Does Section 12(2) of the Securities Act of 1933 Apply to Secondary Trading?: Ballay v. Legg Mason Wood Walker, Inc.

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DOES SECTION 12(2) OF THE SECURITIES ACT OF 1933 APPLY TO SECONDARY TRADING?: BALLAY v. LEGG MASON WOOD WALKER, INC.

INTRODUCTION

The Securities Act of 19331 was enacted in response to the devastating losses sustained in the decade after World War I by members of the investing public as a result of the dishonest practices of those engaged in the sale of securities.2 Enacted at the height of the Great Depression, the 1933 Act sought to prevent the recurrence of such massive frauds by placing on sellers of securities an obligation to fully and fairly disclose all material facts pertinent to the sale.3 Section 12(2) of the 1933 Act,4 a broad antifraud pro-

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1 15 U.S.C. § 77(a)-(mm) (1988) [also referred to as “the Securities Act” or “the 1933 Act”].
2 See President’s Message to Congress Transmitting Recommendation for Federal Supervision of Traffic in Investment Securities in Interstate Commerce (Mar. 29, 1933), reprinted in 2 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 item 15 (1973) [hereinafter LEGISLATIVE HISTORY]; see also H.R. REP. No. 85, 73rd Cong., 1st Sess. 2 (1933), reprinted in LEGISLATIVE HISTORY, supra, item 18 (discussing background of President’s message to Congress).
3 The House Report states the following:
During the post-war decade some 50 billions of new securities were floated in the United States. Fully half or $25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings ... in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise.
Id.

... (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 the light of the circumstances under which they were 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 reasona-

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vision, provides a purchaser of securities with a private cause of action against a seller who omits or misstates a material fact in connection with the sale of such securities. Although the applicability of the statute to initial distributions of securities is well established, district courts are divided on the issue of whether section 12(2) affords a remedy to buyers of securities in the secondary market. Recently, in Ballay v. Legg Mason Wood Walker, Inc., the Court of Appeals for the Third Circuit became the first federal appellate court to address this issue. The court in Ballay held that section 12(2) of the Securities Act of 1933 does not afford a remedy to buyers of securities in the secondary market; rather, the section protects only buyers of initial distributions against fraud and misrepresentation.

In Ballay, forty-one investors brought suit against the brokerage house of Legg Mason Wood Walker, Inc. ("Legg Mason") for alleged oral misrepresentations with respect to the book value of certain securities they had purchased. The plaintiffs asserted

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6 See id.
7 See, e.g., Kaplan v. Pomerantz, 131 F.R.D. 118, 126 (N.D. Ill. 1990) (describing application of § 12(2) to initial distributions as "majority rule").
9 See id. at 684; see also Farley, 750 F. Supp. at 1219 (acknowledging that no circuit court has addressed this issue).
10 Id. at 684. The plaintiffs purchased securities of Wickes Company, Inc. through Legg Mason. Id. According to the testimony of one of its managers, Legg Mason is a full-service brokerage house that subscribes to the "value philosophy" of investing. Id. at 685. Operating under this investment philosophy, Legg Mason promotes investment in those stocks that it views as undervalued and as possessing potential for future growth. Id. In calculating the
causes of action under both section 12(2) of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934.\textsuperscript{12} The jury found for Legg Mason on the section 10(b) claim and for the investors on the section 12(2) claim.\textsuperscript{13} Legg Mason moved for a judgment notwithstanding the verdict or, in the alternative, for a new trial, asserting that section 12(2) should not be applied to sales in the secondary market.\textsuperscript{14} The district court denied the motion,\textsuperscript{15} but certified for interlocutory appeal the issue of whether section 12(2) applies to the secondary market.\textsuperscript{16} The Third Circuit denied Legg Mason's petition for interlocutory appeal,\textsuperscript{17} and judgment was entered against Legg Mason.\textsuperscript{18} On a subsequent appeal brought by both Legg Mason and the plaintiffs,\textsuperscript{19} the Third Circuit

value of these stocks, numerous factors are weighed, including intangible assets such as "goodwill." \textit{Id.} An expert at trial explained that goodwill "represents the amount of money that is paid in the purchase of another firm in excess of what the value of all the assets of that firm are worth." \textit{Id.} at 685 n.3. Plaintiffs in \textit{Ballay} argued that in calculating the book value of the stocks, the company's goodwill should not have been included because intangible assets such as goodwill cannot be readily sold in the event of liquidation, and thus should not be included in calculating the potential "downside" risk of an investment. \textit{Id.} at 685.

\textsuperscript{12} See \textit{id.} at 686. Under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1988), and its implementing rule, 10b-5, 17 C.F.R. § 240.10b-5 (1991), a private cause of action may be brought when there has been a misstatement or an omission of a material fact in connection with the purchase or sale of a security. Section 10(b) states, in pertinent part, the following:

\begin{quote}
It shall be unlawful for any person . . .

\begin{enumerate}
\item To use or employ, in connection with the purchase or sale of any security . . .
\end{enumerate}

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.
\end{quote}

15 U.S.C. § 78j(b). Pursuant to this broad grant of rule-making authority, the SEC promulgated rule 10b-5, which states, in pertinent part, the following:

\begin{quote}
It shall be unlawful for any person . . .

\begin{enumerate}
\item To employ any device, scheme, or artifice to defraud,
\item 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
\item 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.
\end{enumerate}
\end{quote}

\textit{Id.}

\textsuperscript{13} See \textit{Ballay}, 925 F.2d at 686.

