St. John's Law Review

Volume 73, Summer 1999, Number 3 Article 1

Aftermarket Purchaser Standing Under § 11 of the Securities Act of 1933

Brian Murray

ST. JOHN'S LAW REVIEW

VOLUME 73 SUMMER 1999 NUMBER 3

AFTERMARKET PURCHASER STANDING UNDER § 11 OF THE SECURITIES ACT OF 1933

BRIAN MURRAY*

Following the collapse of the financial markets in the United States in October 1929, Congress enacted the Securities Act of 1933 (the "1933 Act").[1] It was a cataclysmic change in the nature of the securities markets. Before the 1933 Act an attitude and legal climate of caveat emptor applied to purchasers of securities.[2] With its passage, Congress provided a remedy of strict liability against an issuer of public securities, which issued a materially false and misleading registration statement pursuant to which its securities were sold to the public.[3]

Although Congress would pass the Securities Exchange Act of 1934,[4] which applies to any securities transaction, the focus of the 1933 Act concerned the initial registrations of securities.[5] As noted in the legislative history of the 1933 Act, billions of dollars worth of securities were brought to market in the 1920s, over half

* B.A., University of Notre Dame, 1983; M.A., University of Notre Dame, 1986; J.D., *cum laude*, St. John's University School of Law, 1990. Mr. Murray is a member of Rabin & Peckel LLP, New York, New York.

1 15 U.S.C. § 77a (1994).

2 *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (noting that prior to the 1933 Act there was a widespread attitude of caveat emptor); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) (stating that a fundamental purpose of the Securities Act of 1933 "was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*"); Silver v. New York Stock Exch., 373 U.S. 341, 351 (1963) (noting the need for higher ethical standards, imposed through statute, after economic disasters in the 1920s).

3 *See* 15 U.S.C. § 77k (1994) (creating liability for misstatements or omissions on a registration statement); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752 (1975) (stating the purpose of the 1933 Act was to regulate initial purchases).

4 15 U.S.C. § 78a (1994).

5 *See* 15 U.S.C. § 77k(a) (conditioning recovery on proof that security was acquired before an earning statement was issued or if after, only if purchaser was unaware of statement); *see also* Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d Cir. 1951) (noting that the 1933 Act only applies to a limited group of plaintiffs who purchased securities, which were the "direct subject" of the registration statement).

of which had become completely worthless by 1933.[6] In signing the 1933 Act into law, President Franklin Delano Roosevelt stated that Congress was putting "the burden of telling the whole truth on the seller" in order to "give impetus to honest dealing in securities and thereby bring back public confidence."[7] In order to put teeth into this idea, two civil liability provisions were built into the 1933 Act, in the hope that this would facilitate the raising of capital by deserving companies.[8]

The first provision, § 11, provides for strict liability and monetary damages for an issuer found to have sold securities pursuant to a materially false or misleading registration statement, and lists four categories of other defendants who are also liable.[9] Section 11 has no reliance requirement and no requirement that a plaintiff even prove damages; rather, a prima facie case consists solely of proving a material misstatement[10] or omission[11] in a registration statement or prospectus.[12] The burden of *disproving* the elements of a § 11 case is on the defendants. As part of their affirmative defenses they are allowed to prove that

---

[6] *See* S. REP. NO. 47, at 2 (1933) (recognizing that the United States lost approximately $25 billion dollars in one decade through the purchase and sale of worthless securities); J. WILLIAM HICKS, CIVIL LIABILITIES: ENFORCEMENT AND LITIGATION UNDER THE 1933 ACT § 4.01[1], at 4-6 (1996) (stating that one half of the securities proved worthless because of lack of fair and honest dealing by dealers and underwriters).

[7] 77 CONG. REC. 937 (1933).

[8] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (noting the act was meant to provide full disclosure which would help the market and raise ethical standards as well as capital); SEC v. Ralston Purina, Co., 346 U.S. 119, 125 (1953) (noting the act is to protect investors as well as the general public).

[9] 15 U.S.C. § 77k (noting that in addition to the issuer, or its director or partner, every person who signed the statement, every underwriter, everyone who it named in the statement, or those who gave authority to the statement may also be liable).

[10] A misstatement can be defined as a statement made on a registration that is untrue or misleading, and would alter the decision of a reasonable person who read them. *See In re* Trump Casino Sec. Litig., 7 F.3d 357, 368–69 (3d Cir. 1993); *see also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").

[11] An omission is a failure to perform a legally imposed obligation. *See* BLACK'S LAW DICTIONARY 1086 (6th ed. 1990).

[12] *See* 15 U.S.C. § 77k(a) (stating that part of the registration statement must contain an untrue statement of a material fact or omit to state a material fact); *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (explaining that a plaintiff only needs to show a material misstatement or omission to establish a prima facie case).

the drop in the price of the stock was not caused by the misstatements or omissions, or that in the exercise of due diligence[13] they could not have known about the false statement or omission.[14] The second provision, § 12, provides for a remedy of rescission against the seller of securities, sold pursuant to a materially false or misleading prospectus (and included in a registration statement).[15]

In order to avail oneself of the protection of § 11 of the 1933 Act, a plaintiff must plead, and eventually prove, that the securities he or she purchased were issued pursuant to the defective registration statement.[16] A purchaser who buys directly on an initial public offering from an underwriter unquestionably has

---

[13] Due diligence is defined as the "measure of prudence . . . properly . . . expected from, and ordinarily exercised by, a reasonable and prudent [person] under the particular circumstance." BLACK'S LAW DICTIONARY 457 (6th ed. 1990); *see also Ernst & Ernst*, 425 U.S. at 208 (noting due diligence is essentially a negligence standard); Glassman v. Computervision Corp., 90 F.3d 617, 627 n.12 (1st Cir. 1996) ("Due diligence is equivalent to non-negligence."); *In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 621 (9th Cir. 1994) (noting that the reasonable investigation test for due diligence is almost identical to the reasonable care test used for negligence).

