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DISAPPEARING WITHOUT A TRACE: SECTIONS 11 AND 12(a)(2) OF THE 1933 SECURITIES ACT

Hillary A. Sale*

Abstract: The judicially created tracing requirement thwarts the remedial sections of the 1933 Securities Act (the "Securities Act") by requiring shareholders to prove the impossible—that their securities were actually issued in the questioned offering. Since 1967, courts addressing this issue have, without question, adopted a requirement for section 11 that plaintiff-shareholders trace their shares to the offering. Recently, courts have expanded it to apply to section 12(a)(2) as well. For any but the first purchases of a share of stock, this requirement has always been virtually impossible to meet. Courts have also used the 1995 opinion in *Gustafson v. Alloyd Co.* to eliminate even the possibility of tracing, thereby further eroding shareholders' access to sections 11 and 12(a)(2). Now, many securityholders cannot sue under either section. This Article examines sections 11 and 12(a)(2) and the cases interpreting them. The analysis shows that tracing is almost impossible whenever a company has made more than one offering of securities of a particular type, and as a result, few, if any, shareholders can successfully sue under sections 11 and 12(a)(2) even though the Securities Act arguably provides them with a remedy. This development of the tracing requirement has the potential to defeat the statute's purpose of promoting full and accurate disclosures in public-offering documents through strong deterrence measures. To resolve the problem, the Article argues that the courts should apply the relaxed rules of causation now employed in the toxic-tort context for indeterminate plaintiffs. Increasingly, courts have allowed these indeterminate plaintiffs to use group-derived statistical evidence to meet their buden of proof. In the securities context, instead of requiring shareholders to prove the impossible, courts should allow them to sustain their burden by employing the best available evidence and proving that it is more likely than not that their securities were issued in the questioned offering. In doing so, courts can both limit the statute's reach and fulfill Congress's purpose in adopting it.

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I. INTRODUCTION

In 1933 and 1934, Congress passed the Securities Act and the Securities Exchange Act. The Acts create financial transparency in the capital markets by requiring companies to make significant initial and ongoing disclosures. To ensure the required disclosures are accurate, the Acts contain several private-enforcement mechanisms, including provisions for shareholder suits for misrepresentations or omissions in a registration statement under section 11[1] or in a prospectus or oral communication under section 12(a)(2).[2] This Article explores the tracing requirement for claims under these Sections. Tracing is one way by which courts are increasingly eliminating the consequences of misstatements and omissions in the public-offering context.

1. *See* 15 U.S.C. § 77k(a) (1994).
2. *See* 15 U.S.C. § 77*l*(2) (1994).

In 1967, Judge Friendly interpreted section 11 to limit its coverage to shareholders who had purchased shares pursuant to an allegedly faulty registration statement.[3] Section 11(a) states, in part: "In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring *such* security . . . may . . . sue."[4] Because the word "such" lacks a reference, Judge Friendly questioned whether the phrase provides a cause of action only to those shareholders who acquired their securities pursuant to a particular offering or to any shareholder who acquired a security of the same type as that issued in a particular offering.[5] He determined that the former interpretation was the appropriate one and established the tracing requirement to implement this interpretation.[6]

Since Judge Friendly's decision, courts have required shareholders to plead and prove that the securities they own were issued in the offering for which they allege the occurrence of a misstatement or omission. Accordingly, to prove their claims under section 11, and sometimes under section 12(a)(2), shareholders must connect, or "trace," the securities they purchased to the offering document at issue. To do so, purchasers who bought in the secondary market (the "Aftermarket") must show that the securities were issued pursuant to the questioned offering—as opposed to another offering of similar securities.[7] Yet, as applied by the courts, the tracing requirement is nearly impossible to meet and, therefore, prevents many shareholders who would otherwise be entitled to a remedy from proving their claims. As a result, the deterrent and remedial purposes of the Securities Act have been severely limited.

The tracing requirement has existed for approximately thirty years, but courts began to apply it aggressively to both sections 11 and 12(a)(2) after the 1995 Supreme Court opinion in *Gustafson v. Alloyd Co.*[8] In *Gustafson*, the Court held that section 12(a)(2) applies only to public offerings of

3. *See* Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967).

4. 15 U.S.C. § 77k(a) (emphasis added).

5. *See Barnes*, 373 F.2d at 271.

6. *See id.* at 273.

7. *See, e.g.*, Cooperman v. Individual, Inc., No. CIV.A.96-12272-DPW, 1998 WL 953726, at *4–8 (D. Mass. May 27, 1998).

8. 513 U.S. 561 (1995).

securities, not private agreements to sell securities.[9] This opinion restricted the civil cause of action available to plaintiffs under section 12(a)(2) of the Act,[10] implicitly limiting securities litigation.[11] Since 1995, courts have employed *Gustafson* to restrict further shareholders' relief under sections 11 and 12(a)(2) to only the initial purchasers of securities in an offering involving an alleged misstatement or omission.[12] Under this interpretation, those who purchase the same securities in the Aftermarket would lack standing. *Gustafson*, and the manner in which the courts have begun to apply it, necessitates a reexamination of the tracing requirement to preserve the remedial purposes of the Securities Act.

Part II of this Article discusses the causes of action that allow plaintiffs to sue on the basis of material misstatements or omissions in the registration statement (section 11) or in the prospectus or oral communication (section 12(a)(2)). Part III sets forth the history and evolution of the tracing requirement, including a description of *Gustafson* and its effect on tracing.

Part IV argues that because of the way the market works, the pre-*Gustafson* tracing requirements were not merely difficult, but as a practical matter, nearly impossible to meet. The emerging post-*Gustafson* law in this area raises the bar even further, eliminating even the possibility of tracing, thereby making it virtually impossible for shareholders to survive a motion to dismiss.[13] Part IV then reexamines *Gustafson* and the courts' interpretation of how it applies to tracing, concluding that courts have

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9. *See id.* at 573. Scholars and courts continue to debate whether the opinion stands for more. *See, e.g.*, *Cooperman*, 1998 WL 953726, at *6 (finding *Gustafson* restricts section 12(a)(2) actions to initial public offerings); *see also infra* notes 285–328 and accompanying text.

10. *See* Therese H. Maynard, *Section 12(2) of the Securities Act of 1933: A Remedy for Fraudulent Postdistribution Trading?*, 20 Sec. Reg. L.J. 152, 153 n.3 (1992) (collecting pre-*Gustafson* cases holding that section 12(a)(2) applied to Aftermarket trading).

11. *See Gustafson*, 513 U.S. at 572 (stating that if section 12(a)(2) extended to nonpublic offerings, it would create "vast additional liabilities . . . independent of . . . substantive obligations" imposed by 1933 Securities Act); Stephen M. Bainbridge, *Securities Act Section 12(2) After the* Gustafson *Debacle*, 50 Bus. Law. 1231, 1255 (1996) (noting that majority opinion implied concern about extent of securities litigation).

12. The opinion raised several presumably unanticipated questions about other provisions of the Securities Act as well. *See* Bainbridge, *supra* note 11, at 1256 (stating that given "complex, technical [nature of] statute, with subtle interrelationships," Court's decision might disturb "fabric of statute," and questioning whether Court "ma[d]e a hash out of" statute); Elliot J. Weiss, *Securities Act Section 12(2) After* Gustafson v. Alloyd Co.: *What Questions Remain*, 50 Bus. Law. 1209, 1225–28 (1995) (noting questions remain about whether certain types of offerings will be subject to section 12(a)(2)) [hereinafter *What Questions Remain*]; Elliot J. Weiss, *Some Further Thoughts on* Gustafson v. Alloyd, 65 U. Cin. L. Rev. 137, 152–53 (1996) (arguing that sales under certain regulations are no longer subject to section 12(a)(2)) [hereinafter *Further Thoughts*].

13. *See infra* notes 285–328 and accompanying text.

improperly used *Gustafson* to restrict shareholders' remedies. The courts' employment of *Gustafson* does, however, create the opportunity to revisit the tracing requirement. A review of the statute, the legislative history, and the case law reveals that tracing is a judicial invention that inappropriately limits the statute in an underinclusive manner. Courts can resolve this problem by applying the rationale behind the relaxed rules of proof of causation applied in the toxic-tort context. Courts should allow shareholders to proceed with their claims if they can provide statistically based evidence to show that it is more likely than not their shares were issued pursuant to the questioned offering. This proposal would allow courts to foster the statute's deterrent and compensatory goals.

II. SECURITIES ACT SECTIONS 11 AND 12(a)(2)

In response to the market crash of 1929,[14] Congress enacted the Securities Act as its first attempt to create federal duties for the registration and disclosure of information in connection with securities offerings.[15] The Securities Act sets forth a standard for truthfulness in offering disclosures and includes several provisions designed to force companies to face the consequences of any misstatements or omissions in those disclosures. Sections 11 and 12(a)(2) of the Act allow securityholders to sue certain defendants for such misstatements or omissions.[16]

A. Section 11

Section 11 provides purchasers of a registered security with a claim against enumerated defendants for material[17] misstatements or omissions in

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14. *See* William O. Douglas & George F. Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171 (1933); *see also* Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 Ohio St. L.J. 329, 337–42 (1988); James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 30 (1959).

15. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (stating that purpose of Act was to provide full disclosure of material information to investors).

16. Section 15 of the Act establishes liability for controlling persons, but this form of liability is secondary in nature and is not separately discussed. *See* 15 U.S.C. § 77o (1994).

17. An alleged misstatement or omission is material if reasonable investors would find it significant in making their investment decisions. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Materiality is a question of fact. *See* McMahan & Co. v. Wherehouse Entertainment, Inc., 900 F.2d 576 (2d Cir. 1990). Under the "bespeaks caution" doctrine, an allegedly misleading statement may be rendered inactionable by virtue of other cautionary language included in the registration statement. *See, e.g.*, *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407 (9th Cir. 1994) (applying bespeaks-caution

the registration statement.[18] In addition to the corporation that is the issuer, other possible defendants include (1) every person who signed the registration statement;[19] (2) current directors or partners of the issuer;[20] (3) future directors or partners named, with consent, in the statement;[21] (4) engineers, accountants, and other persons whose professions give authority to statements they made and who are listed as having either prepared or certified the registration statement;[22] and (5) every underwriter of the registered security.[23]

The purpose of section 11 is to deter fraud by creating a powerful incentive for persons associated with an offering to ensure full and accurate disclosures in the registration statement. It accomplishes this purpose by creating a "stringent standard"[24] of liability on, or serious consequences for, parties who "play a direct role in a registered offering."[25] Section 11 provides shareholders who purchase securities issued pursuant to registration statements with a strict-liability claim against participants in the

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doctrine to section 11 claims). For further discussion of this doctrine and its development, see Harold S. Bloomenthal et al., *Securities Law Handbook* § 16.04 (2d ed. 1997).

18. *See* 15 U.S.C. § 77k(a) (1994); Herman & MacLean v. Huddleston, 459 U.S. 375, 381–82 (1983). Section 11(a) reads, in relevant part:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—
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> . . . .
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> If such 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 under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

15 U.S.C. § 77k(a).

19. *See* 15 U.S.C. § 77k(a)(1).

20. *See* 15 U.S.C. § 77k(a)(2).

21. *See* 15 U.S.C. § 77k(a)(3).

22. *See* 15 U.S.C. § 77k(a)(4).

23. *See* 15 U.S.C. § 77k(a)(5).

24. Herman & MacLean v. Huddleston, 459 U.S. 375, 381–82 (1983).

25. *Id.* at 382; *see also* H.R. Rep. No. 85, at 9 (1933) (stating that heavy legal liability under section 11 corresponds with responsibility to public).

offering of securities because liability accrues "even for innocent misstatements."[26]

To establish a prima facie case, the shareholders must prove that the registration statement contained a material misstatement or omission.[27] The shareholders need not prove that they relied on the registration statement unless they bought the securities more than twelve months after the effective date of the registration statement and the issuer had already distributed an "earnings statement."[28] Otherwise, their reliance is presumed. Indeed, although defendants can raise the issue that shareholders knew of the alleged misstatement or omission, the defendants bear the burden of proving that knowledge.[29] The issuer's only other defenses to strict liability[30] are the lack of materiality[31] and the expiration of the statute of limitations.[32]

One of the key and frequently used defenses available to defendants other than the issuer is the due-diligence defense.[33] The due-diligence requirement helps to implement the statute's goals by creating responsibility for reviewing background and offering materials and ensuring the accuracy of any statements in those materials. Due diligence is required throughout the process of determining whether the proposed offering is appropriate.[34] For example, the issuer's legal counsel must examine relevant records to ensure that the registration statement does not contain material misstatements or omissions.[35] The due-diligence defense thus arises from

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26. *Herman & MacLean*, 459 U.S. at 382 (noting that liability against issuers is "virtually absolute"); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

27. *See Herman & MacLean*, 459 U.S. at 382.

28. 15 U.S.C. § 77k(a) (1994). Rule 158 defines the types of statements that qualify as earnings statements for the purposes of this section. In general, statements that contain the types of information contained in current reports issued pursuant to the Securities and Exchange Act of 1934 will suffice. *See* 1 Thomas Lee Hazen, *The Law of Securities Regulation* § 7.3, at 380–81 n.19 (3d ed. 1995); 9 Louis Loss & Joel Seligman, *Securities Regulation* 4252 & n.138 (3d ed. 1992); Douglas & Bates, *supra* note 14, at 176.

29. *See* 15 U.S.C. § 77k(a).

30. *See* Hazen, *supra* note 28, § 7.4, at 388; Loss & Seligman, *supra* note 28, at 4249, 4255.

31. *See supra* note 17.

32. The statute of limitations for section 11 is one year from the date of discovery of, or the date on which the purchaser should have discovered, the untrue statement or omission, or three years from the effective date of the registration statement. *See* 15 U.S.C. § 77m (Supp. III 1997).

33. *See* 15 U.S.C. § 77k(b) (1994); Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983).

34. *See* Hazen, *supra* note 28, § 7.4, at 389.

35. *See* Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 Geo. Wash. L. Rev. 221, 270 (1995) (noting that both issuers and underwriters must fulfill due-diligence obligations); *see also* Donald C. Langevoort, *Organized Illusions: A*

statutory[36] and regulatory[37] requirements, and it applies to non-expertised portions of the registration statement. The defendants would have a complete defense if, after "reasonable investigation" or after acting with due diligence, they had reasonable grounds to believe, and did so believe, that the registration statement did not contain misleading statements or omissions at the time it became effective.[38]

Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms), 146 U. Pa. L. Rev. 101, 159 (1997) (describing basis of due-diligence requirement as "mistrust of management" as sole source of information, thereby creating bonding of outside professionals with their own reputational interests at stake).

36. *See* 15 U.S.C. § 77k(b)(3); *see also In re* Software Toolworks, Inc., 50 F.3d 615 (9th Cir. 1994) (discussing and applying due-diligence defense to various defendants); Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) (same).

37. *See* 17 C.F.R. § 230.176 (1997) (describing relevant circumstances for review of non-issuer due diligence including: type of issuer, security, or person; office held; presence or absence of relationships to issuer for proposed officers and directors; reasonable reliance on officers, employees, and others whose particular duties should have given them knowledge of particular facts; role of particular persons as underwriters and availability of information; and responsibility for facts or information incorporated into documents).

38. 15 U.S.C. § 77k(b)(3)(A). Insiders who sign registration statements are subject to stringent due-diligence review. *See Escott*, 283 F. Supp. at 684–85. The review is even more stringent for those who are required by section 6 to sign the registration statement. *See* 15 U.S.C. § 77f(a) (1994). In general, signing officers and directors must both read and possess the minimum necessary knowledge to understand the document. *See Escott*, 283 F. Supp. at 684. For a discussion of the due-diligence defense, see Jennifer O'Hare, *Institutional Investors, Registration Rights, and the Specter of Liability Under Section 11 of the Securities Act of 1933*, 1996 Wis. L. Rev. 217, 227–29.

They can also try to prove that they had resigned, or had taken steps to resign, from their positions with the issuer and had informed the Securities and Exchange Commission ("Commission" or "SEC") and the issuer of their actions. *See* 15 U.S.C. § 77k(b)(1). Finally, if the portion of the registration statement at issue became effective without the knowledge of the defendants, and they notified both the Commission and the public when they became aware of that fact, they can escape liability. *See* 15 U.S.C. § 77k(b)(2).

There are two other defenses available. Section 11 applies the same standard to experts for that portion of the registration statement purporting to have been reviewed or evaluated by them. *See* 15 U.S.C. § 77k(b)(3)(B). Experts may also avoid liability if they can prove that the registration statement did not fairly represent the opinion they offered or that it was not a "fair copy" of their report. *See* 15 U.S.C. § 77k(b)(3)(B). Defendants who rely upon experts may attempt to prove they did not believe, or did not have any reasonable grounds to believe, that the expertised portion of the statement contained any misstatements or omissions. *See* 15 U.S.C. § 77k(b)(3)(C). Again, this defense is limited. For example, defendants may not argue that their outside counsel (who are not signatories) reviewed, and thereby expertised, the entire document. *See Escott*, 283 F. Supp. at 683, 687. Instead, this defense is limited to portions of the statement which were purportedly made upon the authority of an expert. *See id.* at 683. And even then, the defendants' obligation may extend to reviewing underlying documents, not just figures or documents the company offers. *See id.* at 697 (refusing to credit underwriters' due-diligence defense based on reliance on company-provided sales figures and holding that due-diligence obligation extends to review of sales contracts); *cf.* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 582 (E.D.N.Y. 1971) (noting that where underwriters are true outsiders, industry standard, which may include reliance on client representations, applies).

Shareholders who succeed in proving their section 11 claim are entitled to damages.[39] They may recover the difference between the amount paid for the securities (not to exceed the public offering price) and (1) the value of the securities at the time of suit, (2) the price at which they sold the securities prior to bringing suit, or (3) the price at which they sold the securities after bringing suit, but before judgment, so long as these damages do not exceed those under option (1).[40] This formula provides the shareholders who do not sell before suit with a potential windfall if their securities appreciate after the filing date, but offers no protection if the price declines after the judgment. The burden is on the defendants to prove that any "depreciation in the value of [the] security" was due to causes other than the misleading statements or omissions.[41] All defendants lacking a defense, except certain outside directors, are jointly and severally liable with a right to contribution.[42]

B. *Section 12(a)(2)*[43]

Section 12(a)(2) is an express, negligence-like cause of action for misstatements or omissions in a "prospectus or oral communication"[44] made

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Finally, any portions of the document purporting to contain statements from public officials or documents will not create liability for persons relying on them, if they can prove that they did not know, and had no reason to know, of any misstatements or omissions contained therein. *See* 15 U.S.C. § 77k(b)(3)(D). The standard of reasonableness applied is that of a "reasonably prudent man in the management of his own property." 15 U.S.C. § 77k(c) (1994).

39. *See* 15 U.S.C. § 77k(e) (1994).

40. *See* 15 U.S.C. § 77k(e).

41. 15 U.S.C. § 77k(e).

42. *See* 15 U.S.C. § 77k(f) (1994). Outside directors without knowledge have proportionate liability. The Private Securities Litigation Reform Act of 1995 added this provision. *See* 15 U.S.C. § 77k(f)(2)(A) (Supp. III 1997).

43. Section 12(1) contains a cause of action against sellers of securities who violate section 5 of the Act. *See* 15 U.S.C. § 77*l*(a)(1) (Supp. III 1997).

44. 15 U.S.C. § 77*l*(2) (Supp. III 1997). Section 12 reads:

(a) *In general.* Any person who—

(1) offers or sells a security in violation of section 5, or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), 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

in connection with the sale or offer for sale of a security. To prove their prima facie case under section 12(a)(2), the shareholders must prove the existence of a material[45] misstatement or omission.[46] Again, reliance is not an element,[47] but section 12(a)(2) shareholders have the burden of proving that they did not know of the misstatement or omission at the time they bought the security.[48]

Section 12(a)(2) liability is limited to sellers of securities, and the buyer must have purchased securities from, or have been in privity with, the seller.[49] As interpreted by the courts, this requirement can severely limit plaintiffs' ability to succeed with a claim under section 12(a)(2).[50]

As a defense, the defendants may argue that they "did not know, and in the exercise of reasonable care could not have known," of the alleged

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> that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.
>
> (b) *Loss causation*. In an action described in subsection (a)(2), if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

45. *See supra* note 17.

46. *See supra* note 17.

47. *See* MidAmerica Fed. Sav. & Loan v. Shearson/American Express, Inc., 886 F.2d 1249, 1256 (10th Cir. 1989); *see also supra* note 28 and accompanying text.

48. *See* 15 U.S.C. § 77*l*(2).

49. The requirement is the same as under section 12(1). *Compare* Pinter v. Dahl, 486 U.S. 622, 650, 654 (1988) (requiring that section 12(1) defendant be seller or person who solicits sale of securities to plaintiff, not just remote participant in preparation of registration statement), *with* Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1220 (1st Cir. 1996) (requiring strict privity between seller and buyer in section 12(a)(2) claim). *See also In re* APAC Teleservices, Inc. Sec. Litig., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,705, at 93,372 (S.D.N.Y. Nov. 12, 1999) (holding privity requirement is met not only by those transferring title but also by any person who successfully solicits sale of securities, including, specifically, persons signing prospectus).

50. *See, e.g.*, *Shaw*, 82 F.3d at 1202 (holding that plaintiffs who purchased in firm-commitment underwriting were in privity only with underwriters, not with issuers). *But see* Milman v. Box Hill Sys. Corp., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,619, at 92,813 (S.D.N.Y. Aug. 16, 1999) (rejecting issuer and individual defendants' argument that because disputed offering was "firm commitment underwriting," they were not in privity with plaintiffs).

misstatement or omission.[51] Courts use various factors to analyze this defense, including level of participation in the transaction, access to source material, skill in finding the truth, financial interest in completing the transaction, and level of trust in the relationship between purchaser and seller.[52]

Section 12(a)(2) claims have the same statute of limitations as those under section 11.[53] The shareholders' remedy is limited to either rescission if the buyers have not sold the security[54] or damages if they have.[55] In addition, since 1995, the defendants may try to prove that the misstatement or omission did not cause the fall in the price of the security.[56]

Before *Gustafson v. Alloyd Co.*,[57] courts and scholars had usually agreed that nonpublic offering buyers could bring a claim under section 12(a)(2).[58] Thus, the pre-*Gustafson* applications of section 12(a)(2) included many opinions where the disputed offering involved either a private-placement or Aftermarket purchaser. As the discussion below reveals, however, *Gustafson* limited the reach of section 12(a)(2), eliminating at least private-placement purchases.[59]

51. 15 U.S.C. § 77*l*(2); *see also* Therese H. Maynard, *The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of 1933*, 69 Notre Dame L. Rev. 57 (1993).