\textsuperscript{14} \textit{Id.}

\textsuperscript{15} \textit{Id.} at 685-87.

\textsuperscript{16} \textit{Id.} at 687.

\textsuperscript{17} \textit{Id.}

\textsuperscript{18} \textit{Id.}

\textsuperscript{19} \textit{Id.} Legg Mason appealed the district court's conclusion that § 12(2) applies to sec-
reversed the district court's decision and held that section 12(2) does not afford a remedy to buyers of securities in the secondary market.\textsuperscript{20}

Writing for the court, Circuit Judge Mansmann began his analysis by examining the precise language of section 12(2).\textsuperscript{21} That section prohibits the misstatement or omission of a material fact in connection with the sale of a security "by means of a prospectus or oral communication,"\textsuperscript{22} language which became crucial to the court's analysis.\textsuperscript{23} Employing the maxim of construction known as \textit{noscitur a sociis},\textsuperscript{24} the court interpreted the term "oral communication" as restricted in its meaning by the neighboring, and more specific term, "prospectus,"\textsuperscript{25} and concluded that the phrase as a whole thus applies only to a prospectus or oral communication issued in connection with an initial offering.\textsuperscript{26} The court then addressed the "'object and structure of the [Securities] Act as a whole'" in an attempt to justify its reliance on the maxim \textit{noscitur a sociis}.\textsuperscript{27} To this end, the court looked to Congress' intent in enacting both the Securities Act of 1933 and the Securities Exchange Act of 1934.\textsuperscript{28} The investors cross-appealed the district court's refusal to charge the jury on their "agency theory of section 10(b) liability." \textit{Id.}\textsuperscript{29} at 693. The court also held that the district court's refusal to give an agency instruction "was harmless error at most" because "the agency theory could not possibly have provided an alternative basis for liability." \textit{Id.} at 695.\textsuperscript{30}

The court feared that a buyer unable to satisfy the rigid scienter, reliance, and causation elements of § 10(b) would have an actionable § 12(2) claim for negligence. \textit{Id.} at 689-89. The \\textit{Ballay} court was concerned that an expansive reading of the phrase "oral communication" would permit a secondary buyer of securities to recover under § 12(2) for negligent misrepresentations, while the same buyer would be barred from recovery under § 10(b) of the Securities Exchange Act of 1934. \textit{Id.} at 689. The court feared that a buyer unable to satisfy the rigid scienter, reliance, and causation elements of § 10(b) would have an actionable § 12(2) claim for negligence. \textit{Id.} In addition, the court noted that to apply the term "oral communication" to secondary trading would lead to the anomalous result of holding sellers in the aftermarket liable only for oral and not written misrepresentations since, under the court's analysis, "prospectus" applies only to initial offerings. \textit{Id.}\textsuperscript{27} at 689-90 (citing \textit{Dole v. United Steelworkers, 110 S. Ct. 929, 935 (1990)}).
Act of 1934 and concluded that the 1933 Act was "clearly" intended to regulate initial offerings. Finally, the court analyzed and distinguished other antifraud provisions contained in the securities acts that had been held applicable to both initial and secondary markets and concluded that a similarly expansive reading of section 12(2) was not required.

It is submitted that by holding section 12(2) applicable only to initial offerings, the Ballay court has given section 12(2) an overly restrictive interpretation. This Comment will suggest that neither the express language of section 12(2) nor the congressional intent underlying both the 1933 and 1934 securities acts dictate the narrow interpretation adopted by the Third Circuit in Ballay. This Comment will examine both the language and the legislative history of the 1933 Act, and will analyze the interpretive treatment accorded other similar antifraud provisions contained in the securities acts. Finally, this Comment will suggest that the application of section 12(2) to secondary trading, contrary to the conclusion reached by the Third Circuit, does not provide a "windfall" to aggrieved purchasers.

I. EXPRESS LANGUAGE OF SECTION 12(2)

Section 12(2) prohibits the use of misleading statements or omissions of material fact in connection with the sale of securities by means of a "prospectus or oral communication." The Ballay court determined that the phrase "prospectus or oral communication" is a term of art that encompasses only a prospectus or other

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28 Id. at 690.
29 Id. at 691-93. Specifically, the Third Circuit examined § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1988), and § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1988), and the application of these sections to trading in secondary markets. Section 17(a) of the 1933 Act proscribes fraudulent conduct in the offer or sale of securities, and states, in pertinent part, that:

It shall be unlawful for any person in the offer or sale of any securities...

(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... not misleading, or

(3) to engage in any transaction, practice, or course of business which operates... as a fraud or deceit upon the purchaser.