[14] *See* 15 U.S.C. § 77k(b)(3) (stating that a person may be exempt from liability upon proof that he or she had reasonable grounds to believe and did believe that the statements were true and there was no omission to state a material fact). Only the non-issuer defendants have the due diligence defense available to them. *See id.* Issuers' liability, however, is virtually absolute even for innocent mistakes. *See In re* Nationsmart Corp. Sec. Litig., 130 F.3d 309, 315 (8th Cir. 1997); *Herman & MacLean*, 459 U.S. at 381–82.

[15] *See* 15 U.S.C. § 77(*l*) (1994) (stating that a person may sue to recover the consideration paid for the security plus interest, less the amount of any income received); *see also* Jackson Tool & Die, Inc. v. Smith, 339 F.2d 88, 89 (5th Cir. 1964) (explaining that plaintiff instituted suit under § 77(l)); Winter v. D.J.&M. Inv. & Constr. Corp., 185 F. Supp. 943, 945 (S.D. Cal. 1960) (noting that the suit was brought under the civil liabilities provisions of § 77(l)).

[16] *See* Shapiro v. UJB Fin. Corp., 964 F.2d 272, 286 (3d Cir. 1992) (stating plaintiffs must prove the purchase was pursuant to the registration statement); *In re* ZZZZ Best Sec. Litig., No. CV-87-3574-RSWL(BX), 1994 WL 746649, at *3 (C.D. Cal. Oct. 26, 1994) ("[A] plaintiff must prove that the shares purchased are traceable to the offering covered by the offending registration statement"); *In re* AES Corp. Sec. Litig., 825 F. Supp. 578, 592 (S.D.N.Y. 1993) (noting a purchase pursuant to a defective registration statement cannot be a secondary purchase, but rather must be traceable to the original statement); Lorber v. Beebe, 407 F. Supp. 279, 286 (S.D.N.Y. 1976) (noting that a plaintiff "must plead and prove that his stock was issued pursuant to the particular" defective statement). A defective registration statement is a statement issued by a company seeking to have securities traded publicly that is somehow lacking in a material aspect. *See* BLACK'S LAW DICTIONARY 1284 (6th ed. 1990).

standing to sue under § 11.[17] Generally, courts have allowed aftermarket purchasers[18] who allege the securities they bought were traceable to the registration statement at issue to have standing to sue under § 11.[19] If other securities of the same type at issue in a case were traded prior to the issuance of the false or misleading registration statement, tracing securities purchased in the open market back to the registration statement is very difficult.[20] Despite the widespread acceptance of tracing as a means of establishing entitlement to the protection of § 11,[21] the tracing theory has been under attack since the Supreme Court's decision in *Gustafson v. Alloyd Co.*,[22] a case involving § 12(2)[23] of the 1933 Act. This article will discuss the continued viability of the tracing theory for a § 11 claim after the *Gustafson* opinion.

---

[17] *See* Gould v. Harris, 929 F. Supp. 353, 359 (C.D. Cal. 1996) (noting that only purchasers who purchased during an initial offering have standing); Kirkwood v. Taylor, 590 F. Supp. 1375, 1378 (D. Minn. 1984) (noting purchasers must trace all shares directly to the offering in order to have standing to sue). Although the *Kirkwood* court referred to buying on the offering as "direct tracing," it is actually not tracing at all. *See id.*

[18] An aftermarket purchaser is one who purchases a security "after it has been initially sold by the issuer through underwriters." BLACK'S LAW DICTIONARY 61 (6th ed. 1990).

[19] *See In re* College Bound Consol. Litig., No. 93 Civ. 2348 (MBM), 1994 WL 172408, at *2 (S.D.N.Y. May 4, 1994) (stating that plaintiff must trace stock back to show it was purchased pursuant to statement); Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 872 (N.D. Cal. 1986) ("There is no dispute among the parties that a plaintiff suing under section 11 must show that he or she purchased stock actually issued in the offering for which the plaintiff claims there was a false or otherwise misleading registration statement."); Unicorn Field, Inc. v. Cannon Group, Inc., 60 F.R.D. 217, 226 (S.D.N.Y. 1973) ("It is now well settled in this Circuit that § 11 of the Securities Act . . . permits recovery only by purchasers of the shares covered by the defective registration statement or by those who can trace their purchases directly to such shares.").

[20] *See* Harden v. Raffensperger, Hughes & Co., 933 F. Supp. 763, 766–67 (S.D. Ind. 1996) (noting the difficulties associated with tracing in the open market).

[21] Tracing is the process by which plaintiffs demonstrate they purchased securities pursuant to the registration statement. *See Kirkwood*, 590 F. Supp. at 1377. The *Kirkwood* court elaborated by discussing four possible tracing methods: direct, fungible mass, contrabroker, and heritage. *See id.* at 1377–83.

[22] 513 U.S. 561 (1995).

[23] Section 12(2) is now codified in § 12(a)(2) of the Securities Act after an amendment to the Securities Act in 1995. "Section 12(2)" and "Section 12(a)(2)" are used interchangeably in this article.