52. *See, e.g.*, Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057, 1068 (6th Cir. 1984).

53. *See supra* note 32 and accompanying text.

54. *See supra* note 32 and accompanying text. Buyers must make their demand for rescission immediately upon discovery of the misrepresentation. *See* Westinghouse Elec. Corp. v. "21" Int'l Holdings, Inc., 821 F. Supp. 212, 220–21 (S.D.N.Y. 1993).

55. *See* 15 U.S.C. § 77*l*(2).

56. *See* 15 U.S.C. § 77*l*(2)(b) (Supp. III 1997) (inserted by Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105, 109 Stat. 737, 757 (1995)).

57. 513 U.S. 561 (1995).

58. *See* Bainbridge, *supra* note 11, at 1231 (noting that as of 1992, only one academic, Elliot Weiss, held "iconoclastic" view that section 12(a)(2) was restricted to public offerings of securities and that only some cases supported that view) (citing Elliott J. Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1 (1992)); Peter V. Letsou, *The Scope of Section 12(2) of the Securities Act of 1933: A Legal and Economic Analysis*, 45 Emory L.J. 95, 98 (1996) (noting that Professor Weiss was exception to virtually unanimous agreement among commentators that section 12(2) applied to secondary and private transactions) (citing same article); *see also* 17A J. William Hicks, *Civil Liabilities: Enforcement and Litigation Under the 1933 Act* § 6.01[3][a] (Release No. 14, Oct. 1995) (suggesting that prior to *Gustafson*, "no one seriously doubted that section 12(2) applie[d] to a placement or distribution of securities"); 3 Louis Loss, *Securities Regulation* 1699 (2d ed. 1961) (stating that section 12(a)(2) applies to all security sales, whether registered or not); Maynard, *supra* note 10, at 153 n.3 (listing numerous cases holding that section 12(a)(2) is not limited to public offerings).

59. *See infra* notes 184–211 and accompanying text.

C. *Key Differences Between Sections 11 and 12(a)(2)*

Sections 11 and 12(a)(2) differ in some important ways. First, section 11(a) states that only shareholders who have acquired securities "at least twelve months after" the registration statement's effective date or after the issuance of an "earnings statement" must prove reliance on an alleged misstatement.[60] Thus, generally, courts presume reliance for shareholders under section 11.[61] Because an offering rarely lasts for a year, this provision is generally interpreted to mean that shareholders need not purchase their shares "in" the offering at issue and can still bring a claim if they purchased in the Aftermarket.[62] Section 12(a)(2) shareholders need not prove reliance at all.[63]

Second, damages under section 11 are different from those provided for under section 12(a)(2). Section 11(e) allows shareholders to recover damages amounting to the difference between the amount they paid for the security and the value of the security at the time of suit or sale not to exceed the offering price.[64] In contrast, section 12(a)(2) shareholders can sue for rescission or, if they no longer hold a security, damages.[65] Section 11's explicit limitation on damages to the offering price of a security has provided courts with language to find that Congress intended the remedy to be available to shareholders purchasing their securities outside the offering or at a price different from the offering price.[66]

Third, section 12(a)(2) contains a privity requirement and section 11 does not.[67] The privity requirement limits access to section 12(a)(2)'s remedy and has allowed some courts to find that privity alone limits access to the remedy.[68]

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60. 15 U.S.C. § 77k(a) (1994); *see also supra* note 28 and accompanying text.

61. *See* Schwartz v. Celestial Seasonings, Inc., 904 F. Supp. 1191, 1196 (D. Colo. 1995).

62. *See infra* notes 69–80 and accompanying text.

63. *See supra* notes 47–48 and accompanying text. The provision of section 11 requiring proof of reliance for securities acquired after the issuance of an earnings statement covering at least 12 months after the effective date of the offering was added to the Securities Act in 1934. *See* 78 Cong. Rec. 10,266 (1934).

64. *See* 15 U.S.C. § 77k(e), (g) (1994).

65. *See* 15 U.S.C. § 77*l*(a)(2) (Supp. III 1997). Paragraph (b) allows sellers to limit damages if they can prove that part or all of the alleged loss was not caused by the alleged misstatement or omission.

66. *See, e.g.*, Adair v. Bristol Tech. Sys., Inc., 179 F.R.D. 126, 131 (S.D.N.Y. 1998); *see also infra* notes 326–27 and accompanying text.

67. *See supra* notes 43–50 and accompanying text.

68. *See infra* notes 165–67 and accompanying text.

III. THE EVOLUTION OF TRACING

A. *Tracing Defined*

Courts use the term "tracing" to refer to the judicially created requirement that to access sections 11 and 12(a)(2) shareholders must plead and prove that they bought shares issued either "in" the public offering for which the registration statement or prospectus was issued, or "pursuant to" that offering.[69] Shareholders who are allowed to purchase "in" an offering are those who are the first buyers of the securities issued (Original Shareholders).[70] This group is usually very limited, including only institutional investors, members of Congress, and those with connections to underwriters.[71] Small investors "can rarely get in on . . . hot"[72] initial public offerings (IPOs) because IPOs are largely "private club[s] that the average investor [i]sn't invited to join."[73] Indeed, on average, small investors receive less than one quarter of the total shares in an IPO.[74] Shareholders who purchase "pursuant to" an offering are those who buy securities issued in a particular offering, but make their purchase in the Aftermarket (Aftermarket Shareholders).[75] Tracing requires shareholders to connect their securities to the registration statement or prospectus for the offering at issue.

Although not initially applied as such, courts now describe the tracing requirement as one of standing. Accordingly, unless the shareholders' securities are connected to the registration statement, or prospectus or oral

69. *See, e.g.*, Feiner v. SS&C Techs., Inc., 47 F. Supp. 2d 250, 252 (D. Conn. 1999).

70. *See, e.g.*, Warden v. Crown Am. Realty Trust, No. CIV.A.96-25J, 1998 WL 725946, at *3 (W.D. Pa. Oct. 15, 1998).

71. *See, e.g.*, Phil Kunta & Natalie Hopkinson, *Congress's Reports Show Some Members Make Fast Profits in IPOs*, Wall St. J., June 15, 1998, at A4.

72. Aaron Lucchetti & Terzeh Ewing, *IPO-Fund Paradox: Sector Is Hot, Investors Are Cool*, Wall St. J., Sept. 3, 1999, at C1.

73. Advertisement for FBR.COM (a division of Friedman, Billings, Ramsey Group), Wall St. J., July 22, 1999, at A15; *cf.* Terzah Ewing, *The Road Now Taken: Exclusive Shows Touting New Issues Arrive on the Web*, Wall St. J., Sept. 22, 1999, at C1 (noting road shows are places where "pros" learn about IPOs but that "small investors aren't invited").

74. Terzah Ewing & Joshua Harris Prager, *Many Are Finding IPOs Still Out of Reach*, Wall St. J., Feb. 28, 2000, at C21 (noting some brokerage firms were making it harder for small investors to access IPOs).

75. *See* Cooperman v. Individual, Inc., No. CIV.A.96-12272-DPW, 1998 WL 953726, at *4 (D. Mass. May 27, 1998) (citing Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967)). Again, FBR.COM's advertisement describes these shareholders as those who "got in eventually. But not until a lot of money had passed hands." Advertisement for FBR.COM, *supra* note 73.

communication on which they are suing, the shareholders do not have standing to bring a case under either section.[76] For example, if the shareholders wish to sue under section 11, alleging a material misstatement or omission in a registration statement covering preferred stock, they must hold preferred stock issued in that particular offering.[77] Shareholders who buy at the same time as the preferred-stock offering, but purchase previously issued common stock, cannot sue under section 11. That stock was not issued pursuant to the new offering and therefore is not protected by a section 11 claim based on the registration statement for the newly issued stock. Thus, even if a misstatement or omission in the preferred-stock registration statement persuaded the shareholders to buy the common shares, the purchasers of the common stock do not have a cause of action under section 11.[78] The same is true of shareholders who buy previously issued common stock at the same time when a company offers new common stock for sale—even if the shareholders were to request shares of the newly issued common stock.[79] Thus the rights of Aftermarket Shareholders of previously issued stock are severely limited by the tracing requirement.[80]

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76. *See, e.g., Cooperman*, 1998 WL 953726, at *4–7.

77. *See* Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d. Cir. 1951) (holding that suit under section 11 may be maintained "only by one who comes within a narrow class of persons—that is, those who purchase securities that are the direct subject of the prospectus and registration statement").

The court, however, allowed the plaintiffs to sue under section 10(b) of the Securities Exchange Act and Rule 10b-5, noting that to hold otherwise "would afford a shelter or sanctuary for those who defraud investors." *Id.* at 787. Ironically, the court supported its holding with the following example:

> [Suppose a] corporation and its "insiders" put out a prospectus and registration statement, which apparently complies with the provisions of the 1933 Act but which, as they well know, is false; this they do with the successful aim of fraudulently inducing some investors to purchase the preferred from the company but also other investors to purchase a much larger amount of the company's common from the "insiders." The fraud-doers would be delighted to reimburse the purchasers of the preferred and to avoid liability to the defrauded purchasers of the large amount of the common.

Id.

78. *See id.*

79. *See* Barnes v. Osofsky, 373 F.2d 269 (2d Cir.1967).

80. *See, e.g.*, Guenther v. Cooper Life Sciences, Inc., 759 F. Supp. 1437 (N.D. Cal. 1990) (holding that Aftermarket Shareholder who was unable to trace securities to offering lacked standing for section 11 claim).

Procedurally, the defendants may raise tracing in a variety of contexts. For example, they may move for dismissal. *See, e.g.*, Adair v. Bristol Tech. Sys., Inc., 179 F.R.D. 126 (S.D.N.Y. 1998) (denying motion to dismiss for lack of standing based on plaintiffs' failure to buy "in" offering and finding that section 11 provides remedies for both purchasers *in* offering and those who can trace their purchase to offering); *In re* Stratosphere Corp. Sec. Litig., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,198 (D. Nev. Apr. 2, 1998) (same). They may also move for summary judgment, arguing that the

The question courts address is whether section 11 provides a cause of action to only those shareholders who acquired their securities pursuant to a particular offering (that is, any shareholder in the chain of title of a particular share) or to all shareholders who acquired a security of the same type as that issued pursuant to a particular offering.[81] Thus, there are three potential types of claimants: (1) Original Shareholders, (2) Aftermarket Shareholders, and (3) shareholders of the same type of stock as that issued in the disputed offering but purchased in a different offering. Assuming that the statute was intended to provide all shareholders who purchase their shares pursuant to an allegedly misleading registration statement with a cause of action (types (1) and (2)) with a claim, requiring tracing results in an underinclusive plaintiff pool. Aftermarket Shareholders of a company with multiple offerings are unlikely to be able to prove that their shares were issued under any one offering and are, therefore, precluded from making a claim. The third category, however, is overinclusive because it provides all shareholders owning shares of the type issued in the offering with a claim, even if the shares were not issued in the disputed offering.

1. Barnes v. Osofsky

In an early and leading case on the subject, *Barnes v. Osofsky*,[82] Judge Friendly[83] resolved the question for the Second Circuit by defining the

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shareholders lack standing. *See* ZZZZ Best Sec. Litig., [1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,485 (C.D. Cal. Oct. 26, 1994) (denying motion for summary judgment and finding tracing irrelevant where plaintiff had purchased type of warrants issued in disputed offering); Abbey v. Computer Memories, 634 F. Supp. 870 (N.D. Cal. 1986) (granting defendants' motion for summary judgment for lack of standing where plaintiff was unable to trace securities to public offering). Defendants also raise tracing in their opposition to the shareholders' motions for class certification, arguing either that the named shareholders are not adequate or typical pursuant to Federal Rule of Civil Procedure 23(a)(3) and 23(a)(4), or are inappropriate due to lack of predominance of common questions of fact and law pursuant to Federal Rule of Civil Procedure 23(b)(3). *See In re* Data Access Sys. Sec. Litig., 103 F.R.D. 130 (D.N.J. 1984) (declining to deny class certification on basis of defendants' argument that plaintiff who purchased "in" offering was not adequate and typical to represent others who purchased in Aftermarket) (same in context of predominance). *But see In re* Regal Communications Corp. Sec. Litig., [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,871 (E.D. Pa. Sept. 14, 1995) (finding opposition to class-certification motion inappropriate vehicle for raising standing arguments). Defendants have also raised the issue in the context of motions to remove a case to the federal court. *See* Bennett v. Bally Mfg. Corp., 785 F. Supp. 559 (D.S.C. 1992) (discussing defendants' argument that plaintiffs lacked standing for 1933 Act claim and included it in complaint only to prevent removal).

81. *See Barnes*, 373 F.2d at 271.

82. 373 F.2d 269 (2d Cir. 1967). In *Barnes*, the issue arose in the context where shareholders would have access to a settlement that limited funds to those shareholders "who beneficially acquired (in [their] own name[s] or otherwise) part of the . . . shares which [were] the subject" of allegedly misleading offering document. *Id.* at 270.

potential plaintiff pool to include types (1) and (2) (Offering Shareholders), but adopting a tracing requirement that restricts the claim to Original Shareholders only. He first considered the language of section 11.[84] He noted that when newly registered shares are combined with those already being traded, the word " 'such' has no referent."[85] Although he posited that the "narrower" interpretation of "acquiring a security issued pursuant to the registration statement" was more natural, he admitted that the statute could easily be interpreted to cover a shareholder who acquired a security "of the same nature" as that issued pursuant to the registration statement.[86] Thus, he reasoned, if a court had a "good reason for doing so" it could adopt the latter interpretation.[87]

Then he addressed the shareholders' contention that the court should adopt the latter, and more broad, understanding of the statute.[88] He agreed that an "unduly optimistic" offering document might affect the price of shares already in the market, not just those being issued.[89] Thus, a materially misleading registration statement might affect contemporaneous purchasers of previously issued securities the same way as it affects Original Shareholders [90] He also observed that the language of section 11 does not indicate that it applies only to the Offering Shareholders. So, to limit its use to only the shareholders who can trace their shares to the offering creates an outcome which "turn[s] on mere accident since most trading is done through brokers who neither know nor care whether [the shares are] newly registered or old shares."[91]

Next, he noted the shareholders' argument that it is virtually impossible to determine whether previously traded shares are old or new. He acknowledged that stock is often held in margin accounts or in street names,

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83. Judge Henry J. Friendly is credited with having shaped much of the law of securities. *See* Margaret V. Sachs, *Judge Friendly and the Law of Securities Litigation: The Creation of a Judicial Registration*, 50 SMU L. Rev. 777, 809–12 (1997) (noting Judge Friendly authored 80 majority securities opinions and was cited in 10 Supreme Court opinions and 355 non-Second Circuit lower federal court opinions); *see also* Bruce A. Ackerman et al., *In Memoriam: Henry J. Friendly*, 99 Harv. L. Rev. 1709, 1715 (1986) (comments of Professor Paul Freund).

84. *See Barnes*, 373 F.2d at 271.

85. *Id.*; *see also supra* note 4 and accompanying text.

86. *Barnes*, 373 F.2d at 271.

87. *Id.*

88. *See id.*

89. *Id.*

90. Indeed, the fraud-on-the-market theory supports this conclusion. *See* Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (adopting fraud-on-the-market theory).

91. *Barnes*, 373 F.2d at 271.

and that many brokerage houses do not identify specific shares with particular accounts, noting that they simply "treat the account as having an undivided interest in the house's position."[92] These problems in identifying particular shares, let alone their source, he reasoned, make tracing difficult.[93] Indeed, interpreting the statute in the more narrow fashion could result in different treatment for similarly situated persons.[94]

Although he acknowledged the shareholders' arguments, Judge Friendly held that to read the statute to allow all type (3) shareholders access to section 11 remedies was "inconsistent with the overall public-offering statutory scheme"[95] of the Act. According to him, the purpose of section 11 was to "insure full and accurate registration statement[s]" through the use of stringent and easily accessible remedies.[96] Because Congress made harsh remedies easily available to shareholders, Judge Friendly reasoned, it was "unlikely" that Congress intended that section 11 contain a remedy for securities other than those issued pursuant to a particular registration statement.[97] He instead found a remedy for type (3) shareholders in a different part of the Act. He distinguished section 11 from sections 12(a)(2) and 17, noting that the latter sections required a different type of proof that is more akin to scienter and, therefore, were not limited to newly issued shares.[98]

In further support of his narrow reading of the statute, Judge Friendly pointed to section 11's damages provision, which limits the maximum recoverable damages to the public-offering price of the security. He reasoned that if the offering price controlled the level of damages, it was illogical to assume that securities not included in that offering would be covered by section 11.[99]

Next, he turned to the legislative history of the statute. Judge Friendly noted that the shareholders pointed to a statement in the legislative history

92. *Id.* at 272.

93. *See id.*

94. *See id.*

95. *Id.*

96. *Id.*

97. *Id.* He also noted that even though *Gustafson* changed the reference to section 12(a)(2), sections 12(a)(2) and 17 were not limited to newly registered securities. *See id.*; *see also id.* at 272 n.1 (noting that purchasers of securities other than those registered may have section 12(a)(2) claim but not section 11 claim).

98. *See id.* at 272. This conclusion is the opposite of that reached by many later courts when interpreting section 12(a)(2). *See, e.g.*, *infra* notes 165, 167, and accompanying text.

99. *See Barnes*, 373 F.2d at 272.

that the "remedies of section 11 were accorded to purchasers 'regardless of whether they bought their securities at the time of the original offer or at some later date.' "[100] Apparently, the shareholders argued that this statement provided a remedy to any purchaser who was "reasonably affected" by registration-statement language. Judge Friendly, however, reasoned that the legislative history could be extended only to the shareholders with traceable shares, or the Offering Shareholders.[101]

He came to this conclusion by noting that both the House and Senate versions of section 11 "established a conclusive presumption" of reliance by those " 'acquiring any securities specified in such statements and offered to the public.' "[102] The bills also stated that the shareholders who acquired securities to which the registration statement related, " 'either from the original issuer or any other person' " would have a cause of action against the enumerated defendants.[103] The Conference Report differed only as to the enumerated defendants and their defenses, but not these provisions.[104] Thus, he reasoned, Congress indicated its agreement that this section of the Act covered only Offering Shareholders.[105]

Then, Judge Friendly examined earlier cases from courts within the Second Circuit, finding them in accord with his view.[106] For example, he considered an opinion in which the court had stated in dictum that "an action under section 11 may be maintained 'only by one who comes within a narrow class of persons, i.e., those who purchase securities that are the direct subject of the prospectus and registration statement.' "[107] This statement, he reasoned, carried "particular weight" because its author was Judge Frank, "a leading member of the SEC in its early days . . . ."[108]

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100. *Id.* at 273 (citing H.R. Rep. No. 85, at 9 (1933)); *see also supra* note 66 and accompanying text.

101. *See Barnes*, 373 F.2d at 273.

102. *Id.* at 272 (citing S. 875, 73d Cong. § 9 (1933) and H.R. 4314, 73d Cong. § 9 (1933)).

103. *Id.*

104. *See id.* at 272–73 (citing H.R. Rep. No. 152, at 26 (1933)).

105. *See id.* (citing H.R. Rep. No. 152, at 26 (1933)).

106. *See id.* at 273.

107. *Id.* (quoting Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951)) (addressing ruling of lower court not raised on appeal that common stockholders did not have cause of action under section 11 for registration statement for preferred stock).

108. *Id.* Judge Friendly also cited *Colonial Realty Corp. v. Brunswick Corp.*, 257 F. Supp. 875 (S.D.N.Y. 1966) (limiting section 11 to purchasers in offering) and 3 Loss, *supra* note 58, at 1731 n.160.

For other early cases finding that the plaintiffs must trace their securities to the offering in question, see *Lorber v. Beebe*, 407 F. Supp. 279, 286 n.3 (S.D.N.Y. 1975) (granting summary judgment for defendants where plaintiff pleaded that he purchased shares " 'pursuant to a Registration Statement' " but

Finally, he acknowledged that his narrow interpretation of the statute could result in an "accidental impact" as between two contemporaneous, open-market purchasers both requesting the same type of securities: one who happens to buy securities issued in a particular offering and another who happens to buy securities from a different, undisputed offering.[109] He remained unpersuaded, however, that other interpretations of the statute were more accurate and concluded that the lower court had properly eliminated from the settlement class those shareholders who could not trace their securities to the offering at issue.[110] Instead, he suggested that it was perhaps time for Congress to "reexamine" the statute.[111]

2. *Tracing Methods*

Since *Barnes v. Osofsky*, shareholders have endeavored, unsuccessfully, to convince the courts either that tracing is not required or that it is properly accomplished through statistical or other means. One case, *Kirkwood v. Taylor*,[112] proposed and discarded several tracing methods. In *Kirkwood*, the court defined four methods of tracing: direct trace, fungible mass, contrabroker, and heritage.[113]

a. *Direct Tracing*

The direct-tracing method applies only to the limited group of Original Shareholders, or those who purchase their securities *in* the public offering at

was unable to prove that his stock was new, not old), and *Wolfson v. Solomon*, 54 F.R.D. 584, 588 (S.D.N.Y. 1972) (noting that plaintiffs purchased shares directly from underwriter).

109. *See Barnes*, 373 F.2d at 273.

110. *See id.*

111. *See id.* Apparently, the plaintiffs urged the court to put the tracing burden on the defendants. The court rejected the suggestion, noting that the plaintiffs had not demonstrated the "unreasonableness" of leaving the burden on them. *See id.* at 273 n.2.