Id.; see also infra note 62 (discussing recent case law denying private right of action under § 17(a) and discussing application of this section to secondary trading).
30 Ballay, 925 F.2d at 688-89.
31 See supra note 4 (setting forth text of § 12(2)).
related instrument issued in connection with an initial distribution of securities.\textsuperscript{33} Several district courts and commentators analyzing this same statutory language, however, have rejected such a narrow reading of the phrase.\textsuperscript{33} In \textit{Elysian Federal Savings Bank v. First Interregional Equity Corp.},\textsuperscript{34} for example, the District Court of New Jersey held that although the term "prospectus" clearly refers to an initial offering, the phrase "or oral communication" is ambiguous.\textsuperscript{35} The \textit{Elysian} court concluded that had Congress intended to limit the application of section 12(2) to initial offerings, more expressly narrow terms were available.\textsuperscript{36}

\textsuperscript{33} \textit{Ballay}, 925 F.2d at 688-89. The \textit{Ballay} court first found that the more general term "oral communication" is limited by the more restrictive term "prospectus." \textit{Id.} at 688. It next found that the term "prospectus" was used by Congress as a term of art that describes the transmittal of information in connection with the initial distribution of a security. \textit{Id.} Finally, in support of its narrow reading of the phrase "prospectus or oral communication," the court pointed to several other uses of the term "prospectus" in the 1933 Act, and noted that the term had been used repeatedly by Congress in provisions concerning registration requirements in initial distributions. \textit{Id.} at 688-89 (citing 15 U.S.C. § 77e(b)(1) (1988) (prospectus not containing required information may not be used in interstate commerce to sell registered securities); \textit{id.} § 77j (mandating information required in prospectus); \textit{id.} § 77s(a) (granting to SEC power to amend rules concerning "registration requirements and prospectuses")). Notwithstanding this conclusion by the \textit{Ballay} court, it is submitted that not only does the term "prospectus" (as defined in § 2(10) of the 1933 Act, 15 U.S.C. § 77b(10) (1988)) encompass more than the materials distributed in connection with an initial distribution, but in addition, the phrase "or oral communication" is itself broad in scope. \textit{See infra} notes 35-36 and accompanying text.

\textsuperscript{34} \textit{Elysian} Fed. Sav. Bank v. First Interregional Equity Corp., 713 F. Supp. 737, 750 (D.N.J. 1989). ("[i]f Congress intended to so narrowly limit the application of section 12(2), more narrow words were available to do so . . . ."); \textit{see also} Hazen, \textit{A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933}, 64 VA. L. Rsv. 641, 644 n.15 (1978) ("unlike the bulk of the 1933 Act, \[§ 12(2)\] is in no way related to the registration requirements"). One commentator notes, [It] is by no means definitive that section 12(2) applies solely to seller misconduct in the distribution of securities . . . . \[S\]ection 12(2) prescribes material misstatements or omissions "by means of a prospectus, or oral communication." Nothing in the section specifically limits the prohibition of such "oral communications" to those occurring only during the initial distribution.


\textsuperscript{35} See, e.g., \textit{Farley v. Baird, Patrick & Co.}, 750 F. Supp. 1209, 1221 (S.D.N.Y. 1990) ("term 'prospectus' does not show that Congress meant to limit \[§ 12(2)\] to initial offerings"); \textit{Elysian Fed. Sav. Bank v. First Interregional Equity Corp.}, 713 F. Supp. 737, 750 (D.N.J. 1989) ("[i]f Congress intended to so narrowly limit the application of section 12(2), more narrow words were available to do so . . . ."); \textit{see also} Hazen, \textit{A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933}, 64 VA. L. Rsv. 641, 644 n.15 (1978) ("unlike the bulk of the 1933 Act, \[§ 12(2)\] is in no way related to the registration requirements"). One commentator notes, [It] is by no means definitive that section 12(2) applies solely to seller misconduct in the distribution of securities . . . . \[S\]ection 12(2) prescribes material misstatements or omissions "by means of a prospectus, or oral communication." Nothing in the section specifically limits the prohibition of such "oral communications" to those occurring only during the initial distribution.


\textsuperscript{36} \textit{Id.} at 750 n.17.
In Farley v. Baird, Patrick & Co., the District Court for the Southern District of New York followed the interpretation adopted by the Elysian court, and further noted that the terms employed by Congress in drafting section 12(2) were themselves broad in scope. The Farley court noted that the term “prospectus” as defined in section 2(10) of the 1933 Act 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.” The court was unable to find any authority that dictated the use of a narrower definition of “prospectus” in the context of section 12(2). The Farley court also looked to the broad definition of the term “offer for sale” in section 2(3) of the 1933 Act. That term includes “every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.” Thus, the court in Farley determined that the term was broad enough to encompass all phases of the selling process and held that section 12(2) was not limited to initial offerings.

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38 Id. at 1221.
40 See Farley, 750 F. Supp. at 1221. The Farley court noted that the inclusion of writings and broadcasts in the statutory definition of the term prospectus “go[es] far beyond what is generally evoked by the [term]—the printed document sent to potential investors pursuant to a registration statement for a batch offering of securities.” Id. at 1220. Thus, Farley concluded that “[e]ven ignoring the broad scope of the phrase, ‘or oral communication,’ the term ‘prospectus’ does not show that Congress meant to limit section 12(2) to initial offerings.” Id. at 1221.
41 See id. (citing § 2(3) of the 1933 Act, 15 U.S.C. § 77b(3) (1988)).
42 Id. (emphasis added).
43 Id. (citing United States v. Naftalin, 441 U.S. 768, 773 (1979)). In Naftalin, the Supreme Court addressed the scope of § 17(a) of the 1933 Securities Act. Naftalin, 441 U.S. at 773. In determining the applicability of the section to frauds against brokers as well as investors, Naftalin held that “the fraud occurred ‘in’ the ‘offer’ and ‘sale.’ The statutory terms, which Congress expressly intended to define broadly, are expansive enough to encompass the entire selling process . . . .” Id. (footnotes omitted).