1. PRE-*GUSTAFSON* CASELAW CONCERNING THE TRACING THEORY

For the past thirty years, the law has been settled in the Second Circuit, and most other jurisdictions, that purchasers in the secondary market who can trace their stock back to an initial public offering ("IPO") have standing to sue for violations under § 11.[24] In *Barnes v. Osofsky*,[25] the Second Circuit was faced with the issue of whether a purchaser of stock who bought on the open market and could not trace the stock back to an offering should be entitled to damages even though purchasers who purchased during the same time period, but could trace back, would be so entitled. The plaintiffs in *Barnes* had purchased stock in the open market, some of which was traceable to a registration statement and some of which was not.[26] Although they were participating in the recovery with regard to their purchases, which were traceable to the registration statement, the district court denied them recovery for those shares purchased in the open market that were not traceable to the registration statement.[27] The plaintiffs made an equitable argument, stating that those who could not trace their shares to the registration statement suffered to the same extent as those who were able to trace back.[28] The *Barnes* court refused to extend § 11 to purchasers who could not trace their stock to the defective registration statement.[29] While the court acknowledged that an open market purchaser's ability to trace back is an accident of fate resulting in

[24] *See, e.g.*, McFarland v. Memorex Corp., 493 F. Supp. 631, 641–42 (N.D. Cal. 1980) (denying plaintiff standing where plaintiff failed to trace stock to statement); Lorber v. Beebe, 407 F. Supp. 279, 287 (S.D.N.Y. 1976) (holding plaintiff must show stock was actually issued pursuant to the challenged statement). With regard to claims under § 12(2) of the 1933 Act, the law was unsettled prior to *Gustafson*. *Compare* Pacific Dunlop Holdings Inc. v. Allen & Co., 993 F.2d 578, 595 (7th Cir. 1993) ("Contrary to the Third Circuit, we hold that section 12(2) applies to initial offerings and secondary market transactions.") *with* Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682, 689 (3d Cir. 1991) (stating that § 12(2) does not apply to aftermarket trading). Given the limited holding of *Gustafson*, the law still is unsettled.

[25] 373 F.2d 269 (2d Cir. 1967).

[26] *See id.* at 271 (limiting recovery to those who could establish they purchased pursuant to the statement).

[27] *See id.*

[28] *See id.* at 271–72 (explaining the plaintiff's argument that a narrow construction offends the principle of equal treatment for people whose entitlement is not significantly different).

[29] *See id.* at 273.

unequal treatment under § 11, it nevertheless decided not to depart from the statutory scheme.[30]

2. THE IMPORTANCE OF THE STANDING ISSUE

The question of who has standing to sue under § 11 has significant consequences in most securities class actions. In recent years, if the price of an IPO rises immediately after the offering, the initial purchasers often sell shares shortly after the offering.[31] If standing is limited to purchasers who bought directly on the initial public offering, an issuer's exposure in a suit under the 1933 Act can be greatly reduced.

The measure of damages under § 11 is the purchase price of the stock (not to exceed the offering price), less the price of the stock on the day the lawsuit is initiated.[32] If the stock has been sold prior to the initiation of the lawsuit, damages consist of the difference between the purchase price (not to exceed the offering price) and the sale price.[33] Thus, if the stock is sold at a profit, the initial purchaser has no statutory damages. If a subsequent purchaser, who sees the price of the stock drop below the offering price upon disclosure of the previously undisclosed facts, cannot trace his stock back to an underwriter in order to have standing, there will be no statutory damages for that share.[34]

For instance, if stock is sold in an offering at $20 per share, and the initial purchaser sells at $25, the initial purchaser will have no statutory damages. The second purchaser of that share, who buys stock at $25 and sells the stock at $10, will have lost $15 on his trade. There will be statutory damages of $10 ($20 offering price minus $10 price when the suit is filed) provided the second purchaser has standing. If the second purchaser has no standing, the defendants have reduced damages by $10 per share for each share the initial purchaser sold at a profit for the claims under §11 of the 1933 Act. The second purchaser will still have a

---

[30] *See id.*

[31] *See generally*, Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965 (1995).

[32] *See* 15 U.S.C. § 77k(e) (1994) (indicating that a suit filed under this section can recover the difference between these two prices).

[33] *See id.* The damages are also limited if the stock is sold after the lawsuit is filed, but prior to judgment. *See id.*

[34] *See* 17 C.F.R. § 240.10b-5 (1998) (explaining the requirements for a cause of action brought under § 10(b) of the 1934 Act).

cause of action under § 10(b) of the Securities Exchange Act of 1934, but the burden will be on the plaintiff to prove both damages and the defendants' state of mind, whereas under § 11 the burden is on the defendants to disprove those elements.[35]

Even if the stock price does not rise after the IPO, the damages will still be limited if only the initial purchaser has standing. If the stock is sold in the offering at $20, and sinks to $10 when the suit is started, statutory damages are presumed to be $10 per share for the purchasers who have not sold their shares prior to the commencement of the action. If the initial purchaser sells at $15, the damages for that share will be only $5 ($20 purchase price minus $15 sale price) if only the initial purchaser has standing. If subsequent purchasers are allowed to trace back to the offering, the second purchaser will also have $5 in damages ($15 purchase price minus $10 when the suit is initiated). Thus, total damages for that share will be $5 to the initial purchaser and $5 to the second purchaser for a total of $10.

3. THE *GUSTAFSON* OPINION

Gustafson v. Alloyd Co.[36] involved neither an IPO nor the issue of standing of an aftermarket purchaser. Further, *Gustafson* only involved a claim under §12(2) of the 1933 Act. In *Gustafson*, Justice Kennedy, writing for a five justice majority, summarized the issue in the opening lines of the opinion as follows:

> Under § 12(2) of the Securities Act of 1933 buyers have an express cause of action for rescission against sellers who make material misstatements or omissions "by means of a prospectus." The question presented is whether this right of rescission extends to a private, secondary transaction, on the theory that recitations in the purchase agreement are part of a "prospectus."[37]

Gustafson involved individuals who were the sole shareholders of a privately held corporation and who entered into a contract to sell their shares to another party.[38] Rather than conducting a mid-year inventory of the company, the purchaser relied on estimates, and included provisions in the contract of

