RUTGERS LAW REVIEW

VOLUME 63 | *FALL 2010* | NUMBER 1

ARTICLES

THE ASSAULT ON SECTION 11 OF THE SECURITIES ACT: A STUDY IN JUDICIAL ACTIVISM

Marc I. Steinberg & Brent A. Kirby***

ABSTRACT

This article focuses on the federal courts' restrictive interpretation of Section 11 of the Securities Act of 1933, the most investor-friendly express remedy that the "New Deal" Congress enacted. This judicial erosion has resulted in a cause of action that extends to fewer investors and is riddled with uncertainty at the pleading stage. The authors posit that recent federal court decisions that have added reliance as an element of Section 11 claims and rejected the use of statistical evidence to prove tracing are inconsistent with Section 11's text and legislative history. The article then explores the inconsistencies associated with pleading Section 11 claims that "sound in fraud" by asserting that these claims should be extended the longer statute of limitations available to such fraud-based claims under the Sarbanes-Oxley Act of 2002. The authors conclude that the federal courts' focus on impeding vexatious litigation has resulted in unduly restrictive judicial interpretations that have altered the very nature of Section 11.

* Rupert and Lillian Radford Professor of Law and Senior Associate Dean for Research, Southern Methodist University Dedman School of Law.

** J.D., 2010, Southern Methodist University Dedman School of Law.

I. INTRODUCTION

For the last thirty-five years, Congress and the federal courts have restricted the scope of the federal securities laws, making it more difficult for aggrieved investors to obtain redress. Supreme Court decisions such as *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*[1] and *Gustafson v. Alloyd Co.*[2] restricted the reach of the securities laws and overturned decades of virtually unanimous appellate court decisions.[3] Congress, with the passage of The Private Securities Litigation Reform Act (hereinafter "PSLRA"),[4] enacted substantive provisions making it more difficult for investors to prevail under the securities laws. At a time when investors have lost record amounts of money due to fraud and corporate corruption,[5] plaintiffs have sought refuge in perhaps the most consumer-friendly

---

1. 511 U.S. 164 (1994).
2. 513 U.S. 561 (1995).
3. *See infra* notes 21-34 and accompanying text.
4. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 743, 758 (codified at 15 U.S.C. § 78u-4 (2006) [hereinafter "PSLRA"].
5. Over the past decade, investors have seen a series of disclosure-based scandals in violation of the securities laws from major corporations such as WorldCom, Tyco Int'l, Global Crossing, Adelphia Communications, and perhaps most notably, Enron. *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431 (S.D.N.Y. 2003); *In re* Tyco Int'l, Ltd., 535 F. Supp. 2d 249 (D.N.H. 2007); *In re* Global Crossing Sec., 225 F.R.D. 436 (S.D.N.Y. 2004); *In re* Enron Corp. Sec., 258 F. Supp. 2d 576 (S.D. Tex. 2003); *In re* Adelphia Commc'ns Corp., 285 B.R. 580 (Bankr. S.D.N.Y. 2002). In 2009, Bernard Madoff was convicted of perpetrating the largest investor fraud committed by a single person in history. *See* Robert Frank & Amir Efrati, *'Evil' Madoff Gets 150 Years in Epic Fraud*, WALL ST. J., June 30, 2009, at A1, *available at* http://online.wsj.com/article/SB124604151653862301.html. The government alleged that his Ponzi scheme caused investors to lose a total of thirteen billion dollars. *Id.* (quoting Madoff's attorney disputing the government's calculations). Also in 2009, the SEC charged R. Allen Stanford with "orchestrating a fraudulent, [$8] billion investment scheme" where he allegedly used "false promises and fabricated historical return data to prey on investors." Press Release, SEC, SEC Charges R. Allen Stanford, Stanford Int'l Bank for Multi-Billion Dollar Investment Scheme (Feb. 13, 2009), *available at* http://www.sec.gov/news/press/2009/2009-26.htm. In April 2010, the SEC filed charges against Goldman, Sachs & Co. for allegedly "defrauding investors by misstating and omitting key facts about a financial product tied to subprime mortgages," which allegedly resulted in investor losses in excess of one billion dollars. Press Release, SEC, SEC Charges Goldman Sachs With Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages (Apr. 16, 2010), *available at* http://www.sec.gov/news/press/2010/2010-59.htm. This suit was settled for $550 million in July 2010, with Goldman admitting it made "a mistake." Suzanne Craig & Kara Scannell, *Goldman Settles Its Battle with SEC - $550 Million Deal Ends Showdown That Shook Street*, WALL ST. J., July 16, 2010, at A1.

remedy under the federal securities laws: Section 11 of the Securities Act of 1933 (hereinafter "Section 11").[6] However, Section 11, the last refuge favorable to injured investors, is under siege.

This Article will focus on how the federal courts' restrictive interpretation of Section 11 of the Securities Act of 1933 (hereinafter "Securities Act")[7] has limited that statute's scope by increasing plaintiffs' pleading and burden of proof requirements. The article will begin by providing a brief historical progression highlighting several pivotal cases that have severely limited the reach of the securities laws. The article will then provide foundational information relating to Section 11. Section IV focuses on a recent Eleventh Circuit decision, subsequently followed by other courts, which added "reliance" as an element of a plaintiff's Section 11 prima facie case.[8] That section posits that neither statutory text, legislative history, nor federal jurisprudence support this approach. Section V examines a recent Fifth Circuit ruling as well as other decisions that reject the use of statistics to prove tracing in Section 11 claims. Lastly, Section VI discusses the inconsistencies associated with pleading fraud under Section 11, as courts apply the heightened pleading requirements applicable to fraud-based claims yet deny these claims the benefit of the applicable statute of limitations for fraud-based claims otherwise available under the Securities Acts.

II. A HISTORY OF JUDICIAL RESTRICTION

The Securities Act of 1933 and the Securities Exchange Act of 1934 (hereinafter "Securities Exchange Act")[9] are designed to protect investors by promoting full disclosure of information necessary to make informed investment decisions.[10] The Acts accomplish this goal in part by providing investors private civil remedies against sellers of securities and other responsible parties.[11] Beginning almost thirty-

6. Securities Act of 1933, Ch. 38, Pub. L. No. 73-22, 48 Stat. 74, 82 (1933) (codified as amended at 15 U.S.C. § 77k (2006)) [hereinafter "Section 11"].

7. Securities Act of 1933, Ch. 38, Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a - 77aa (2006)) [hereinafter "Securities Act"].

8. APA Excelsior III L.P. v. Premiere Techs, Inc., 476 F.3d 1261, 1271-72 (11th Cir. 2007) (requiring reliance as an element of a prima facie claim under Section 11).

9. Securities Exchange Act of 1934, Ch. 303, Pub. L. No. 291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a - 78nn (2006)) [hereinafter "Securities Exchange Act"].

10. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) ("One of [the Securities Exchange Act's] central purposes is to protect investors through the requirement of full disclosure. . . ."); SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (stating that the Securities Act is designed "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions").

