*, No. 92-2514, 1993 U.S. App. LEXIS 36891, at *1 (7th Cir. June 11, 1993).

should be interpreted broadly and, therefore, be inclusive of all written communications in the sale of securities, including stock purchase agreements.¹³⁵ Relying on its recent decision in *Pacific Dunlop*, the court interpreted section 12(2) expansively and determined that the cause of action for rescission under section 12(2) of the 1933 Act "applies to *any communication* which offers any security for sale . . . including the stock purchase agreement."¹³⁶

On remand to the district court, Gustafson again sought summary judgment for Alloyd Co.'s section 12(2) claim.¹³⁷ In addition, Alloyd Co. renewed its cross motion for summary judgment with respect to Gustafson's liability for breach of warranty.¹³⁸ The U.S. Magistrate Judge to whom the motion was referred eventually recommended both motions be denied.¹³⁹ However, shortly before the issuance of a recommendation by a magistrate judge, the Supreme Court granted *certiorari* to resolve the conflict of whether the written sales contract was a prospectus as that term is used in section 12(2) of the 1933 Act.¹⁴⁰

C. The Supreme Court

The Supreme Court granted *certiorari* in *Gustafson* to decide whether the right of rescission pursuant to section 12(2) of the 1933 Act extends to secondary transactions based on the supposition that recitations in the purchase agreement are part of a "prospectus."¹⁴¹ Holdings argued that "prospectus" is defined "broad[ly] enough to encompass the contract" between it and Gustafson.¹⁴² Conversely, Gustafson contended that "prospectus" has a much narrower meaning, arguing that it referred to "a communication soliciting the public to purchase securities from the issuer."¹⁴³

¹³⁵*Pacific Dunlop*, 993 F.2d at 582.

¹³⁶*Gustafson*, 115 S. Ct. at 1065 (emphasis added).

¹³⁷*Alloyd Co.*, No. 91-C889, 1994 U.S. Dist. LEXIS 3641, at *1.

¹³⁸*Id.*

¹³⁹*Id.* at *47 (finding that genuine issues of fact existed as to the scope of the warranty provisions, including whether Gustafson warranted that there would be no material adjustments to the estimates, and whether Alloyd relied on the alleged warranties).

¹⁴⁰*Id.* at *17 n.9 (referring to *Gustafson*, 114 S. Ct. 1215).

¹⁴¹*Gustafson*, 115 S. Ct. at 1064.

¹⁴²*Id.* at 1066.

¹⁴³*Id.*

1. The Majority Opinion

In a 5-4 decision, the Supreme Court held that the purchase agreement between Holdings and Gustafson was not a "prospectus" as defined in the 1933 Act, and thus, Holdings could not rescind the agreement under section 12(2) of the 1933 Act.¹⁴⁴ In reaching its decision, the Court relied on three sections of the 1933 Act as support for a narrow interpretation of the word "prospectus."¹⁴⁵

The Court relied on "the premise that the term should be construed, if possible, to give it a consistent meaning throughout the Act."¹⁴⁶ First, the Court focused on section 10.¹⁴⁷ The mandate of section 10 is clear; a prospectus as defined in this section must include "the 'information contained in the registration statement.'"¹⁴⁸ Based on this directive, the Court held that a prospectus under section 10 is "confined to documents related to public offerings by an issuer or its controlling shareholders."¹⁴⁹

Relying on its original premise, the Court held that the definition of prospectus in section 10 should be given the same meaning as section

¹⁴⁴*Id.* at 1067. Specifically, the Court concluded that "'prospectus' is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder." *Id.* at 1073-74. Thus, because the purchase agreement at issue in this case was not "held out to the public," it was not a prospectus under the meaning of the word in the 1933 Act. *Id.* at 1074-75.

¹⁴⁵The court states that § 2(10) defines a "prospectus," § 10 "sets forth the information that must be contained in a prospectus," and § 12 "imposes liability based on misstatements in a prospectus." *Gustafson*, 115 S. Ct. at 1066 (referring to 15 U.S.C. §§ 77b(10), 77j & 77l (1994)); see also Simon M. Lorne, *Recent Judicial Developments Under the Securities Laws*, in *ADVANCED SECURITIES LAW WORKSHOP 1995*, at 757, 768 (Harvey L. Pitt chair, 1995) (discussing the Supreme Court decision in *Gustafson*).

¹⁴⁶*Gustafson*, 115 S. Ct. at 1066.

¹⁴⁷15 U.S.C. § 77j (1994). Section 77j(a)(1) is referenced by the Court, and provides in pertinent part: "[A] prospectus relating to a security other than a security issued by a foreign government or political subdivision thereof, shall contain the information contained in the registration statement . . ." *Id.*; see also Lorne, *supra* note 145, at 768 (contending that the Court's analysis of this section was at the "heart" of its decision).

¹⁴⁸*Gustafson*, 115 S. Ct. at 1067 (referring to 15 U.S.C. § 77j(a)(1) (1994)). The Court appears to conclude that there is a "prospectus" for § 12(2) purposes only if the security must be registered, or if the only reason for non-registration is inclusion in the list of exempted securities in § 3. Lorne, *supra* note 145, at 768. Lorne's conclusion is supported by the Court's statement that except for the exemptions listed in § 3, the mandate of § 10 is "unqualified." *Id.* (citing *Gustafson*, 115 S. Ct. at 1067).

¹⁴⁹*Gustafson*, 115 S. Ct. at 1067. The Court reasoned that because of the exemptions in § 4, these types of documents are the only ones which require a filing of a registration statement. *Id.* (referring to 15 U.S.C. §§ 77d, 77e, 77(b)(11) (1994)); see Lorne, *supra* note 145, at 768-69 (noting this rationale).