---

[35] *See* 17 C.F.R. § 240.10b-5 (1998); *supra* notes 10–13 and accompanying text.
[36] 513 U.S. 561 (1995).
[37] *Id.* at 564.
[38] *See id.*

sale for adjustments after the closing if the estimates were inaccurate.[39] The contract of sale was executed on December 20, 1989 and provided for a payment of $18,709,000 and an additional payment of $2,122,219 to reflect the estimated increase in net worth from the previous year.[40] If the audit and financial statements for the year showed a variance between the estimated income and actual net earnings, the buyer could receive an adjustment.[41] When the actual audited financial statements were completed, they indicated that actual earnings were lower than estimated earnings, therefore entitling the buyer to an adjustment of $815,000.[42] The buyers rejected a tender of the $815,000 and instead sued under § 12(2) to rescind the contract of sale, arguing that the contract constituted a prospectus.[43] "The determinative question, then, is whether the contract between [the buyer and seller] is a 'prospectus' as the term is used in the 1933 Act."[44]

Having thus phrased the question, Justice Kennedy embarked on an odyssey of statutory interpretation, beginning with § 10 of the Securities Act of 1933,[45] which sets forth what information must be contained in a prospectus.[46] As there was "no dispute that the contract in this case was not required to contain the information contained in a registration statement and that no statutory exception was required to take the document out of § 10's coverage,"[47] Justice Kennedy found that the contract was not a prospectus. He also found:

> That does not mean that a document ceases to be a prospectus whenever it omits a required piece of information. It does mean that a document is not a prospectus within the meaning of that

---

[39] *See id.* at 565.

[40] *See id.*

[41] *See id.*

[42] *See id.*

[43] *See id* at 565–66.

[44] *Id.* at 568. Justice Kennedy also described the question as "whether a prospectus is a document soliciting the public to purchase securities from the issuer." *Id.* at 579.

[45] 15 U.S.C. § 77j (1994).

[46] *See id.* The Act requires that a prospectus contain the information found in the registration statement. *See id.* In some situations, this information may be summarized or omitted. *See id.*

[47] *Gustafson*, 513 U.S. at 569.

section if, absent an exemption, it need not comply with § 10's requirements in the first place.[48]

4. EARLY POST-*GUSTAFSON* DECISIONS

Gustafson only involved a claim under § 12(2), and the first decisions after *Gustafson* that examined the standing issue only involved claims under § 12(2).[49] These initial decisions held that *Gustafson* precluded aftermarket purchasers from having standing under § 12(2). For example, in *Komanoff v. Mabon, Nugent & Co.*,[50] the court simply noted that in *Gustafson* the Supreme Court held, "Section 12(2) extends only to initial public offerings of stock, and not to secondary market transactions."[51] Soon thereafter, with little or no analysis, many courts began to expand this premise to § 11.[52] The first case to consider the issue of aftermarket purchaser standing under § 11 after *Gustafson* was *Stack v. Lobo*.[53] The *Stack* court declared that "[i]n *Gustafson*, the Supreme Court held that § 12(2) applies only to initial

---

[48] *Id.*

[49] *See, e.g.*, ESI Montgomery County, Inc. v. Montenay Int'l Corp., 899 F. Supp. 1061, 1065 (S.D.N.Y. 1995) (finding the plaintiffs could only have a § 12 claim if they purchased in an IPO); Glamorgan Coal Corp. v. Ratner's Group PLC, No. 93 CIV. 7581 (RO), 1995 WL 406167, at *2–3 (S.D.N.Y. July 10, 1995) (discussing *Gustafson* and liability under § 12); Komanoff v. Mabon, Nugent & Co., 884 F. Supp. 848, 857 (S.D.N.Y. 1995) (dismissing the §12 claims since the claims were related to secondary transactions and § 12 claims only extend to IPOs); *In re* Valence Tech. Sec. Litig., No. C 94-1542-SC, 1995 WL 274343, at *17 (N.D. Cal. May 8, 1995) (focusing on liability under § 12). *Glamorgan* and the other § 12(2) decisions were later distinguished by a court which refused to apply *Gustafson* to § 11 because the *Glamorgan* decision "is attributable not to the holding of *Gustafson* alone, but to the combination of that holding with section 12's privity requirement." *In re* Fine Host Corp. Sec. Litig., 25 F. Supp. 2d 61, 67 (D. Conn. 1998).

[50] 884 F. Supp. 848 (S.D.N.Y. 1995).

[51] *Id.* at 857.

[52] Not every court followed a broad interpretation. In In re *U.S.A. Classic Sec. Litig.*, No. 93 Civ. 6667 (JSM), 1995 WL 363841, at *2–3 (S.D.N.Y. June 19, 1995), the court did not apply the *Gustafson* analysis to the § 11 claim, even though it did so for the § 12(2) claim. Likewise in *Lilley v. Charren*, 936 F. Supp. 708, 715 (N.D. Cal. 1996), the court did not discuss *Gustafson*'s applicability, even though it was decided a year earlier, and simply stated that a plaintiff would have standing if he can trace his purchase to a public offering. *See* Schoenhaut v. American Sensors, Inc., 986 F. Supp. 785, 789–90 (S.D.N.Y. 1997) (holding that tracing is viable to confer standing for § 11 and § 12(2) without mentioning the decision in *Gustafson*).

[53] 903 F. Supp. 1361 (N.D. Cal. 1995).

distributions of securities in public offerings,"[54] a statement which is hard to reconcile with the text of *Gustafson*. The *Stack* court then noted that *Gustafson* applied equally to § 11 and concluded that this precluded aftermarket transactions from the scope of § 11.[55] *Stack* did not consider the statutory language of § 11 in reaching its decision.