11. Harry Shulman, *Civil Liability and The Securities Act*, 43 YALE L.J. 227, 227 (1933) (stating that "[c]ivil liability is imposed largely as one appropriate means of

five years ago, courts began chipping away at the breadth of the securities laws by imposing restrictive interpretations to private rights of action. The Supreme Court, during its 1974 and 1975 terms, narrowly construed the Securities Exchange Act, imposing stricter requirements for plaintiffs to prevail.[12] *Blue Chip Stamps v. Manor Drug Stores*,[13] a decision criticized by the dissent for its "solicitousness for corporate well-being" and inconsistency with the "traditions and the intent of the securities laws,"[14] limited the availability of Section 10(b) to purchasers and sellers of securities.[15] Likewise, in *Ernst & Ernst v. Hochfelder*,[16] the Court, rejecting the SEC's view, held that plaintiffs must allege and prove scienter in private Section 10(b) actions.[17] Additionally, in other decisions, the Supreme Court imposed new restrictions on claims brought under Sections 14(a)[18] and 16(b)[19] of the Securities Exchange Act.[20]

---

accomplishing" disclosure of material information by issuers).

12. *See* Paul Brest, *The Supreme Court 1975 Term: Narrowing Liability Under the 1934 Act*, 90 HARV. L. REV. 1, 255 (1976) (discussing how the Supreme Court "restrict[ed] liability under the securities laws" by narrowly construing the Securities Exchange Act).

13. 421 U.S. 723 (1975).

14. *Id.* at 762 (Blackmun, J., dissenting).

15. *See id.* at 731-51 (majority opinion). The Court's decision precluded "[t]hree principal classes of potential plaintiffs" from bringing a claim under Section 10(b): (1) individuals "who allege that they decided not to purchase [the security] because of an unduly gloomy representation or the omission of favorable material[;]" (2) "shareholders in the issuer who allege that they decided not to sell their shares because of an unduly rosy representation or a failure to disclose unfavorable material[;]" and (3) "shareholders . . . who suffered loss in the value of their investment due to corporate or insider activities in connection with the purchase or sale of securities which violate Rule 10b-5." *Id.* at 737-38.

16. 425 U.S. 185 (1976).

17. *Id.* at 193. *But see id.* at 215-16 (Blackmun, J., dissenting) (admonishing the Court for interpreting Rule 10b-5 "restrictively and narrowly and thereby stultif[ying] recovery for the victim").

18. Section 14(a) of the Securities Exchange Act and Rule 14a-9, as interpreted by the Supreme Court, provides an implied private right of action for material misstatements or half-truths in a proxy statement. *See* 15 U.S.C. § 78n (2006); 17 C.F.R. § 240.14a-9 (2010); J.I. Case Co. v. Borak, 377 U.S. 426, 430-31 (1964). The Supreme Court interpreted this right of action by rejecting the view that a misstatement of half-truth is "material" for purposes of Section 14(a) if a reasonable shareholder *might* consider it important. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Instead, the Court adopted the view that there must be "a substantial likelihood that a reasonable shareholder *would* consider it important in deciding how to vote." *Id.* (emphasis added).

19. Section 16(b) of the Securities Exchange Act "was designed to prevent a corporate director or officer or the 'beneficial owner of more than 10 per centum' of a corporation from profiteering through short-swing securities transactions." Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 234 (1976); *see* 15 U.S.C. § 78p(a)-(b) (2006). *Foremost-McKesson* limited Section 16(b) by holding that "a beneficial

More recently, the securities laws faced another round of assault with decisions like *Central Bank of Denver v. First Interstate Bank of Denver*,[21] *Gustafson v. Alloyd Company*,[22] and the passage of PSLRA. Prior to *Gustafson*, appellate courts were unanimous in the view that Section 12(2), now Section 12(a)(2), of the Securities Act applied to initial offerings, irrespective of whether they were public or private in nature.[23] In a five-to-four decision in *Gustafson*, the Supreme Court overruled these decisions and limited Section 12(2) to public offerings.[24] Similarly, in another five-to-four decision in *Central Bank of Denver*, the Supreme Court ruled contrary to "hundreds of judicial and administrative proceedings in every Circuit in the federal system"[25] by holding there is no private aiding and abetting liability under Section 10(b).[26] As recently as 2008, the Supreme Court continued its restrictive interpretation of Section 10(b), this time by narrowly interpreting who can be found liable as a primary actor under Section 10(b).[27]

The federal courts were not alone in this erosion of the federal securities laws. Congress played its part by overriding President Clinton's veto and enacting the PSLRA, which set forth heightened

---

owner must account for profits only if he was a beneficial owner '*before* the purchase.'" 423 U.S. at 249-50 (emphasis added).

20. For decades, this author has focused on this very subject. Ralph C. Ferrara & Marc I. Steinberg, *A Reappraisal of* Santa Fe*: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980); Marc. I. Steinberg, *Implied Private Rights of Action Under Federal Law*, 55 NOTRE DAME L. REV. 33 (1979); Marc I. Steinberg, *The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws*, 67 CORNELL L. REV. 557 (1982); Marc. I. Steinberg, *Section 17(a) of the Securities Act of 1933 after* Naftalin *and* Redington, 68 GEO. L.J. 163 (1979).

21. 511 U.S. 164 (1994).

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

23. *Id.* at 602 (Ginsburg, J., dissenting) (noting that "every Court of Appeals to consider the issue has ruled that private placements are subject to § 12(2)").

24. *See id.* at 584 (majority opinion).

25. *Cent. Bank of Denver, N.A.*, 511 U.S. at 192.

26. *Id.* at 191. *See generally* Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489 (1995) (analyzing effects of Supreme Court cases interpreting federal securities laws).

27. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 166-67 (2008). In *Stoneridge*, investors brought a securities fraud class action against Charter, whose securities the investors held, and its suppliers. *Id.* at 152-53. Investors sought to hold Charter's suppliers liable for knowingly entering into a fraudulent "arrangement[] that allowed [Charter] to mislead its auditors and issue a [materially] misleading financial statement affecting [Charter's] stock price." *Id.* The Court concluded that Charter's suppliers were not liable under Section 10(b) because their participation in the fraudulent arrangements was not disclosed to the public, and thus the element of reliance could not be met. *Id.* at 161.

pleading requirements,[28] enhanced protection for publicly-issued, forward-looking statements,[29] restrictions on discovery,[30] and other amendments making it more difficult for investors to prevail under the securities laws.[31] Three years later, Congress further limited the reach of both federal and state securities laws by enacting the Securities Litigation Uniform Standards Act of 1998 (hereinafter "SLUSA"), which generally preempts state-law class-action claims for nationally traded securities listed on a regulated national exchange.[32] This pre-emption not only acts to bar state-law class-action claims brought by plaintiffs who have a private remedy under federal law, but also bars class-action claims for which federal law provides no private remedy.[33]

28. 15 U.S.C. § 78u-4(b)(2) (2006) (requiring plaintiffs' Section 10(b) claims to be plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind").