12(2) of the Act.¹⁵⁰ Thus, if the purchase agreement before the Court is not a prospectus under section 10, it is not a prospectus under section 12(2).¹⁵¹ In supporting its conclusion, the Court relied on the Act's structure,¹⁵² the language of section 12(2),¹⁵³ and the Act's overall purpose.¹⁵⁴ In addition, it rejected Holdings' proposition that several meanings of "prospectus" exist within the 1933 Act, and that the term as defined in section 12(2) should refer to a broader set of communications than defined in section 10.¹⁵⁵

Finally, the Court focused on section 2(10), which defines the term "prospectus."¹⁵⁶ The Court rejected Holdings' contention that the use of the term "communication" means that "any written communication that

¹⁵⁰*Gustafson*, 115 S. Ct. 1067. Thus, prospectus as defined in § 12(2) should also be limited to documents "related to public offerings by an issuer or its controlling shareholders." *Id.*

¹⁵¹*Id.* Relying on previous decisions, the Court noted that "'identical words used in different parts of the same Act are intended to have the same meaning.'" *Id.* at 1067 (quoting *Department of Revenue of Or. v. ACF Indus., Inc.*, 114 S. Ct. 843, 845 (1994)); but see *infra* note 197 for a discussion of Justice Ginsburg's disagreement with this premise in her dissent.

¹⁵²*Gustafson*, 115 S. Ct. at 1067. The Court, in following the "most natural and symmetrical reading" of the Act, stated that liability for § 12(2) "cannot attach unless there is an obligation to distribute the prospectus in the first place." *Id.* Sections 4, 5, 7, and 10 of the 1933 Act, when read together, create such an obligation. *Id.* (referring to 15 U.S.C. §§ 77d, 77e, 77g, & 77j (1994)).

¹⁵³*Gustafson*, 115 S. Ct. at 1067-68. In its analysis of § 12(2), the Court began by stating that § 12(2) exempts prospectuses relating to the sales of government-issued securities from its scope. *Id.* at 1068. The Court reasoned that "[i]f Congress intended § 12(2) to create liability for misstatements contained in any written communication . . . including secondary market transactions — there is no ready explanation for exempting government-issued securities." *Id.* However, the Court found that the exemption makes "perfect sense" if § 12(2) is applied solely to initial distributions by issuers, because the "anomaly disappears," and immunity is created for governmental authorities. *Id.*

¹⁵⁴The Court interpreted the primary purpose of the 1933 Act as creating federal registration and disclosure obligations in connection with public offerings. *Gustafson*, 115 S. Ct. at 1068. After analyzing the legislative intent of the Act, the Court was "reluctant" to apply § 12(2) to secondary market transactions. *Id.* The Court found it "more reasonable" to interpret the Act's liability provisions as providing remedies for violations of registration and disclosure obligations. *Id.*

¹⁵⁵*Id.* The Court noted the reliance of Alloyd Holdings, Inc. on the contention that "[t]he 1933 Act contemplates many definitions of a prospectus" as expounded in *Pacific Dunlop*. *Id.* (citing *Pacific Dunlop*, 993 F.2d at 584). The Court also noted the dissents' distinction between formal prospectuses, as subject to both §§ 10 and 12, versus informal prospectuses subject only to § 12. *Id.* The Court rejected this view by stating that the Act does not distinguish between formal and informal prospectuses, thus the dissents' reliance on these terms "belies the claim of fidelity to the text of the statute." *Gustafson*, 115 S. Ct. at 1069.

¹⁵⁶*Gustafson*, 115 S. Ct. at 1069; see *supra* note 107 for the language of § 2(10).

offers a security for sale is a 'prospectus.'¹⁵⁷ The Court relied on two rules of statutory construction.¹⁵⁸ Consequently, the first rule rejects statutory readings which would render words redundant.¹⁵⁹ The second rule is that the doctrine of *noscitur a sociis* prevails in statutory interpretation.¹⁶⁰ The Court held that the term "communication" in section 2(10)'s definition of "prospectus" must be interpreted as referring to writings that are *similar to* other forms of public communication such as a "notice, circular, or advertisement," rather than being interpreted as *defining* these words.¹⁶¹

The Court distinguished *Naftalin*, where the Court interpreted section 17(a) of the 1933 Act as applying to both initial distributions and secondary market transactions, and used *Naftalin* to bolster its holding that "the term 'prospectus' relates to public offerings by issuers and their controlling shareholders."¹⁶² In *Naftalin*, the Court noted that section 17(a) contained no language that suggested a restriction of the scope of liability under that section.¹⁶³ The Court in *Gustafson* relied on this in concluding that since section 17(a) does not contain the word "prospectus," no limitation exists; however, since section 12(2) does contain this term, a limitation to public offerings may exist.¹⁶⁴

¹⁵⁷*Gustafson*, 115 S. Ct. at 1069 (emphasis added). Alloyd argued that the broad definition of prospectus in § 2(10) should be applied in § 12(2) even though it was incompatible with the limitations set forth by the meaning of the term in § 10. *Id.*; see Lorne, *supra* note 145, at 768 (noting the Court's rejection of Alloyd's argument).

¹⁵⁸*Gustafson*, 115 S. Ct. at 1069.

¹⁵⁹*Id.* If Holdings' contention was correct in this regard, it would render the words "notice, circular, advertisement [and] letter" redundant since they are all forms of written communication. *Id.* The Court refused to construe these words as having no purpose, and this prevented the Court from extending the broad definition of "communication." *Id.*

¹⁶⁰*Id.* This doctrine means "a word is known by the company it keeps." *Id.* The court uses this doctrine to avoid giving one word, in this instance the word "communication," a meaning so broad as to be inconsistent with the words surrounding it in the clause. *Id.* (citing *Jarecki*, 367 U.S. at 307, for the proposition that to allow this inconsistency would give "unintended breadth to the Acts of Congress"); see *supra* notes 87 & 111 discussing the application of this doctrine in *Ballay* and *Pacific Dunlop*.

¹⁶¹*Gustafson*, 115 S. Ct. at 1070. Alloyd argued the proposition that "prospectus" defined these terms. *Id.* at 1069. The Court determined that a "prospectus" is a "term of art," which accounted for Congress's "partial circularity" in this definition. *Id.* at 1070.

¹⁶²*Id.* In *Naftalin*, the Court recognized that "'the 1933 Act was primarily concerned with the regulation of new offerings,'" yet the Court held that § 17(a) was "'intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading.'" *Id.* (quoting *Naftalin*, 441 U.S. at 777-78) (emphasis added).

¹⁶³*Id.* at 1071 (citing *Naftalin*, 441 U.S. at 778).