Convinced that the broadly defined terms comprising § 12(2) represented Congress’ desire that the section have a broad scope, see Farley, 750 F. Supp. 1221, the Farley court held that “[w]here the language of the section is so consistently broad, reference to the general focus of the 1933 Act . . . is unwarranted.” Id.

Farley also relied on dicta set forth in Short v. Belleville Shoe Mfg., 908 F.2d 1385 (7th Cir. 1990), cert. denied, 111 S. Ct. 2887 (1991). In Short, the Seventh Circuit reviewed the function of several sections of the federal securities laws and found that “section 12(1) deals with sales ‘in violation of section 5’—that is, unregistered sales of securities required to be registered. Section 12(2) addresses all other forms of materially incorrect or misleading selling literature and oral communications in the sale of a security.” Id. at 1390 (emphasis
It is asserted that ample authority exists to support a broad reading of section 12(2). The Third Circuit in Ballay chose instead to rely on the maxim *noscitur a sociis* in determining that section 12(2) should apply only to initial offerings.\(^{44}\) However, it is generally understood that maxims are to be employed merely as a "guide to legislative intent,"\(^{45}\) and not rigidly so as to thwart legislative intent or to render general words meaningless.\(^{46}\) It is submitted that by employing the maxim *noscitur a sociis*, the Third Circuit interpreted the language of section 12(2) in a manner that did, in fact, render the words "or oral communication" meaningless. Legislatures are "presumed to have used no superfluous words" in drafting their statutes.\(^{47}\) It is submitted that in its unduly restrictive interpretation of section 12(2), the Ballay court disregarded this elementary principle and rendered ineffective the phrase "or oral communication."\(^{48}\)

II. LEGISLATIVE HISTORY OF SECTION 12(2)

In determining the scope of section 12(2), the Ballay court subscribed to the view that the Securities Act of 1933 was intended to regulate only initial distributions, whereas the Securities Exchange Act of 1934 was intended to regulate subsequent trading.\(^{49}\) However, other courts and commentators addressing this issue have concluded that the two securities acts are not as independent in their respective scopes as the Third Circuit indicated in

\(^{44}\) Ballay, 925 F.2d at 688.

\(^{45}\) 2A SUTHERLAND, supra note 24; see also Russell Motor Car Co. v. United States, 261 U.S. 514, 519 (1923) ("[rules of statutory construction] have no place . . . except in the domain of ambiguity").

\(^{46}\) See 2A SUTHERLAND, supra note 24, wherein the author warns that in some circumstances application of this maxim should be avoided because "it assumes the existence of self-evident meaning in particular words," an assumption which he refers to as a "fallacy." Id.

\(^{47}\) Tabor v. Ulloa, 323 F.2d 823, 824 (9th Cir. 1963) (citing Platt v. Union Pac. R.R., 99 U.S. 48, 58 (1878)).

\(^{48}\) See United States v. Menasche, 348 U.S. 528, 538-39 (1955) ("[i]t is our duty to 'give effect, if possible, to every clause and word of a statute'") (quoting Montclair v. Ramsdell, 107 U.S. 147, 152 (1883)).

\(^{49}\) See Ballay, 925 F.2d at 690-91.; Ralph v. Prudential-Bache Sec., 692 F. Supp. 1322, 1324 (S.D. Fla. 1988); SSH Co. v. Shearson Lehman Bros., 678 F. Supp. 1055, 1059 (S.D.N.Y. 1987); see also L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 87 (2d ed. 1988) ("1933 Act is concerned primarily with distributions. Post distribution trading was to be the subject of further legislation, which turned out to be the 1934 Act.") (emphasis in original).
Ballay.50

In Elysian, for example, the District Court of New Jersey determined that the 1933 Act encompassed more than mere initial offerings of securities. In reaching this conclusion, the court cited the comparative analysis undertaken by the Third Circuit in In re Data Access Systems Securities Litigation51 concerning the purposes of the two securities acts.52 In Data Access, the Third Circuit noted that the Securities Act of 1933 was described as “an Act 'to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.'”53 The Securities Exchange Act of 1934 was described as an Act “to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.”54 In light of the nonexclusive language used in both securities acts, the Elysian court thus concluded that “the Securities Act may have a broader concern, i.e., to ensure full and fair disclosure concerning securities sold across state lines. There is no suggestion that the concern about full and fair disclosure is restricted to new offerings of se-

50 See, e.g., Elysian Fed. Sav. Bank, 713 F. Supp at 748-49; Scotch v. Moseley, Hallgarten, Estabrook & Weeden, 709 F. Supp 95, 97 (M.D. Pa. 1988) (“while it is true that the 1933 Act was primarily concerned with regulating the distribution of new securities, its scope is not so limited”). In Elysian, the defendant asserted that § 12(2) applies only to initial distributions. Elysian, 713 F. Supp. at 748. While the court conceded that there was some validity to this “generic” argument, it determined that the “conceptual overlap and interrelationship” of the two statutes was not abundantly clear. Id. Specifically, the court noted that the 1934 Act was divided into two titles: Title I, entitled “Regulation of Securities Exchanges,” and Title II, entitled “Amendments to Securities Act of 1933.” Id. Thus, the court stated, “On this basis alone, it does not appear accurate to flatly state the Securities Act has nothing to do with issues addressed by the Exchange Act.” Id.; see also Abrams, The Scope of Liability Under Section 12 of the Securities Act of 1933: “Participation” and the Pertinent Legislative Materials, 15 Fordham Urb. L.J. 877, 902 n.138 (1987) (“1933 and 1934 acts’ spheres of regulation are not mutually exclusive”); Comment, Applying Section 12(2) of the 1933 Securities Act to the Aftermarket, 57 U. Chi. L. Rev. 955, 957 (1990) (“many cases rely on a false assumption that a ‘bright line’ exists between the 1933 and 1934 Acts”).