29. 15 U.S.C. § 78u-5 (2006) (applying to Securities Exchange Act); 15 U.S.C. § 77z-2 (2006) (applying to Securities Act); *see* Inst. Investors Group v. Avaya, Inc., 564 F.3d 242, 254 (3d Cir. 2009) (stating PSLRA safe harbor provisions "immunize[ ] from liability any forward-looking statement, provided that: the statement is identified as such and accompanied by meaningful cautionary language; or is immaterial; or the plaintiff fails to show the statement was made with actual knowledge of its falsehood"); *accord* Lormand v. US Unwired, Inc., 565 F.3d 228, 243 (5th Cir. 2009).

30. 15 U.S.C. § 78u-4(b)(3)(B) (2006) (staying discovery for claims brought under the Securities Exchange Act during pendency of defendant's summary judgment motion); 15 U.S.C. § 77z-1(b)(1) (2006) (staying discovery for claims brought under the Securities Act during pendency of defendant's summary judgment motion).

31. *See* 15 U.S.C. § 78u-4(a)(5) (prohibiting class action settlement agreements of Securities Exchange Act claims to be filed under seal without a showing of good cause); 15 U.S.C. § 77z-1(a)(5) (prohibiting class action settlement agreements of Securities Act claims to be filed under seal without a showing of good cause); 15 U.S.C. § 78u-4(a)(6) (setting limitations on attorneys' fees for Securities Exchange Act claims); 15 U.S.C. § 77z-1(a)(6) (setting limitations on attorneys' fees for Securities Act claims); 15 U.S.C. § 78u-4(c) (providing sanctions for "abusive litigation" resulting from Securities Exchange Act claims); 15 U.S.C. § 77z-1(c) (providing sanctions for "abusive litigation" resulting from Securities Act claims); *see also* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 81 (2006) (noting that PSLRA "limit[s] recoverable damages and attorney's fees, provide[s] a 'safe harbor' for forward-looking statements, impose[s] new restrictions on the selection of (and compensation awarded to) lead plaintiffs, mandate[s] imposition of sanctions for frivolous litigation, and authorize[s] a stay of discovery pending resolution of any motion to dismiss"); 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, 587-88 (1998) (explaining how many sections of the PLSRA contained identical amendments to both the Securities Act and the Securities Exchange Act).

32. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) [hereinafter "SLUSA"]; *see* JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE, H.R. REP. NO. 105-803, at 13 (1998) (SLUSA aimed to "prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than Federal, court.").

33. *See Merrill Lynch*, 547 U.S. at 74, 83-84 (holding that SLUSA "pre-empts state-

Unlike the narrowing of the Section 10(b) right of action, Section 11, until recently, had survived unabated and served as one of the last plaintiff-friendly refuges for investors. Now, like its comrades, Section 11 has fallen victim to judicially created restrictions which threaten the statute's vitality.

III. THE SOLE SURVIVOR: SECTION 11 ENDURES THE INITIAL JUDICIAL ONSLAUGHT

The Securities Act, designed to restore confidence in the United States' financial markets following the stock market crash of 1929,[34] aims to protect investors by requiring comprehensive disclosure in public offerings of securities.[35] "The Act seeks not only to secure

---

law class-action claims" involving a nationally traded security "brought by plaintiffs who have a private remedy under federal law" as well as to "claims for which federal law provides no private remedy" so long as such alleged misconduct is "in connection with the purchase or sale" of such security).

Perhaps the most puzzling restriction imposed on the securities laws in the class-action setting is a Fifth Circuit decision from 2007 in which the court held that plaintiffs were required to *prove*, at the class certification stage, an element of their prima facie case - loss causation - for causes of action brought under Rule 10b-5. *See* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 269 (5th Cir. 2007) (holding that in Rule 10b-5 claims, plaintiff's must prove loss causation by a preponderance of the evidence "at the class certification stage" when relying on the fraud-on-the-market presumption). The *Oscar* decision has subsequently been followed in numerous Fifth Circuit decisions. *See, e.g.*, Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 597 F.3d 330, 335 (5th Cir. 2010), *cert. granted*, 131 S. Ct. 856 (2011); Fener v. Operating Eng'rs Constr. Indust., 579 F.3d 401, 407 n.9 (5th Cir. 2009); Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 228 (5th Cir. 2009). These cases impede the litigation of meritorious securities fraud cases as plaintiffs must bear the additional costs and time delays of a mini-trial in order to qualify for class certification. *See* Michael J. Kaufman & John M. Wunderlich, *The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions*, 43 U. MICH. J.L. REFORM 323, 330-34 (2010), for an excellent discussion of the implications of *Oscar*.

34. Letter from President Franklin D. Roosevelt to Duncan V. Fletcher, Chairman of the Banking and Currency Committee (Feb. 9, 1934), *in* S. REP. NO. 73-792, at 2 (1934); 77 CONG. REC. 2910, 2914 (1933) (statements of Representative Greenwood) ("[T]he necessity for this legislation to help restore confidence in our local banking institutions is great."); Candida P. Jose, Note, *Section 11 of the Securities Act of 1933: The Disproportionate Liability Imputed to Accountants*, 27 DEL. J. CORP. L. 565, 565 (2002) (noting that the Securities Act was designed in part "to 'bring back investor confidence'" following the stock market crash of 1929). *Accord* Michael A. Lynn, Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 GEO. WASH. L. REV. 627, 630-31 (1982); Krista L. Trunquist, Note, *Pleading Under Section 11 of the Securities Act of 1933*, 98 MICH. L. REV. 2395, 2403-04 (2000).

35. *See* S. REP. NO. 73-47, at 1 (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, ITEM NO. 17 (J.S. Ellenberger & Ellen P. Mahar eds., 2001) ("The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign

accuracy in the information that is volunteered to investors, but also . . . to compel the disclosure of significant matters which were heretofore rarely, if ever, disclosed."[36] The Securities Act effectuates this disclosure regime by requiring companies to file a registration statement with the SEC and to provide investors detailed information in a prospectus before selling securities to the public.[37] Section 11 creates a private cause of action for securities purchasers against certain enumerated parties based on material misrepresentation(s) or half-truth(s) in a registration statement.[38] As stated by the Supreme Court, Section 11 "was designed to assure compliance with the disclosure provisions of the [Securities] Act by

---

commerce and providing protection against fraud and misrepresentation."). "It should give impetus to honest dealing in securities and thereby bring back public confidence." 77 CONG. REC. 937 (1933) (message from the President - Regulation of Securities Issues, Presented to the Senate, March 28, 1933), *reprinted in* 1 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, ITEM NO. 3 ("There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public."); Kenneth Culp Davis, *Administrative Powers of Supervising, Prosecuting, Advising, Declaring, and Informally Adjudicating*, 63 HARV. L. REV. 193, 206 (1949) ("The major purpose of the Securities Act is to protect investors by requiring full and truthful disclosures.").