¹⁶⁴*Id.* If the absence of limiting language in § 17(a) resulted in a broad interpretation in *Naftalin*, then the presence of limiting language in § 12(2) should require a narrow

Finally, the Court invalidated the interpretation of legislative history that supported an expanded reading of section 12(2), which was included in the SEC's amicus brief and in Justice Ginsburg's dissent.¹⁶⁵ The Court held that "[m]aterial not available to the lawmakers is not considered . . . to be legislative history," and that "[a]fter-the-fact statements by proponents of a broad interpretation are not a reliable indicator of what Congress intended."¹⁶⁶ The Court further based its holding on a section from the House Report which stated: "The bill affects only new offerings of securities."¹⁶⁷

2. The Dissenting Opinions

The two dissenting opinions took very similar approaches in interpreting the 1933 Act.¹⁶⁸ Both made a "textual analysis" of the 1933 Act and concluded that section 12(2) applies to secondary and private sales of a security as well as to initial public offerings.¹⁶⁹ Justice Thomas and Justice Ginsburg agreed with the majority that the only way to

interpretation of *Gustafson*. *Id.* The *Naftalin* court found that the legislative history of § 17(a) clearly supported a broad interpretation of this section, whereas there is no comparable legislative history supporting such an interpretation of § 12(2). *Id.*

¹⁶⁵*Id.* Both the SEC, in its amicus brief, and Justice Ginsburg, in her dissent, relied heavily on legislative intent to show that the scope of § 12(2) should be expanded. *Id.* at 1071. The Court deemed much of this history to be irrelevant because it was written after the 1933 Act was passed, as opposed to while the Act was under deliberation. *Id.*; see also Lorne, *supra* note 145, at 769 (noting the Court's rejection of this evidence of legislative history because it was "irrelevant to understanding Congress's intentions").

¹⁶⁶*Gustafson*, 115 S. Ct. at 1071. Even though most of the history relied upon by the SEC and Justice Ginsburg was found to be irrelevant, the Court recognized one pre-enactment memorandum from the SEC's brief. *Id.* The Court dismissed this memorandum as being "irrelevant" because it did not refer to the issue regarding the meaning of prospectus in § 12(2) of the 1933 Act. *Id.*; see also Lorne, *supra* note 145, at 769 (stating that the Court "considered the commentators irrelevant to understanding Congress's intentions," and the few materials it discussed were "interpreted differently than . . . the Commission's brief" (referring to the above-mentioned memorandum)).

¹⁶⁷*Gustafson*, 115 S. Ct. at 1072 (quoting House Report, *supra* note 29, at 5, reprinted in 2 LEGISLATIVE HISTORY, *supra* note 3, item 18, at 5). The House Report continues by stating that the 1933 Act "does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering." *Id.* The Court determined that nothing in the legislative history supports two types of prospectuses, one formal and one informal, as contended by Justice Ginsburg in her dissent. *Id.* at 1073. See *supra* note 155 for a discussion of formal and informal prospectuses.

¹⁶⁸Justice Thomas wrote the first of the two dissents and was joined by Justices Scalia, Ginsburg, and Breyer in his opinion. *Gustafson*, 115 S. Ct. at 1074-79 (Thomas, J., dissenting). The second dissent was written by Justice Ginsburg, with Justice Breyer joining. *Id.* at 1079-83 (Ginsburg, J., dissenting).

¹⁶⁹*Id.* at 1074.

interpret section 12(2) as being limited to initial distributions is by reading the clause "by means of a prospectus or oral communication" in its narrowest sense.¹⁷⁰ They diverged from the majority, in that the majority relied on the extrinsic meaning of "prospectus"; whereas, the dissents advocated using this meaning only "[i]n the absence of [a statutory] definition."¹⁷¹

a. *Justice Thomas's Dissenting Opinion*

Justice Thomas's dissent rebutted several of the statutory interpretation arguments set forth by the majority. Justice Thomas first focused on the language of section 2(10), the definitional provision of the Act.¹⁷² He proposed that Congress' inclusion of "prospectus" within the definition of the same term in section 2(10) indicated that Congress intended "prospectus" to be more than a "term of art" and to have several uses within the statute.¹⁷³ Justice Thomas contested the majority's application of the doctrine of *nosctitur a sociis*.¹⁷⁴ He contended that the doctrine applies only "where words are of obscure or doubtful meaning."¹⁷⁵ Justice Thomas viewed the majority's premise,¹⁷⁶ that a given term has a "consistent meaning throughout the Act,"¹⁷⁷ as being unpersuasive because it is merely a general presumption that may be

¹⁷⁰*Id.*

¹⁷¹*Id.* (quoting *FDIC v. Meyer*, 114 S. Ct. 996, 1001 (1994)).

¹⁷²*Gustafson*, 115 S. Ct. at 1074 (Thomas, J., dissenting). Justice Thomas proposed that the Court should have begun its analysis with the "language [of the statute] itself." *Id.* He viewed it as "unfortunate" that the majority went beyond the "four corners of the statute" to consult the structure of the Act as a whole, rather than "adopting the definition provided by Congress." *Id.*; see also Lorne, *supra* note 145, at 770 (noting that the majority's decision incorrectly "ignore[d] the plain language of the definition in the statute in search of a definition for a term of critical importance").

¹⁷³*Gustafson*, 115 S. Ct. at 1074 (Thomas, J., dissenting). Justice Thomas found support in Congress' decision to include the word "prospectus" within § 2(10)'s list of terms defining "prospectus," as an indication of Congressional intent to create more than a term of art. *Id.* To further support his position, Justice Thomas cited several other statutes where Congress chose to use such circular definitions as "catch-all" provisions to "sweep up anything it had forgotten to include in its definition." *Id.* at 1075.

¹⁷⁴*Id.* at 1075.

¹⁷⁵*Id.* at 1075 (quoting *Russell Motor Car Co. v. United States*, 261 U.S. 514, 519 (1923)).

¹⁷⁶*Id.* The majority argued that "prospectus" must have the same meaning in both §§ 10 and 12. *Id.* Because § 10 applies a narrow definition of "prospectus," § 12 must apply that same narrow definition. *Id.*

¹⁷⁷*Gustafson*, 115 S. Ct. at 1066.