The opinion following *Stack* was *Gannon v. Continental Insurance Co.*,[56] which noted that the prevailing law in the Third Circuit was *Ballay*.[57] Similar to *Stack*, the *Gannon* court interpreted *Gustafson* to apply only to IPOs.[58] Two months later, the same conclusion was reached in *Gould v. Harris*.[59] In reaching its conclusion, the *Gould* court simply noted that § 11 and § 12(2) share the same legislative history.[60]

The first decision to recognize that *Gustafson*'s holding actually involved the issue of what constitutes a prospectus, and not whether aftermarket purchasers have standing, was *Murphy v. Hollywood Entertainment Corp.*[61] In *Murphy*, the court noted

---

[54] *Id.* at 1375. The court also relied on the dissenting opinion of Justice Ginsburg to support its conclusion. Despite the fact that the majority stated "this Court concludes that § 11 is not applicable to aftermarket transactions," it earlier stated that claims may be brought under § 11 "by those whose securities are traceable to the public offering," and notes that the complaint does not allege the shares at issue were traceable to the IPO. *Id.* at 1375, 1376. As a result, *Stack* is cited by courts for the proposition that aftermarket purchasers have no standing. *See* Adair v. Bristol Tech. Sys., Inc., 179 F.R.D. 126, 131 (S.D.N.Y. 1998); *In re* Valence Tech. Sec. Litig., No. C 95-20459 JW, 1996 WL 37788, at * 4 (N.D. Cal. Jan. 23, 1996). Courts also refer to the case for the related proposition that those who can trace their purchase to the IPO may have standing. *See* Van de Walle v. Salomon Bros., Inc., No. 9894, 1997 WL 633288, at *4 n.26 (Del. Ch. Oct. 2, 1997) (noting that *Stack* indicated purchasers who could trace their purchase to a public offering would have standing under § 11 and § 12, but also noting that *Stack* relied on a pre-*Gustafson* case for that proposition); Murphy v. Hollywood Entertainment, Corp., No. CIV. 95-1926-MA, 1996 WL 393662, at *3 (D. Or. May 9, 1996) (noting that *Stack* found purchasers lacked standing because they failed to allege their purchases were traceable to the IPO).

[55] *See Stack*, 903 F. Supp. at 1375 (noting that *Gustafson* applies equally to § 11 because § 11 and § 12 share the same legislative history and several cases before *Gustafson* also claimed that § 11 only applied to IPOs).

[56] 920 F. Supp. 566 (D.N.J. 1996).

[57] *See supra* note 24 and accompanying text.

[58] *See Gannon*, 920 F. Supp. at 575.

[59] 929 F. Supp. 353, 358 (C.D. Cal. 1996).

[60] *See id.* at 358 (following the reasoning in *Stack*); *see also* Rhodes v. Omega Research, Inc., 38 F. Supp.2d 1353, 1365 (S.D. Fla. 1999) (holding that *Gould* would prelude a claim under § 11 and § 12(a)(2) because of the failure to assert the shares were purchased in a public offering).

[61] No. CIV. 95-1926-MA, 1996 WL 393662 (D. Or. May 9, 1996).

that *Gustafson*'s "holding was premised upon a public/private distinction rather than the question presented here of the coverage of [§] 12(2) for sales direct from an offering versus aftermarket transaction."[62] Relying in part on *Stack*, the court ultimately decided to limit § 11 standing to purchasers directly on the offering.[63] The court seemed torn, however, and noted that it was "hesitant to read too much into the dicta of any decision."[64]

The court in In re *WRT Energy Securities Litigation* reached a similar decision.[65] The court in *WRT Energy* held that "the standing principles the Supreme Court announced in *Gustafson* apply equally to section 11 claims."[66] It also noted, as did *Stack* and *Gould*, that § 11 and §12(2) share the same legislative history.[67] Interestingly, none of these decisions examined the express language of § 11 when deciding whether that section extended to aftermarket purchasers, despite the principle that a court should construe a statute by its express language.[68]

5. THE RECENT TREND IS TO PERMIT TRACING

The trend of recent holdings is that tracing is still viable to confer standing under § 11, even after the *Gustafson* opinion.[69]

---

[62] *Id.* at *3.

[63] *See id.* at *3–4 (agreeing with the other courts which based their decisions on the broad discussion of the 1933 Act by the Supreme Court in *Gustafson*).

[64] *Id.* at *3.

[65] No. 96 CIV. 3610, 96 CIV. 3611, 1997 WL 576023 (S.D.N.Y. Sept. 15, 1997).

[66] *Id.* at *6. The irony is that no standing principles were announced in *Gustafson*, it was merely an opinion about what constituted a prospectus. *See supra* notes 36–48 and accompanying text.

[67] *See id.* (quoting HR REP. NO. 73-85, at 5 (1933)) (noting that "the 1933 Act governs only 'new offerings' rather than 'the ordinary redistribution[s] of securities' ").

[68] The analyses focused on case law interpreting the statute rather than the actual words of the statute. But, as the Supreme Court has noted, " '[t]he starting point in every case involving construction of a statute is the language itself.' " Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1985) (Powell, J., concurring) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975)). *Blue Chip Stamps* was a statutory interpretation case concerning securities under the 1934 Act.