In 1983, the Supreme Court decided *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). Although the focus of this opinion was whether purchasers should be barred from suing under section 10(b) of the Exchange Act if they also had access to section 11, the Supreme Court described section 11 as providing only purchasers of registered securities with claims. *See id.* at 381–82. It also stated that section 11 provides purchasers of registered offerings with special protection. *See id.* at 383. Neither that opinion nor *Barnes* discussed the underinclusive nature of the tracing doctrine and how it could erode the deterrent effect of sections 11 and 12(a)(2). Indeed, although *Barnes* applied the tracing doctrine only to section 11, courts discussing tracing in the context of section 12(a)(2) have found that it applied to claims under that section as well. *See infra* notes 163–70 and accompanying text.

112. 590 F. Supp. 1375 (D. Minn. 1984).

113. *See id.* at 1378–83.

issue. According to the *Kirkwood* court, the indicia for determining whether a shareholder's purchase qualifies under this method include: (1) a broker indicating interest on behalf of a customer; (2) a customer who receives a copy of the "red herring," or preliminary, prospectus; (3) a purchase order with a notation indicating an offering purchase; (4) a purchase price matching the offering price;[114] (5) a lack of a commission; (6) a confirmation slip with language regarding the offering; and (7) a special code for the transaction at the brokerage firm.[115]

Using these indicia, the *Kirkwood* court found that a shareholder who purchased two hundred shares of stock on the offering date from an offering underwriter bought traceable shares.[116] It noted, however, that because the shareholder could not trace its other Aftermarket securities to the offering, it lacked standing under section 11 for those shares.[117]

b. Fungible-Mass Tracing

The second test, the fungible-mass method, is based on statistical probability.[118] Under this theory, the shareholders argued that because brokers keep securities in house holding accounts, which are essentially one fungible mass of securities, neither shareholders nor brokers can know with certainty which security is transferred.[119] Accordingly, they argued statistics could be employed to show the probability that any given shares were issued in the questioned offering. For example, in another case, *In re Elscint, Ltd. Securities Litigation*,[120] the shareholders argued that they should be able to pursue their section 11 claims using statistics based on the percent of newly issued shares in the market.[121] The defendants responded by arguing that unless the shareholders could actually trace their Aftermarket purchases to newly issued shares, they lacked standing to sue

114. Unless an offering is oversubscribed and all shares are sold at the offering price, the purchase price for a share bought in an offering may differ from the offering price. *See In re* Worlds of Wonder Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 95,004, at 95,630 (N.D. Cal. Mar. 23, 1990) (noting that although offering price was $18, plaintiff bought shares from sub-underwriter for higher price).

115. *See Kirkwood*, 590 F. Supp. at 1378 (citing affidavit).

116. *See id.*

117. *See id.*

118. *See id.* at 1378–79.

119. *See id.*

120. 674 F. Supp. 374 (D. Mass. 1987).

121. *See Elscint*, 674 F. Supp. at 379; *see also Kirkwood*, 590 F. Supp. at 1378–79; Lorber v. Beebe, 407 F. Supp. 279, 286 (S.D.N.Y. 1976).

under section 11 and were not qualified to serve as class representatives for a section 11 class.[122]

The shareholders responded that they should not have to offer "chain of title" proof to show "beyond question" that their shares were issued in the offering.[123] Instead, they argued, the court should allow them to use "probabilistic" evidence to support their standing.[124] They also argued that the required level of proof regarding the status of their shares was only a "preponderance of the evidence."[125]

The court agreed that the tracing precedents did not require proof "beyond question."[126] But, it stated, the shareholders' argument could not succeed without a "better foundation" than that their shares "might" have been issued pursuant to a registration statement.[127] Instead, the court noted, the only shareholders who could have a viable claim under section 11 were those who could "prove" that their shares were new.[128] The court also agreed that the applicable standard of proof was the preponderance of the evidence.[129] Thus, according to the court, the shareholders needed to prove a purchase of "some particular number of 'new' shares, each at some particular price" in order to support both liability and damages.[130] Yet, the court also reasoned that the required proof could be direct, circumstantial, or both, and that the latter category could include statistical evidence if it had as its basis data that was "adequately authenticated and supportably interpreted."[131]

The court, however, did not explain what it meant by such statistical proof when it rejected the shareholders' proffered calculations.[132] The shareholders argued that there was a fifty-percent probability the shares they purchased on certain dates contained some new shares and an eighty-two-percent probability for other dates.[133] The court said this evidence fell

122. *See id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.* (citing sur-reply of named underwriters).

128. *Id.*

129. *See id.* at 380.

130. *Id.*

131. *Id.*

132. *See id.*

133. *See id.*

"short" of that required to allow it to infer that "any one of the plaintiffs, more probably than not, purchased at least some determinate number of 'new' shares."[134] To accept the shareholders' theory, the court reasoned, it would have to find that the section 11 standard did not require them to be purchasers of a determinate number of new shares at a determinate price.[135] The court was unwilling to reach that conclusion and found that the shareholders were unable to serve as class representatives.[136]

The court rejected the shareholders' tort analogy.[137] The shareholders argued that in recent cases, courts had accepted group-based statistical evidence to allow plaintiffs to meet their burden of production that a particular form of negligence was a "substantial factor" in the alleged harm.[138] The example the court described was one in which the shareholders might argue that the evidence supported a "reasoned inference" that some form of negligence increased the risk of death by twenty-five percent, but there was insufficient proof to show that it was more than fifty percent probable death would not have occurred but for the alleged negligence or that negligence was a cause in fact of the death.[139] The court posited that applying this analogy would allow the shareholders to "relax[]" the tracing requirement so that meeting it with probabilistic evidence would be possible, even if that evidence did not support a reasoned inference that the suing shareholder purchased a determinate number of shares that were, more probably than not, new shares.[140]

The court found that the analogy was plausible but rejected it and the use of the plaintiffs' use of statistical evidence. In doing so, the court noted that to whatever extent the cases indicated the standard of proof for causation had relaxed in the torts realm, the change was not appropriate in the securities context.[141] Instead, the court concluded that securities laws protect

134. *Id.* The court declined to address the defendants' challenges to the premises and inferences involved in the plaintiffs' statistical analyses. *See id.*

135. *See id.* Other courts have rejected statistical analyses as well. *See, e.g.*, *In re* Quarterdeck Office Sys., Inc. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,092, at 98,742 (C.D. Cal. Sept. 30, 1993) (finding insufficient plaintiffs' assertion that it was more probable than not that their shares were issued pursuant to registration statement because 97% of shares outstanding when they purchased their shares were covered by registration statement).

136. *See Elscint*, 674 F. Supp. at 382.

137. *See id.* at 381.

138. *Id.* at 380–81 (citing various cases in which plaintiffs had used statistical evidence to support "substantial factor" element).

139. *Id.* at 381.

140. *Id.*

141. *See id.*

persons from financial, not physical harm, and therefore, the protection need not be as expansive.[142] The court also noted that the cases the shareholders cited were the exception, not the norm, and should not be expanded to a general category of cases in either the tort or securities context.[143] Thus, according to the court, the proposed class plaintiffs could not represent, or be members of, the class.[144]

c. *Contrabroker Tracing*

The contrabroker tracing method would allow the shareholders to argue that they purchased their shares from their broker who in turn had purchased the shares from another broker/market maker in the stock.[145] In *Kirkwood*, the shares the second broker sold were from its house account, not from one of its customers.[146] The second broker was also an underwriter for the offering; thus, the shareholders argued, their shares were traceable to the offering.[147]

The court rejected this argument, reasoning that to accept it would require an assumption that the broker's house account contained only offering shares on the dates on which the shareholders purchased their stock.[148] According to the court, the shareholders had not provided any evidence as to whether the brokers were market makers in the stock before

142. *See id.*

143. *See id.*

144. *See id.* at 382. The court did not dismiss the complaint as requested by some of the defendants. Instead, it found that the tracing issue was more properly decided at the summary-judgment, not the class-certification or motion-to-dismiss stage. *See id.* In reaching this conclusion, the court noted that to require the shareholders explicitly to allege tracing before discovery, a standard that might convert the motion into one for summary judgment, was inappropriate. *See id.* at 383. Several other courts have declined to find a lack of standing at the motion-to-dismiss stage for the same reasons. *See, e.g., In re* Data Access Sys. Sec. Litig., 103 F.R.D. 130, 146 (D.N.J. 1984) (holding that plaintiff's ability to trace stock is merits issue not properly resolved at class-certification stage). *But cf. In re* Quarterdeck Office Sys., Inc. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,092, at 98,742 (C.D. Cal. Sept. 30, 1993) (noting that although standing is merits issue, court may consider evidence, such as that pertaining to tracing, which goes to class-certification requirements). Although this might seem helpful to the plaintiffs, it is unlikely that even with discovery, the plaintiffs can prove tracing. *See infra* note 212 (citing cases discussing impossibility of tracing standard). Thus, they are likely to lose on this element at summary judgment. *See, e.g.*, Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 875 (N.D. Cal. 1986) (granting summary judgment where defendants showed that tracing was impossible for plaintiffs to prove).

145. *See* Kirkwood v. Taylor, 590 F. Supp. 1375, 1381 (D. Minn. 1984).

146. *See id.*

147. *See id.*

148. *See id.*

the offering date.[149] If so, the court reasoned, the house accounts might have included old and new shares.[150] Moreover, the court noted, if it accepted this argument, shareholders would be able to meet the tracing requirement solely by buying their securities from market-maker brokers.[151] Thus, the court concluded that this method was also insufficient.

d. Heritage Tracing

Finally, the *Kirkwood* court considered the heritage tracing method.[152] The shareholders argued that they could compare the individual stock certificates (Individual Certificates) they received from their brokers to the records of the company's transfer agent, identify the certificates by code number,[153] and then identify the stock certificates from which the Individual Certificates were issued (Surrendered Certificates).[154] Because some of the Surrendered Certificates were offering certificates, the plaintiffs, by comparing the two, proposed to trace their shares' heritage to the offering.[155]

The defendants successfully repelled this argument with two points. First, only some of the Surrendered Certificates to which the plaintiffs traced their shares were traceable to original offering certificates.[156] Second, the total number of shares represented by the Surrendered Certificates exceeded the total number of shares in the Individual Certificates.[157] Therefore, the defendants argued, there was no way to tell which, if any, of the plaintiffs' shares were actually traceable to the disputed offering document.[158]

The court agreed, noting that in no case was it clear "that all or even any of plaintiffs' shares [were] *necessarily* offering shares."[159] Thus, it

149. *See id.*

150. *See id.*

151. *See id.*

152. *See id.* at 1382.

153. *See id.* The shareholders were able to trace their certificates because the stocks were issued in their names. Today, however, the usual practice is to hold shares in street names. As a result, this method is unlikely to prove fruitful for modern shareholders. *See infra* note 236.

154. *See Kirkwood*, 590 F. Supp. at 1382.

155. *See id.*

156. *See id.*

157. *See id.*

158. *See id.*

159. *Id.* (italics in original).

concluded, the plaintiffs had succeeded in proving only that they "might" have purchased shares issued in the questioned offering (Offering Shares) and such a showing was insufficient to establish their claim.[160] Although it conceded that the shareholders faced a difficult task,[161] the court decertified the section 11 class and granted summary judgment for those defendants facing only section 11 claims.[162]

3. *Pre-*Gustafson *Tracing*

After *Barnes*, defendants began to use the tracing requirement to argue that only Offering Shareholders had standing to pursue section 11 and 12(a)(2) claims and that direct tracing was the only way to prove such status. In response, most courts held that shareholders must trace section 11 claims.[163] Some also required section 12(a)(2) shareholders to trace their

160. *Id.*; *see also* Barnes v. Osofsky, 373 F.2d 269, 273 (2d Cir. 1967); McFarland v. Memorex Corp., 493 F. Supp. 631, 641–42 & n.14 (N.D. Cal. 1980) (finding insufficient plaintiff's declaration containing "unverified speculation as to the meaning of certain notations on unauthenticated copies of . . . confirmation slips"); Lorber v. Beebe, 407 F. Supp. 279, 286–87 (S.D.N.Y. 1975). Courts have rejected any sort of burden shifting that would allow the plaintiffs to produce evidence sufficient to show that they might have purchased in the offering, and then shift the burden to the defendants, who have access to and control over more information. *See, e.g.*, *Barnes*, 373 F.2d at 273 n.2; *Lorber*, 407 F. Supp. at 287.

161. *See Kirkwood*, 590 F. Supp. at 1383.

162. *See id.* at 1386–87.

163. *See, e.g.*, *In re* College Bound Consol. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,310, at 90,134 (S.D.N.Y. May 4, 1994) (requiring tracing of section 11 claims); *In re* Kendall Square Research Corp. Sec. Litig., 868 F. Supp. 26, 29 (D. Mass. 1994) (same); *In re* Quarterdeck Office Sys., Inc. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,092, at 98,742 (C.D. Cal. Sept. 30, 1993) (same); Westinghouse Elec. Corp. v. "21" Int'l Holdings, Inc., 821 F. Supp. 212, 218 (S.D.N.Y. 1993) (same); Guenther v. Cooper Life Sciences, Inc., 759 F. Supp. 1437, 1439 (N.D. Cal. 1990) (same); Eichenholtz v. Brennan, No. CIV.A.88-515(JCL), 1989 WL 85616, at *11 (D.N.J. July 27, 1989) (same); *In re* Elscint, Ltd. Sec. Litig., 674 F. Supp. 374, 376 (D. Mass. 1987) (same); Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 872–74 (N.D. Cal. 1986) (same); *In re* Lilco Sec. Litig., 111 F.R.D. 663, 671 (E.D.N.Y. 1986) (same); *In re* Masstor Sys. Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 92,719, at 93,487 (N.D. Cal. Mar. 27, 1986) (same); *Kirkwood*, 590 F. Supp. at 1378 (same); *In re* Data Access Sys. Sec. Litig., 103 F.R.D. 130, 145–46 (D.N.J. 1984) (same); Ross v. Warner, 480 F. Supp. 268, 273–74 (S.D.N.Y. 1979) (same); Pearlman v. Gennaro, Fed. Sec. L. Rep. (CCH) ¶ 94,006, at 94,052–53 (S.D.N.Y. May 31, 1973) (same); Wolfson v. Solomon, 54 F.R.D. 584, 588 (S.D.N.Y. 1972) (same); Colonial Realty Corp. v. Brunswick Corp., 257 F. Supp. 875, 877 (S.D.N.Y. 1966) (same); *cf. In re* Seagate Tech. Sec. Litig., 115 F.R.D. 264, 267 (N.D. Cal. 1987) (requiring tracing for section 11 claim and not discussing issue with respect to section 12(a)(2) claim). *But see In re* Delmarva Sec. Litig., 794 F. Supp. 1293, 1309 (D. Del. 1992) (finding only purchasers *in* offering have claim); Langert v. Q-1 Corp., Fed. Sec. L. Rep. (CCH) ¶ 94,445, at 95,541 (S.D.N.Y. Mar. 15, 1974) (noting only shareholders purchasing directly from underwriters have section 11 and 12(a)(2) causes of action); *cf.* Mullaly v. Q.T. Wiles, No. CIV.A.91-M-731, 1991 WL 504866, at *3 (D. Colo. Oct. 24, 1991) (appearing to require purchases *in* offering for both sections).

claims.[164] More often, courts discussed tracing for section 11 claims and addressed section 12(a)(2) only in the privity context.[165] The language of section 12(a)(2), which courts have interpreted to require strict privity between the offeror/seller and the purchaser, arguably limits the availability of the claim to Original Shareholders.[166] In more recent years, a few courts have found that shareholders making section 12(a)(2) claims must plead and prove that they were Original Shareholders,[167] but those making section 11

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164. *See, e.g.*, Shapiro v. UJB Fin. Corp., 964 F.2d 272, 286–87 (3d Cir. 1992) (requiring tracing for both sections); *In re* AES Corp. Sec. Litig., 825 F. Supp. 578, 592–93 (S.D.N.Y. 1993) (same); PPM Am., Inc. v. Marriott Corp., 820 F. Supp. 970, 975–76 (D. Md. 1993) (same); Ciresi v. Citicorp, 782 F. Supp. 819, 823 (S.D.N.Y. 1991) (same); *In re* Worlds of Wonder Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 95,004, at 95,630 (N.D. Cal. Sept. 30, 1990) (same); Bernstein v. Crazy Eddie, Inc., 702 F. Supp. 962, 972 (E.D.N.Y. 1988) (same); Hammond v. Hendrickson, No. 85-C-9829, 1986 WL 8437, at *4 (N.D. Ill. July 30, 1986) (same); *In re* Eagle Computer Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 92,741, at 93,604–06 (N.D. Cal. Mar. 31, 1986) (same); *cf.* McMahan & Co. v. Wherehouse Entertainment, Inc., 859 F. Supp. 743, 755 (S.D.N.Y. 1994) (requiring tracing for section 12(a)(2)); McCowan v. Dean Witter Reynolds, Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,423, at 92,727 (S.D.N.Y. Apr. 12, 1989) (same); Ackerman v. Clinical Data, Inc., Fed. Sec. L. Rep. (CCH) ¶ 92,207, at 91,568 (S.D.N.Y. July 11, 1985) (same).

165. *See, e.g.*, *In re* ZZZZ Best Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,485, at 91,309–10 (C.D. Cal. Oct. 26, 1994) (requiring tracing for section 11, but discussing section 12(a)(2) only in privity context); *In re* Westinghouse Sec. Litig., 832 F. Supp. 948, 966, 983–85 (W.D. Pa. 1993) (same); *In re* PNC Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 96,865, at 93,524–25 (W.D. Pa. June 9, 1992) (same); *In re* Newbridge Networks Sec. Litig., 767 F. Supp. 275, 279–81 (D.D.C. 1991) (same); Persky v. Turley Gould, Fed. Sec. L. Rep. (CCH) ¶ 96,483, at 92,132–34 (D. Ariz. 1991) (same); Rice v. Windsor Indus., Inc., No. 85-C-4196, 1986 WL 2728, at *6–7 (N.D. Ill. Feb. 27, 1986) (same); Gibb v. Delta Drilling Co., 104 F.R.D. 59, 69–71 (N.D. Tex. 1984) (same); Klein v. Computer Devices, Inc., 591 F. Supp. 270, 273 & n.15 (S.D.N.Y. 1984) (same); *McFarland*, 493 F. Supp. at 641–42, 647 (same); Lorber v. Beebe, 407 F. Supp. 279, 286–88 (S.D.N.Y. 1975) (same); Unicorn Field, Inc. v. Cannon Group, Inc., 60 F.R.D. 217, 222–23, 226 (S.D.N.Y. 1973) (same); *cf.* Akerman v. Oryx Communications, 810 F.2d 336, 344 (2d Cir. 1987) (eliminating section 12(a)(2) issue on privity basis).

166. *See* Danis v. USN Communications, Inc., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,692, at 93,283 (N.D. Ill. Oct. 6, 1999) (stating privity requirement of section 12 may restrict potential plaintiffs to original shareholders); *In re* Number Nine Visual Tech. Group Sec. Litig., No. CIV.A.96-11207-WGY, 1999 WL 362789, at *29 n.7 (D. Mass. June 1, 1999). For a discussion of privity, see *supra* notes 49–50 and accompanying text.

167. *See In re* Chambers Dev. Sec. Litig., 848 F. Supp. 602, 617 (W.D. Pa. 1994) (requiring purchase "in" offering for section 12(a)(2)); *cf.* Reed v. Prudential Sec., Inc., 875 F. Supp. 1285, 1291–92 (S.D. Tex. 1995) (deciding that section 12(a)(2) applies only to initial offerings, thus presumably negating tracing); *In re* Proxima Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,236, at 99,622 (S.D. Cal. May 3, 1994) (limiting section 12(a)(2) shareholders to those who purchased *in* offering as defined by prospectus-delivery period); Wade v. Industrial Funding Corp., Fed. Sec. L. Rep. (CCH) ¶ 98,144, at 99,024–25 (N.D. Cal. Aug. 30, 1993) (limiting 12(a)(2) shareholders to prospectus-period purchasers); Tregenza v. Great Am. Communications Co., 823 F. Supp. 1409, 1418 (N.D. Ill. 1993) (same); Budget Rent A Car Sys., Inc. v. Hirsch, 810 F. Supp. 1253, 1256–59 (S.D. Fla. 1992) (noting that for section 12(a)(2) to apply, plaintiff must allege purchase *in* offering, but not discussing whether tracing would be sufficient); Leonard v. Stuart-James Co., 742 F. Supp. 653, 658 (N.D. Ga. 1990) (same); Kaplan v. Pomerantz, 131 F.R.D. 118, 127 (N.D. Ill. 1990) (noting difference between purchasing *in* offering and

claims need not.[168] Shareholders able to meet the so-called direct-tracing test were few in number.[169] For example, one court dismissed counts under both sections where a plaintiff had actually purchased on the offering date at the offering price, but failed to allege that the shares he purchased "were a part of the stock" issued on that date.[170]

A few courts adopted a method that allowed a limited number of Aftermarket Shareholders to meet the tracing requirement.[171] For example, in *Wade v. Industrial Funding Corp.*,[172] the court found that the shareholders who purchased within the prescribed ninety-day prospectus delivery period had standing, but those purchasing more than ninety days after the offering did not.[173] The court based its ninety-day rule on section 4(3)(B) of the Securities Act and accompanying regulations, which require that a prospectus be distributed to all Aftermarket Shareholders within ninety days after the offering date for IPO securities that are traded on a national securities exchange.[174]

Aftermarket purchase, but not deciding whether difference matters); Ralph v. Prudential-Bache Sec., Inc., 692 F. Supp. 1322, 1323–24 (S.D. Fla. 1988) (same); SSH Co. v. Shearson Lehman Bros., 678 F. Supp. 1055, 1059 (S.D.N.Y. 1987) (same).