"overcome when Congress indicates otherwise."¹⁷⁸ Justice Thomas contended that Congress attempted to overcome this presumption through the following measures: (1) by creating dual definitions of "prospectus" as either a document that "offers any security for sale" or one that "confirms the sale of any security"; (2) by including a "preface" to section 2 stating that the definition applies "unless the context otherwise requires"; and (3) by using the term "prospectus" in "at least two different senses" in section 2(10).¹⁷⁹

Justice Thomas's final statutory interpretation rebuttal involved a study of section 12(2) and its surrounding text.¹⁸⁰ He noted that section 4 of the 1933 Act¹⁸¹ exempts certain transactions from the registration requirements in section 5.¹⁸² He concluded that section 12(2)'s lack of reference to the exempt transactions in section 4 indicates that Congress did not intend the exemptions to apply in section 12(2).¹⁸³ Justice Thomas concluded that "[s]ection 12(2)'s explicit exception only for government securities shows that Congress knew how to exempt certain securities and transactions when it wanted to." However, with respect to section 12(2), they did not.¹⁸⁴

Following his rebuttal of the majority's linguistic arguments, Justice Thomas focused on the majority's application of the principles in *Naftalin*.¹⁸⁵ He contended that if the majority had remained "faithful" to *Naftalin*, it would have held that section 12(2) applies to both initial and

¹⁷⁸*Gustafson*, 115 S. Ct. at 1076 (Thomas, J., dissenting).

¹⁷⁹*Id.*

¹⁸⁰*Id.* at 1077.

¹⁸¹15 U.S.C. § 77d (1994). Justice Thomas noted that this section of the 1933 Act is "appropriately entitled 'Exempted Transactions,'" and that secondary market transactions are not included in this list of exemptions. *Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting).

¹⁸²*Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting); see Louis Loss, *Securities Act Section 12(2): A Rebuttal*, 48 BUS. LAW. 47, 48 (1992) (asserting that § 5 is the "central provision of the registration scheme" by making it unlawful for "any person" to offer or sell or deliver a security" through mail or interstate facilities without "registration and delivery of a statutory prospectus"); Prentice, *supra* note 3, at 112 (stating that § 5 is one of the "focal points" of the Act by requiring "registration of certain public offerings and the use of a prospectus in their sale").

¹⁸³*Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting). Specifically, the dissent noted that § 12(2) is "notable for its silence." *Id.* In other words, if Congress intended these exemptions to apply in § 12(2), it "would have been simple for Congress to have referred to the § 4 exemptions in § 12(2)." *Id.*

¹⁸⁴*Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting). Justice Thomas contended that if the majority's argument was correct, then it would have "precluded any need to include § 4 at all," because § 5 could have listed the exemptions therein. *Id.*

¹⁸⁵*Id.* at 1077-78.

secondary market transactions.¹⁸⁶ The *Naftalin* court rejected two arguments regarding the scope of the 1933 Act, both of which support Justice Thomas's contentions.¹⁸⁷ The majority understood *Naftalin* to require that no provision in the 1933 Act should be interpreted to extend liability to secondary market transactions "unless either the statutory language or the legislative history clearly indicate" that Congress had this intent.¹⁸⁸ Justice Thomas, contends that *Naftalin* "implements the opposite rule," and thus "a provision of the 1933 Act extends to both initial offerings and secondary trading *unless* the text makes a 'distinction between the two kinds of transactions.'" ¹⁸⁹

Following his interpretation of *Naftalin*, Justice Thomas engaged in what may be the most forceful argument of his dissent. In this part of his analysis, he argued that the majority's holding was motivated mostly by "its policy preferences"¹⁹⁰ and that the desired level of securities liability is best left to Congress.¹⁹¹ Justice Thomas referred to the majority's concern that extending section 12(2) to apply to both initial distributions and secondary transactions may result in an increase in securities litigation.¹⁹² He argued that in attempting to preserve its policy preferences, the majority "disrupt[ed] the process of statutory interpretation" by beginning its interpretation "from beyond the four corners of the 1933 Act" rather than relying on section 2(10), the

¹⁸⁶*Id.* at 1078.

¹⁸⁷*Id.* at 1077. The first argument the *Naftalin* court dismissed was that § 17 of the 1933 Act is limited to new issues, and in doing so the court made "no distinctions" between initial distributions and ordinary market trading. *Id.* at 1077-78 (quoting *Naftalin*, 441 U.S. at 778). Additionally, it refused to infer that the 1934 Act's prohibition of fraud in the secondary sale of securities meant that the 1933 Act was intended to apply solely to initial distributions. *Id.* at 1078 (citing *Naftalin*, 441 U.S. at 778). Justice Thomas found relevance in the *Naftalin* court's conclusion that "[t]he fact that there may well be some overlap [between the Acts] is neither unusual nor unfortunate." *Id.* (citing *Naftalin*, 441 U.S. at 778) (citation omitted).

¹⁸⁸*Gustafson*, 115 S. Ct. at 1078 (Thomas, J., dissenting).

¹⁸⁹*Id.* (emphasis added) (quoting *Naftalin*, 441 U.S. at 778).

¹⁹⁰*Id.* Justice Thomas noted the majority's "chiding tone" when it stated it was "reluctant to conclude that § 12(2) creates vast additional liabilities that are entirely independent of the new substantive obligations that the Act enumerates." *Id.* (referring to the majority's opinion at 1068). The dissent contended that "[i]t is not the usual practice of this Court to require Congress to explain why it has chosen to pursue a certain policy. Our job simply is to apply the policy, not to question it." *Id.* at 1078-79.

¹⁹¹*Id.* at 1079. In his dissent, Justice Thomas agreed with the majority's concern that an extension of § 12(2) would lead to increased securities litigation.