[69] *See* Hertzberg v. Dignity Partners, Inc., No. 98-16394, 1999 WL 651947, at *5-6 (9th Cir. Aug. 27 1999) (stating that the *Gustafon* decision has not caused any circuit to reconsider their views concerning standing); Feiner v. SS&C Tech., Inc., No. Civ.A.3:97-CV656, 1999 WL 269103, at *1 (D. Conn. Mar. 23, 1999) (certifying a class action that included aftermarket purchasers provided that the purchasers can be traced to the offering); Adair v. Bristol Tech. Sys., Inc., 179 F.R.D. 126, 130–33 (S.D.N.Y. 1998) (holding that aftermarket purchasers have standing to sue if the purchased securities are traceable to the registration in question); Schwartz v. Ce-

The trend began with some courts holding that tracing an aftermarket purchase to an IPO was still valid to confer standing, but the initial cases offered little or no analysis.[70] The most recent decisions have an expansive analysis. The first such case was *Schwartz v. Celestial Seasonings, Inc.*,[71] in which the court agreed with the plaintiffs that *Gustafson* "did not address, in *dicta* or otherwise, the scope of § 11's pronouncement that 'any person acquiring such security' may bring a § 11 claim."[72] The *Celestial Seasonings* court examined the express statutory language of § 11, as well as the legislative history, and held that "notwithstanding *Gustafson*, . . . § 11 extends not only to persons who buy 'in the Offering,' but to all persons who acquired stock traceable to a public offering conducted *via* a [false and] misleading registration statement."[73] The court distinguished the earlier cases

lestial Seasonings, Inc., 178 F.R.D. 545, 556 (D. Colo. 1998) (holding that §11 "extended to all persons who acquired stock traceable to a public offering conducted *via* a misleading registration statement"); *In re* Fine Host Corp. Sec. Litig., 25 F. Supp. 2d 61, 67 (D. Conn. 1998) (quoting 15 U.S.C. § 77k (1999)) (contrasting the limiting language of § 12, limiting liability to purchasers of IPOs to the expansive recovery of § 11, allowing for recovery by "any person acquiring such security"); *In re* Websecure, Inc. Sec. Litig., 182 F.R.D. 364, 368 (D. Mass. 1998) (stating that securities purchases traceable to an offering confer standing); Cooperman v. Individual, Inc., No. Civ.A. 96-12272, 1998 WL 953726, at *4 (D. Mass. May 27, 1998) (noting that § 11 "imposes . . . continuing liability for misstatements or material omissions in registration statements," thus standing is not limited to initial purchasers, but extends to subsequent purchasers of securities traceable to the relevant registration statement), *aff'd*, 171 F.3d 43 (1st Cir. 1999); *In re* Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d. 1096, 1119 (D. Nev. 1998) (conferring standing on purchasers of securities traceable to a public offering, not just direct purchasers). *But see In re* Paracelsus Corp., Sec. Litig., 6 F. Supp. 2d 626, 631 (S.D. Tex. 1998) (dismissing plaintiff's § 11 claims relating to certain securities because they failed to allege a purchase of a security pursuant to an offering statement). The limited scholarly literature available also supports such a construction of § 11. *See* Vincent R. Cappucci, *Misreading 'Gustafson' Could Eliminate Liability Under § 11*, N.Y. L.J., Sept. 22, 1997, at 1 (contending that the legislative history of § 11 and the statutory language support standing for aftermarket purchasers).

[70] *See In re* Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d at 1119 ("[T]his Court disagrees with the *Gould* court, which found that the dicta in *Gustafson* . . . eliminated the well established rule of allowing Plaintiffs to pursue their claims if their purchases can be 'traced' to the offering at issue.") (citation omitted); *In re* Paracelsus Corp., Sec. Litig., 6 F. Supp. 2d at 631–32 (holding that until an appellate court holds otherwise, pleadings will be sufficient to survive a motion to dismiss if they allege that shares were purchased pursuant to a prospectus, even after *Gustafson*).

[71] 178 F.R.D. at 545.

[72] *Id.* at 555.

[73] *Id.* at 556.

limiting § 11 to direct purchasers on the IPO by noting that none of them examined the text of § 11.[74]

The next decision was from the Southern District of New York in *Adair v. Bristol Technology Systems, Inc.*[75] In *Adair*, the court explicitly disagreed with the holding of *WRT Energy*[76] and instead followed the holding of *Celestial Seasonings.* Noting that *Gustafson* did not involve a § 11 claim or an IPO, Judge Sweet stated that the issue before the *Gustafson* Court was whether a private agreement to sell constituted a prospectus for purposes of § 12(2) of the 1933 Act.[77] Judge Sweet noted that the legislative history was ambiguous with regard to § 11's application to aftermarket purchasers and stated that "[i]t does not affect the ordinary redistribution of securities." He further noted that "[section] 11 remedies are available 'regardless of whether [plaintiffs] bought their securities at the time of the offer or at some later date.' "[78]

---

[74] *See id.* at 557.

[75] 179 F.R.D. 126 (S.D.N.Y. 1998).

[76] Interestingly, an opinion issued after *Adair*, *In re* Summit Medical Sys., Inc., 10 F. Supp. 2d 1068, 1070 (D. Minn. 1998), follows the holding of *WRT Energy*, and like *WRT Energy*, contains no discussion of the express statutory language of § 11, while deciding *Gustafson* precludes aftermarket purchasers from suing under § 11. The same conclusion was reached in *Warden v. Crown Am. Realty Trust*, No. Civ. A. 96-25J, 1998 WL 725946, at *2 (W.D. Pa. Oct. 15, 1998). In *Warden*, the original plaintiffs made a "half-hearted" argument in favor of standing. *See id.* The proposed intervenor, who apparently made a more spirited attempt, still failed to cite the relevant case law in his favor. *See id.* at *3, n.1. The *Warden* court, like *Summit*, did not consider the statutory language of § 11, and appears to have misread *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272 (3d Cir. 1992), which clearly states that alleging "traceability" is sufficient at the pleading stage. *See id.* at 286. *Summit* and *Warden* are the only decisions issued in 1998 to limit § 11 standing to purchasers directly on the offering. *See Summit*, 10. F. Supp. 2d at 1070 (holding that "[s]ection 11 is applicable only to shareholders who acquired their stock in the IPO"); *Warden*, 1998 WL 726946, at *3 (rejecting the contention that "the nominal plaintiffs need not have purchased shares in the . . . IPO").