168. *See Chambers Dev.*, 848 F. Supp. at 617 (allowing tracing for section 11 claims); *Proxima*, Fed. Sec. L. Rep. (CCH), at 99,622 (same); *Wade*, Fed. Sec. L. Rep. (CCH), at 99,023 (recognizing tracing for section 11 claims).

169. *See supra* notes 114–17 and accompanying text.

170. Ackerman v. Clinical Data, Inc., Fed. Sec. L. Rep. (CCH) ¶ 92,207, at 91,568–69 (S.D.N.Y. July 11, 1985) (dismissing section 11 and 12(a)(2) claims of plaintiff who purchased on same date as offering at offering price).

171. *See Proxima*, Fed. Sec. L. Rep. (CCH), at 99,619 (limiting section 12(a)(2) shareholders to those who purchased *in* offering as defined by prospectus-delivery period); *Wade*, Fed. Sec. L. Rep. (CCH), at 99,024 (limiting section 12(a)(2) shareholders to prospectus-period purchasers).

172. *Wade*, Fed. Sec. L. Rep. (CCH), at 99,024. *But see In re* Quarterdeck Office Sys., Inc. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,092, at 98,742 (C.D. Cal. Sept. 30, 1993) (allowing tracing for section 11 claims, but not through probability method).

173. *See Wade*, Fed. Sec. L. Rep. (CCH), at 99,024–25.

174. *See* 15 U.S.C. § 77d (1994); 17 C.F.R. § 230.174 (1998). The prospectus delivery period varies depending on the type of issuer and the type of offering. For example, an IPO on neither a national securities exchange nor an interdealer quotation system is subject to the longer 90-day requirement. *See* 17 C.F.R. § 230.174(d). Ironically, the rationale for this limitation is that it is an unnecessary burden to force issuers to find purchasers. *See* 53 Fed. Reg. 11,844 (1988).

B. Gustafson v. Alloyd Co.[175]

1. *Background*

Since 1995, courts have deployed the Supreme Court opinion *Gustafson v. Alloyd Co.* to erode further section 11 and 12(a)(2) claims. Although the opinion was not about tracing, courts have employed it to restrict further shareholders' ability to trace their purchases.[176] *Gustafson* involved a dispute between the plaintiffs/purchasers of Alloyd Co. and the defendants/former shareholders over a private stock placement agreement (the "Agreement").[177] The contract for the sale of Alloyd provided that, if at year end, the financial statements and audit revealed a difference between the estimated value and the actual value of the company, the disappointed party would be entitled to an adjustment in the purchase price.[178] When Alloyd's year-end earnings for 1989 were lower than the negotiation estimates, the buyers had a contractual right to recover $815,000.[179] Instead, the buyers sued, seeking rescission of the Agreement—arguably a prospectus under section 12(a)(2)—and claiming that the selling shareholders' financial statements had "render[ed] untrue the representations and warranties" in the Agreement.[180]

The U.S. District Court for the Northern District of Illinois granted the defendants' motion for summary judgment, finding that section 12(a)(2)

175. 513 U.S. 561 (1995).

176. This opinion has provoked considerable discussion among scholars, with most being critical of it. *See* Bainbridge, *supra* note 11, at 1231–32 (criticizing majority opinion as "most poorly reasoned, blatantly results-driven securities opinion" of recent vintage); Ted J. Fiflis, Gustafson vs. Alloyd Co., Inc.: *Judicial vs. Legislative Power*, 23 Sec. Reg. L.J. 423 (1996) (suggesting majority engaged in judicial activism by ignoring clear statutory construction, thereby resulting in ill-thought opinion with unsettling consequences); Edmund W. Kitch, Gustafson v. Alloyd Co.: *An Opinion That Did Not Write*, 1995 Sup. Ct. Rev. 99, 121–22 (suggesting opinion creates new and surprising definition for prospectus by ignoring language and structure of statute, thereby decreasing confidence in judiciary); Letsou, *supra* note 58, at 99 (using economic and legal analyses to argue that majority correctly limited section 12(a)(2) to public communications, but wrongly excluded Aftermarket trading); Therese Maynard, *A Requiem: Reflections on* Gustafson, 57 Ohio St. L.J. 1327, 1351 (1996) (arguing majority's methodology jeopardizes securities-law interpretations by distorting statutes to achieve desired results); *cf.* Weiss, *Further Thoughts*, *supra* note 12, at 142, 149 (suggesting Court's reasoning was "silly" and "puzzling"); Weiss, *What Questions Remain*, *supra* note 12, at 1210 (agreeing with outcome, but criticizing breadth and approach of majority).

177. *See Gustafson*, 513 U.S. at 564.

178. *See id.* at 565.

179. *See id.*

180. *Id.* at 565–66.

claims can arise only out of public offerings and not private stock placements such as the one at issue in the case.[181] The Seventh Circuit vacated that judgment and remanded based on another opinion it had recently issued, in which it reasoned that the definition of prospectus was properly interpreted as including all communications offering the sale of securities[182] and, therefore, covered the private-placement transaction at issue.[183]

2. *Majority Opinion*

In a five-to-four decision, the Supreme Court reversed the Seventh Circuit, holding that the Agreement was not a public-offering prospectus, and could not, therefore, be the subject of a section 12(a)(2) claim.[184] The majority focused on the definition of the term "prospectus" and narrowed its definition by reviewing three sections of the Securities Act: section 10, which sets forth the requisite information to be included in a prospectus for a public offering;[185] section 12(a)(2); and section 2(10), which contains definitions.[186]

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181. *See* Alloyd Co. v. Gustafson, No. 91-C-889 (N.D. Ill. May 29, 1992). The district court reasoned that private-sale agreements, like the one at issue, are not comparable to public offerings because the plaintiffs "had direct access to financial and other company documents, and had the opportunity to inspect the seller's property." *Id.* The court relied on *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991).

182. *See* Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578, 583 (7th Cir. 1993).

183. *See id.* at 595.

184. *See Gustafson*, 513 U.S. at 584. Justice Kennedy wrote the majority opinion and was joined by Chief Justice Rehnquist, and Justices Stevens, O'Connor, and Souter. Justice Thomas wrote a dissent, and was joined by Justices Scalia, Ginsburg, and Breyer. *See id.* at 584–96 (Thomas, J., dissenting). Justice Ginsburg, joined by Justice Breyer, wrote an additional dissent. *See id.* at 596–604 (Ginsburg, J., dissenting).

185. *See* 15 U.S.C. § 77j (1994).

186. *See* 15 U.S.C. § 77b(10) (1994); *see also Gustafson*, 513 U.S. at 568–78. Justice Thomas's dissent takes issue with the majority's choice to consider the statute's definition section last rather than first. *See Gustafson*, 513 U.S. at 585–87; *see also infra* notes 197–200 and accompanying text. According to the Court, the relevant part of section 10 states:

> Except to the extent otherwise permitted or required pursuant to this subsection or subsections (c), (d), or (e) of this section—
>
> (1) a prospectus relating to a security other than a security issued by a foreign government or political subdivision thereof, shall contain the information contained in the registration statement. . . .
>
> (2) a prospectus relating to a security issued by a foreign government or political subdivision thereof shall contain the information contained in the registration statement. . . .

Gustafson, 513 U.S. at 568–69 (quoting 15 U.S.C. § 77j(a)).

The Court concluded that unless otherwise exempted by section 3[187] of the Securities Act, section 10 requires that a prospectus provide the required registration-statement information.[188] Section 10 does not define the term prospectus, but the Court found that it does provide guidance as to what a prospectus cannot be if the Securities Act "is to be interpreted as a symmetrical and coherent regulatory scheme, one in which the operative words have a consistent meaning throughout."[189] Working backwards in this manner, the Court first determined that, by definition, a prospectus must include the information contained in a registration statement.[190] Because the Agreement did not contain the requisite information, the Court then reasoned that it was not a prospectus under section 10.[191] The Court concluded that only public offerings require registration statements; thus, a section 10 prospectus can only be a document related to a public offering by an issuer or its controlling shareholders.[192] Further, the Court stated that it could meet its goal of providing the term with a consistent meaning throughout the Securities Act only by establishing that the meaning of the term prospectus was the same under both sections 10 and 12.[193]

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187. *See* 15 U.S.C. § 77c (1994) (exempting governmental and certain other types of securities from Act).

188. *See Gustafson*, 513 U.S. at 569.

189. *Id.*

190. *See id.*

191. *See id.* The Court cautioned that sellers cannot prevent a document from being a prospectus by omitting required information. *See id.*

192. *See id.*

193. *See id.* at 570. The Court reviewed other sections of the statute, including section 12. *See id.* at 571. The Court noted that section 12(a)(2) excludes government-issued securities, indicating that Congress did not intend for liability to extend to any written communication relating to the sale of securities. *See id.* at 571. Yet, according to the Court, there was "no ready explanation" for exempting government securities, unless the term prospectus relates only to documents offering securities sold to the public by an issuer. *See id.*

Next, the Court addressed the Act's definitional section, section 2(10), and stated that the plaintiffs' argument rested primarily on one word of that section. *See id.* at 573. Section 2(10) reads:

> The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that (a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 77j of this title) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 77j of this title at the time of such communication was sent or given to the person to whom the communication was made, and (b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of section 77j of this title may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be

The Court also reasoned that the primary purpose of the Act was to create disclosure and registration obligations in connection with public offerings. A restrictive interpretation of the term prospectus better "linked" section 12(a)(2) to the duties created by the Securities Act.[194] Finally, the Court turned to the legislative history of the Securities Act, noting that the plaintiffs and the dissenters inappropriately relied on "statements by commentators and judges written after the [Securities] Act was passed . . . ."[195] According to the Court, other contemporaneous statements and congressional documents were consistent with its interpretation that section 12(a)(2) was available only for public offerings.[196]

> executed, and contain such other information as the Commission by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

15 U.S.C. § 77b(10) (1994).

Focusing on the portion of section 2(10) which provides that "[t]he term 'prospectus' means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security," the Court stated that the plaintiffs "[c]oncentrat[ed]" on the word "communication." *Gustafson*, 513 U.S. at 573–74. According to the Court, the plaintiffs argued that any written communication offering securities for sale was a prospectus. Applying this definition to section 12(a)(2), the Court reasoned, would make any material misstatement or omission in any communication offering a security for sale subject to those provisions. *See id.* at 574. Such an interpretation, according to the Court, would give the word prospectus a "capacious" and "incompatible" definition for section 10. *Id.* Instead, the Court reasoned, the term prospectus actually refers to documents soliciting the public to buy securities. *See id.* To read the term communication otherwise would make the terms, "notice, circular, advertisement, [and] letter," which are all forms of written communication, redundant and would indicate that the terms had no purpose. *Id.* at 574–75.

The Court also applied the doctrine of *noscitur a sociis*—a word is known by the company it keeps. *See id.* Applying this doctrine, the Court found that the terms "prospectus, notice, circular, advertisement, [and] letter," refer to documents of wide circulation. *Id.* at 575. In similar vein, the Court reasoned that the inclusion of such terms as "radio or television" indicates that the word communication was meant to refer to public communication. *Id.*

The Court also considered an earlier opinion in which it held that section 17(a) of the Act applies to fraud in either initial distributions or ordinary market trading of securities. *See id.* at 576–77 (citing United States v. Naftalin, 441 U.S. 768 (1979)). That opinion expanded section 17(a) to market trading, in what the *Gustafson* Court termed a "departure" from the Securities Act's limitation to new offerings. *See id.* at 578. In *Naftalin*, the Court had relied on the absence of limiting language in section 17(a) and contrasted the limiting language of "by means of a prospectus or oral communication" in section 12(a)(2). *Id.* at 577.

194. *Id.* at 572.

195. *Id.* at 578–79.

196. *See id.* at 579–83 (citing various legislative documents using term "public" when referring to civil remedies).

3. *Justice Thomas's Dissent*

Unlike the majority, Justice Thomas began his interpretation of section 12(a)(2) with the Act's definition section, section 2(10).[197] According to Justice Thomas, the "breadth" of the terms in section 2(10) left the majority without an argument that the term "prospectus" applied only to public offerings of securities.[198] He argued that by including the word prospectus as one of the many types of documents qualifying as a prospectus, Congress indicated its intent that the term be broader than its dictionary definition or its definition as a term of art.[199] Instead, in section 2(10), he reasoned, Congress defined types of communications, not transactions.[200]

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197. *See id.* at 585 (Thomas, J., dissenting).

198. *Id.* at 585–86.

199. *See id.* at 586.

200. *See id.* According to Justice Thomas, sections 3 and 4 set out exempted transactions. *See id.* Thus, it was appropriate to use the definition of the term "prospectus" in section 2(10) to define that term for the Securities Act. *See id.* Justice Thomas criticized the majority's reliance on *noscitur a sociis*, noting that the majority used it "to create ambiguities in § 2(10)." *Id.* Instead, he argued, the canon appropriately applies only when the statute is ambiguous, not when the statute is clear. *See id.* According to Justice Thomas, reading one word, prospectus, as controlling the other terms in the statute, "def[ies] common sense." *Id.* at 587.

Justice Thomas conceded that other portions of the statute limit the term prospectus, particularly section 10. *See id.* at 588. Although he agreed with the majority that generally terms should be given the same meaning throughout the statute, he argued that the presumption is rebutted when, as here, Congress has indicated otherwise. *See id.* For example, he argued that section 2(10) defines a prospectus to include documents offering and confirming the sale of securities, but section 10 includes only the former. *See id.* This makes sense, he reasoned, because it would be "radical" to require every confirmation slip to include all of the information required by section 10. *Id.* Further, he noted, the preface to section 2 states that its six definitions apply "'unless the context otherwise requires.'" *Id.* at 588–89 (quoting 15 U.S.C. § 77b (1994)). Section 10's context, he reasoned, creates the exception. *See id.* at 589.

Justice Thomas then turned to the text of section 12(2) and concluded that it also supported his interpretation. *See id.* He noted that section 12(2) does not distinguish between initial public offerings and other transactions. *See id.* at 589–90. Thus, he concluded, if Congress intended to distinguish them, it could have done so by including language limiting the section to public offerings. *See id.* at 590. Moreover, he pointed out, the absence of limiting language in section 12(2) is striking when compared to the specificity of section 4 exemptions. *See id.* at 591.

In Part II of his dissent, Justice Thomas rejected the majority's analysis of *Naftalin*, arguing the opinion indicates that when the statutory language lacks limitations, the Court has held that the Securities Act extends beyond public offerings. *See id.* at 592. Section 12(2), he argued, is similar to section 17(a) in this respect and should, therefore, be interpreted similarly. *See id.* at 592–94.

Finally, Justice Thomas accused the majority of being "motivated by its policy preferences." *Id.* at 594. He quoted two portions of the majority opinion indicating reluctance to expand liability under the Act. *See id.* Then, he stated that the majority exceeded the bounds of its authority by questioning policy, not simply applying it. *See id.* In doing so, he noted, the majority not only turned statutory-construction methods upside down, but also "frustrat[ed] Congress's will." *Id.* at 595.

4. Justice Ginsburg's Dissent

Justice Ginsburg agreed with Justice Thomas's language- and structure-based arguments[201] and argued that the statute's drafting history and its longstanding scholarly and judicial interpretations contradicted the majority opinion.[202] In her view, the drafting history "is at least consistent with" the argument that section 12(a)(2) is not limited to public offerings.[203] She reviewed the British Companies Act ("British Act") on which Congress based the Securities Act, noting that it contained language limiting the definition of a prospectus to communications "'offering [securities] to the public.'"[204] Congress borrowed its section 2(10) list of terms from the British Act, she argued, but did not adopt its limiting language,[205] indicating by "conspicuous omission" that it intended the term to include more than public-offering communications.[206]

She then pointed to the House Conference Report, asserting that it does not indicate that section 12(a)(2) is limited to public offerings[207] and that it does not use the word "prospectus."[208] Turning to commentators writing shortly after the Act's passage, she concluded that they—some of whom were involved in its drafting—understood the section to include public and private offerings as well as resales.[209] In addition, she noted that all of the Courts of Appeal had agreed that section 12(a)(2) applies to private

201. *Id.* at 596–99 (Ginsburg, J., dissenting).

202. *Id.* at 599–604.

203. *Id.* at 599.

204. *Id.* (quoting British Companies Act, 19 & 20 Geo. 5, ch. 23 (1929)); *see also* SEC v. Ralston Purina Co., 346 U.S. 119, 123 (1953); Landis, *supra* note 14, at 34; Note, 20 Va. L. Rev. 451, 456–58 (1934).

205. *See Gustafson*, 513 U.S. at 599–600.

206. *Id.* at 600.

207. *See id.* (citing H.R. Conf. Rep. No. 152, at 26–27 (1933)). For analyses of the legislative history, see Landis, *supra* note 14, at 29–49; Therese H. Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 Wm. & Mary L. Rev. 847, 870–92 (1991); Robert N. Rapp, *The Proper Role of Securities Act Section 12(2) as an Aftermarket Remedy for Disclosure Violations*, 47 Bus. Law. 711, 715–16, 719–27 (1992). For contemporaneous discussions of the Act, see generally Douglas & Bates, *supra* note 14; Harry Shulman, *Civil Liability and the Securities Act*, 43 Yale L.J. 227 (1933); Arthur H. Dean, *The Federal Securities Act: I*, Fortune, Aug. 1933, at 50; and Arthur H. Dean, *The Federal Securities Act: II*, Fortune, Aug. 1933, at 53.

208. *Gustafson*, 513 U.S. at 600.

209. *See id.* at 601–02.

placements.[210] Thus, she concluded, section 12(a)(2) appropriately applies to a private resale of securities.[211]

IV. THE EFFECT OF TRACING

A. *The Tracing Requirement Prohibits Valid Claims*

As defined and applied, the tracing requirement inappropriately limits the reach of sections 11 and 12(a)(2) to Original Purchasers and thereby undermines the statute's purpose.[212] The tracing requirement is a judicial invention, created to implement the Second Circuit's interpretation of section 11 as providing remedies to Offering Shareholders. Although the interpretation was arguably correct given the statute's language and history, the prescribed tracing approach actually diminishes the remedial purpose of the statute. Indeed, the effect of the tracing requirement and *Gustafson* on the accessibility of section 11 and 12(a)(2) claims to shareholders is dramatic.

The Second Circuit's mistaken finding that the tracing requirement would both prevent overinclusiveness and fulfill the statute's purpose has resulted in scores of dismissed cases.[213] The *Barnes* court concluded that only those section 11 shareholders who could trace their shares to the offering at issue were entitled to a share of the class settlement.[214] The court

210. *See id.* at 602. She does note, however, that the courts of appeals were divided as to whether section 12(2) applied to Aftermarket purchases. *See id.*

211. *See id.* at 603.

212. *See, e.g.*, Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967) (acknowledging, without comment or analysis, shareholders' argument that preexisting shares make tracing impossible); *In re* Eagle Computer Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 92,741, at 93,604 (N.D. Cal. Mar. 31, 1986) (noting defendants' argument that second offering made it impossible for shareholders purchasing after that offering to trace shares); Lorber v. Beebe, 407 F. Supp. 279, 286 (S.D.N.Y. 1976) (rejecting pleadings where plaintiff failed to plead facts connecting shares to offering documents and noting that presence of other offerings made it impossible for court to make assumptions).

213. The courts often do not have to face the effect of their opinions because most find that shareholders must allege they purchased their shares either in or pursuant to the offering at the motion-to-dismiss or class-certification stage. Many courts specifically indicated that whether the shareholders could meet the direct tracing requirement was best decided after discovery, thus allowing the shareholders to gain a toehold in the litigation. *See, e.g.*, Shapiro v. UJB Fin. Corp., 964 F.2d 272, 286 (3d Cir. 1992) (agreeing with lower court finding that "pursuant to" allegations were sufficient at "early stage" of litigation); *In re* Seagate Tech. Sec. Litig., 115 F.R.D. 264, 267 (N.D. Cal. 1987) (noting that "pursuant to" allegation was all that was required for conditional class certification).

214. *See Barnes*, 373 F.2d at 273.

held that section 11 required this conclusion even if tracing might be difficult.[215] The court rejected the shareholders' plea to shift the burden of traceability to the defendants, noting, ironically, that the shareholders had not "demonstrated the unreasonableness of leaving th[e] burden on them."[216] A reexamination of the *Barnes* opinion reveals that without so stating, the court made a choice between an underinclusive and an overinclusive interpretation of section 11 and in so doing, undermined its purposes.[217]

Further, what began as an argument by the plaintiffs that the court should not impose a tracing requirement because it was impossible for them to meet has become an argument by defendants that courts should dismiss section 11 and 12(a)(2) claims because plaintiffs cannot provide the requisite proof of tracing.[218] Of all the decisions surveyed for this Article,[219] in only five cases were the shareholders possibly able to meet the direct-tracing requirement.[220] What began with *Barnes* as a shield to prevent non-

215. *See id.* at 272.

216. *Id.* at 273 n.2; *see also supra* note 111.

217. The difference is important. The purpose of deterring fraud in the securities market is to prevent the phenomenon referred to as a "market for lemons." *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488 (1970). In the securities market, fraud is perceived as "bad" because it makes it difficult for investors to differentiate quality securities from nonquality ones—well-managed companies and poorly run ones can sell their shares for the same prices. *See* Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 Ariz. L. Rev. 711, 713 (1996). As a result, increasing numbers of poorly managed companies will enter the market until investors realize that market prices do not distinguish such companies from their well-managed counterparts. Investors then lose confidence in all securities and begin to discount them. *See id.* When this happens, good firms leave the market because the market prices for their securities are insufficient. The only companies left are those for whom the market price, although low, is presumably higher than the value of the securities. *See id.* An underinclusive interpretation of the statute can encourage fraud and thereby contribute to a market for lemons. *See id.* at 714. The key, of course, is to set the right limit. *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, 673 (1984) (stating that "[a] world with fraud, or without adequate truthful information, is a world with too little investment, and in the wrong things to boot"); *cf.* Grant Gilmore, *Article 9 of the Uniform Commercial Code—Part V, Default*, 7 Q. Rep. 4, 7 (1952) ("In this sort of situation there are always two extremes to be avoided. One is setting the barriers against fraud so high that legitimate business operations are blocked. The other is setting them so low that fraud flourishes unchecked.").