52 Elysian, 713 F. Supp. at 748-49.
53 Data Access, 843 F.2d at 1547 (citing Securities Act of 1933, Pub. L. No. 22, 48 Stat. 74, 74 (1933)) (emphasis added).
The legislative materials upon which the 1933 Act was predicated similarly do not support the argument that this law was intended to affect only initial offerings. Although the report of the House of Representatives that accompanied the 1933 Act states that "[t]he bill affects only new offerings of securities," it also states within the same section that "[t]he [Federal Trade] Commission may apply to the courts to enjoin any device, scheme, or artifice to defraud . . . whether new or already outstanding." In addition, the key Senate Report that accompanied enactment of the bill did not expressly limit the bill's application to initial distributions. Instead, it characterized the purpose of the bill as "protect[ing] the investing public and honest business," and described the basic policy of the bill as that of "informing the investor of the facts concerning securities to be offered for sale . . . and providing protection against fraud and misrepresentation."

III. Section 10(b) and Its Bearing on the Application of Section 12(2) to Secondary Markets

Section 12(2) of the 1933 Act and section 10(b) of the 1934 Act, the primary antifraud provisions of the federal securities laws, enable a purchaser of securities to bring a private cause of action based on violation of 10(b) and 12(2).

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55 Elysian, 713 F. Supp. at 749 (emphasis added).
56 See infra notes 57-60 and accompanying text (discussing legislative history of 1933 Act).
57 H.R. REP. No. 85, 73rd Cong., 1st Sess. 5 (1933), reprinted in 2 LEGISLATIVE HISTORY, supra note 2.
58 Id. at 6 (emphasis added). This language contemplates the injunctive authority of the Federal Trade Commission, which, upon enactment of the 1933 Act, was responsible for administering and enforcing the law. See S. REP. No. 47, 73rd Cong., 1st Sess. 2 (1933), reprinted in 2 LEGISLATIVE HISTORY, supra note 2, item 17. It is suggested, however, that this language negates the argument that the 1933 Act was intended to regulate only initial distributions. See United States v. Naftalin, 441 U.S. 768, 777-78 (1979) (rejecting argument that 1933 Act regulates exclusively new offerings and applying § 17(a) of Act to ordinary market trading).
59 See S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933), reprinted in 2 LEGISLATIVE HISTORY, supra note 2, item 17.
60 Id.
61 See Abrams, supra note 50, at 905-07. A survey conducted by Abrams concerning the legislative history of the two statutes indicates that the two bills together were intended to serve as "the foundation of a unified regulatory program." Id. at 906. Section 10(b) of the 1934 Act and rule 10b-5 promulgated thereunder have proved to be the more frequently invoked of the two antifraud provisions. See O'Hara, Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller, 31 UCLA L. REV. 921, 923-24 (1984) (explaining how interpretive history of § 12(2) has remained relatively dormant due to "ever-burgeoning volume of litigation brought under rule 10b-5").
action for damages resulting from fraudulent representations or omissions in the sale of securities.62

Actions instituted under section 12(2) differ from those brought under section 10(b) in several respects.83 First, section 10(b) requires proof of scienter. Thus, a plaintiff must demonstrate that the defendant made a material misstatement or omission in an intentional or reckless manner.64 The scienter requirement of

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62 See supra notes 4 and 12 (setting forth text of §§ 12(2) and 10(b), respectively). Another antifraud provision contained in the 1933 Act, § 17(a), 15 U.S.C. § 77(q)(a) (1988), had previously been construed as affording a private right of action for purchasers of securities. See, e.g., Kirchner v. United States, 603 F.2d 234, 241 (2d Cir. 1978) (private cause of action recognized under § 17(a)); Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1040 n.2 (7th Cir. 1979) (same). The section has subsequently been interpreted so as to deny such a remedy. See, e.g., Yoder v. Orthomolecular Nutrition Inst., 751 F.2d 555, 559 n.3 (2d Cir. 1985) (describing Kirchner holding as "open to reexamination"); The Ltd. v. McCrory Corp., 683 F. Supp. 387, 396 (S.D.N.Y. 1988) ("[t]here is [now] ample reason to think that the Kirchner holding is no longer valid") (quoting Ackerman v. Clinical Data, Inc., 1985 WL 1884 (S.D.N.Y. July 11, 1985)).

When the Supreme Court confronted the issue of the applicability of § 17(a) to secondary trading in United States v. Naftalin, 441 U.S. 768 (1979), it held that the section "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. at 778. The court identified this aspect of § 17(a) as "a major departure" from the remainder of the 1933 Act. Id. As a result of this limiting language, the Ballay court refused to apply the Supreme Court's expansive interpretation of § 17(a) to § 12(2). Ballay, 925 F.2d at 691; accord Mix v. E.F. Hutton & Co., 720 F. Supp. 8, 12 (D.D.C. 1989) ("Court ... rejects the reasoning of those courts that have cited Naftalin and Section 17(a) as supporting an equally expansive interpretation of Section 12(2)"). The Ballay court's refusal was based in part upon differences in the language employed in the two sections. See Ballay, 925 F.2d at 691-92.