¹⁹²*Gustafson*, 115 S. Ct. at 1079 (Thomas, J., dissenting). The dissenters agreed with the majority's concern; however, they also recognized that it is Congress' duty to impose standards of liability, and the Court's duty is merely to enforce these standards. *Id.*

definitional provision of the Act.¹⁹³ Furthermore, by pursuing its policy preferences and relying on extrinsic sources, the majority "frustrat[ed] Congress' will" by leaving little reason for Congress to have included section 2(10) as the definitional provision of the statute.¹⁹⁴

b. *Justice Ginsburg's Dissenting Opinion*

Justice Ginsburg agreed with the language and structure-based arguments set forth by Justice Thomas. Justice Ginsburg made additional arguments based on legislative history and the "longstanding scholarly and judicial understanding of section 12(2)."¹⁹⁵ Her opinion focused on what she referred to as the Court's "backward" reading of the 1933 Act,¹⁹⁶ noting the majority's misplaced reliance on the premise that the same term should have a consistent meaning throughout the Act.¹⁹⁷

¹⁹³*Id.* The dissent maintained that the majority should have begun its interpretation, first by reading the provision, then by "ascertaining the meaning of any important or ambiguous phrases by consulting any definitional clauses in the [statute]." *Id.* Only in the absence of a definitional provision should a court turn to "extrinsic definitions or to structure" as the majority did in its interpretation of § 12(2) of the 1933 Act. *Id.*

¹⁹⁴*Id.* See LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 183-84 (PLI Incorporating Release No. 2, B9-0302, July 1995). Soderquist asserts that the above is a proper reading of the majority's decision because offerings under § 3 are considered to be "limited public offerings" and because the court explicitly stated that liability cannot attach unless there is an obligation to distribute a prospectus or "unless there is an exemption," which seemingly refers to the § 3 exemptions. *Id.* (quoting *Gustafson*, 115 S. Ct. at 1067).

¹⁹⁵Lorne, *supra* note 145, at 770. Both the legislative history and the scholarly and judicial understanding of this provision "caution against judicial resistance to the statute's defining text." *Gustafson*, 115 S. Ct. at 1080 (Ginsburg, J., dissenting).

¹⁹⁶*Gustafson*, 115 S. Ct. at 1080 (Ginsburg, J., dissenting). The majority's backward reading of the term is accomplished by incorrectly "read[ing] into the literally and logically prior definition section, § 2(10), the meaning 'prospectus' has in § 10." *Id.*

¹⁹⁷*Gustafson*, 115 S. Ct. at 1080 (Ginsburg, J., dissenting). Justice Ginsburg used prior case law to support her proposition that this presumption cannot be applied in all situations. *Id.* (citing *Atlantic Cleaners & Dryers, Inc. v. United States*, 286 U.S. 427 (1932)). The Court held:

[T]here is a natural presumption that identical words used in different parts of the same act are intended to have the same meaning. . . . But the presumption is not rigid and readily yields whenever there is such variation in the connection in which the words are used as reasonably to warrant the conclusion that they were employed in different parts of the act with different intent

It is not unusual for the same word to be used with different meanings in the same act, and there is no rule of statutory construction which precludes the courts from giving to the word the meaning which the legislature intended it should have in each instance.

Id. (quoting *Atlantic Cleaners*, 286 U.S. at 433).

After adopting many of Thomas's arguments, Justice Ginsburg attempted to show that the legislative history behind the 1933 Act supports her conclusion that section 12(2) is not limited to public offerings.¹⁹⁸ She discussed the British Companies Act, which she claimed served as a basis for the 1933 Act.¹⁹⁹ Justice Ginsburg contended that the difference between the wording of the definition of "prospectus" in the two Acts is indicative of Congress' intent to expand the definition of "prospectus" in the 1933 Act.²⁰⁰ She also studied the House Report describing the final version of the 1933 Act, which nowhere suggested that section 12(2) was limited to initial offerings.²⁰¹ Acknowledging the conflicting intentions in the House and Senate reports,²⁰² Justice Ginsburg adopted the Conference Report. She felt it was the only report describing the 1933 Act in its final form and the least ambiguous in describing the Act's intended scope.²⁰³

Justice Ginsburg also recognized that since the enactment of the 1933 Act, most commentators have found section 12(2) to create liability for more than simply initial distributions,²⁰⁴ yet the appellate courts have

¹⁹⁸*Id.* at 1081. While the dissent recognized that the legislative history for much of the 1933 Act indicates limitation to public offerings, it maintained that several sections of this Act, namely §§ 12(2) and 17(a) do not limit the scope. *Id.* In support of this argument, the dissent referred to its earlier decision in *Naftalin*, where the Court expanded the scope of § 17(a) to apply to secondary trading. *Id.*

¹⁹⁹*Id.* (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 123 (1953); see also *supra* note 40 and accompanying text.

²⁰⁰*Gustafson*, 115 S. Ct. at 1081 (Ginsburg, J., dissenting). The British Companies Act defined "prospectus" as "any prospectus, notice, circular, advertisement, or other invitation, offering to the public for subscription or purchase any shares or debentures of a company." *Id.* Although the first four words are the same in both Acts, Justice Ginsburg noted Congress' choice not to use the words "offering to the public" as they were used in the British Companies Act. *Id.*

²⁰¹*Id.* Not only does the Conference Report fail to expressly limit § 12(2) to initial offerings, but it also omits the word "prospectus," which "one would expect . . . to figure prominently, if it were the significant limitation the Court describes." *Id.*

²⁰²*Id.* Compare House Report, *supra* note 29, at 5, reprinted in 2 LEGISLATIVE HISTORY, *supra* note 3, item 18, at 5 (supporting the majority's view that § 12(2) applies solely to initial distributions) with H.R. 5480, 73d Cong., 1st Sess. (1933), reprinted in 3 LEGISLATIVE HISTORY, *supra* note 3, item 27, at 60 (supporting the dissent's opinion that the meaning of "prospectus" in § 12(2) should be read expansively).

²⁰³*Gustafson*, 115 S. Ct. at 1081 (Ginsburg, J., dissenting). Justice Ginsburg asserted that the majority mistakenly relied on the House Report, which "predate[d] the Conference Report" and did not incorporate the final version of § 12(2) of the 1933 Act. *Id.* at 1081 n.4. Thus, Justice Ginsburg does not find the House Report to be persuasive evidence of the drafter's intent. *Id.*

²⁰⁴*Gustafson*, 115 S. Ct. at 1082 (Ginsburg, J., dissenting). Since the passage of this Act, many commentators have agreed that §§ 12(2) and 17(a) apply to both primary and secondary market transactions. *Id.* (citing Rapp, *supra* note 14, at 711; but see Weiss, *supra*

generally been divided on the issue.²⁰⁵ Justice Ginsburg expressed concern that when private placements have been the subject of the dispute, every court of appeals considering the issue has held that these transactions were subject to section 12(2).²⁰⁶ She viewed the majority's decision, that "the term 'prospectus' relates to public offerings by issuers and their controlling shareholders" and thus excludes private placements by negative implication, placing them in the realm of secondary transactions that are beyond the reach of section 12(2), as incorrect.²⁰⁷

IV. EVALUATION

The Court's decision in *Gustafson* has been met by reproach from securities market analysts.²⁰⁸ Much of this negative criticism may be contributed to the effects *Gustafson* has had on the lower courts, the Supreme Court's misreliance on "policy preferences,"²⁰⁹ and *Gustafson's* ambiguous effects on the private placement of securities.²¹⁰

note 2, at 1).