218. *Compare Barnes*, 373 F.2d at 270, *with In re* Eagle Computer Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 92,741, at 93,604 (N.D. Cal. Mar. 31, 1986).

219. This Article has attempted to include all of those opinions available in print and online as of January 2000. Obviously, not all such opinions are published or online. Arguably, the stringency of the tracing requirement may be partially responsible for the small number of claims because plaintiffs unable to trace may refrain from filing claims.

220. *See, e.g.*, *In re* Stratosphere Corp. Sec. Litig., No. CV-S-96-0708-PMP (RLH), 1998 WL 167259, at *21 (D. Nev. Apr. 2, 1998) (rejecting motion to dismiss where plaintiffs alleged purchases directly in offering at issue); *In re* U.S.A. Classic Sec. Litig., [1995 Transfer Binder] Fed. Sec. L. Rep.

Offering Shareholders from proceeding with section 11 claims has become a sword in the hands of defendants, particularly since 1995, for both sections 11 and 12(a)(2). Indeed, in one case, the defendants argued the section 11 cause of action should be dismissed because shareholders who purchased in an IPO probably sold their shares quickly and did not suffer any losses. The argument is essentially that Original Shareholders do not lose money, only Aftermarket Shareholders do.[221]

Stripped of its rhetoric, *Barnes* implemented an underinclusive interpretation of section 11 and restricted access to a remedy Congress had intended.[222] In failing to consider the practical impossibility of the tracing requirement, the court departed from the basic canon of statutory interpretation—interpreting the statute to give it meaning. The court first held that Congress intended for Aftermarket Shareholders to have a remedy under section 11 and that the statute so provided.[223] Then the court created the tracing requirement. When the Aftermarket Shareholders argued that tracing was impossible because they would be precluded from accessing the remedy the court had held should be available to them, the court summarily rejected them. It only acknowledged, without any analysis, that tracing might be difficult.[224] By doing so, it denied those shareholders a remedy.[225]

(CCH) ¶ 98,837 (S.D.N.Y. June 19, 1995) (noting purchases on date of IPO); *In re* Kendall Square Research Corp. Sec. Litig., 868 F. Supp. 26, 29 (D. Mass. 1994) (rejecting motion to dismiss where shareholder purchased at offering price on offering date); *In re* Newbridge Networks Sec. Litig., 767 F. Supp. 275, 279 (D.D.C. 1991) (same); *In re* Data Access Sec. Litig., 103 F.R.D. 130, 146 (D.N.J. 1984) (stating that one plaintiff was Original Purchaser); Wolfson v. Solomon, 54 F.R.D. 584, 590 (S.D.N.Y. 1972) (noting that named plaintiffs bought shares "on or about" offering date).

221. *See In re* Computron Software, Inc. Sec. Litig., No. CIV.A.96-1911 (AJI), 1998 WL 236232, at *5 (D.N.J. Apr. 22, 1998) (noting argument of defendants that Original Shareholders likely sold their shares "long before" company disclosed problems and did not, therefore, suffer any loss). Of course, the argument probably does not apply to small shareholders lucky enough to gain access to such an offering. Those shareholders have probably been told that if they turn their shares around quickly—otherwise known as "flipping" and the best way to ensure a profit—they will not gain access to any such future offerings. *See* Andrew Siconolfi & Patrick McGeehan, *Wall Street Brokers Press Small Investors to Hold IPO Shares*, Wall St. J., June 26, 1998, at A1.

222. *See Barnes*, 373 F.2d at 271–73. The court also stated that tracing was not necessary for section 12(a)(2) or section 17. *See id.* at 272.

223. *See id.* at 271–72.

224. *See id.* at 272.

225. *See id.*

To understand the impossibility of the tracing requirement, one must consider how offerings and the stock markets work.[226] Tracing should not be an issue when the offering in question is an IPO. When a company offers shares of stock to the market for the first time, those are the only shares available. Thus, no matter when a shareholder buys securities, the securities are from that offering.[227]

Yet, as applied by the courts, who have expanded it to section 12(a)(2), the tracing requirement prohibits Offering Shareholders from accessing either section even if only Offering Shares are on the market. For example, in *Stack v. Lobo*,[228] the court dismissed the shareholders' section 12(a)(2) claims, relying in part on the shareholders' failure to specify the circumstances surrounding their purchases.[229] Yet, under the facts outlined by the court, the only offering ever made by the company was an IPO; thus, no matter when the shareholders purchased their shares, the shares were presumably from that offering.[230] Presumptively, then, the shares were traceable. Or consider *Mark v. Fleming Co.*,[231] in which the court dismissed the shareholder's section 11 claims because the shareholder did not allege that he purchased in the offering.[232] The court's chronology of events

226. In 1933, when Congress passed the Securities Act, offerings were not always oversubscribed at the offering date. Thus, it is arguable that tracing may have been possible, at least more often, then than now. *See, e.g.*, H.R. Rep. No. 73-85, at 16 (1933) (stating that "average public offering has been distributed within a year"). Now, however, changes in the market and underwriter practices are arguably further support for interpreting the provisions to provide remedies for all Offering Shares.

227. *But see infra* notes 228–34 and accompanying text.

228. 903 F. Supp. 1361 (N.D. Cal. 1995).

229. *See id.* at 1375.

230. *See id.* at 1366 (mentioning only company's IPO). When reviewing the plaintiffs' amended complaint, the court found that *Gustafson* prohibited the plaintiffs' claims because they purchased their shares in the Aftermarket, not directly in the IPO. *See id.* at 1374–76; *see also* Adair v. Bristol Tech. Sys., Inc., 179 F.R.D. 126 (S.D.N.Y. 1998) (defining and discussing tracing even when only offering in issue was IPO); *In re* Quarterdeck Office Sys., Inc. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,092, at 98,742 (C.D. Cal. Sept. 30, 1993) (same); Budget Rent a Car Sys., Inc. v. Hirsch, 810 F. Supp. 1253, 1258 (S.D. Fla. 1992) (dismissing section 12(a)(2) claim where plaintiff failed to allege that securities were purchased *in* offering, but facts describe only one offering of securities); *cf. In re* Computron Software, Inc., No. 96-1911(AJL), 1998 WL 236232 (D.N.J. Apr. 22, 1998) (discussing difficulty of tracing in context of settlement opinion, but only one offering was noted in facts). *But see In re* U.S.A. Classic Sec. Litig., [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,837 (S.D.N.Y. June 19, 1995) (noting that where company had made only one public offering, standing at motion-to-dismiss stage appeared clear); Pearlman v. Gennaro, No. 72 Civ. 2247, 1973 WL 390, *1–2 (S.D.N.Y. May 31, 1973) (presuming plaintiffs' shares were covered by registration statement when only one offering was mentioned in facts).

231. No. CIV-96-0506-M (W.D. Okla. filed Mar. 27, 1998).

232. *See id.*

revealed, however, that the company had made only one offering.[233] The court incorrectly denied the shareholder a remedy. By definition, he was an Offering Shareholder and should not have had to go through the exercise of tracing his shares.[234]

With each additional offering, however, the number of shareholders who can trace and sue for any one offering is increasingly limited. Brokers hold shares of stock in general accounts.[235] The shares are fungible.[236] Neither the brokers nor the shareholders know which issue of a particular security is being transferred. When a company makes a second offering of stock, the only purchasers who know the offering origins of their securities are Original Shareholders in either offering and those who purchased between the first and second offerings.[237] Accordingly, under the tracing requirement, they are the only shareholders who would have the opportunity to sue.[238] Shareholders who buy securities after the second offering will be unable to trace their shares to either offering and therefore will never have the benefit of sections 11 and 12(a)(2).[239] And, correlatively, the deterrent effect of the statute is reduced for companies who have made a second offering of stock.[240] As a practical matter, the courts have created a perverse incentive for companies and their underwriters to press forward with follow-on and secondary offerings that sometimes occur within months of

233. *See id.*

234. *But see* Hertzberg v. Dignity Partners, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,627, at 92,853 (9th Cir. Aug. 27, 1999) (overruling *Mark* implicitly by holding that where only one offering had occurred, traceability could be presumed).

235. *See supra* note 119 and accompanying text.

236. *See supra* note 119 and accompanying text. Most securities are held in "street name" or the name of a beneficiary. *See* Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 U.S.C. L. Rev. 1071, 1073 & n.3 (1999). Now, when securities are traded, the depository retains ownership and does not issue new certificates for each trade. *See id.* Most securities are traded through a depository system, with certificates on deposit at the Depository Trust Corporation (DTC) and registered under the name of Cede & Co., the DTC's nominee. *See id.* "The vast majority of shares of major securities issues are on deposit at DTC and thus are not held in the name of their beneficial owners." *Id.* Thus, stock held in street name can amount to as much as 80% of an issuer's outstanding shares. *See id.*

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

238. Courts do not, however, assume that even these shareholders can trace. *See supra* notes 228–34 and accompanying text.

239. *See* Harden v. Raffensberger, Hughes & Co., 933 F. Supp. 763, 766 (S.D. Ind. 1996) (when "securities of an identical kind (or of the same nature as those registered) were already traded on the open market," plaintiffs must trace their shares).

240. *See* Scott Thurm, *Juniper Planning Follow-On Offering After IPO Success*, Wall St. J., Sept. 2, 1999, at B7 (reporting that Juniper Networks, Inc. was planning "unusually quick follow-on offering" to take place within three months of IPO).

the IPOs and that make it impossible for most shareholders to trace and, therefore, to sue under these sections.[241]

In addition, even shareholders savvy enough to try to preserve their rights under the statute by requesting only covered securities are prevented from accessing their statutory remedy. Brokers cannot promise to provide only Offering Shares because of the fungibility of shares in brokerage accounts.[242] Accordingly, the shares received may or may not be Offering Shares. And no matter what they receive, the purchasers cannot prove what type of shares they own.[243]

Situations in which the shares in the second offering were of a different type than those in the first are also affected by the way courts apply the tracing requirement.[244] Those offerings presumably covered only a certain type of security, and therefore, it is possible to determine from which

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241. *See Harden*, 933 F. Supp. at 766 (suggesting that questions of fact concerning tracing may be difficult); Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 875–76 (N.D. Cal. 1986) (granting summary judgment where defendants showed that tracing was impossible for plaintiffs to prove); Lorber v. Beebe, 407 F. Supp. 279, 287 (S.D.N.Y. 1976) (rejecting arguments that because tracing was impossible to prove, court should not require it) (citing Barnes v. Osofsky, 373 F.2d 269, 273 (2d Cir. 1967)).

Moreover, the existence of shelf offerings further compounds the problem. These offerings are so called because companies prepare the abbreviated registration materials in advance and then make the offering when the company pinpoints the market date, allowing the company flexibility in raising capital. *See* Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1200 (1st Cir. 1996); *see also* SEC Form S-3, item 11(a). In part, the rationale for allowing such offerings is that eligible companies are subject to the Exchange Act's quarterly and annual reporting requirements. *See Shaw*, 82 F.3d at 1209. Yet, because of certain limitations in Exchange Act regulations, a company can actually make such an offering without disclosing certain information that is material but not yet regulatorily ripe. *See* Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Non-Disclosure*, 46 U.C.L.A. L. Rev. 675, 681–88 (1999). Due to the manner in which courts apply tracing requirements, Offering Shareholders who were harmed will be left without access to their section 11 and 12(a)(2) remedies.

Consider the facts in *Shaw*, 82 F.3d at 1210–11. Although it did not discuss tracing, the *Shaw* court reviewed the interim disclosure problem. Digital Equipment Corp. made a shelf offering at a time when the company had had several bad quarters but had recently enjoyed better revenue growth. *See id.* at 1199–200. Eleven days before the end of a quarter, the company made a $400 million shelf offering of securities. One week later, the offering closed. *See id.* Three weeks later, the company announced that instead of the predicted upturn, third-quarter revenues were down by $183 million. *See id.*

The First Circuit denied the defendants' motion to dismiss in part because the shelf-offering timing was suspicious. *See id.* Though not raised, the tracing problem existed here and would have prevented plaintiffs from accessing an important remedy.

242. *See supra* notes 235–36 and accompanying text.

243. *See supra* notes 226–41 and accompanying text.

244. *See, e.g., In re* ZZZZ Best Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,485, at 91,309–10 (C.D. Cal. Oct. 26, 1994) (noting that although securities of company were on market at time of alleged false offering documents, documents covered warrants which were newly issued).

offering the shares were issued simply by examining their type.[245] Accordingly, it is also possible to determine who should have access to a remedy. Yet, here as well, courts appear to require the plaintiffs to allege, sometimes with specificity, that their shares were Offering Shares.[246]

The presence of unregistered shares has the potential to complicate further shareholders' access to a remedy. For example, some defendants have argued that if, in addition to the IPO shares, unregistered shares entered the market pursuant to Rule 144(k),[247] Aftermarket Shareholders cannot know whether their shares proceeded from registered or unregistered shares and cannot, therefore, trace their shares.[248] As a result, those shareholders should be precluded from suing under these sections.[249] This argument, if accepted by courts, creates an incentive for defendants to sell their unregistered shares as soon as they are allowed, again making it impossible for shareholders to sue under these sections.

The tracing requirement also creates "accidental" standing.[250] Consider two shareholders who, at the same time and after an offering, buy shares in a company already being traded on the open market. One receives newly issued shares; the other receives previously issued shares. Assuming they could trace their shares, the tracing requirement would provide the former, but not the latter, with a remedy even if both bought because of offering publicity.[251] Applying the more stringent requirement which permits only the Original Shareholders to sue allows fewer shareholders to state a claim under either section, assuming *arguendo* that they could trace their shares. Aftermarket Shareholders who, if allowed to allege traceability, could have survived a motion to dismiss, and thereby engage in discovery,[252] would

245. *See id.*

246. *See, e.g.*, *In re* Worlds of Wonder Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 95,004, at 95,630 (N.D. Cal. Mar. 23, 1990) (defining and discussing tracing issue when company issued both common stock in IPO and debentures in separate offering); *cf.* Mark v. Fleming, No. CIV-96-0506-M, slip op. at 3–6 (W.D. Okla. Mar. 27, 1998) (listing only one offering of fixed notes, but dismissing section 11 claim for failure to plead traceability).

247. *See, e.g.*, *In re* Masstor Sys. Corp. Sec. Litig., No. C-84-20599 RPA, 1986 WL 36310, at *1 (N.D. Cal. Mar. 27, 1986).

248. *See id.*

249. *See id.*

250. Judge Friendly conceded that this problem would occur, but stated that the court remained "unpersuaded that, by departing from the more natural meaning of the words, a court could come up with anything better." Barnes v. Osofsky, 373 F.2d 269, 273 (2d Cir. 1967).

251. *See id.*

252. *See, e.g.*, *In re* Data Access Sys. Sec. Litig., 103 F.R.D. 130, 146 (D.N.J. 1984) (noting that prior to discovery, inability to trace did not preclude class certification).

now be precluded from doing so. If a court strictly applies the Original-Shareholder limitation, or if the company had previously issued shares of the type issued in the new offering, even those shareholders who purchased on the day of the offering would be left without a section 11 or 12(a)(2) remedy.

Moreover, under the fraud-on-the-market doctrine,[253] any misstatement or omission in a registration statement would affect all shareholders, new or old.[254] Indeed, even though section 11 and 12(a)(2) plaintiffs need not prove reliance,[255] such a misstatement might actually cause purchasers to attempt to buy stock in an offering. Yet, no matter what prompts them to request Offering Shares, in today's market average shareholders do not have access to those shares. Instead, they are forced to buy in the Aftermarket.[256] Thus, even a shareholder who relied on a misstatement or omission would be denied a remedy under the Securities Act.

To offset the restrictiveness of the tracing requirement, some courts have referred shareholders to section 10(b) and Rule 10b-5 of the 1934 Securities Exchange Act, noting that those who could not trace their claims under section 11 or 12(a)(2) were not denied a remedy entirely, but instead had to pursue a different remedy.[257] This argument is problematic because, although sections 11 and 12(a)(2) are strict-liability and negligence causes of action,[258] section 10(b) is scienter-based.[259] As a result, the Securities Act claims should be easier to prove than their Securities Exchange Act counterpart.[260] Further, the Supreme Court required scienter for section

253. *See supra* note 90.

254. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 241–43 (1988) (finding that price of securities is based on available material company information and that misleading statements defraud purchasers regardless of reliance).

255. *See supra* notes 29, 47, and accompanying text.

256. *See supra* notes 71–75 and accompanying text.

257. *See, e.g., In re* Summit Med. Sys., Inc., 10 F. Supp. 2d 1068, 1070–71 (D. Minn. June 29, 1998) (finding only Original Shareholders had standing under Act and referring Aftermarket Shareholders to 10b-5); Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 875 (N.D. Cal. 1986) (noting that plaintiffs faced with inability to meet tracing requirement could "still pursue" claims under 10b-5); Langert v. Q-1 Corp., Fed. Sec. L. Rep. (CCH) ¶ 94,445 (S.D.N.Y. Mar. 15, 1974).

258. *See supra* notes 26, 44, and accompanying text.

259. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).

260. *See* Steven Thel, *Essay: Section 12(2) of the Securities Act: Does Old Legislation Matter?*, 63 Fordham L. Rev. 1183, 1184–85 (1995); *see also* Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 Wash. U. L.Q. 537, 583 (1998) (arguing that pre-PSLRA courts incorrectly found that Securities Act claims were subject to scienter-based standard and noting that PSLRA applies standard only to Exchange Act claims).

10(b) because, unlike sections 11 and 12(a)(2), it is a judicially implied remedy.[261] It is ironic therefore that the courts would prohibit shareholders from accessing explicit, legislatively crafted remedies by referring them to a more restrictive, judicially implied one.

The tracing requirement defeats Congress's attempt to create accessible, strict-liability type claims. Congress created strict-liability and negligence causes of action to deter misstatements in the documents corporations use to raise capital.[262] Presumably, Congress did so at the risk of eliminating some "beneficial speech."[263] Congress was attempting to eliminate the informational asymmetries that exist in this context.[264] Simply put, the insiders have significant knowledge about the company that outsiders do not. The Securities Act's disclosure provisions are one way in which Congress attempted to rectify this situation for public offerings.[265] Forcing shareholders to prove a heavier burden of fraudulent intent defeats that purpose.[266]

Indeed, the direct tracing requirement can undermine the statute's nonreliance-based remedies. Neither section 11 nor section 12(a)(2) requires shareholders to prove reliance on the alleged misstatement or omission,[267] but the tracing requirement operates to limit the shareholders' claims. By not requiring proof of reliance, Congress made class actions possible, thereby maximizing the deterrent effect of these sections. Requiring proof of direct traceability, however, undercuts the statute's power by effectively requiring reliance as an element.

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261. *See Ernst & Ernst*, 425 U.S. at 197.

262. *See, e.g.*, Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 Va. L. Rev. 623, 630 (1992) (describing social costs of misstatements as including wealth transfers from plaintiff to defendant and incentives for defendants to invest in lying or make decisions that result in inefficient allocations of wealth); Cynthia Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 Harv. L. Rev. 1197 (1999); *see also* Sale, *supra* note 260, at 590.

263. Mahoney, *supra* note 262, at 647–48 (noting that imposing liability for innocent and negligent misstatements can result in overdeterring speech, even beneficial speech).

264. *See* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 Yale L.J. 239, 267–68 (1984); Letsou, *supra* note 58, at 125; Sale, *supra* note 260, at 592; *see also* James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 Geo. Wash. L. Rev. 745, 746–48 (1984) (discussing agency theory and informational asymmetry problems).

265. *See* Letsou, *supra* note 58, at 125; Sale, *supra* note 260, at 592.

266. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983).

267. *See supra* notes 28, 47, and accompanying text.

Additionally, the Acts' provisions "involve distinct causes of action and were intended to address different types of wrongdoing."[268] To say that the same claim may be actionable under both statutes is not the same as saying that one substitutes for the other.[269] Indeed, Congress added section 10(b) in 1934, without eliminating sections 11 and 12(a)(2); thus, presumably, it did not intend section 10(b) to be a replacement for those sections. Moreover, sections 11 and 12(a)(2) impose liability, and thereby due-diligence responsibilities, on defendants whose conduct is not otherwise subject to suit under section 10(b) and Rule 10b-5. Liability under the latter is limited to those who make an alleged misstatement or omission, or "speakers."[270] Section 11, however, specifically extends liability to other persons involved in an offering.[271] By doing so, section 11 seeks, through the enforcement of those due-diligence obligations, to deter misstatements and omissions in the offering process.[272] Referring shareholders to section 10(b) does not advance that purpose.

In further support of the tracing requirement, the *Barnes* court pointed to the provisions of sections 11(g) and 11(e).[273] Both place limits on damages tied to the offering price, not the purchase price, of the security.[274] These provisions, the court found, "point[ed] in the direction" of limiting section 11 to Offering Shareholders.[275] Otherwise, it reasoned, the total "recovery would be diluted" by non-offering claimants, particularly when the new issue was relatively small.[276] This argument fails to address the

268. *Herman & MacLean*, 459 U.S. at 381.

269. *See id.* at 383; *cf.* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 Chi. L. Rev. 611, 636–37 (1985) (arguing that stringent remedies are appropriate in stock-issuance cases where allocative efficiency loss from misstatement or omission is most significant and where measurement of damages is "exceptionally difficult," thus appropriately burdening defendant with any uncertainty); *see also* Mahoney, *supra* note 262, at 633 (arguing that fraud in issuance market results in misdirection of capital to issuer and, therefore, has more severe allocative impact than when it occurs in Aftermarket).

270. Westinghouse Sec. Litig., 90 F.3d 696, 710 (3d Cir. 1996) (noting elements of section 10(b) claim, including that plaintiff must identify defendant who made alleged misstatement or omission).

271. *See supra* notes 19–23 and accompany text.