[77] *See* 179 F.R.D. at 131.

[78] *Id.* at 132 (quoting H.R. REP. No. 73-85, at 5 (1933). The latter legislative history cited by Judge Sweet states, in relevant part:

> Inasmuch as the value of a security may be affected by the information given in the registration statement, irrespective of whether a particular sale takes place in interstate or intrastate commerce, the civil remedies accorded by this subsection against those responsible for a false or misleading registration statement filed with the Federal Trade Commission are given to all purchasers regardless of whether they bought their securities in an interstate or intrastate transaction and regardless of whether they bought their securities at the time of the original offer or at some later date, pro-

Judge Sweet examined the express statutory language of § 11[79] and found that the *Barnes* case was still good law and aftermarket purchasers do have standing.[80] The *Adair* court noted that "the language of § 11 is broad: 'Any person acquiring such security . . . may . . . sue.' "[81] In addition the court noted that:

> [Section] 11(a) states that if a 'person acquired the security after the issuer has made generally available to its security holders an earnings statement covering a period of at least twelve months beginning after the effective date of the registration statement,' then the right of recovery is conditioned upon proof that the person actually relied on the false statement in the registration statement.[82]

Such a purchaser by definition must have purchased in the aftermarket.[83]

In addition, Judge Sweet examined another provision of § 11 that seems to mandate the standing of aftermarket purchasers. Section 11(e) allows purchasers to recover for " 'such damages as shall represent the difference between *the amount paid for the*

> vided, of course, that the remedy is prosecuted within the period of limitations provided by section 13.

H. R. REP. No. 85, at 22 (1933). In 1933, registration statements were filed with the FTC because the SEC was not created until the Securities Exchange Act of 1934 was passed. *See* Dow Jones & Co. v. Commissioner of Internal Revenue, 41 T.C. 102, 111 (1963).

[79] *See supra* note 68 (noting that an analysis of a statute should begin with the express language of the statute).

[80] *See Adair*, 179 F.R.D. at 130–33 (referring to the thirty year history in the Second Circuit of allowing standing based on purchases traceable to relevant registration documents). Another court in the Second Circuit recently reached the same conclusion. In In re *Fine Host Corp. Sec. Litig.*, 25 F. Supp. 2d 61, 66–67 (D. Conn. 1998), the court held that "[t]he holding of *Gustafson* in no way compels a result different from that reached in *Barnes*."

[81] *Adair*, 179 F.R.D. at 132. The *Fine Host* court compared the express language of §§ 11 and 12, noting that § 11 states "any person" may sue, whereas § 12 "expressly limits recovery to only those purchasers who purchase their shares directly from a seller who makes use of a false or misleading prospectus." *In re* Fine Host Corp. Sec. Litig., 25 F. Supp. 2d at 67.

[82] *Adair*, 179 F.R.D. at 132.

[83] *See id.* (concluding that "Congress therefore explicitly contemplated that a plaintiff could purchase a registered security well after the IPO and still have a remedy under § 11"). A court in Massachusetts adopted the *Adair* analysis. *See In re* Websecure, Inc. Sec. Litig., 182 F.R.D. 364 (D. Mass. 1998). In *Websecure*, the court stated it "agree[d] with the *Adair* analysis and with its conclusions" and held a plaintiff may plead a purchase in the IPO or a purchase traceable to the IPO to have standing. *Id.* at 368.

security (not exceeding the price at which the security was offered to the public)' " and the lesser of either the value when the suit was filed or the price at which the security was sold, if sold before judgment.[84] This clause has meaning only if it applies to secondary market transactions.[85] Judge Sweet thus concluded that aftermarket purchasers still have standing to pursue claims under § 11 of the 1933 Act after *Gustafson.*[86]

An opinion issued two weeks after *Adair* has an expansive analysis of why *Gustafson* does not preclude purchasers from suing under § 11. In *Cooperman v. Individual, Inc.*,[87] the court stated that "*Gustafson* was a decision not on standing, but rather on the substantive elements of a § 12(2) action."[88] The court further stated that "[i]n other words, the [*Gustafson*] Court held that there is no right of recovery for misrepresentations in the aftermarket, but it did not preclude an aftermarket purchaser from recovering for misrepresentations in an IPO."[89] This observation helps reconcile opinions like *Stack* with both *Gustafson* and *Adair*. By limiting *Gustafson* to its facts, it simply states that the provisions of § 12(2) are only implicated when a prospectus is issued within the meaning of the Securities Act.

The *Gustafson* opinion says exactly this: "[i]t is not plausible to infer that Congress created this extensive liability for every casual communication between buyer and seller in the secondary market."[90] The liability stems from a misstatement in a prospectus. Once a prospectus is issued, however, any stock issued pursuant to that prospectus which is purchased either on the offering or in the aftermarket, will be afforded the protections of the Securities Act. Purchasers in the aftermarket will therefore have standing if they can show their stock is traceable to the offering.

---

[84] *Adair*, 179 F.R.D. at 133 (citation omitted).

[85] All initial purchasers of an IPO acquire the security at the offering price. Thus, the statute's reference to purchases other than at the offering price can only be interpreted as allowing standing for aftermarket purchasers.

[86] *See Adair*, 179 F.R.D. at 133; *see also In re* Fine Host Corp. Sec. Litig., 25 F. Supp. 2d at 67 ("*Gustafson* therefore does not overrule *Barnes*, either directly or by necessary implication.").

[87] No. Civ.A. 96-12272, 1998 WL 953726, at *6 (D. Mass. May 27, 1998), *aff'd on other grounds*, 171 F.3d 43 (1st Cir. 1999).

[88] *Id.* at *6.

[89] *Id.*

[90] Gustafson v. Alloyd Co., 513 U.S. 561, 578 (1995).