It has been argued that the reasoning employed by the Supreme Court in expanding § 17(a) to reach "any fraudulent scheme in an offer or sale of securities" should also be applied to § 12(2). See, e.g., Elysian, 713 F. Supp. at 749 (citing Naftalin, 441 U.S. at 778) (emphasis added). This proposition stems from the fact that § 12(2) "comprises the other antifraud provision of the 1933 Act." Id. (emphasis added).

63 See infra notes 64-85 and accompanying text (discussing differences between actions brought under §§ 10(b) and 12(2)).

64 See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), wherein the Supreme Court held that "a private cause of action for damages will [not] lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud." Id. at 193; see also Aaron v. SEC, 446 U.S. 680, 691 (1980) ("rationale of Hochfelder ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5"). Hochfelder specifically left open the question of whether reckless behavior is sufficient to establish civil liability under § 10(b) and rule 10b-5. Hochfelder, 425 U.S. at 193-94 n.12. Since the Hochfelder decision, several lower courts have held that reckless conduct, as well as consciously fraudulent conduct, is sufficient for the imposition of rule 10b-5 liability. See, e.g., Warren v. Reserve Fund, Inc., 728 F.2d 741, 745 (5th Cir. 1984) (standard of severe recklessness dictates extreme departure from standards of ordinary care); Coleco Indus. v. Berman, 567 F.2d 569, 574 (3d Cir. 1977) (describing above as majority view), cert. denied, 439 U.S. 830 (1978); see also 5A A. Jacobs, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 63, at 3-272 to 3-279 (rev. 2d ed. 1991) (discussing Hochfelder and development of scien-
section 10(b) has proved to be a formidable obstacle to recovery. Section 12(2), on the other hand, requires a showing of mere negligence as a prerequisite to recovery.

Section 10(b) also requires a plaintiff to prove reliance on the defendant's misstatement or omission that caused him to suffer damage. The standard of causation is generally more relaxed under section 12(2), however, and reliance is not an element for a section 12(2) cause of action.

See, e.g., Renovitch v. Kaufman, 905 F.2d 1040, 1046 (7th Cir. 1990) (affirming summary judgment granted by district court on scienter issue); Ross v. Bolton, 904 F.2d 819, 824 (2d Cir. 1990) (dismissing complaint for insufficient allegations of scienter); Warren, 728 F.2d at 747 ("facts fall far short of establishing scienter").

See supra note 4 (statutory language states that seller held liable when he fails to "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission"). In light of the language contained therein, a § 12(2) plaintiff need only demonstrate negligence in order to recover. See Wachovia Bank & Trust Co. v. National Student Mktg. Corp., 650 F.2d 342, 356 (D.C. Cir. 1980) (negligent conduct of defendant suffices), cert. denied, 452 U.S. 954 (1981); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 695 (5th Cir. 1971) (plaintiffs need not prove scienter on part of defendant). See also Jackson v. Oppenheim, 533 F.2d 826, 829 n.7 (2d Cir. 1976) (innocent misrepresentations and omissions do not give rise to a cause of action under § 12(2)). See generally 5 A. Jacobs, supra note 64, § 3.01[c], at 1-63 to 1-72 (general discussion of requirements of § 12(2) action).

See Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988) ("reliance is an element of a Rule 10b-5 cause of action"); Hochfelder, 425 U.S. at 206 ("burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage") (quoting S. Rep. No. 792, 73d Cong., 2d Sess. 12-13 (1934)). While reliance can be described as "the plaintiff's attitude towards the defendant's misleading statement or omission," causation concerns the relationship between the defendant's act and the plaintiff's injury. See 5A A. Jacobs, supra note 64, § 64.01[a], at 3-309.

The heavy burden imposed on § 10(b) plaintiffs to establish both reliance and causation has been lifted considerably by the Supreme Court's recognition of certain presumptions in lieu of a requirement of direct proof. See, e.g., Basic, 485 U.S. at 247 (when investor buys or sells at price set by market, reliance on integrity of that price presumed for purposes of rule 10b-5 action); duPont v. Brady, 828 F.2d 75, 78 (2d Cir. 1987) (once materiality and scienter have been proved, there is presumption that investment decision would have been influenced by knowledge of omitted facts); Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972) (when duty to disclose material information has been breached, causation element presumed to be established); see also Note, The Reliance Requirement in Private Actions Under SEC Rule 10b-5, 88 Harv. L. Rev. 584, 587-89 (1975) (discussing when positive proof of reliance is not required).

Ballay, 925 F.2d at 692.

See Junker v. Croy, 650 F.2d 1349, 1359 (5th Cir. 1981). The Junker court summarized the elements of a § 12(2) action as follows:

To recover under [§ 12(2)], the plaintiff must establish that the defendant, as a seller of a security . . . misrepresented or failed to state material facts to the plaintiff in connection with the sale. In addition the plaintiff must show that he had no knowledge of the untruth or omission. However, the plaintiff need not establish
In *Ballay*, in light of the jury's determination that Legg Mason was liable under section 12(2) but not under section 10(b), the Third Circuit expressed concern over the double standard that might result if section 12(2) were made available as a remedy to purchasers in the aftermarket. The *Ballay* court sought to prevent a situation whereby a purchaser, aware of his inability to meet the stringent requirements of section 10(b), would instead seek redress under section 12(2). It is suggested, however, that there are two countervailing considerations that prevent purchasers from obtaining such an unfair advantage.