272. *See supra* notes 33–38 and accompanying text; *see also* Hertzberg v. Dignity Partners, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,627, at 93,851–52 (9th Cir. Aug. 27, 1999) (noting that section 11 applies to persons other than issuers); Versyss Inc. v. Coopers & Lybrand, 982 F.2d 653, 657 (1st Cir. 1992) (holding that section 11 "readily impos[es] liability on ancillary parties to the registration statement (like accountants) for the benefit of purchasers").

273. *See* Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967).

274. *See supra* notes 39–40, 64–66, and accompanying text.

275. *Barnes*, 373 F.2d at 272.

276. *Id.*

underinclusive nature of the court's interpretation. As it pointed out, these provisions reveal that Congress contemplated Aftermarket Shareholders[277] sharing in the damages. In any case other than that involving only an IPO, however, the impossibility of tracing their securities eliminates exactly those plaintiffs.[278]

In support of its interpretation, the *Barnes* court noted that the section 11 penalty was so stringent and accessible that Congress must have intended it to be available only to Offering Shareholders.[279] Yet, Congress's primary concern was to deter companies from committing fraud, or to force them to make full and accurate disclosures.[280] Viewed in that light, the better interpretation would have been one providing as many Offering Shareholders as possible with access to this remedy, not just Original Shareholders.[281] The court could have chosen an interpretation consistent with that intent, albeit an overinclusive one.[282]

The *Barnes* court's review of the statute's legislative history also elucidates the expansive purpose of the statute. The court pointed to the language in the legislative history: "'In case any such statement shall be false in any material respect, any persons acquiring any securities to which such statement relates, either from the original issuer or any other person' shall have a cause of action."[283] This language, the court argued, clearly indicated that Congress intended a remedy for Aftermarket Shareholders.[284] The court then eliminated access to the remedy by requiring tracing—an inconsistent and insufficient solution.

Finally, the court's failure to address the impossibility of the direct tracing requirement belies its protest that it could do no better with the

277. *See supra* note 91 and accompanying text.

278. *See supra* notes 93–97 and accompanying text.

279. *See Barnes*, 373 F.2d at 272.

280. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976) (stating that purpose of Securities Act is to provide "full disclosure [for] public offerings . . . , to protect investors against fraud, and . . . to promote ethical standards or honesty and fair dealing"); S. Rep. No. 47, at 128 (1933) (purpose of bill is to prevent "further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentations . . . [and] . . . protect honest enterprise, seeking capital by honest presentation"). Indeed, one purpose of the Securities Act was to remedy some of the deficiencies in the protection afforded by common-law fraud claims. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

281. *See* Williams, *supra* note 262, at 1227 (stressing that purpose of Securities Act is to subject companies' capital-raising efforts to public scrutiny, thereby forcing truthfulness in those efforts).

282. *See supra* note 217 and accompanying text.

283. *Barnes*, 373 F.2d at 272.

284. *See id.* at 273.

statute. The court could have devised a means by which Aftermarket purchases could meet the tracing requirement. Although such an approach might have been overinclusive, it would have correctly implemented the statute and fulfilled the statute's purpose.

B. *The Courts' Deployment of* Gustafson *Has Exacerbated the Effect of the Tracing Requirement*

Since 1995, defendants have aggressively employed *Gustafson* to limit further shareholders' access to sections 11 and 12(a)(2) by allowing them to plead traceability. They argued that the *Gustafson* Court held that liability for misstatements and omissions attaches only to securities for which either a registration statement or, as defined in that opinion, a prospectus was required and only for those securities purchased in the public offering.[285] Thus, in the context of section 12(a)(2) liability, defendants have argued that Aftermarket Shareholders are indistinguishable from owners of securities in a private-placement transaction—neither is entitled to section 12(a)(2) and, by extension, section 11 remedies.[286] This reading of *Gustafson* is based, in part, on earlier opinions in which courts had held that section 12(a)(2) did not extend to any Aftermarket transactions, even those involving Offering Shares.[287] Under this public-offering view, only the limited class of Original Shareholders would be able to sue under section 12(a)(2).

The impact of *Gustafson* on section 12(a)(2) claims has been dramatic. In some cases decided after *Gustafson*, courts have found that tracing is no longer an option and that only Original Purchasers can sue under section 12(a)(2).[288] For example, one court used *Gustafson* to dismiss, without leave

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285. *See, e.g.*, Saslaw v. Askari, No. 95 Civ. 7641 (LAP), 1997 WL 221208, at *6 (S.D.N.Y. Apr. 25, 1997).

286. *See id.*

287. *See supra* note 167.

288. *See In re* Valence Tech. Sec. Litig., No. C 95-20459 JW, 1996 WL 37788, at *3–4 (N.D. Cal. Jan. 23, 1996) (dismissing section 12(a)(2) claims for failure to allege purchases *in* public offering and finding that 12(a)(2) applies only to transactions that require delivery of prospectus and that *Gustafson* made tracing irrelevant); Weinstein v. Media Vision Tech. Sec. Litig., No. C 94-1015 EFL, 1995 WL 787549, at *1–2 (N.D. Cal. Oct. 23, 1995) (holding that *Gustafson* appears to eliminate 12(a)(2) plaintiffs who are Aftermarket purchasers). *But see In re* Paracelsus Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 90,172, at 90,559–60 (S.D. Tex. Mar. 6, 1998) (finding pursuant-to allegations sufficient to withstand motion to dismiss of 12(a)(2) claim); Schoenhaut v. American Sensors, Inc., 986 F. Supp. 785, 789–90 (S.D.N.Y. 1997) (same); *In re* U.S.A. Classic Sec. Litig., [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,837 (S.D.N.Y. June 19, 1995) (same).

to plead or prove tracing, claims brought under section 12(a)(2), noting (without deciding) that *Gustafson* might be read to eliminate the possibility of tracing for section 11 claims as well.[289] Others have noted that section 12(a)(2), but not section 11, claims might now be limited to Original Shareholders.[290] Further, in some cases, the shareholders have "conceded" that *Gustafson* eliminates even the possibility of tracing for section 12(a)(2) claims.[291]

The post-*Gustafson* opinions on section 11 are split almost evenly between those allowing tracing and those finding that only Original Shareholders can sue.[292] Before *Gustafson*, more courts allowed tracing for section 11 claims than for section 12(a)(2) claims.[293]

Since *Gustafson*, however, many courts have arguably undermined the deterrent effect of the Securities Act by finding that Aftermarket Shareholders are no longer entitled to trace purchases under either section,

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289. *See Saslaw*, 1997 WL 221208, at *4–5, *7 (dismissing section 12(a)(2) claims based on *Gustafson*'s majority opinion but noting that arguments that *Gustafson*'s dissenting opinion supported dismissal of section 11 claims were persuasive).

290. *See, e.g., In re* Fine Host Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 90,334, at 91,591 (D. Conn. Oct. 22, 1998) (noting logic of Supreme Court's interpretation of section 12(a)(2) did "not necessarily" apply to section 11); *see also* Schwartz v. Celestial Seasonings, Inc., 178 F.R.D. 545, 555–56 (D. Colo. 1998). The court also considered other provisions of section 11 and its legislative history, discussed above. *See Schwartz*, 178 F.R.D. at 556 & n.7; *see also In re* Number Nine Visual Group Tech. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 90,504, at 92,448–49 (D. Mass. June 1, 1999) (noting that although Aftermarket Purchasers may sue under section 12(a)(2), they are limited by the privity requirement); *supra* notes 49–50 and accompanying text.

291. *See* Fazio & Fazio Living Trust v. Palmieri et al., No. C96-1096D, slip. op. at 7 (W.D. Wash. Apr. 10, 1997).

292. *Compare supra* note 290, *with supra* note 163.

293. *See, e.g.*, Shapiro v. UJB Fin. Corp., 964 F.2d 272, 286–87 (1992) (holding that plaintiffs must address tracing in context of section 11 claim but not discussing tracing in analysis of section 12(a)(2) claim). *Compare supra* note 163 (collecting cases requiring tracing for section 11 claims), *with supra* note 164 (collecting cases requiring tracing for both).

It is possible that the courts did so because section 12(a)(2) claims could be eliminated through the application of the privity doctrine. *See supra* note 165 (collecting cases requiring tracing for section 11 claims and discussing 12(a)(2) claims in privity context). This doctrine, originally applied to section 12(1), requires purchasers to allege and prove privity with the sellers of the securities at issue. *See* Pinter v. Dahl, 486 U.S. 622, 641–55 (1988); *see also* Note, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. Chi. L. Rev. 955, 962 (1990). As applied by the courts, this doctrine can be restrictive, thereby limiting the availability of a section 12(a)(2) claim. *See, e.g.*, Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1214–15 (1st Cir. 1996) (holding that only underwriters are sellers in firm-commitment offering); *see also* Patricia A. O'Hara, *Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller*, 31 U.C.L.A. L. Rev. 921, 930 (1984). As a result, courts may properly have resolved such claims without discussing tracing. *Cf. In re* Number Nine Visual Group Tech. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 90,504, at 92,448 & n.7 (D. Mass. June 1, 1999) (noting privity requirement of section 12(a)(2) may limit standing to Original Purchasers).

which has resulted in a decrease in the number of shareholders even able to argue that they are entitled to the Securities Act's explicit remedies.[294]

Some courts have reached this conclusion by relying on dicta in *Gustafson*.[295] For example, in *Murphy v. Hollywood Entertainment Corp.*,[296] the court found that *Gustafson*'s holding rested on the distinction between a public offering and a private transaction.[297] It then stated that the Court's "dicta provide[d] strong support" for dividing share purchases into two categories—those purchased in an offering and those purchased in the Aftermarket.[298] In support of its reading, the *Murphy* court cited the Supreme Court's references to the Securities Act's role in regulating the disclosure of information in the public-offering context, as well as other comments, including the Court's statement that "'liability imposed by section 12[(a)](2) cannot attach unless there is an obligation to distribute the prospectus in the first place.'"[299] Thus, the *Murphy* court concluded that only Original Shareholders could maintain suits under either section.[300]

In another case, the court applied the twenty-five-day purchase rule to the shareholders' section 12(a)(2) claims, finding that none of the

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294. *See, e.g.*, *In re* Summit Med. Sys., Inc., 10 F. Supp. 2d 1068, 1070–71 (D. Minn. 1998) (reading *Gustafson* as eliminating tracing option and requiring, for both sections, that plaintiffs purchase in offering, and dismissing claims of Aftermarket purchasers); *In re* WRT Energy Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 99,560, at 97,789–90 (S.D.N.Y. Sept. 15, 1997) (same); Murphy v. Hollywood Entertainment Corp., Fed. Sec. L. Rep. (CCH) ¶ 99,241, at 95,345–46 (D. Or. May 9, 1996) (same); *cf. Fazio*, slip. op. at 7 (finding that *Gustafson* eliminated tracing for 12(a)(2) claims and that section 11 requires purchasers *in* offering); *In re* Valence Tech. Sec. Litig., No. C 95-20459 JW, 1996 WL 37788, at *3–4 (N.D. Cal. Jan. 23, 1996) (dismissing section 12(a)(2) claims for failure to allege purchases *in* public offering and finding that 12(a)(2) applies only to transactions that require delivery of prospectus and that *Gustafson* made tracing irrelevant); Weinstein v. Media Vision Tech. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,958, at 93,621 (N.D. Cal. Oct. 23, 1995) (finding that *Gustafson* appeared to eliminate 12(a)(2) plaintiffs who are Aftermarket purchasers).

295. *See, e.g.*, *Summit Med.*, 10 F. Supp. 2d at 1070 (noting that *Gustafson* touched only "tangentially" on issue of standing of section 11 plaintiffs and stating that Supreme Court referred, "in dicta, to the same interpretation being applied to both sections 11 and 12(a)(2)"); *see also Murphy*, Fed. Sec. L. Rep. (CCH), at 95,345–46 (noting that *Gustafson* dicta provided "strong support for finding a clear dividing line" between shares purchased in offering and those in purchased in Aftermarket); *Weinstein*, Fed. Sec. L. Rep. (CCH), at 93,621 (stating that *Gustafson* "strongly suggests" that 12(a)(2) plaintiffs may not be Aftermarket purchasers).

296. Fed. Sec. L. Rep. (CCH) ¶ 99,241, at 95,345 (D. Or. May 9, 1996).

297. *Id.*

298. *See id.*

299. *Id.* (quoting Gustafson v. Alloyd Co., 513 U.S. 561, 571 (1995)). This same language, however, can easily be interpreted to expand the class of plaintiffs—including at least those to whom a prospectus was sent or to whom the seller had an obligation to send a prospectus. *See supra* note 15 and accompanying text.

300. *See Murphy*, Fed. Sec. L. Rep. (CCH), at 95,346.

shareholders had purchased their shares within twenty-five days of the offering and dismissed the claims.[301] Further, the court found that *Gustafson* limited section 11 claims to Original Shareholders.[302]

Some courts have found, however, that *Gustafson*'s holding is more limited and does not eliminate tracing.[303] One court simply stated its

301. *See* Stack v. Lobo, 903 F. Supp. 1361, 1374–76 (N.D. Cal. 1995); *see also* Brosious v. Children's Place Retail Stores, Fed. Sec. L. Rep. (CCH) ¶ 90,651, at 93,033 (D.N.J. Aug. 23, 1999); *supra* notes 172–74 and accompanying text.

302. *See Stack*, 903 F. Supp. at 1374–76; *see also Brosious*, ¶ 90,651, at 93,033 (limiting section 11 standing to Original Purchasers); Feiner v. SS&C Techs. Inc., 47 F. Supp. 2d 250, 251–53 (D. Conn. Mar. 23, 1999) (stating that 12(a)(2) shareholders entitled to receiving prospectus can maintain claims); Levitin v. A Pea in the Pod, Inc., No. 3:94-CV-0247-D, 1997 WL 160184, at *3–4 (N.D. Tex. Mar. 31, 1997) (applying prospectus-delivery-period rationale to 12(a)(2) claim). *But see* Weinstein v. Jain, Fed. Sec. L. Rep. (CCH) ¶ 98,958, at 93,621 (N.D. Cal. Oct. 23, 1995) (expressing skepticism about prospectus-delivery period extending possible period for offering purchasers, but allowing plaintiff leave to replead).

303. For section 11 claims, *see Hertzberg v. Dignity Partners, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 90,627, at 92,852 (9th Cir. Aug. 27, 1999) (holding Aftermarket Shareholders who can trace are entitled to pursue remedy under section 11); *Salomon Smith Barney v. Asset Securitization Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 90,723, at 93,492 (S.D.N.Y. Nov. 30, 1999) (finding secondary-market participants who can trace have standing and refusing to construe *Gustafson* as eliminating tracing option); *Danis v. USN Communications, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 90,692, at 93,283 (N.D. Ill. Oct. 6, 1999) (same); *In re Number Nine Visual Group Technology Securities Litigation*, 51 F. Supp. 2d 1 (D. Mass. June 1, 1999) (noting tracing remains viable for sections 11 and 12(a)(2)); *Feiner*, 47 F. Supp. 2d at 252–53 (noting traceability applied to section 11 claims and applying prospectus-delivery-period limitation to section 12(a)(2) claims); *In re Fine Host Corp. Securities Litigation*, 25 F. Supp. 2d 61 (D. Conn. 1998) (allowing tracing of section 11 claims and noting that privity limits section 12(a)(2) claims); *In re Websecure, Inc. Securities Litigation*, 182 F.R.D. 364 (D. Mass. 1998) (finding traceability for section 11 claims survived *Gustafson* but did not discuss it in section 12(a)(2) context); *Schwartz v. Celestial Seasonings, Inc.*, 178 F.R.D. 545, 554–57 (D. Colo. 1998) (finding that notwithstanding *Gustafson*, section 11 covers persons both buying "in" offering and acquiring securities "traceable" to offering); *Adair v. Bristol Technology Systems, Inc.*, 179 F.R.D. 126, 130–31 (S.D.N.Y. 1998) (finding that law of Second Circuit for 30 years had allowed tracing for section 11 and *Gustafson* did not change it) (citing Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967)); *In re Stratosphere Corp. Securities Litigation*, 1 F. Supp. 2d 1096 (D. Nev. 1998) (finding that standing under section 11 requires purchase in, or traceability to, public offering, and disagreeing with other courts which had found that *Gustafson* eliminated tracing) (citing Gould v. Harris, 929 F. Supp. 353 (C.D. Cal. 1996)); *Copland v. Grumet*, Fed. Sec. L. Rep. (CCH) ¶ 90,158, at 90,468 (D.N.J. Jan. 9, 1998) (granting shareholders leave to replead and allege traceability); *Schoenhaut v. American Sensors, Inc.*, 986 F. Supp. 785, 789 (S.D.N.Y. 1997) (finding allegations of traceability sufficient to withstand motion to dismiss); *In re Numerex Corp. Securities Litigation*, 913 F. Supp. 391, 395 n.4 (E.D. Pa. 1996) (assuming, for purposes of motion, that plaintiffs could trace shares to offering); and *Lilley v. Charren*, 936 F. Supp. 708, 715–16 (N.D. Cal. 1996) (allowing plaintiffs leave to replead dates and circumstances of trades). *Cf. Stack*, 903 F. Supp. at 1375–76 (applying *Gustafson* to dismiss section 12(a)(2) and 11 claims where plaintiffs neither purchased in offering nor alleged traceability); *In re Valence Tech. Securities Litigation*, No. C-95-20459-JW, 1995 WL 798927, at *3–4 (N.D. Cal. Sept. 19, 1995) (same). *But see* Harden v. Raffensperger, Hughes & Co., 933 F. Supp. 763, 766–67 (S.D. Ind. 1996) (stating that if shares existed

disagreement with the post-*Gustafson* cases eliminating the "well-established rule" allowing Aftermarket Shareholders to pursue traceable claims.[304] Another court within the Second Circuit noted that tracing had been the law there for thirty years,[305] and that *Gustafson* neither discussed a section 11 nor a public-offering claim.[306] The final substantive paragraph of *Gustafson*, however, does state such a limit. There, the Court said:

> In sum, the word "prospectus" is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder. The contract of sale, and its recitations, were not held out to the public and were not a prospectus as the term is used in the 1933 Act.[307]

In rejecting the argument that *Gustafson* does not eliminate tracing, courts have faced language in the *Gustafson* dissents.[308] For example, in *Adair v. Bristol Technologies*,[309] the court noted Justice Ginsburg's statement that "there is no dispute that . . . [section 11] appl[ies] only to public offerings—or to be more precise, to transactions subject to

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on market prior to offering, section 11 is unavailable as a remedy and indicating, at least by inference, that only purchasers of IPO shares have remedy).

For section 12(a)(2) claims, see *In re Paracelsus Corp. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶ 90,172, at 90,559 (S.D. Tex. Mar. 6, 1998) (finding pursuant-to allegations sufficient to withstand motion to dismiss); *Schoenhaut*, 986 F. Supp. at 789–90 (same); and *In re U.S.A. Classic Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶ 98,837, at 93,046–47 (S.D.N.Y. June 16, 1995) (same).

304. *Stratosphere*, 1 F. Supp. 2d at 1119 (referring to *Gustafson* in section 11 context); *see also* Johnson v. Mutual Sav. Bank, No. 95-C-2379, 1996 WL 79414, at *4 (N.D. Ill. Feb. 21, 1996) (noting that *Gustafson* does not require plaintiffs to allege purchases *in* offering and stating that allegations of purchases *pursuant to* offering are sufficient).

305. *See Adair*, 179 F.R.D. at 130–31.

306. *See id.*; *see also Salomon Smith Barney*, Fed. Sec. L. Rep. (CCH), at 93,492 (finding *Gustafson* extended only to private-placement transactions, not public offerings); *Schwartz*, 178 F.R.D. at 555–56 (noting that *Gustafson* did not address, in dicta or otherwise, scope of section 11); *U.S.A. Classic*, Fed. Sec. L. Rep. (CCH), at 93,046 (noting that *Gustafson* addressed private offering, but offering in this case was public).

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

308. *See Adair*, 179 F.R.D. at 132. *But see In re* Summit Med. Sys., Inc., 10 F. Supp. 2d 1068, 1070 (D. Minn. 1998) (noting that dissenting opinions supported dismissal of section 11 claims where plaintiffs did not purchase in IPO); Vande Walle v. Salomon Brothers, Inc., Fed. Sec. L. Rep. (CCH) ¶ 99,577, at 97,857 (Del. Ch. Oct. 2, 1997) (noting that four dissenting Justices "agreed" that section 11 applied only to offering shareholders); *In re* WRT Energy Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 99,560, at 97,790 (S.D.N.Y. Sept. 15, 1997) (noting that both *Gustafson* majority and dissents support limiting standing for both sections to Offering Shareholders); Saslaw v. Askari, Fed. Sec. L. Rep. (CCH) ¶ 99,461, at 97,055–56 (S.D.N.Y. Apr. 25, 1997) (dismissing section 12(a)(2) claims based on *Gustafson* majority; noting arguments that dissent supported dismissal of section 11 claims was persuasive).