36. Shulman, *supra* note 11, at 227; Gustafson v. Alloyd Co., Inc., 513 U.S. 561, 571 (1995) ("The primary innovation of the [Securities Act of] 1933 Act was the creation of federal duties—for the most part, registration and disclosure obligations—in connection with public offerings."); *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (recognizing the Securities Act "was designed to provide investors with full disclosure of material information concerning public offerings"); *see also* Friedrich Kessler, *The American Securities Act and its Foreign Counterparts: A Comparative Study*, 44 YALE L.J. 1133, 1134 (1935) ("[T]he Securities Act tries to put at the disposal of an investor all the information which is deemed necessary to enable him to form an intelligent judgment regarding the merits of a security.").

37. Davis, *supra* note 35, at 206 (noting the purpose of the Securities Act is accomplished "through registration statements which elaborately set forth the necessary facts."); *see* Kessler, *supra* note 36, at 1134 ("[T]he Act tries to accomplish its purpose by prescribing that no offer for the interstate sale of any security covered by the Act can be made . . . unless a registration statement . . . is filed with the [SEC] . . . ."); William B Snyder, Jr., Comment, *The Securities Act of 1933 After SLUSA: Federal Class Actions Belong in Federal Court*, 85 N.C.L. REV. 669, 672-73 (2007) (stating the Securities Act accomplishes its purpose "by requiring companies to file a registration statement with the [SEC]").

38. *See* 15 U.S.C. §77k. Section 11 liability extends to: every person who signs the registration statement; directors (or persons performing similar functions) or partners of the issuer; accountants, engineers, or other professionals who provide expert statements in the registration statement; and underwriters with respect to the security at issue. *Id.*; *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 381 (1983) ("Section 11 of the 1933 Act allows purchasers of a registered security to sue certain enumerated parties in a registered offering when [materially] false or misleading information is included in a registration statement.").

imposing a stringent standard of liability on the parties who play a direct role in a registered offering."[39]

To prevail on a Section 11 claim, a plaintiff need only prove: (1) a requisite jurisdictional nexus; (2) that he/she acquired a security pursuant to a registration statement; (3) that at the time the registration statement became effective, it contained a materially misleading statement or half-truth; and (4) that the claim was brought within the applicable statute of limitations.[40] These minimal pleading requirements, combined with the virtually absolute strict liability against the issuer and imposition of a stringent due diligence defense upon other subject defendants, make Section 11 an attractive weapon for aggrieved investors.[41]

Based on the plain language of Section 11, reliance on a materially false or misleading statement is typically not an element of the plaintiff's prima facie case.[42] As explained by the Supreme

39. *Herman & MacLean*, 459 U.S. at 381-82; *see also In re* Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 359 (2d. Cir. 2010) (noting that under Section 11, "[i]ssuers are subject to 'virtually absolute' liability" and other potential defendants "may be held liable for mere negligence"); J&R Marketing, SEP v. General Motors Corp., 549 F.3d 384, 392 (6th Cir. 2008) (citing 15 U.S.C. § 77k(a)) (stating Section 11 "imposes strict liability on those who fail to include information required to be stated in the registration statement") (internal quotation marks omitted); Wagner v. First Horizon Pharmaceutical Corp., 464 F.3d 1273, 1277 (11th Cir. 2006) (quoting *Herman & MacClean*, 459 U.S. at 382) (asserting that Section 11 liability is "virtually absolute, even for innocent misstatements") (internal quotation marks omitted); *In re* Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 269 (3d Cir. 2006) ("Section 11 is a virtually absolute liability provision.") (internal quotation marks omitted); Krim v. pcOrder.com, Inc., 402 F.3d 489, 495 (5th Cir. 2005) ("Section 11's liability provisions are expansive—creating 'virtually absolute' liability for corporate issuers . . . ."); Sherman v. Network Commerce, Inc., 94 Fed. Appx. 574, 575 (9th Cir. 2004) ("[Section] 11 is a strict liability provision."); Romine v. Acxiom Corp., 296 F.3d 701, 704 (8th Cir. 2002) ("The issuer's liability is virtually absolute.") (internal quotation marks omitted); Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496-97 (7th Cir. 1986) (recognizing that liability under Section 11 is "presumptive or absolute").

40. *See Herman & MacLean*, 459 U.S. at 382; 15 U.S.C. § 77k.

41. *See generally* sources cited *infra* notes 46-47.

42. *See* 15 U.S.C. § 77k; *see also* Stark Trading v. Falconbridge Ltd., 552 F.3d 568, 573 (7th Cir. 2009) (noting that Section 11 "does not require proof of reliance"); *In re* Constar Int'l Inc. Sec. Litig., 585 F.3d 774, 784 (3d Cir. 2009) ("Since reliance is irrelevant in a [Section] 11 case, a [Section] 11 case will never demand individualized proof as to an investor's reliance . . . .); *Sherman*, 94 Fed. Appx. at 575 (stating "a plaintiff need not allege or prove reliance" in a Section 11 claim); *In re* Initial Public Offering Sec. Litig., 483 F.3d 70, 73 n.1 (2d Cir. 2007) (quoting Romback v. Chang, 355 F.3d 164, 169 n. 4 (2d Cir. 2004) (noting that Section 11 does not require plaintiffs to allege reliance)); Glassman v. Computervision Corp., 90 F.3d 617, 628 n.13 (1st Cir. 1996) (noting Section 11 claims do not require allegations of reliance); Alpern v. UtiliCorp United, Inc., 84 F.3d 1525, 1541 (8th Cir. 1996) ("A claim under [Section] 11 does not require proof of reliance . . . ."); Comment, *Civil Liability For Misstatements in*

Court, "[i]f a plaintiff purchased a security issued pursuant to a registration statement, he need only show a material misstatement or omission to establish his prima facie case."[43] In other words, plaintiffs typically need not prove they relied on the registration statement in order to prevail on a Section 11 claim.

The sole exception to this principle, the earnings statement exception, requires plaintiffs to prove reliance where they bought the security more than twelve months after the effective date of the registration statement and the issuer had already distributed an earnings statement.[44] Even where the plaintiff must prove reliance, such reliance may be established without proving that the plaintiff ever read the registration statement.[45] Once a plaintiff proves its prima facie case, liability against the issuer of the security is virtually absolute, even for innocent misstatements.[46] As to other Section 11 defendants, a strict due diligence defense applies.[47]

Documents Filed under Securities Act and Securities Exchange Act, 44 YALE L.J. 456, 459 (1935) [hereinafter "*Civil Liability for Misstatements*"] ("[T]he plaintiff need not prove reliance during at least the first year after registration . . . .").

43. *Herman & MacLean*, 459 U.S. at 382.