²⁰⁵*Id.* at 1082 n.5 (comparing *Pacific Dunlop*, 993 F.2d at 578 with *First Union*, 997 F.2d at 842-44).

²⁰⁶*Id.* (citing *Metromedia Co. v. Fugazy*, 983 F.2d 350, 360-61 (2d Cir. 1992), *cert. denied*, 508 U.S. 952 (1993); *Pacific Dunlop Holdings Inc. v. Allen & Co.*, 993 F.2d 578 (7th Cir. 1993); *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973)).

²⁰⁷*Gustafson*, 115 S. Ct. at 1082 (Ginsburg, J., dissenting). The Court was incorrect in not expressly including private placements as within the scope of § 12(2); the "longstanding acceptance by the courts [of a judicial interpretation], coupled with Congress's failure to reject" that interpretation, "argues significantly in favor of accept[ing] it." *Id.* (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 (1975)).

²⁰⁸*See, e.g.*, Stephen M. Bainbridge, *Colloquy, Securities Act Section 12(2) After the Gustafson Debacle*, 50 BUS. LAW. 1231, 1270 (1995) (concluding that "the majority opinion is at best bizarre and borders on the irresponsibly unintelligible," whereby it "unnecessarily put a vast body of even more well-settled law at risk"); Margaret A. Bancroft, *Responding to Gustafson: Company Registration and a New Negligence Standard*, 9 INSIGHTS 14 (July 1995) (asserting that *Gustafson* "splintered a key column of the Securities Act"); Booth, *supra* note 59, at 8 (stating that the Court has "rearranged the face of federal securities law" with this decision); Lorne, *supra* note 145, at 770 (concluding that the implications of this decision may be difficult "for those who daily need to interpret the statute"); SODERQUIST, *supra* note 194, at 183-84 (extending Professor Loss's statement that "[e]very so often a faulty decision by one court is picked up by a second, and then by a few more, until it acquires a life of its own," to *Gustafson*, where the aforementioned process "has reached its zenith" (referring to Loss, *supra* note 18, at 908)).

²⁰⁹*See supra* text accompanying notes 190-94 for Justice Thomas's remarks regarding the policy preferences of the majority.

²¹⁰*See infra* part IV.C.

A. *The Effects of Gustafson on the Courts*

Courts addressing the issues raised in *Gustafson* were immediately affected by the unexpected decision²¹¹ arising from this "little known" case.²¹² Negative consequences of *Gustafson* have been seen in many cases where the alleged harm is a result of secondary transactions, and the plaintiffs were relying on section 12(2) as a means of recovery.²¹³

Gustafson has prompted some courts to dismiss claims brought under section 12(2) due to the limitations placed on its scope.²¹⁴ Consequently, plaintiffs alleging harm from secondary market transactions are forced to rely upon section 10(b) or Rule 10b-5 as a means of recovery.²¹⁵ If the plaintiffs are unable to prove the heightened burden of proof required pursuant to 10(b) or Rule 10b-5, they are left without any means of recovery under the 1933 and 1934 Acts.²¹⁶ Further, courts

²¹¹See Booth, *supra* note 59, at 8 (remarking that the Court "unexpectedly limited" the reach of § 12(2)); see also HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *EMERGING TRENDS IN SECURITIES LAW* § 1.02, at 1-5 to 1-6 (1995) (remarking that *Gustafson*, while being factually similar to *Pacific Dunlop* because both involved the "sale of stock by large shareholders in a closely held corporation to a third party," went beyond *Ballay* in its decision).

²¹²Maynard, *supra* note 120, at 33. *Gustafson* was a "relatively obscure" case in terms of its background. *Id.* The case was unreported by the district court and, on appeal, there was no opinion accompanying the Seventh Circuit's order to remand the case in light of its holding in *Pacific Dunlop*. *Id.* Furthermore, following *Pacific Dunlop*'s voluntary dismissal, the Court promptly granted review of *Gustafson*, which indicated its "intense interest in deciding the ongoing controversy regarding the scope of section 12(2)." *Id.*

²¹³See *infra* notes 214-17 and accompanying text.

²¹⁴See generally *Stack v. Lobo*, 903 F. Supp. 1361 (N.D. Cal. 1995) (dismissing plaintiff's § 12(2) claim for lack of standing because plaintiffs had purchased shares in aftermarket trading, not as part of the initial public offering); *Komanoff v. Mabon, Nugent & Co.*, 884 F. Supp. 848 (S.D.N.Y. 1995) (dismissing claims of excessive trading against a broker); *Baxter v. Baron & Co.*, No. 94 Civ. 3913 (JGK), [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,923 (S.D.N.Y. Oct. 12, 1995) (dismissing plaintiff's cause of action alleging securities fraud in secondary market trading); *Farley v. Baird, Patrick & Co.*, No. 90 Civ. 2168 (MBM), [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,931 (S.D.N.Y. Aug. 22, 1995) (dismissing plaintiff's § 12(2) claim because defendant's sale of securities was "outside the reach of § 12(2) liability"). Cf. *In re U.S.A. Classic Sec. Litig.*, No. 93 Civ. 6667 (JSM), [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,837 (S.D.N.Y. June 19, 1995) (upholding plaintiff's § 12(2) claim based on evidence showing that some class members had purchased in the company's initial public offering).

²¹⁵See the following commentators all noting the same: Booth, *supra* note 59, at 12; Bruce A. Mann & Tamra D. Browne, *Unconventional Private Offering Techniques*, CA36 A.L.I.-A.B.A., Course of Study Materials, 597, 616 (1995); Glenn M. Reiter & Gregory W. Conway, *Due Diligence in Offerings by Non-U.S. Issuers*, in *INTERNATIONAL SECURITIES MARKETS*: 1995, at 195, 211-12 (Alan L. Beller & Michael D. Mann co-chairs, 1995).