309. Adair v. Bristol Tech. Sys., Inc., 179 F.R.D. 126, 132 (S.D.N.Y. 1998).

registration."[310] The defendants argued that this language, in combination with the majority opinion, supported their contention that after *Gustafson*, only Original Shareholders could sue under section 11.[311] The court disagreed. Rather than limiting the cause of action to Original Shareholders, the court found that taken in context, the statement cited by the defendants supported only Justice Ginsburg's view that section 12(a)(2) was not limited to public offerings and that section 11 was.[312] That issue, the court noted, was not in dispute. Further, the court found Justice Ginsburg's comment did not go so far as to limit the availability of the cause of action to only those purchasing in an offering.[313]

The court then turned its attention to the defendants' deployment of Justice Thomas's dissent, finding that they had taken portions of his opinion out of context as well.[314] Specifically, the court referred to a comment by Justice Thomas that "issuers" are specifically delineated under section 11 and not under section 12(a)(2). The court found that Justice Thomas used this statement to support only his contention that section 11's registration-statement reach was more limited than section 12(a)(2)'s prospectus reach.[315] Again, the court noted that this issue—who the proper defendants were—was not in dispute, nor was the fact that the offering in question was public.[316] Thus, the court found, the statement was consistent with retaining the option to trace for Aftermarket Shareholders.[317]

Next, the court considered the defendants' construction of the Securities Act's legislative history which, the defendants argued, supported their view that section 11 applied only to Original, and not Aftermarket, Shareholders.[318] The court noted that the same legislative history indicated that section 11 remedies apply "regardless of whether [plaintiffs] bought their securities at the time of the original offer or at some later date."[319] The court concluded that the legislative history was, therefore, "at best

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310. *Id.* (citing Gustafson v. Alloyd Co., 513 U.S. 561, 600 n.4 (1995)).
311. *See id.*
312. *See id.*
313. *See id.*
314. *See id.*
315. *See id.*
316. *See id.*
317. *See id.* at 133.
318. *See id.* at 132 (citing H.R. Rep. No. 85, at 5 (1933)).
319. *Id.* (quoting H.R. Rep. No. 85, at 5 (1933)).

ambiguous" as to whether tracing was available for Aftermarket Shareholders.[320]

The court then argued that the text of the statute supported the conclusion that *Gustafson* did not eliminate the tracing doctrine.[321] Specifically, the court pointed out that the language of section 11 is "broad," and that the statute opens its remedy to "any person acquiring such securit[ies]."[322] Next, it noted that section 11(a) contains a special provision for persons acquiring securities after the issuer has filed what is commonly referred to as an annual report.[323] Under section 11(a), such persons must prove actual reliance on the alleged misstatement or omission.[324] This provision, the court concluded, indicated that in crafting the remedy under section 11, Congress "contemplated" that the plaintiffs could purchase registered securities at least a year after the date of an offering.[325]

The court also noted that section 11(e), which sets forth the formula for calculating damages, further supported its conclusion that Aftermarket Shareholders may sue pursuant to section 11.[326] The court reasoned that section 11(e) reveals that Congress contemplated coverage for purchases made in the Aftermarket by providing plaintiffs with damages calculated at prices other than the offering price.[327] Accordingly, the court found the statute provided for a remedy for Aftermarket Shareholders.[328]

C. *Tracing Should Be Reexamined*

The time has come to reexamine the tracing requirement. Although it has been in existence for over thirty years, no court has ever offered an alternative to the tracing requirement as defined and applied by the Second Circuit in *Barnes*. Indeed, the courts have simply adopted a requirement that was initially nearly impossible to meet, but never fully examined as such. As a result, the expansion of the tracing requirement has eliminated from

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320. *See id.*

321. *See id.*

322. *Id.*

323. *See id.* The statute 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 . . . ." *Id.*

324. *See id.*

325. *Id.*

326. *See id.* at 133.

327. *See id.*

328. *See id.*

the statute's protection the very plaintiffs courts have found the statute was designed to protect.[329] The way courts have applied *Gustafson* has further limited the plaintiffs who may have remedies under sections 11 and 12(a)(2), potentially undermining the deterrent purpose of the 1933 Act.[330]

In part, the lack of discussion of tracing may be due to the relative dearth of opinions involving Securities Act claims. For example, in the first thirty-five years of the statute's life, companies filed over 30,000 registration statements with the SEC.[331] In the same time period, only two such cases were tried to a conclusion.[332] Published settlements involving opinions exist for only six cases.[333] The small number of such settlements is striking, and it is further limited by the availability of reported and electronic-database opinions. Now, the courts' deployment of *Gustafson* further threatens to erode any remaining claims and, thereby, the deterrent value in the statute.[334] Thus, the time has also come to reexamine how and whether *Gustafson* applies to the tracing doctrine.

To begin with, those courts employing *Gustafson* to limit claims to those of Original Shareholders have interpreted *Gustafson* in a way that could defeat the stated purpose of sections 11 and 12(a)(2)—deterring fraud-like behavior.[335] *Gustafson* focused on the difference between private and public

329. *See* Oliver Wendell Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 469 (1897) (arguing that "[i]t is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV. It is still more revolting if the grounds upon which it was laid down have vanished long since, and the rule simply persists from blind imitation of the past.").

330. It is worth noting that, to the author's knowledge, no empirical evidence exists to show whether issuers and underwriters actually proceed on the assumption that if they misspeak, they will suffer few, if any, consequences because of the tracing requirement. The same lack of evidence applies to whether attorneys advise them that, given the tracing requirement, few if any plaintiffs would succeed in a suit for any such misstatement or omission. *Cf.* Austin Sarat & William L.F. Felstiner, *Lawyers and Legal Consciousness: Law Talk in the Divorce Lawyer's Office*, 98 Yale L.J. 1663 (1989) (describing and quoting database of conversations between family-law lawyers and clients).

331. *See* 9 Loss & Seligman, *supra* note 28, at 4272.

332. *See id.*

333. *See id.*

334. When Congress passed the PSLRA, it made several revisions to both the 1933 and 1934 Acts. *See, e.g.*, Sale, *supra* note 260, at 586–88 (summarizing changes). Although it changed the pleading standard for section 10(b) and Rule 10b-5 claims, it did not make any such changes for 1933 Act claims. *See id.* at 583–93; *see also In re* NationsMart Corp. Sec. Litig., 130 F.3d 309, 314–16 (8th Cir. 1997) (holding that heightened pleading standards are inapplicable to 1933 Act claims). Indeed, the only revision to the 1933 Act that changed sections 11 or 12(a)(2) was the provision allowing defendants to invoke a loss-causation defense to damages under section 12. *See* 15 U.S.C. § 77*l*(b) (1994). The reforms were responsive to the pleas of both the courts and the industry. *See* Sale, *supra* note 260, at 552–56.

335. *See supra* notes 14–16, 24–26, and accompanying text.

sales of securities. The Court discussed offerings and Aftermarket purchases, but did not address the tracing requirement or even section 11.[336] Indeed, given that the questioned transaction was a private purchase, tracing and Aftermarket purchases were not even at issue. Moreover, the Court's goal in defining the term prospectus narrowly was to establish a consistent definition, not to prevent Aftermarket Shareholders from bringing claims.[337] Given the above, using *Gustafson* to limit access to the remedies under sections 11 and 12(a)(2) by further restricting the tracing requirement is inappropriate.[338]

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336. *See* Danis v. USN Communications, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,692, at 93,282 (N.D. Ill. Oct. 6, 1999) (noting *Gustafson* dealt with section 12(a)(2), not section 11); *In re* Cendant Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 90,708, at 93,391 (D.N.J. July 27, 1999).

337. *See supra* note 193 and accompanying text.

338. The critical nature of the commentaries on the opinion indicates that courts would do well to refrain from expanding its reach. For example, Professor Peter Letsou argues that the Court should have limited itself to a holding that would have precluded buyers who are able to "fend for themselves" or who have access to the same information as mandated through section 12(a)(2), but which would not necessarily exclude open-market purchasers from the remedy. Letsou, *supra* note 58, at 123–33 (citing SEC v. Ralston Purina, 346 U.S. 119, 125–26 (1953)). According to Letsou, such a holding would have been consistent with the text of section 12(a)(2), its relationship to the Act, its legislative history, and economic theories. *See id.* at 133–46. In support of his contentions, Letsou notes, for example, that when Congress was drafting the 1933 Act, it was responding to the stock-market crash. *See id.* at 140–41. The legislative history reveals Congress's concern about public transactions and, correlatively, to the extent that Congress intended to limit the application of section 12(a)(2), any implied limitation should extend only to private transactions. *See id.* at 141.

In his economic-theory argument, Letsou notes that federal remedies such as those provided in the Securities Act enable parties to reach agreements about purchase price where informational asymmetries might otherwise prevent such an outcome. *See id.* at 146–52. Parties can eliminate these asymmetries through direct access to, and analysis of, company information. *See id.* The Securities Act addresses these asymmetries by creating an incentive for issuers to provide truthful and accurate information to the public market through underwriters, thus eliminating the information gap. *See id.* at 150–52. Consequently, public purchasers who cannot fend for themselves may rely on section 12(a)(2) to enforce the information-provision requirement. *See id.*; *see also* Sale, *supra* note 260, at 590–92. The same informational-asymmetry problem does not, however, apply to private purchasers who have the opportunity and resources to investigate the company's documents; thus, those purchasers do not need access to section 12(a)(2). *See* Letsou, *supra* note 58, at 125–34; *see also* Easterbrook & Fischel, *supra* note 217, at 674–80.

Professor Stephen M. Bainbridge also criticizes the Supreme Court's *Gustafson* opinion, calling it the "most poorly-reasoned, blatantly results-driven securities opinion in recent memory." Bainbridge, *supra* note 11, at 1231–32. He criticizes the majority's analytical approach, finding fault, for example, with its refusal to use the definition section to ascertain the meaning of the term "prospectus." *See id.* at 1235–42. He argues that public policy concerns drove the Court's opinion, particularly a perception that the Acts were being overused by aggressive plaintiffs' attorneys, who were filing "vexatious often frivolous" cases. *See id.* at 1254; *see also* Fiflis, *supra* note 176, at 428–32 (noting that Court disregarded plain meaning of statute and assumed law-making role of Congress to implement public policy) (citing Thel, *supra* note 260).

Congress designed sections 11 and 12(a)(2) to act as a strong deterrent to what it perceived to be the outrageously fraudulent behavior of issuers prior to the Act.[339] These sections were designed to eliminate the informational asymmetries inherent in the public-offering context by requiring companies to make full and accurate disclosures of specified company information before selling securities to the public. These disclosures enable purchasers to evaluate the company before purchasing such securities.[340] Companies selling securities to the public without making the accurate disclosures ordered by these sections are engaging in conduct similar to insider trading.[341] Accordingly, these sections function like the insider-trading disclose-or-abstain rule.[342] Further, those who suffer a loss due to a misstatement or omission are accorded strict-liability and negligence-like remedies precisely because Congress deemed the protection of capital raising to be worthy of such strict remedies.

Before *Gustafson*, shareholders usually survived motions to dismiss or oppositions to class certification because courts did not expect them to

Moreover, Bainbridge notes that *Gustafson* leaves several issues unsettled. *See* Bainbridge, *supra* note 11, at 1258–60. For example, the ambiguity in the Court's treatment of the term "public offering" means that readers now do not know whether "public offering" refers to primary and secondary transactions or public and private transactions. *See id.* at 1259. Bainbridge concludes that the most straightforward reading of the statute indicates that section 12(a)(2) applies to all primary-market transactions. *See id.* at 1259–60.

Professor Theresa Maynard argues that the *Gustafson* opinion is likely to have a "profound" impact on the practice of securities law. Maynard, *supra* note 176, at 1327. Specifically, she notes that the Court's methodology is a "dramatic shift" from its prior approach to interpretations of securities law. *Id.* at 1328. By skipping the Act's definitional section and contriving its own definition for the term prospectus, the Court shifted its methodology in a manner that resulted in a "complete surprise" to those attempting to follow the Court's securities jurisprudence. *Id.* at 1342–43. More "disturbing," she argues, is the potential effect of this shift on the securities bar. *Id. Gustafson* creates a wide opening for lawyers who should have a "reasonable basis" for bringing lawsuits. *Id.* at 1346. According to Maynard, any "position that *might possibly* persuade a court of the desired result" is now acceptable. *Id.* at 1345; *see also* Patricia J. Chapman, *Has the* Chevron *Doctrine Run Out of Gas? Senza Ripieni Use of* Chevron *Deference or the Rule of Lenity*, 19 Miss. C. L. Rev. 115, 143 n.179 (1998) (describing Court's statutory-interpretation approach in *Gustafson* and noting that it illustrates "confusion wrought by judicial disagreements on the proper choice and use of interpretive methods" as disagreement over term "prospectus" led to disagreements over "role[] of statutory definitions, dictionary definitions, usages, legislative history, canons of construction, stare decisis, and the effect of congressional reenactment after consistent judicial interpretation").

339. *See supra* notes 14–16 and accompanying text.

340. *See supra* notes 14–16, 24–26, 334–37, and accompanying text.

341. *See* Sale, *supra* note 260, at 590–92; *see also* Letsou, *supra* note 58, at 125.

342. *See* Donna M. Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. Cin. L. Rev. 1129, 1156–68 (1999) (describing disclose-or-abstain rule for insider trading).

provide evidence of traceability prior to discovery.[343] Courts generally allowed the shareholders to proceed on the basis of allegations that they purchased pursuant to an offering.[344] If the shareholders were unable to prove traceability, the court might consider the issue at summary judgment or, perhaps, recertify the class.[345] Accordingly, shareholders had access to discovery and, thus, the opportunity to determine whether the alleged misstatement or omission was in fact misleading. When *Gustafson* is applied to find that only Original Shareholders qualify as plaintiffs, it eliminates Aftermarket Shareholders, arguably those most likely to make a claim.[346] Moreover, eliminating Aftermarket Shareholders at the motion-to-dismiss stage prevents discovery and thereby allows defendants to avoid the consequences of any fraud-like statements, defeating the deterrent purpose of the statute. To ensure that the goals of the Acts are accomplished, the tracing requirement must be modified.

D. *Adopting Proof Methods from Toxic-Substance Litigation to Sections 11 and 12(a)(2) Tracing Requirements*

As discussed above, courts since *Barnes* have made it increasingly difficult for plaintiffs to obtain their remedies under sections 11 and 12(a)(2). In *Kirkwood v. Taylor*,[347] the court rejected all of the tracing methods proposed by the shareholders except direct tracing, which, as defined by that court, is available only to Original Shareholders.[348] In doing

343. *See supra* note 144.

344. *See supra* note 220 and accompanying text.

345. *See, e.g.*, Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 873 & n.2, 874 (N.D. Cal. 1986) (rejecting request for additional discovery where court found tracing would be impossible and granting summary judgment).

346. *See In re* Computron Software, Inc., 6 F. Supp. 2d 313, 319 (D.N.J. 1998) (noting defendants' argument that Original Purchasers probably sold shares "long before" disclosure of problems and, therefore, were unlikely to have suffered losses); *see also* Siconolfi & McGeehan, *supra* note 221, at A1 (describing how big investors often "dump" hot IPO shares or engage in "flipping" within hours of offering).

347. 590 F. Supp. 1375 (D. Minn. 1984).

348. *See id.* at 1378–83; *see also supra* notes 112–17 and accompanying text. Some courts have attempted to skirt this problem by adopting the prospectus-delivery requirement that allows Aftermarket Shareholders who purchased their shares within the prospectus delivery period, often only 25 days, to meet the tracing requirement. This theory has the appeal of a bright-line rule—only those shareholders who purchase within the requisite number of days after the offering would have standing to sue. It is, however, unworkable. First, the requisite number of days varies. *See supra* notes 171–74 and accompanying text. Moreover, some offerings are not subject to the prospectus-delivery requirement. Thus, many shareholders would still be left without a remedy. It is not, therefore, a bright-line rule. *See*

so, it emphasized that the rejected methods would not have allowed the shareholders to prove that they actually held Offering Shares.[349] Rather, it found that at the most, the heritage, contrabroker, and fungible-mass methods would allow the shareholders to prove only that they "might" have held such shares.[350] Such proof, the court concluded, was insufficient for standing purposes.[351] Other courts have added further restrictions or tried

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Kirkwood, 590 F. Supp. at 1375. Finally, given *Gustafson*'s approach to defining and restricting the term prospectus, it is inappropriate to apply a prospectus standard to a registration-statement claim.

Courts have also rejected pleas from shareholders to shift the burden of proof on tracing to defendants. *See supra* note 111. Shifting the burden of proof will not solve the problem. Tracing is impossible, thus merely shifting the burden of proving it to the defendants will ensure only that the defendants, instead of the plaintiffs, always lose. *Compare, e.g.*, Harris v. Owens-Corning Fiberglass Corp., 102 F.3d 1429, 1432 (7th Cir. 1996) (imposing burden of production regarding causation on plaintiff in asbestos litigation), *with* Richards v. Owens Illinois, 14 Cal. 4th 985, 989 (1997) (holding that plaintiff bears burden of proving asbestos product was "defective," asbestos caused injury, and exposure to defendant's asbestos product; burden then shifts to defendant to prove product did not cause injury).

349. *See Kirkwood*, 590 F. Supp. at 1380.

350. *See id.*

351. *See id.* at 1383. The courts have been overly restrictive in their approaches, relying on Judge Friendly's determination that tracing is required as a matter of statutory interpretation. Unlike these courts, however, Judge Friendly did not mention the term "standing" or even analyze the issue as such. Instead, the court held only that the shareholders could not share in the settlement unless they could show that their Aftermarket Shares were actually Offering Shares. *See* Barnes v. Osofsky, 373 F.2d 269, 271 (2d Cir. 1967). Since *Barnes*, however, courts have repeatedly implemented the tracing requirement, defining the issue as one of standing. *See supra* note 163 and accompanying text. None of these courts have explained the issue. Instead, they simply state that shareholders must trace their shares to acquire standing, citing to *Barnes*. *See, e.g.*, Adair v. Bristol Tech. Sys., Inc., 179 F.R.D. 126 (S.D.N.Y. 1998); Harden v. Raffensperger, Hughes & Co., 933 F. Supp. 763, 766 (S.D. Ind. 1996); Stack v. Lobo, 903 F. Supp. 1361, 1375–76 (N.D. Cal. 1995); *In re* Delmarva Sec. Litig., 794 F. Supp. 1293, 1309 (D. Del. 1992); Guenther v. Cooper Life Sciences, Inc., 759 F. Supp. 1437, 1439 (N.D. Cal. 1990); *In re* Ramtek Sec. Litig., No. C 88-20195 RPA, 1990 WL 157391, at *5 (N.D. Cal. Sept. 7, 1990); Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 873–75 (N.D. Cal. 1986); Gibb v. Delta Drilling Co., 104 F.R.D. 59, 69–70 (N.D. Tex. 1984).

Standing, in the Article III constitutional sense, is not, however, at issue here. The history of the statute reveals that Congress intended to exercise its maximum Article III powers. *See* H.R. Rep. No. 85, at 22 (1933), *reprinted in* 2 J.S. Ellenberger & Ellen P. Mahar, *Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934* (1973) (stating that it was "obviously" within Congress's power to accord remedies to all purchasers affected by misstatements or omissions in registered documents and that congressional power was vested "as far and to whatever circumstances the Constitution allows"). The issue is whether the plaintiffs can prove the statutory elements of their case by a preponderance of the evidence. This is the standard applied to civil causes of action under the Securities Act. *See* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943) (noting that preponderance is sufficient for civil cause of action under section 17(a) of Securities Act). The issue, then, is one of injury and whether holding proper shares is actually a requirement of the cause of action. *See In re* Regal Communications Corp. Sec. Litig., No. 94-179, 1995 WL 550454, at *10–11 (E.D. Pa. Sept. 14, 1995) (noting that where proffered class representatives have suffered injury, they have standing, and stating that whether they hold proper shares is actually requirement of cause of action). Accordingly, the courts have erred by setting forth a requirement that is impossible for many statutorily slight permutations on the direct-tracing method, but none have solved the problem the direct-tracing requirement creates—precluding shareholders who are entitled to a remedy from accessing it.

Courts will not, however, give up thirty years of tracing jurisprudence and start allowing all open-market purchasers to sue under sections 11 and 12(a)(2). Instead, the courts can resolve this problem by reconsidering the ways in which they allow plaintiffs to trace their shares and adopt a statistical approach like the one rejected by the *Kirkwood* court. In *Kirkwood*, the shareholders proposed to compare total Offering Shares to total shares on the market to provide proof of the likelihood that any share purchased in the Aftermarket was an offering share.[352] Given that the standard of proof is only a preponderance of the evidence, the shareholders argued, such a measure was sufficient.[353] The court rejected the plaintiffs' proposed probability measure because it offered proof only that the shares *might* have been Offering Shares. The court further found that the plaintiffs should not be able to use statistically derived proof for causation because it was still relatively rare in the toxic-tort context.[354] Now, however, acceptance of such proof has gained ascendancy in all types of civil litigation[355] and can be used for proof of traceability here. Further, allowing statistically based proof would satisfy the statute's requirements and effect the statute's goal in an efficient and pragmatic manner.

Although addressing the causation element in the context of a settlement opinion, the *In re "Agent Orange" Product Liability Litigation*[356] court was one of the first courts to face and explore in detail the indeterminate-plaintiff question for toxic torts.[357] The problem the court faced was that even if the class as a whole could prove Agent Orange could have caused the disease at issue, it was unlikely individual class members would be able

eligible plaintiffs to prove. Indeed, by limiting potential plaintiffs to those who can meet the direct-tracing requirement, the courts have arguably imposed a requirement as difficult to prove as a reliance requirement would be. Yet, Congress created a reliance-free remedy because it wanted the remedies to be accessible. *See supra* note 267 and accompanying text.

352. *See Kirkwood*, 590 F. Supp. at 1378–79.

353. *See id.* at 1378.

354. *See id.*

355. *See* David L. Faigman et al., 3 *Modern Scientific Evidence* § 20.12.2[4][b] (West 1999).

356. 597 F. Supp. 740 (E.D.N.Y. 1984).

357. *See* Michael D. Green, *Expert Witnesses and Sufficiency of Evidence in Toxic Substances Litigation*, 86 Nw. U. L. Rev. 643, 659 (1992) (discussing *Agent Orange* decision and noting that many "evidentiary questions about toxic causation came to the fore" in lawsuit).

to prove that Agent Orange specifically caused their injury.[358] Such proof was unavailable because the type of scientific evidence employed to establish causation for diseases is based on comparing the evidence of disease in different groups. Thus, it was impossible to separate the "background" level of cancer in the population from that contracted by the plaintiffs exposed to Agent Orange.[359] Ideal proof that would trace the pathological steps in the development of, and the role played by Agent Orange in, an individual's cancer was beyond the capacity of scientific methodology to produce.[360] The causation problem thus resulted in indeterminate plaintiffs.[361]

Relying on the group-based evidence before it, the court also found that the probability of proof of specific causation would be less than fifty percent for any plaintiff. It reached this conclusion because even where it was possible to prove Agent Orange could cause the type of injury suffered by the plaintiffs as a whole, the background causes of the disease were far more prevalent than any effect of Agent Orange. As a result, the court found it was impossible to "pinpoint" those plaintiffs for whom Agent Orange was, in fact, the cause of their cancer.[362] Therefore, the court found that group-based statistical evidence would suffice for proof of causation if it offered proof that the likelihood exceeded fifty percent that Agent Orange caused the type of cancer in question, as opposed to being the specific cause.