6. PROSPECTUS DELIVERY REQUIREMENTS OF § 4(3)(B)

In addition to the express statutory language of § 11, there is another section of the 1933 Act that confers standing to sue on at least some aftermarket purchasers. Section 4(3)(B) of the 1933 Act requires that a prospectus be delivered within 90 days of an initial public offering for each sale by a dealer of the securities covered by the registration statement.[91] Any securities sold by an underwriter as part of its initial allotment of securities must be accompanied by a prospectus. Subsequent sales of a security covered by the registration statement of an underwriter who has sold out its initial allotment, however, must still be accompanied by a prospectus, if the sale is within the 90 day window.[92] Dealers who were not underwriters of the offering must also provide a prospectus with all sales during the 90 day window.[93] The SEC has promulgated a rule that shortens the 90 day prospectus delivery requirement to 25 days if the stock is already listed for trading on a national exchange on the date of the offering.[94]

Under § 4(3)(B), therefore, all purchasers of a stock issued in an initial public offering should receive a prospectus in connection with their purchase as long as the purchase occurs within

---

[91] The ninety day requirement applies to issuers who have not registered securities previously. *See* 15 U.S.C. § 77d(3)(C) (1994). Issuers with prior registrations are subject to a forty day prospectus delivery requirement. *See* 15 U.S.C. § 77d(3)(B) (1994).

[92] *See* Levitin v. A Pea in the Pod, Inc., No. 3:94-CV-0247, 1997 WL 160184, at *3 (N.D. Tex. March 31, 1997) (noting the 90 day prospectus delivery requirement of IPOs); 17 C.F.R. § 230.174 (1999) (limiting period to 25 days for issuers listed on national securities exchanges or NASDAQ); Stack v. Lobo, 903 F. Supp. 1361, 1375 (N.D. Cal. 1995) (noting the 25 day prospectus delivery requirement for listed securities).

[93] *See* 17 C.F.R. § 230.174.

[94] *See* 17 C.F.R. § 230.174(d). This rule states:

> If (1) the registration statement relates to the security of an issuer that is not subject, immediately prior to the time of filing the registration statement, to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934, and (2) as of the offering date, the security is listed on a registered national securities exchange or authorized for inclusion in an electronic inter-dealer quotation system sponsored and governed by the rules of a registered securities association, no prospectus need be delivered after the expiration of twenty-five calendar days after the offering date. For purposes of this provision, the term *offering date* refers to the later of the effective date of the registration statement or the first date on which the security was bona fide offered to the public.

Id.

25, 40, or 90 days of the offering, depending on the issuer's prior registration status or listing on an exchange. Since sales within the 25, 40, or 90 day window are accompanied by the delivery of a prospectus, they would seem to be akin to sales directly on the offering.[95] In *Feiner v. SS&C Technologies Inc.*,[96] in the context of examining the standing of aftermarket purchasers under § 12(2), the court concluded that limiting standing to purchasers directly on the offering would "eviscerate" the prospectus delivery requirements. The court held that all purchasers within 25 days of the offering had standing to sue, provided they were in privity with the defendant.[97] Another court has done this as well, holding that § 4(3)(B) "statutorily extends the period of an initial public offering by ninety (90) days following the commencement of the offering" and all purchasers in that period who received prospectus "may therefore be considered to have purchased on the initial public offering."[98]

The *Feiner* and *Wade* cases were decided under § 12(2), but given the applicability of § 4(3)(B) to both § 11 and § 12, there is no reason to limit their application to § 12. Section 4(3)(B) would seem to afford aftermarket purchasers (who receive a prospectus) standing under both § 11 and § 12(2) for a minimum of 25 and a maximum of 90 days after the offering.

---

[95] *See Levitin*, 1997 WL 160184, at *3 ("Any redistribution of that stock within the statutory period of time takes on the characteristics of a new offering."). The court in *Levitin* noted that a purchaser within 25 days after an IPO has standing to sue under § 12(2). *See id.*; *see also Stack*, 903 F. Supp. at 1375 (concluding plaintiffs did not purchase within 25 days of the offering, so they had no standing); *In re* Proxima Corp. Sec. Litig., No. 93-1139-IEG, 1994 WL 374306, at *10–11 (S.D. Cal. May 3, 1994) (holding that open market purchases within 90 days of IPO retained characteristics of new offering due to 4(3)(B) and plaintiffs who purchased within 90 day period could sue under § 12(2)). *But see In re* Valence Tech. Sec. Litig., C 95-20459, 1996 WL 37788, at *4 (N.D. Cal. Jan. 23, 1996) ("[Section] 12(2) applies only to a transaction which requires a prospectus to be delivered."); *In re* Media Vision Tech, No. C-94-1015, 1995 WL 787549, at *2 (N.D. Cal. Oct. 23, 1995) ("It does not appear to the Court that plaintiffs' analysis is correct [that § 4(3)(B) extends the period of an IPO 90 days].").

[96] No. CIV.A.3:97-CV656, 1999 WL 269103, at *2 (D. Conn. Mar. 23, 1999).

[97] *Id.* at *3.

[98] Wade v. Industrial Funding Corp., No. C 92-0343, 1993 WL 650837, at *5 (N.D. Cal. Aug. 30, 1993) (dismissing claims for § 12(2) purchasers, except for purchasers in IPO or purchasers within 90 day delivery requirement window).

CONCLUSION

Following an initial flurry of decisions after *Gustafson* which limited standing under § 11 to purchasers on an IPO, the more recent and more well-reasoned decisions allow aftermarket purchasers standing to sue under § 11. Such decisions are not only consistent with both the explicit statutory language of § 11, and to a limited extent with § 4(3)(B), but, are also truer to the legislative spirit behind the Securities Act in providing the broadest possible protection to purchasers of initial public offerings.