²¹⁶See Booth, *supra* note 59, at 11 (remarking that "it is now clear that Section 12(2) does not apply" to secondary transactions, and "therefore the plaintiff must prove all the

are bound to follow *Gustafson's* holding that the meaning of the term "prospectus," for the purposes of section 12(2), is limited to public offering documents.²¹⁷

B. *Effect of Policy Preferences on the Court*

Gustafson's policy preferences may have been misguided by a failure to recognize that the very differences between the antifraud provisions of the 1933 and 1934 Acts would limit increases in section 12(2) litigation without resorting to restricting the scope of section 12(2).²¹⁸ The Supreme Court previously held that policy considerations may be used in construing terms in the federal securities acts;²¹⁹ however, the "policy preferences"²²⁰ in *Gustafson* may have guided the Court astray

elements of a Rule 10b-5 case (including scienter and reliance)").

²¹⁷See *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, 899 F. Supp. 1061 (S.D.N.Y. 1995) (granting summary judgment against plaintiff's § 12(2) action arising out of limited partnership interests purchased through a privately negotiated agreement); *Glamorgan Coal Corp. v. Ratner's Group PLC*, No. 93 Civ. 7581 (RO), 1995 U.S. Dist. LEXIS 9548 (S.D.N.Y. July 7, 1995) (rejecting plaintiff's argument that a private placement memorandum containing the same information as a prospectus must comply with § 10 of the 1933 Act); *Pollack v. Laidlaw Holdings, Inc.*, No. 90 Civ. 5788 (DLC), [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,741 (S.D.N.Y. May 3, 1995) (dismissing plaintiff's § 12(2) claim based on defendant's oral misrepresentations about the nature of the plaintiff's investments); *Endo v. Albertine*, No. 88 C 1815, 1995 U.S. Dist. LEXIS 4517 (N.D. Ill. Apr. 7, 1995) (concluding that class members who purchased securities pursuant to a private sale agreement did not have a § 12(2) cause of action against defendants).

²¹⁸See *Rapp*, *supra* note 14, at 725-26 (noting the *Ballay* court's concern regarding the potential for increased litigation pursuant to § 12(2), and invalidating these concerns by focusing on the different remedies offered in the antifraud provisions of the 1933 and 1934 Acts); *Zucal*, *supra* note 61, at 1191-94 (discussing the policy concerns of the *Ballay* court, and how extending § 12(2) liability would not worsen these concerns).

²¹⁹See *Zucal*, *supra* note 61, at 1194 (referring to the Court's decision in *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692-93 n.6 (1985)).

²²⁰*Gustafson*, 115 S. Ct. at 1078 (Thomas, J., dissenting) (quoting Justice Thomas's statement that "[t]he majority's analysis of § 12(2) is motivated by its policy preferences"). See *Zucal*, *supra* note 61, at 1191-94. The *Ballay* court's concern involved situations where purchasers who were aware of an inability to meet the heightened requirements of a § 10(b) cause of action would instead turn to § 12(2) and its lesser requirements, thus creating an increase in § 12(2) litigation. *Id.* (referring to *Ballay*, 925 F. 2d at 689). The *Ballay* court resolved its concerns by limiting the application of § 12(2) only to actions arising out of initial distributions. *Id.*; see also *Therese H. Maynard, The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of 1933*, 69 NOTRE DAME L. REV. 57, 68-87 (1993) (focusing on how the "underlying philosophy of the 1933 Act" is intended to eliminate misrepresentations of material fact by broker-dealers such as the firm Legg Mason in *Ballay*, and thus the "very viability of the brokerage industry" would not be threatened by an "overwhelming volume of lawsuits"); *Rapp*, *supra* note 14, at 725-727 (addressing the *Ballay* court's concern that the lesser burden of proof under § 12(2) would eliminate the use of

in its reasoning. While the Court's concerns are valid, they can be quieted by focusing on the differences between section 10(b) and section 12(2).²²¹

One commentator found several considerations that would prevent substantial increase in section 12(2) litigation as a result of expanding its scope, which may be similarly extended to *Gustafson*.²²²

The first consideration addresses the broader range of potential defendants who may be liable under section 10(b) of the 1934 Act as opposed to section 12(2) of the 1933 Act.²²³ Section 10(b) has been extended to a wider range of defendants than section 12(2), which only allows plaintiffs to recover against a "seller" of securities.²²⁴ As a result, if courts find that section 12(2) applies to secondary trading, the limitations on potential defendants under section 12(2) would at least "offset any advantage gained as a result of the lesser standard of proof under section 12(2)."²²⁵

A second consideration addresses the wide variety of damages available under section 10(b), unlike section 12(2), which restricts damages to rescission or its monetary equivalent.²²⁶ Section 10(b) has been used more by plaintiffs as a means of recovery because its damages "substantially outstrip" those available under section 12(2).²²⁷ It has been argued that if courts found section 12(2) to apply to secondary trading, many plaintiffs would still rely on section 10(b), regardless of the lesser standard of proof under section 12(2).²²⁸

§ 10(b) and Rule 10b-5 as a means of recovery for purchasers).

²²¹Zucal, *supra* note 61, at 1191-92 (noting that there are countervailing considerations involving the differences between § 12(2) and 10(b) that would prevent an increase in § 12(2) litigation if courts were to extend 12(2) liability to apply to both initial distributions and aftermarket trading); *see also* Rapp, *supra* note 14, at 725-26 (remarking that the existence of important differences in the elements of § 12(2) and 10(b), and Rule 10b-5, does not indicate that the scope of § 12(2) should be limited by the courts; rather, it supports extending the scope of § 12(2) as a remedy for all purchasers).

²²²*See* Zucal, *supra* note 61, at 1191-94.

²²³Zucal, *supra* note 61, at 1191. Courts have broadly construed the language in § 10(b), which prohibits the use of any manipulative or deceptive device "in connection with the purchase or sale of any security." *Id.* (citing 15 U.S.C. § 78j(b)).

²²⁴*Id.* at 1191-92.

²²⁵*Id.* at 1192.

²²⁶Zucal, *supra* note 61, at 1192-93. Plaintiffs have received various types of damages pursuant to § 10(b), such as "benefit-of-the-bargain, out-of-pocket loss, disgorgement, and rescission." *Id.* at 1193; *see also* Reiter & Conway, *supra* note 215, at 210 (noting that under § 10(b) and Rule 10b-5, a successful plaintiff may recover out-of-pocket damages).