44. *See* 15 U.S.C. § 77k ("If such person acquired the security after the issuer has made generally available to its security holders an earning 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."); Marc I. Steinberg, SECURITIES REGULATION 310 (revised 5th ed. 2009) (stating that except for the earnings statement exception, reliance is not required to be proven by a plaintiff in a Section 11 action).

45. *See* 15 U.S.C. § 77k(a); Steinberg, *supra* note 44 (stating that "reliance [in such situation] may be shown by means other than the actual reading of the prospectus"); *Civil Liability For Misstatements, supra* note 42, at 459 ("[E]stablishing reliance is not insurmountable, for the plaintiff can do so without proving that he actually read the statement which he alleges has misled him.").

46. *Herman & MacLean*, 459 U.S at 382. Notably, a key defense provided under Section 11, lack of loss causation, allows defendants to reduce their liability by proving that the misstatement or half-truth at issue did not cause the financial loss. *See infra* notes 202-208 and accompanying text.

47. *Herman & MacLean*, 459 U.S. at 382 (stating non-issuer defendants "bear the burden of demonstrating due diligence" in order to avoid liability); *see also* 15 U.S.C. § 77K(b)(3); *In re* Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 359 n.7 (2d Cir. 2010) ("[S]ection 11 provides several due diligence defenses available to non-issuer defendants." (internal citation omitted)); Lone Star Ladies Inv. Club v. Schlotzsky's Inc., 238 F.3d 363, 369 (5th Cir. 2001) ("Defendants other than the issuer can avoid liability by demonstrating due diligence[.]"); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1230 (10th Cir. 1996) ("[A]ccountants [i.e. experts] bear the burden of demonstrating due diligence once a plaintiff shows a material misstatement or omission in a registration statement."); *In re* Software Toolworks Inc., 50 F.3d 615, 621 (9th Cir. 1994) ("Underwriters . . . may absolve themselves from liability by

IV. PLAINTIFFS LEARN THEY CAN'T *RELY* ON SECTION 11 FOR PROTECTION

This universal construction of Section 11 was met with disagreement by the Eleventh Circuit's 2007 holding in *APA Excelsior III L.P. v. Premiere Technologies, Inc.* (hereinafter "*APA Excelsior III*").[48] In this case, the Eleventh Circuit effectively added reliance as a required element of a Section 11 claim.[49] The court concluded that Section 11 normally creates a presumption of reliance but this presumption can be refuted.[50] Ultimately, the court upheld the district court's grant of summary judgment based on plaintiffs' impossibility of reliance.[51] While the court purported to limit its holding to the "limited and narrow" facts of the case, other courts have cited *APA Excelsior III* for the much broader proposition that "an investor cannot recover under Section 11 where it is certain that a purchase of the securities was motivated by factors other than the registration statement."[52] This section analyzes the Eleventh Circuit's holding in *APA Excelsior III* and thereafter demonstrates that statutory language, congressional history, and federal jurisprudence all support the conclusion that reliance is not an element of a Section 11 claim.

A. *The Court's Misplaced Reliance: APA Excelsior III*

APA Excelsior III arose from litigation over a stock-for-stock merger and acquisition between Xpedite Systems, Inc. (hereinafter "Xpedite") and Premiere Technologies (hereinafter "Premiere").[53] Plaintiffs included "investment funds and individuals who [were] former shareholders of Xpedite," and two members of Xpedite's board of directors.[54] Defendant, Premiere, entered the picture when Xpedite's board of directors sought "strategic alternatives to provide

---

establishing a 'due diligence' defense."); Newcome v. Esrey, 862 F.2d 1099, 1106 (4th Cir. 1988) (recognizing that Section 11 contains a due diligence defense).

48. APA Excelsior III L.P. v. Premiere Techs, Inc., 476 F.3d 1261, 1275-77 (11th Cir. 2007).

49. *See id.* at 1271-72.

50. *See id.*

51. *See id.* at 1277. "What must be decided in this case is whether Congress intended this presumption [of reliance] to apply . . . when reliance is rendered *impossible* by virtue of a pre-registration commitment." *Id.* at 1272 (emphasis added).

52. *Id.* at 1277; *In re* HealthSouth Corp. Sec. Litig., 261 F.R.D. 616, 647 (N.D. Ala. 2009) (internal quotation marks omitted); *see also In re* Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132, 1162 n.34 (C.D. Cal. 2008) (stating that pursuant to *APA Excelsior III,* reliance may have to be proved where "it appears from the face of the complaint that a plaintiff cannot have actually relied on the registration statement").

53. APA Excelsior III L.P. v. Premiere Techs, Inc., 476 F.3d 1261, 1263 (11th Cir. 2007).

54. *Id.*

an exit strategy for Xpedite's early investors."[55] "Premiere proposed a stock-for-stock merger acquisition . . . ."[56] "As a condition of entering the merger agreement, . . . Premiere required all Plaintiffs . . . to execute stockholder agreements. Under these stockholder agreements, Plaintiffs granted irrevocable proxies to Premiere to vote their Xpedite stock in favor of the merger."[57] Plaintiffs were further required to execute affiliate letters which acknowledged that Premiere was "under no obligation to file a registration statement with the [SEC] covering the disposition of [their] shares."[58]

"More than two months later, . . . Premiere's registration statement for the Xpedite merger became effective. . . . [A]ll Xpedite shareholders received 1.165 shares of Premiere common stock for each share of Xpedite stock they owned."[59] A few months after the merger, "Premiere announced that it would have a shortfall in its revenues, and that it would be taking a charge against its bad debt reserves."[60] This caused Premiere stock to decline twenty-eight percent in one day and eventually decline sixty-nine percent from the merger price.[61] Plaintiffs alleged, among other claims, that the decline in stock price was the result of numerous material misstatements and omissions in the registration statement, and that these defects violated Section 11.[62] In defining the issue presented on appeal, the court narrowed plaintiffs' appeal to a single question: "Are sophisticated investors involved in an arms-length merger transaction entitled to recover under Section 11 of the Securities Act of 1933 if they make a legally binding investment commitment months before the issuance of a defective registration statement?"[63] The court held that Section 11 creates a "presumption of reliance"

55. *Id.*

56. *Id.* at 1264.

57. *Id.*

58. *Id.* at 1264-65 (emphasis omitted) (quoting from affiliate letter).

59. *APA Excelsior III*, 476 F.3d at 1265. On February 27, 1998, a majority of both Xpedite's and Premiere's shareholders voted to approve the merger.

60. *Id.*

61. *Id.* Premiere publicly announced the bad news on June 9th and 10th. On June 10th, Premiere's stock "dropped from $14.4375 per share to $10.375 per share." *Id.* The downturn in Premiere's stock price was relatively temporary. Premiere's stock price "rebounded to more than $20 per share—a 100% increase from the low in June 1998." *Id.* at 1265 n.1.