The first consideration addresses the potential class of defendants susceptible to suit under each of the two sections. Section 10(b) prohibits the use of any manipulative or deceptive device "in connection with the purchase or sale of any security." Courts have broadly construed the "in connection with" language, resulting in the imposition of liability on a wide range of defendants. Plaintiffs seeking to recover under section 12(2), on the other hand, must prove that the defendant acted with scienter or that he relied in any way on the defendant's misrepresentations or omissions.

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*Id.* (citing *Hill York Corp.*, 448 F.2d at 695) (emphasis added); see also *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990) (reliance not required for recovery); *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 782 (11th Cir. 1988) ("reasonable reliance" not an element under § 12(2)).

*Ballay*, 925 F.2d at 686.

*Id.* at 689; see also *supra* note 26 (discussing *Ballay* court's concern over expansive reading of phrase "oral communication" in § 12(2)).

*Ballay*, 925 F.2d at 689.

See *supra* note 12 (setting forth text of § 10(b)).

See, e.g., *IT v. Cornfeld*, 619 F.2d 909, 922-23 (2d Cir. 1980) (actual participant in fraud no less guilty because someone else originated plan); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 861-63 (2d Cir. 1968) (phrase "in connection with the purchase or sale of any security" interpreted broadly), *cert. denied*, 394 U.S. 976 (1969). In addition to those persons found primarily liable for a rule 10b-5 violation, derivative or secondary liability has often been found under a number of theories. See 5A A. *Jacobs*, *supra* note 64, § 40.01, at 2-416 (these theories include aiding and abetting, conspiracy, controlling person liability, beneficial ownership, responsibility of principal for agent's acts, "directly or indirectly" language of rule § 20(b) of Exchange Act, and failure adequately to train or supervise employees). See generally *Fischel, Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Calif. L. Rev. 80, 80-82 (1981) (discussing liability under rule 10b-5 for aiding and abetting, conspiracy, and respondeat superior).

See, e.g., *Renovitch v. Kaufman*, 905 F.2d 1040, 1045 n.7 (7th Cir. 1990) ("one may be held secondarily liable under § 10(b) and rule 10b-5 without having actually purchased or sold a security"); *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 932 (7th Cir.) (person other than purchaser or seller of security faces liability as aider and abetter where requisite intent is present), *cert. denied*, 488 U.S. 926 (1988).
other hand, may do so only against a "seller" of securities. In interpreting the scope of the term "seller" in section 12(1), the United States Supreme Court, in Pinter v. Dahl, narrowly defined the term to include either the owner who passed title, or any person who successfully solicits the purchase. Lower courts have frequently applied the rationale adopted in Pinter to actions involving section 12(2). Consequently, it is suggested that were section 12(2) to apply to secondary trading, the restriction to a narrower range of defendants would offset any advantage gained as a result of the lesser standard of proof under section 12(2).

The second consideration addresses the nature of the remedies available under the two sections. Section 12(2) contemplates that the available recovery is limited to damages that are equal to those available in rescission. Litigants seeking redress under section 10(b), on the other hand, have recovered under various theories of

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76 See supra note 4 (setting forth text of § 12(2)); Collins v. Signetics Corp., 605 F.2d 110, 113 (3d Cir. 1979) (absence of privity between plaintiff purchaser and non-seller issuer defendant precluded recovery); see also Note, The Forgotten Warrior: Section 12(2) of the Securities Act of 1933 and the Battle Against Insider Trading, 90 COLUM. L. REV. 226, 229 (1990) ("scope of the phrase 'anyone who offers or sells any security,' dramatically influences the regulatory power of Section 12(2)").


78 Id. at 643. The person soliciting the purchase must be "motivated at least in part by a desire to serve his own financial interests or those of the securities owner." Id. at 647. The Pinter Court reasoned that if the solicitor of the purchase had such a motivation, "it is fair to say that the buyer 'purchased' the security from him and to align him [the solicitor] with the owner in a rescission action." Id. In interpreting § 12(1), the Pinter Court limited the definition of "seller" to one who passed title or one who solicits the purchase on the grounds that to expand the scope of the term would "expose securities professionals, such as accountants and lawyers, whose involvement is only the performance of their professional services, to . . . strict liability for rescission." Id. at 651.

79 See, e.g., Cyrak v. Lemon, 919 F.2d 320, 324-25 (5th Cir. 1990) (adopting Pinter definition of seller for § 12(2) action); Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 635 (3d Cir. 1989) ("no reason to distinguish the scope of 'seller' for purposes of sections 12(1) and 12(2)'"; Capri v. Murphy, 856 F.2d 473, 478 (2d Cir. 1988) (section 12(2) claim should be considered in light of Pinter); see also Schneider, Section 12 of the Securities Act of 1933: The Privity Requirement in the Contemporary Securities Law Perspective, 51 TENN. L. REV. 235, 261 (1984) (principles of statutory construction dictate that classes of potential defendants under both §§ 12(1) and 12(2) must be identical).