Many other courts have considered this problem in various toxic-substance contexts and have permitted proof of causation through statistically based evidence.[363] The use of statistically derived evidence for

358. *See Agent Orange*, 597 F. Supp. at 833.

359. *Id.* at 834; *see also* Green, *supra* note 357, at 647 (noting that where "background rates of the disease" exist, epidemiology cannot provide direct evidence of causation of disease in any individual).

360. *See* Green, *supra* note 357, at 645.

361. *See Agent Orange*, 597 F. Supp. at 833–35; *cf.* William K.S. Wang & Marc I. Steinberg, *Insider Trading* § 6.5.4, at 450 (discussing indeterminate plaintiffs in insider-trading context).

362. *Agent Orange*, 597 F. Supp. at 833–35.

363. *See, e.g.*, Daubert v. Merrell Dow Pharms., Inc., 43 F.3d 1311, 1320 (9th Cir. 1995) (Bendectin); DeLuca v. Merrell Dow Pharms., Inc., 911 F.2d 941, 958–59 (3d Cir. 1990) (same); Hall v. Baxter Healthcare Corp., 947 F. Supp. 1387, 1403 (D. Or. 1996) (breast implants); Marder v. G.D. Searle & Co., 630 F. Supp. 1087, 1092 (D. Md. 1986) (intrauterine device); Cook v. United States, 545 F. Supp. 306, 308 (N.D. Cal. 1982) (vaccine). For opinions suggesting that even lower levels of proof would be acceptable, see *In Re Joint E&S Distributors Asbestos Litigation*, 52 F.3d 1124, 1134 (2d Cir. 1995) (criticizing lower court for applying standard requiring that epidemiological evidence provide proof of doubling of risk and holding that lower levels were sufficient with proper jury instructions); *Allen v. United States*, 588 F. Supp. 247, 418–19 (D. Utah 1984); and *Grassis v. Johns-Manville Corp.*, 591 A.2d

proof of causation resolves the indeterminate-plaintiff problem by assessing causation "with due regard for the available evidence,"[364] allowing plaintiffs who have proved the other elements of their cases to receive compensation for any damages for which they have proved the cause with a greater than fifty-percent probability.[365] The exception to this rule is when the absence of particularistic or direct evidence is due to destruction of evidence by the plaintiffs, or "spoliation." As a result, even when the evidence is "thin and attenuated," probabilities based on statistically derived evidence are now sufficient to support causation in the toxic-tort context because "stronger and better evidence is unavailable."[366]

Further, the use of statistical evidence in these cases resolves a problem that a particularistic-evidence requirement creates. The harm from retaining a particularistic-evidence requirement exceeds the harm from allowing statistical evidence[367] because a requirement that is impossible for the plaintiffs to prove allows the defendants to escape liability, even where it is "virtually certain" that the defendants injured thousands of people and caused significant damages.[368]

671, 674–76 (N.J. Super. Ct. App. Div. 1991). For a discussion of this issue in the asbestos-litigation context, see Faigman, *supra* note 355, § 40.1.2.

364. Green, *supra* note 357, at 680.

365. *See Agent Orange*, 597 F. Supp. at 835; *see also* David Rosenberg, *The Causal Connection in Mass Exposure Cases: A "Public Law" Vision of the Tort System*, 97 Harv. L. Rev. 849, 857 (1984). Although no longer discussed as "strong" and "weak," early scholarship on this issue and the *Agent Orange* decision discussed the evidence as divisible into those categories. The strong version of the preponderance rule rejects the possibility that statistics alone would be sufficient for proof of causation. *See Agent Orange*, 597 F. Supp. at 835; *Rosenberg*, *supra*, at 857. Instead, it requires some form of particularistic or anecdotal evidence. *See Agent Orange*, 597 F. Supp. at 835. That evidence is "'proof that can provide direct and actual knowledge of the causal relationship between the defendant's tortious conduct and the plaintiff's injury.'" *Id.* (citing Rosenberg, *supra*, at 870); *see also* Ryan v. Eli Lilly & Co., 514 F. Supp. 1004, 1008 (D.S.C. 1981); Namm v. Charles E. Frosst & Co., 427 A.2d 1121, 1125 (N.J. Super. Ct. App. Div. 1981).

Conversely, the weak version of the preponderance rule allows verdicts based only on statistical evidence. *See Agent Orange*, 597 F. Supp. at 835. Arguably, particularistic evidence does not differ in a "significant qualitative way" from statistical evidence. *Id.* The term particularistic proof implies that "direct and actual knowledge of the causal relationship between the defendant's tortious conduct and the plaintiff's injury" exists. *Id.* at 836. Yet, in reality, particularistic evidence provides no more than a basis for drawing a conclusion about a "perceived balance of probabilities." *Id.* (citing Rosenberg, *supra*, at 870).

366. Green, *supra* note 357, at 681; *see also Agent Orange*, 597 F. Supp. at 836.

367. *See* Green, *supra* note 357, at 681.

368. *Id.*; *see also* Richard Delgado, *Beyond* Sindell: *Relaxation of Cause-in-Fact Rules for Indeterminate Plaintiffs*, 70 Cal. L. Rev. 881, 893 (1982) (noting that relaxing cause-in-fact rules allows for recovery corresponding to injury actually done); Green, *supra* note 357, at 684 (noting that one must consider possibility of false negatives).

This argument applies to securities cases under sections 11 and 12(a)(2). Assuming that they can prove the existence of a misstatement or omission, Offering Shareholders are entitled to a remedy under sections 11 and 12(a)(2).[369] Their injury is "mass" in nature, not sporadic; that is, all Offering Shareholders are presumed to have been injured by the existence of the misstatement or omission. Yet, courts have held that to prove their case, the shareholders must connect their shares to the offering at issue. For Aftermarket Shareholders, that requirement, like proof of causation for indeterminate tort plaintiffs, is impossible because specific evidence of the connection does not exist.[370] As in the toxic-tort context, particularistic or direct evidence is unavailable.[371] Further, the plaintiffs are not responsible for their inability to provide the requisite evidence. Instead, the nature of the securities market makes the evidence unavailable. As a result, these plaintiffs, like those in the toxic-tort context, are indeterminate.[372] Thus, assuming that they can prove the existence of a misstatement or omission—or that the defendants caused the "harm" as defined by the statute—allowing them to use statistically derived evidence would provide these indeterminate plaintiffs with an opportunity to prove, by a preponderance of the evidence,[373] that their shares were Offering Shares.

To see how statistically based evidence might work for proof of traceability, consider a simplified example. Assume that a company, New Company, made an IPO (Initial Offering) of 1000 shares at a price of five dollars per share. From the time of the Initial Offering until New Company's next offering of the same type of shares, all of the shares on the market would be from the Initial Offering and one-hundred percent of the shares on the market would be Offering Shares. Therefore, regardless of when they bought their shares, all of the shareholders would be Offering Shareholders and should have access to the remedies of sections 11 and 12(a)(2). Here, statistically derived proof solves the problem of

369. *See, e.g., supra* notes 17–59 and accompanying text.

370. *See supra* notes 193–231 and accompanying text.

371. *Cf.* Green, *supra* note 357, at 680 (suggesting that "[t]he point is that plaintiffs should be required to prove causation by a preponderance of the *available evidence*, not by some predetermined standard that may require nonexistent studies").

372. *See id.* at 648 n.23.

373. This is the standard of proof generally accepted in all civil litigation. *See* Federal Judicial Ctr., *Reference Manual on Scientific Evidence* 169 (1999); Green, *supra* note 357, at 691. *But see* Daniel A. Farber, *Toxic Causation*, 71 Minn. L. Rev. 1219, 1232–51 (1987) (advocating that lesser proof levels should be accepted in toxic-tort context); Steve Gold, *Causation in Toxic Tort: Burdens of Proof, Standards of Persuasion and Statistical Evidence*, 96 Yale L.J. 376, 395–401 (1986) (same).

shareholders who purchase Offering Shares in the Aftermarket and are, therefore, unable to meet the direct tracing requirement. All Offering Shareholders, not just Original Shareholders, would be able to proceed with their section 11 and 12(a)(2) claims.[374]

Assume now that New Company decides to make a follow-on offering (Second Offering) of 500 shares of stock of the same type as that issued in its Initial Offering. Now, if the Aftermarket Shareholders who purchased either before or after the second offering want to sue for an alleged misstatement or omission in the Initial Offering documents, they would be able to offer statistically derived evidence to prove their share ownership. Shares on the market issued in the Initial Offering amount to sixty-six percent of the total shares issued, providing all Aftermarket Shareholders with access to a remedy for the Initial Offering. Only Original Shareholders of the Second Offering would be able to sue for any misstatement or omission in that offering because shares from that offering would amount only to thirty-three percent of the shares on the market. For the Initial Offering, the statistically derived evidence for tracing may be overinclusive, providing some Second Offering Shareholders with remedies for a misstatement or omission in the Initial Offering. For the Second Offering, the scope of the potential plaintiffs remains underinclusive.[375] And, any time the percentage of later Offering Shares exceeds those in the earlier, disputed offering, the plaintiffs will not succeed with their statistically based evidence.

The sections themselves provide several good reasons to justify the proposed approach. First, section 11 obviates proof of reliance for plaintiffs who bought within a year of offering,[376] thereby effectively limiting the pool of potential plaintiffs to those purchasing within that time frame. Second, section 12(a)(2) limits the plaintiff class to those in privity with the seller, again a substantial obstacle for any shareholder not purchasing from

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374. In our civil justice system, the purpose of the preponderance-of-the-evidence standard is to minimize errors in adjudication. *See* Green, *supra* note 357, at 687. The goal is to minimize errors favoring either the plaintiff or the defendant, resulting in a "fifty-plus standard" as a measure of the burden of proof. *Id.* Accepting statistical proof of traceability for sections 11 and 12(a)(2) would allow plaintiffs the opportunity to present other elements of their case, and if they were able to do so, to proceed to a jury. Thus, the use of statistics here accomplishes a purpose similar to that underlying the preponderance-of-the-evidence rule, creating balance between the plaintiffs and the defendants.

375. Note that this proposal has the potential to solve the problem direct tracing creates when shares enter the Aftermarket through Regulation 144(k). *See supra* notes 247–49 and accompanying text. Now, when the unregistered shares are a small percentage of the shares available, Offering Shareholders will be able to use statistics to trace their shares to the allegedly faulty offering.

376. *See supra* note 28 and accompanying text.

a market maker.[377] Third, both sections have one-year inquiry-notice requirements or three-year absolute statutes of limitations.[378] Thus, once New Company makes information available, either through a published report or a press release, the statute of limitations begins to run, further limiting the availability of the remedies.[379]

Fourth, the statute caps defendants' total liability by limiting recoveries to the offering price.[380] Thus, the defendants will not pay any more in damages than they earned from the offering.[381] Further, each plaintiff's damages are limited to the offering price,[382] and shareholders able to meet the fifty-percent standard would be entitled only to a pro rata share of the total damages.[383] Moreover, any Aftermarket Shareholders who sold before

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377. *See supra* notes 49–50 and accompanying text.

378. *See supra* notes 32, 53, and accompanying text.

379. Under the efficient-market hypothesis, we assume that all publicly available information entering the market is reflected in the price of shares. Accordingly, all purchasers, even non-Offering Purchasers, are presumably harmed by a misstatement or omission. Thus, some affected shareholders would still be denied recovery. *Cf.* Delgado, *supra* note 368, at 892 (noting that in toxic-tort context, relaxed causation rules allow all persons injured by defendants' conduct to recover). Moreover, over time, as the total number of shares on the market increase, the probability that shares from any one offering would exceed 50% would decrease, appropriately leaving more Aftermarket Shareholders without a remedy. Thus, this proposal is underinclusive as well.

Over the life of the company, however, the insider-trading analogy, and thereby the public-offering misstatement problem, presumably diminishes. *Cf.* Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1203–04 (1st Cir. 1996) (noting quarterly reports help provide requisite information in shelf-offering context). Indeed, for this reason, Congress required proof of reliance for investors asserting section 11 claims more than a year after the offering. *See supra* note 28. Further, the 1934 Act and accompanying regulations require companies to issue quarterly and annual statements that cover much of the material in an offering document. In addition, companies regularly issue press and other releases discussing changes. Accordingly, this proposal would protect early investors in young companies—potentially the investors taking the largest risks and those most likely to be harmed by informational asymmetries and inefficiencies arising from those asymmetries or from imperfect information.

380. Both sections limit damages to the offering price of the securities. *See* 15 U.S.C. §§ 77k(e), 77*l*(2) (1994). Further, section 11 specifically limits the maximum aggregate recovery to the offering price. *See* 15 U.S.C. § 77k(g) (1994) ("In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public."); *see also In re* Gap Stores Sec. Litig., 79 F.R.D. 283, 298 (N.D. Cal. 1978) (noting aggregate damages "can never exceed" offering amount); *cf.* Barnes v. Osofsky, 373 F.2d 269, 271 (2d Cir. 1967) (noting that expanding recovery to all Aftermarket Purchasers would dilute recovery pool). Further, defendants have the option to correct potential damages by proving that the alleged loss was not caused by the alleged misstatement or omission. *See* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 Chi. L. Rev. 611, 636 (1985) (noting that loss-causation provision allows for use of market model to correct potential damage award).

381. *Cf.* Delgado, *supra* note 368, at 893–94 (noting that loss-spreading effect of relaxing cause-in-fact rules allows "exact" accident costs to be imposed on defendants).

382. *See* 15 U.S.C. §§ 77k(e), 77*l*(2).

383. *See supra* note 365 and accompanying text.

the price declined are ineligible. In addition, the defendants are entitled to argue that any recovery should be reduced if the loss was caused by something other than the alleged misstatement or omission.[384] Thus, if the defendants made the proper disclosure, or the allegedly misleading disclosure or omission did not cause the fall in the price of the stock, the defendants have the opportunity to reduce or eliminate any damages.[385] These statutory provisions limit the possibility for excess liability and over-deterrence—one of the main concerns in the tort context.[386] In the terms of the hypothetical described previously, the statutory-damages limitations would limit the defendants' total liability to $5000, calculated by multiplying the offering price, five dollars, by the number of shares, which is 1000. The plaintiffs' potential damages are limited to five dollars per share, no matter what they paid for their shares, and all shareholders would divide the total recovery. Thus, the most problematic effect of the proposal would be to dilute the recovery pool. Such dilution is justifiable[387] because without an alternative to tracing, no Aftermarket Shareholders would ever be able to recover.[388]

The most important argument supporting this proposal is that without a new way to prove tracing, the mechanism to enforce the recovery rights of Aftermarket Shareholders is eliminated. It is increasingly likely, therefore, that defendants will never face the consequences of untruthful offering documents. Indeed, in support of the argument in favor of direct tracing, at least one defendant has argued that because IPOs are usually profitable investments in the short run, Original Shareholders never lose money; only

384. *See supra* note 65.

385. Moreover, under the fraud-on-the-market doctrine, even non-Offering Shareholders were harmed by the misstatement or omission. Thus, even though they are entitled to a remedy under the Exchange Act, there is arguably a justification for providing them with one here. *See supra* notes 253–56 and accompanying text; *see also In re* Computron Software, Inc. Sec. Litig., 6 F. Supp. 2d 313, 319 (D.N.J. 1998) (noting argument of defendants that Original Shareholders likely sold their shares "long before" company disclosed problems and did not, therefore, suffer any loss).

386. *See* Charles Nesson, *The Evidence or the Event? On Judicial Proof and the Acceptability of Verdicts*, 98 Harv. L. Rev. 1357, 1360 (1985) (discussing deterrence aspect of trials and problems of probabilistic proof in inculcating deterrence message); *see also* W. Page Keeton et al., *Prosser and Keeton on the Law of Torts* 284 (5th ed. 1984) (suggesting that legal responsibility must be limited to causes "closely connected" to injury to justify liability).

387. *See* Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967).

388. *See supra* notes 212–84 and accompanying text; *cf. In re* "Agent Orange" Prods. Liab. Litig., 597 F. Supp. 740, 838 (E.D.N.Y. 1984) (arguing that although use of statistically derived evidence might allow some plaintiffs who were not injured by Agent Orange to collect damages, thereby diluting recovery pool and denigrating other plaintiffs' injuries, alternative was no recovery and no deterrence).

Aftermarket Shareholders do.[389] As a result, the deterrent effect of the statute is at least undermined, if not eliminated.[390] The result is a market for lemons.[391]

Although defendants might argue that eliminating tracing will increase the so-called strike value of complaints in these cases, the Securities Act itself contains a built-in limitation on such complaints. Section 11(e) of the Securities Act allows the court to require a plaintiff to post a bond for costs, including attorneys' fees, and allows the court to assess such costs where appropriate.[392] Congress designed this provision to deter actions brought solely for settlement, or strike value.[393] Further, judges can address any such problem by taking an active role in managing discovery in such cases to minimize the strike value of such complaints. For example, the court could design a limited initial-discovery program focused on the alleged misstatements or omissions, including a proscribed set of documents and a prohibition on depositions. Thus, in a case alleging a misstatement or omission in connection with the Initial Offering described above, the court might require production only of the files of the chief financial officer, the underwriters, and the accountants related to the Initial Offering.[394] A limited discovery plan would counterbalance the shift in the balance of power that this proposal makes for plaintiffs.[395]

Moreover, when Congress enacted the Private Securities Litigation Act in 1995, it created several provisions to limit strike suits, then largely perceived to be a problem with section 10(b) claims. Congress did not, however, prescribe similar changes for the Securities Act. And, whether over- or under-deterrence would result from this proposal is only part of the concern to be addressed. The effect of the judicially created tracing requirement is to eliminate at the pleading stage potentially valid claims. To the extent that this motivation, like the Supreme Court's in *Gustafson*, is based, even in part, on a perception of excess securities claims, the result is courts eliminating causes of action.[396] Congress created a statutorily based

389. *See supra* note 220 and accompanying text.

390. *See* Delgado, *supra* note 368, at 894 (noting that relaxed cause-in-fact rule promotes deterrence goals).

391. *See supra* note 217.

392. *See* 15 U.S.C. § 77k(e) (1994).

393. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740–41 (1975); H.R. Conf. Rep. No. 1838, at 42 (1934).

394. *See* Sale, *supra* note 260, at 580–81.

395. *See id.*

396. *See supra* notes 176, 200, 213, 338, 397.

reason. Further complicating the policy-based elimination of such claims is that judges suffer from bounded rationality and, at least arguably, have an incentive to reduce their case loads.[397]

Additionally, although the proposal might result in an overinclusive plaintiff pool, it would not have the same effect on the defendants. To succeed with their claims, plaintiffs would still have to prove the existence of a misstatement or omission—a difficult task at best. Thus, the argument that statistics can result in trapping otherwise nonliable defendants does not apply here. Only those defendants who were involved in the issuance of a registration statement, prospectus, or oral communication containing a misstatement or omission would be liable.[398]

Finally, the use of statistics here works to ensure that the statute's purpose is carried out.[399] The purpose of the statute is to protect investors and the integrity of the capital market by eliminating the informational asymmetries inherent in public offerings.[400] Indeed, it would help to force defendants to take seriously their statutory due-diligence responsibilities to deter misstatements and omissions—the reason Congress created such stringent provisions as sections 11 and 12(a)(2) in the first place.[401]

397. The development of the tracing requirement is arguably one of the many ways in which the courts avoid having to deal with the hard issues that securities cases can present—either in the discovery or the substantive contexts. *See* Mitu Gulati & C.M.A. McCauliff, *On Not Making Law*, 61 Law & Contemp. Probs. 157 (1998) (arguing that courts have used various procedural mechanisms to avoid hard cases, including those involving securities issues); Sale, *supra* note 260, at 582 (noting that judges dislike discovery process); *see also* Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 S.M.U. L. Rev. 1589, 1635–44 (positing theory that limited number of securities-fraud cases before Supreme Court and bounded rationality may, in part, account for Court's willingness to accept SEC's position on cases).

398. *See* Nesson, *supra* note 386, at 1378–85 (describing problem of allowing jury to assess liability of Blue Bus Co. based on percent of its buses traveling route where accident by unidentified bus occurred, thereby potentially "tagging" defendants who did not commit offense). Here, proof of the existence of a misstatement or omission prevents nonliable defendants from being overincluded by the proposed statistical solution.

399. Moreover, the main argument against allowing juries to consider statistical evidence is that it provides "a false veneer of certainty." Green, *supra* note 357, at 693. Here, however, the difficult element to prove is actually the misstatement or omission. Thus, allowing a case to proceed on the basis of statistical proof of an Offering Share is less likely to result in the jury's uncritical acceptance of the plaintiffs' case.

400. *See supra* notes 14–16, 339–42, and accompanying text.

401. *See supra* notes 14–16, 32–36, 339–42, and accompanying text; *see also* Delgado, *supra* note 368, at 894–95 (noting that in cause-in-fact context, relaxed rule creates incentive for defendants to "investigate" danger of their actions on others).

V. CONCLUSION

Tracing is a judicial invention that creates an impossible task for plaintiffs—namely, connecting Aftermarket purchases to the offering document or communication in question. As a result, although Aftermarket Shareholders are entitled to a remedy under the statute, they are precluded from accessing it. Thus, tracing is underinclusive and potentially eliminates the consequences the statute was designed to impose. The courts' deployment of *Gustafson* to restrict further and often to eliminate even the pleading of traceability also limits the availability of these remedies. The combination of tracing and *Gustafson* is likely to defeat Congress's goal in enacting the statute: ensuring truth in public-offering documents. To correct this problem, courts should allow shareholders to use statistical evidence to connect the securities they hold to the offering at issue. This method would reinstate the consequences intended as an incentive for due diligence as to the truthfulness of offering documents—one of the most important aspects of our financial markets.