62. *Id.* at 1265. Plaintiff alleged Premiere's registration statement overstated its prior acquisitions of and attempts to integrate two voice messaging businesses, misrepresented the status and viability of "Orchestrate" (a comprehensive suite of integrated communications services), and failed to disclose that Premiere was experiencing dramatic declines in revenue from its business relationship with two other entities. *Id.*

63. *Id.*

which did not apply under the "limited and narrow" facts of the case, and thus summary judgment was appropriate as plaintiffs could not establish reliance.[64] In reaching its decision, the court noted that "Plaintiffs were sophisticated investors with due diligence rights, but they failed to exercise them in any meaningful way."[65]

While the court specifically limited its holding to the "limited and narrow" facts of the case, the Eleventh Circuit's analysis created a new, unprecedented ground for summary judgment in Section 11 cases: impossibility of reliance. The court's analysis began with the so-called "commitment theory": "once the decision is made and the parties are committed to the transaction, 'there is little justification for penalizing alleged omissions or misstatements which occur thereafter and which have no effect on the decision.'"[66] The court conceded that application of the commitment theory in Section 11 cases was an issue of first impression.[67] As such, the court turned to the statutory language of Section 11 and general principles of statutory interpretation, thereby focusing on "the underlying purpose of, and legislative intent behind, the statute."[68] The court reasoned that to the extent that the unambiguous language of Section 11

64. *Id.* at 1277.

65. *Id.* at 1264. The Court's reference to plaintiffs' due diligence rights is problematic because Section 11 does not impose a duty of due diligence or even of reasonable investigation upon purchasers of securities. Under Section 11, a buyer does not even have to prove that he/she saw the registration statement to prevail. *See* 15 U.S.C. § 77k; Marc I. Steinberg, UNDERSTANDING SECURITIES LAW 208-09 (5th ed. 2009) (noting that except for the "earning statement" exception, reliance is not required under Section 11); Trunquist, *supra* note 34, at 2401-02 (stating a buyer need not have seen the registration statement to collect damages under Section 11).

66. *APA Excelsior III*, 476 F.3d at 1267 (quoting SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682, 703-04 (D.D.C. 1978)). The commitment theory originated from the contract law principle that "securities are considered sold when the parties are obligated to execute the transaction." Westinghouse Elec. Corp. v. '21' Int'l Holdings, Inc., 821 F. Supp. 212, 218 (S.D.N.Y. 1993); *see* Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 891 (2d Cir. 1972) ("'Commitment' is a simple and direct way of designating the point at which, in the classical contractual sense, there was a meeting of the minds of the parties; it marks the point at which the parties obligated themselves to perform . . . ."). The commitment theory originally defined the purchase date in the context of Rule 10b-5 claims and has also been applied in Section 12(2) cases. *See* Kahn v. Kohlberg, Kravis, Roberts & Co., 970 F.2d 1030, 1040-42 (2d Cir. 1992) (applying commitment theory to Rule 10b-5 case); Pell v. Weinstein, 759 F. Supp. 1107, 1113-14 (M.D. Pa. 1991), *aff'd*, 961 F.2d 1568 (3d Cir. 1992) (applying the commitment theory to Section 12(2)).

67. *APA Excelsior III*, 476 F.3d at 1267. Prior to *APA Excelsior III*, the district court for the Southern District of New York determined that the commitment theory did not apply to Section 11 causes of action because Section 11 grants a cause of action "without any reference to a requirement, inference or presumption that the plaintiff might have relied on the registration statement." *Westinghouse Elec. Corp.*, 821 F. Supp at 218.

68. *APA Excelsior III*, 476 F.3d at 1268.

would lead to an unreasonable result for plaintiffs, statutory intent may properly be considered.[69]

The court began by interpreting Section 11 to create a presumption of reliance for any person who acquired a security pursuant to a defective registration statement.[70] Rejecting the plaintiffs' argument that reliance is not an element of a Section 11 claim, the court asserted that reliance need not be proven, but rather, is typically presumed.[71] The court supported this conclusion with reference to a leading treatise stating "there is a *conclusive presumption* of reliance for *any person* purchasing the security prior to the expiration of twelve months."[72] In rejecting plaintiffs' argument that reliance is not required under Section 11, the court also cited to several ambiguous statements contained in the congressional history that made glancing reference to reliance.[73]

Despite this "presumption of reliance" that applies to "any person," the court nonetheless looked to whether the presumption applied to the plaintiffs in the case at bar.[74] The court determined that the presumption did not apply to plaintiffs in this case, reasoning that "Congress assumed that only those who acquire their stock *after* the effective date of the registration statement would be affected by material defects."[75] In the court's view, congressional history supported application of a presumption of reliance because material misstatements and half-truths in a registration statement "affect the market price and impel the purchase."[76] Thus, the presumption of reliance only applies to those who purchase securities "at the time of or after the registration statement."[77] The court further supported its conclusion by referring to the earnings

69. *Id.* (citing United States v. American Trucking Ass'ns, 310 U.S. 534, 534-44 (1940)).

70. *Id.* at 1271.

71. *Id.* at 1272.

72. *Id.* at 1271 (quoting 1 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 7.3[4], at 351 (4th ed. 2002)) (emphasis added).

73. *Id.* at 1272 (citing H.R. 5480, 73d Cong., § 9 (1933) (where there is a defective registration statement, "the public shall be presumed to rely" on it); S. REP. NO. 47, 73d Cong., at 4-5 (1933) (stating if there is a defective registration statement, "the buyer presumably relies on it" and that he who "allows untruths to be published and relied upon" should suffer the loss); H.R. REP. NO. 85, 73d Cong., at 9 (1933) (noting that Section 11 is enforced against "those who purport to issue statements for the public's reliance")).

74. *Id.* at 1271-76.

75. *Id.* at 1273.

76. *Id.* at 1274 (citing H.R. NO. 85, 73d Cong., at 10 (1933) ("The connection between the statements made and the purchase of the security is clear, and, *for this reason*, it is the essence of fairness to insist upon the assumption of responsibility for the making of these statements.")).

77. *Id.*

statement exception, which requires plaintiffs to prove reliance on the defective registration statement where an earnings statement covering at least twelve months following the registration statement has been made publicly available.[78] The underlying logic of this exception is that once an annual earnings statement is issued, the purchase price of the security acquired will be predicated upon the earnings statement rather than on the defective registration statement.[79] The court analogized that plaintiffs' acquisition of Premiere stock must have been based on factors other than the content of the registration statement and thus the presumption of reliance did not apply.[80]

Lastly, the court looked to the "tracing" requirement under Section 11 to support its conclusion that the presumption of reliance does not apply to plaintiffs who commit to purchase a security prior to the issuance of the subject registration statement.[81] To have standing, "a plaintiff must be able to trace [his/her purchase of] stock to the defective registration statement."[82] The court reasoned that plaintiffs could not trace their stock to the defective registration statement because they had a binding commitment to purchase the stock months before the registration statement became effective.[83] Further, the Court said the stock could not have been purchased pursuant to a registration statement because "under the affiliate letters, no registration statement was even required as to [the affected] shares."[84]

78. *Id.* at 1275; H.R. REP. NO. 1838, 73d Cong. at 41 (1934). For further discussion on the post-earnings statement see *infra* notes 95, 102-105 and accompanying text.