80 See supra note 4 (setting forth text of § 12(2)). Section 12(2) specifically provides for the return of the price paid to the seller, plus interest, less any income received while the security was held. Id. If the plaintiff no longer owns the security in question, the damages to be recovered are to be the "substantial equivalent of rescission." Randall v. Loftagaarden, 478 U.S. 647, 656 (1986) (quoting L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 1020 (1st ed. 1983)); see also Kane v. Shearson Lehman Hutton, Inc., 916 F.2d 643, 646 (11th Cir. 1990) (recovery for loss on sale of stock not reduced by profits made in earlier transaction).
damages, including benefit-of-the-bargain,\textsuperscript{81} out-of-pocket loss,\textsuperscript{82} disgorgement,\textsuperscript{83} and rescission.\textsuperscript{84} Indeed, because recovery under section 10(b) may "substantially outstrip" recovery under section 12(2), the former remedy has been more frequently invoked by aggrieved parties.\textsuperscript{85} Thus, the application of section 12(2) to the secondary market, notwithstanding its lesser standard of proof, is unlikely to encourage plaintiffs to forgo the section 10(b) remedy if that is available to them. Permitting investors to invoke section 12(2) in secondary market trading will neither undermine the policies of section 10(b) nor place purchasers at an unfair advantage in their quest to be compensated for fraud.

\textsuperscript{81} See, e.g., Osofsky v. Zipf, 645 F.2d 107, 114 (2d Cir. 1981) (benefit-of-the-bargain damages may be appropriate under § 10(b) when established with reasonable certainty). Benefit-of-the-bargain is defined as "the difference between the represented value of the security purchased or sold and the fair value of the security on the date of the trade." See Kaufman, No Foul, No Harm: The Real Measure of Damages Under Rule 10b-5, 39 CATH. U.L. Rev. 29, 30-31 (1989).

\textsuperscript{82} See, e.g., Randall, 478 U.S. at 661-62 (describing out-of-pocket damages as traditional recovery under rule 10b-5); James v. Meinke, 778 F.2d 200, 205 (5th Cir. 1985); Woods v. Barnett Bank, 765 F.2d 1004, 1013 (11th Cir. 1985); Huddleston v. Herman & MacLean, 640 F.2d 534, 555 (5th Cir. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375 (1983); Glick v. Campagna, 613 F.2d 31, 36 (3d Cir. 1980). Out-of-pocket recovery has been described as "the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct." See Kaufman, supra note 81, at 31 (citing Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972)).

\textsuperscript{83} See, e.g., Affiliated Ute, 406 U.S. at 155 (if it exceeds his own loss, § 10(b) plaintiff can recover defendant's profit from fraud); see also Kaufman, supra note 81, at 31 (describing disgorgement as "return[ing] to the plaintiff the amount of the defendant's unjust enrichment").

\textsuperscript{84} See, e.g., Randall, 478 U.S. at 656 (plaintiff entitled to return of consideration paid reduced by any profit made or income received from security).

\textsuperscript{85} Note, supra note 76, at 232. The author states, "Not only are rule 10b-5 plaintiffs always entitled to damages rather than rescission, but they may also recover an amount in damages that substantially exceeds their out-of-pocket loss." Id. (citing Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 318 n.33 (1985)).

Relying on Hoxworth v. Blinder, Robinson & Co., 903 F.2d 186, 203 n.25 (3d Cir. 1990), the Third Circuit in Ballay construed the measure of damages available under § 12(2) as being greater than that which is available under § 10(b). Ballay, 925 F.2d at 693. A closer look at Hoxworth, however, reveals that the court in that case merely recognized that "the availability of section 12(2) as an alternative theory of recovery could, on certain facts, substantially increase the value of plaintiffs' expected judgment." Hoxworth, 903 F.2d at 203 n.25 (emphasis added). The court in Hoxworth then set forth the factual circumstances that would be required in order to yield what it described as a "potentially more pro-plaintiff" measure of damages. Id. at 203 & n.25. In discussing whether § 12(2) does in fact apply to the aftermarket, the court in Hoxworth stated, "[a]lthough limiting the availability of section 12(2) to primary distributions could decrease the likely size of plaintiffs' expected judgment, we cannot even guess whether it does." Id. at 203-04 (emphasis in original).
The United States Supreme Court, in *Landreth Timber Co. v. Landreth*, approved the use of policy considerations in construing terms contained in the federal securities acts. Designed to combat the fraudulent practices plaguing the securities markets, the antifraud provisions of the Securities Act of 1933 should be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." It is submitted that by holding section 12(2) inapplicable to secondary trading, the *Ballay* court interpreted the language of the statute in a manner that undermines the underlying purpose of the 1933 Act as well as the statute. Further, it is urged that if and when other circuits are confronted with this issue, section 12(2) should be construed in greater harmony with its express language and legislative history and in furtherance of its underlying remedial purpose.

*Catherine Zucal*

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87 *Id.* at 694-95 n.7 ("it is proper for a court to consider—as we do today—policy considerations in construing terms in [the securities acts]"); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) ("[i]t is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance"); Abrams, *supra* note 50, at 911-15 (arguing that "*Landreth* footnote . . . approves consideration of more than Congress’ purposes for enacting a securities provision or statute. . . . [A]ll nine Justices expressly approved consideration of securities policy—consideration of the result that a congress should favor, without express reference to Congress’ purposes for enacting the provision or statute").
88 *See supra* notes 1-3 and accompanying text.