²²⁷Zucal, *supra* note 61, at 1193.

²²⁸*Id.*

Finally, other commentators have focused on the past co-existence of the differing remedies as further support for the premise that expanding the scope of section 12(2) would not increase litigation.²²⁹ This indicates that if *Gustafson* had interpreted section 12(2) to apply to initial distributions and secondary market trading, it would not have rendered section 10(b) obsolete as a means of recovery for purchasers of securities.

C. *The Effects of Gustafson on Private Placements*

It is still not known for sure whether the *Gustafson* Court intended to include private placements among transactions which are beyond the reach of section 12(2).²³⁰ This concern, first expressed by Justice Ginsburg in her dissent,²³¹ has been voiced by several securities market analysts since the decision.²³² One commentator has argued that private placements of securities may increase because *Gustafson* seems to indicate that issuers in private placements may not be held liable for negligent misstatements under section 12(2).²³³

²²⁹Rapp, *supra* note 14, at 726. Sections 12(2) and 10(b) remedies have never been mutually exclusive because "[e]ach has its own essential elements, and both may not be available in a given set of circumstances." *Id.* This proposition is contrary to Courts' findings in *Gustafson* and *Ballay*; however, over the years § 12(2) "has not eviscerated" § 10(b) or Rule 10b-5.

²³⁰As of yet, no courts have tested these waters. The only district court to uphold a § 12(2) claim arising from a secondary market transaction did so based on evidence that the plaintiff had purchased some of the security in the initial product offering. *In re U.S.A. Classic Sec. Litig.*, No. 93 Civ. 6667 (JSM), [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,837 (S.D.N.Y. June 19, 1995); see also BLOOMENTHAL & WOLFF, *supra* note 211, at 1-23 n.57 (referring to this holding in *In re U.S.A. Classic Sec. Litig.* and also noting that the court did not find it necessary to determine when "an initial product offering ends and secondary market transactions begin").

²³¹See *supra* text accompanying notes 206-16.

²³²See Bancroft, *supra* note 208, at 14 (proposing that *Gustafson* places private placements "outside the discipline provided by a negligence standard"); Booth, *supra* note 59, at 10 (stating that *Gustafson* "appears to insulate private offerings from § 12(2) while leaving small (but public) offerings exposed," and even though not addressing private placements in particular, noting that the Court is drawing a distinction between public and private offerings); Mann & Browne, *supra* note 215, at 15 (asserting that *Gustafson* "eliminated civil liability for negligent misrepresentations in the private placements of securities"); Reiter & Conway, *supra* note 215, at 212 (evaluating the effects of *Gustafson*'s "altering the legal liability 'landscape' for Rule 144A and other private offerings"); Vizcarrondo & Houston, *supra* note 59, at 544 (stating that the Court's decision in *Gustafson* leaves unclear the applicability of § 12(2) to private placement offerings).

²³³See Bancroft, *supra* note 208, at 15. Bancroft notes that if this occurs, the market will have, in effect, "dismissed the [1933 Act] as irrelevant with respect to seasoned issuers and

Most commentators have contended that if private placements are excluded from the scope of section 12(2), there may be a dual effect. It may strengthen disclosure under the 1934 Act, while undermining one of the primary purposes of the 1933 Act.²³⁴ Plaintiffs who are unable to rely on section 12(2) will be forced to turn to section 10(b) or Rule 10b-5 as the only available civil remedies for claims of fraud. However, a potential problem remains in that plaintiffs who cannot meet the "public offering" or other requirements of section 12(2) may similarly not be able to meet the more stringent requirements of section 10(b) or Rule 10b-5.²³⁵ This may potentially lead to the creation of an entire class of plaintiffs without judicial recourse.

V. CONCLUSION

President Roosevelt intended the 1933 Act to "protect the public with the least possible interference to honest business."²³⁶ In his recommendation to Congress, the President did not differentiate between protecting the public during or after the initial distribution of securities; he referred only to the *general* public.²³⁷ By limiting the scope of section 12(2), *Gustafson* has affected the securities market and undermined one of the primary purposes of the 1933 Act.

By limiting the term "prospectus" as applying to only public offerings and their controlling shareholders, the Court has forced many plaintiffs to rely on section 10(b) of the 1934 Act or Rule 10b-5 for securities fraud. This is a source of potential harm to the public.²³⁸ The

the integrity of the Act will be compromised." *Id.*; see *Vizcarrondo & Houston*, *supra* note 59, at 544-45. The *Gustafson* Court's broad language confining "prospectuses" to "'documents related to public offerings by an issuer or its controlling shareholders,' and stating that 'the 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),' " could be read to preclude a plaintiff alleging a misrepresentation in a private placement from recovering under § 12(2). *Id.* at 545 (quoting *Gustafson*, 115 S. Ct. at 1067).

²³⁴See generally *Zucal*, *supra* note 61, at 1194 (urging subsequent courts addressing the issue of the scope of § 12(2) liability to come to the opposite conclusions of the *Ballay* court, because *Ballay* "undermine[d] the underlying purpose" of the 1933 Act).

²³⁵See *Ernst & Ernst*, 425 U.S. at 201-06; *Mann & Browne*, *supra* note 215, at 616 (noting the severe limitations set by the Court, and stating that "the only remaining civil remedy for fraud in a private placement transaction is under Rule 10b-5" or § 10(b) of the 1934 Act); see also *id.* (stating that plaintiffs relying on these causes of action must prove scienter in order to recover, and this requirement in particular may limit potential plaintiffs).

²³⁶President's Message, *supra* note 4, at 1, reprinted in 2 LEGISLATIVE HISTORY, *supra* note 3, item 15, at 1 (1973).

²³⁷*Id.*

²³⁸See *supra* notes 230-35 and accompanying text.

Court's decision is inconsistent with the legislative history of the Act as set forth in the Senate and Conference Reports, with the decisions of many lower courts, and with the conclusions of many securities market analysts. Rather than restraining the growth of the securities market by limiting the scope of section 12(2), the Court should have expanded its scope to include both initial distributions and secondary transactions, thereby remaining consistent with the history of the 1933 Act.

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