79. *APA Excelsior III*, 476 F.3d at 1275 (quoting Hertzberg v. Dignity Partners, Inc., 191 F.3d 1076, 1081-82 (9th Cir. 1999) (quoting H.R. REP. NO. 1838, 73d Cong., at 41 (1934)).

80. *Id.*

81. *Id.* at 1276.

82. *Id.*; *see infra* notes 142-148 and accompanying text.

83. *APA Excelsior III*, 476 F.3d at 1263. The court conceded "that plaintiffs in one sense 'acquired' their stock only after consummation of the merger and after the registration statement was filed." *Id.* at 1276 n.6. This should have been sufficient to meet the tracing requirement, which only requires a plaintiff to prove his/her securities were issued pursuant to the allegedly faulty registration statement.

84. *Id.* at 1276. The affiliate letters entered into between plaintiffs and Premiere did not alleviate Premiere of its duty to file a registration statement for the newly issued securities. Section 5 of the Securities Act requires a seller of securities to file a registration statement before offering any security for sale unless the securities offered come within a recognized exemption. *See* 15 U.S.C. § 77e (2006); Riley v. Simmons, 45 F.3d 764, 774 (3d Cir. 1995). *See generally* Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119 (1953) (delineating which parties are able to claim exemption under the statute).

B. *Follow the Leader: Courts Rely on APA Excelsior III to Further Restrict the Scope of Section 11*

While the Eleventh Circuit was the first court to hold that reliance is a required element of a Section 11 claim, its decision in *APA Excelsior III* has already had far reaching impact as several district courts have followed and expanded on the Eleventh Circuit's holding.[85] For example, courts have applied the logic from *APA Excelsior III* to Section 11 claims involving Rule 144A/*Exxon Capital* exchange transactions.[86] In these cases, plaintiffs typically purchase unregistered bonds prior to the issuance of a registration statement and then trade the unregistered bonds for registered bonds issued pursuant to a valid registration statement.[87] Accordingly, once the investor acquires the registered bonds, they should be entitled to recovery under Section 11 for material misstatements or half-truths in the registration statement. However, in *In re HealthSouth Corp.*,[88] the defendant argued that *APA Excelsior III*'s "irrevocable commitment theory" precluded plaintiffs' Section 11 claim because plaintiffs purchased their unregistered bonds before the filing of a registration statement.[89] The court agreed with the defendant, citing *APA Excelsior III* for the broad position that "a registration statement cannot be the basis for an investment decision where an

85. *See, e.g., In re* HealthSouth Corp. Sec. Litig., 261 F.R.D. 616, 647 (N.D. Ala. 2009) (Finding investors who exchanged unregistered bonds for registered bonds were precluded from asserting claims under Section 11 because "the decision to own a registered bond occurred when the investors decided to purchase the unregistered bond[s]. . . . [And] *before* the filing of the registration statement." (emphasis in original)); *In re* Refco, Inc. Sec. Litig., 503 F. Supp. 2d 611, 633-37 (S.D.N.Y. 2007) (citing APA Excelsior III, L.P. v. Premiere Techs, Inc., 476 F.3d 1261 (11th Cir. 2007), for the proposition that reliance is impossible where plaintiffs are irrevocably committed to purchase securities prior to the issuance of the registration statement); *In re* Levi Strauss & Co. Sec. Litig., 527 F. Supp. 2d 965, 976-77 (N.D. Cal. 2007) (following *Refco's* interpretation of *APA Excelsior III*).

86. A Rule 144A/*Exxon Capital* exchange "transaction is a capital raising technique where an issuer first sells securities to an initial purchaser in a private offering exempt from the registration requirements of the Securities Act." *In re Levi Strauss & Co.* Sec. *Litig.*, 527 F. Supp. 2d at 975 n.11. The investor "is then authorized to sell the unregistered securities to [Qualified Institutional Buyers] in a private transaction similarly exempt from registration under Rule 144A." *Id.* The Rule 144A offering is then followed by an SEC-registered exchange offering where the issuer offers to exchange the Rule 144A securities for similar, freely resalable registered securities. *Id. See generally* Steinberg, *supra* note 44, at 294-99; Marc I. Steinberg & Daryl L. Lansdale, Jr., *Regulation S and Rule 144A: Creating a Workable Fiction in an Expanding Global Securities Market*, 29 INT'L LAW. 43 (1995).

87. *See* cases cited *supra* note 85 and accompanying text.

88. *In re* HealthSouth Corp. Sec. Litig., 261 F.R.D. 616 (N.D. Ala. 2009).

89. *Id.* at 647 (quoting *APA Excelsior III*, 476 F.3d at 1277).

investor made its investment decision *before* the registration statement has been filed."[90] The Court noted "[e]very court that has addressed this issue after *APA Excelsior [III]* has agreed that plaintiffs who acquired registered bonds through a voluntary 144A/*Exxon Capital* exchange are precluded from asserting claims under Section 11."[91] These cases have all cited and adopted the arguments from *APA Excelsior III*, but ultimately resolved the cases on grounds of materiality and traceability.[92]

C. *How Presumptuous: The Court's Incorrect Conclusion that Section 11 Presumes Reliance*

While the court in *APA Excelsior III* attempted to justify its holding with tenuous references to congressional history, the court's true rationalization is apparent in its assertion that plaintiffs were not entitled to the presumption of reliance "as a matter of common sense."[93] This argument resonates with tones of judicial activism.[94]

---

90. *Id.* (emphasis in original).

91. *Id.* at 647 (citing *In re* Levi Strauss & Co. Sec. Litig., 527 F. Supp. 2d 965, 976-77 (N.D. Cal. 2007); *In re* Refco, Inc. Sec. Litig., 503 F. Supp. 2d 611, 633-37 (S.D.N.Y. 2007)).

92. *In re* Healthsouth Corp. Sec. Litig., 261 F.R.D. at 647 (resolving the case as an issue of standing); *In re* Refco, Inc. Sec. Litig., 503 F. Supp. 2d at 633-37 (resolving the case as an issue of materiality).

93. 476 F.3d at 1273-74. ("First, *as a matter of common sense*, Plaintiffs are not entitled to the presumption in light of the timing of their investment decision and commitment . . . . Thus, as a matter of common sense reasoning, the presumption should only apply to those who purchase securities at the time of or after the registration statement." (emphasis added)). Note that Section 11(e) provides a defense of lack of loss causation, i.e., the defendant may prove that the disclosure deficiency did not cause the financial loss. *See, e.g.*, Akerman v. Oryx Commc'ns, Inc., 609 F. Supp. 363, 371-72 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336 (2d Cir. 1987). The court in *APA Excelsior III* briefly recognized that its "rationale encompasse[d] the lack of causation analysis the district court employed and, therefore," it was not "necessary to separately address the district court's alternative holding that Plaintiffs could not establish loss, causation and damages." 476 F.3d at 1277 n.8. This would have been a more appropriate ground for dismissal and would have avoided the necessity of the court's analysis focusing on reliance as an element of a Section 11 claim.

94. While there is little consensus on the meaning of the term "judicial activism," the term has been used to describe a decision that reaches "an interpretation that exceeds a text's original meaning or its plain language[.]" Caprice L. Roberts, *In Search of Judicial Activism: Dangers in Quantifying the Qualitative*, 74 TENN. L. REV. 567, 574 (2007); *see* Randy E. Barnett, *Is the Rehnquist Court an "Activist" Court?: The Commerce Clause Cases*, 73 U. COLO. L. REV. 1275, 1275-80 (2002); Erwin Chemerinsky, *Conservatives Embrace Judicial Activism in Campaign Finance Ruling*, L.A. TIMES, Jan. 22, 2010, *available at* http://articles.latimes.com/2010/jan/22/opinion/la-oe-chemerinsky22-2010jan22. In order to prevent what the court saw as an "unreasonable result" that defied "common sense," the court reached an interpretation of Section 11 that exceeded the statute's text and original meaning. *See APA Excelsior III*, 476 F.3d at 1268 ("[T]o the extent that we believe it would lead to an *unreasonable*

The fundamental error with the Eleventh Circuit's holding is not only its finding that plaintiffs were not entitled to an irrefutable presumption of reliance, but more broadly, its finding that reliance is a required element in a Section 11 claim.[95] The following discussion explains how this holding is inconsistent with existing case law, statutory language, and statutory history.

1. A Prudent Interpretation: A Review of Federal Jurisprudence

Of the other federal appellate courts that have discussed reliance in the context of Section 11 claims, virtually all have stated either in holding, dicta, or analysis that proof of reliance is not required.[96] Not only are the circuit courts virtually unanimous in their consensus that reliance is not a required element in a Section 11 claim, but the Supreme Court also appears to be in accord with these federal circuits.[97] In addressing the purpose of Section 11, the Supreme Court proclaimed "[i]f a plaintiff purchased a security issued pursuant to a registration statement, he need only show a material misstatement or omission to establish his prima facie case. Liability

---

result for Plaintiffs to obtain refuge under Section 11 on the facts as presented in the case . . . ." (emphasis added)). The court's decision appears to have been influenced by its belief that plaintiffs should not be able to recover under Section 11 because they were sophisticated and failed to perform due diligence. *See id.* at 1277. The court noted that, while not essential to its holding, it was pertinent that plaintiffs had access to inside information and had an opportunity to learn of potential problems with defendant Premiere's business relationships and products. *Id.* at 1277. The court also noted that "Plaintiffs were sophisticated investors with due diligence rights, but they failed to exercise them in a meaningful way." *Id.* at 1264. While these facts are irrelevant under Section 11, they appear to have been relevant to the court's decision.

95. Pursuant to the post-earnings statement exception, the only instance where reliance is an element of a Section 11 claim is when a company has issued an earnings statement covering at least twelve months following the date of the registration statement. *See* sources cited *supra* note 44.

96. Stark Trading v. Falconbridge Ltd., 552 F.3d 568, 573 (7th Cir. 2009) ("plaintiffs' claim under [S]ection 11 . . . does not require proof of reliance."); *In re* Constar Int'l Inc. Sec. Litig., 585 F.3d 774, 784 (3d Cir. 2009) ("reliance is *not* an element under § 11"); *In re* Initial Pub. Offering Sec. Litig., 483 F.3d 70, 73 n.1 (2d Cir. 2007) (quoting Rombach v. Chang, 355 F.3d 164, 169 n.4 (2d Cir. 2004) ("Neither Section 11 nor Section 12(a)(2) requires that plaintiffs allege . . . reliance . . . ."); Sherman v. Network Commerce, Inc., 94 Fed App'x. 574, 575 (9th Cir. 2004) (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200 (1976) ("Because [Section] 11 is a strict liability provision . . . a plaintiff need not allege or prove reliance."); Rosenzweig v. Azurix Corp., 332 F.3d 854, 872 (5th Cir. 2003) ("[Section] 11 . . . imposes liability without a showing of fraud or reliance"); Alpern v. Utilicorp United, Inc., 84 F.3d 1525, 1541 (8th Cir. 1996) ("A claim under [Section] 11 does not require proof of reliance . . . ."); Glassman v. Computervision Corp., 90 F.3d 617, 628 n.13 (1st Cir. 1996) (stating "Section 11. . . claims do not require allegations of scienter and reliance").

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

against the issuer of a security is virtually absolute."[98] The Supreme Court's unambiguous language in *Herman & MacLean* provides strong support that reliance is not an element of a plaintiff's prima facie case.[99]

2. Misstatement or Omission? Section 11 Omits Any Reference to Reliance

In all statutory construction cases, as set forth by the Supreme Court, "[t]he first step 'is to determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case.'"[100] The inquiry ceases "if the statutory language is unambiguous and the statutory scheme is coherent and consistent."[101] When performing this analysis, the plain language of Section 11 leaves little room for interpretation. Other than the earnings statement exception, nothing in the text of Section 11 mentions reliance as an element of a Section 11 claim.[102] The fact that Congress specifically enumerated a single instance where reliance is required lends persuasive support to the proposition that reliance is not otherwise necessary to establish a Section 11 claim.[103] To read otherwise would make the post-earnings exception redundant. If one is to assume that recovery under Section 11 is always conditioned upon proof of reliance, then the earnings statement exception would be unnecessary.[104]

D. Relying on History to Disprove Reliance

While the plain language of Section 11 makes clear that reliance is not an element of a Section 11 claim, further support can be found by placing the statute's words in their proper context, by reference to legislative history.[105] Significantly, the original language of Section

98. *Id.*

99. *Id.*

100. Barnhart v. Sigmon Coal Co., Inc., 534 U.S. 438, 450 (2002) (quoting Robinson v. Shell Oil Co., 519 U.S. 337, 340 (1997)). The language of a statute controls when it is sufficiently clear in its context. *E.g., Ernst & Ernst*, 425 U.S. at 201; *accord* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 174-75 (1994) (stating that "[t]he ascertainment of congressional intent with respect to the scope of liability created by a particular section of the Securities Act must rest primarily on the language of that section" (quoting Pinter v. Dahl, 486 U.S. 622, 653 (1988))).

101. *Barnhart*, 534 U.S. at 450 (internal quotation marks omitted).

102. *See* 15 U.S.C. § 77k (2006).

103. *See* sources cited *infra* notes 115-118 and accompanying text.

104. *See id.*

105. *See* Tidewater Oil Co. v. United States, 409 U.S. 151, 157 (1972) ("[W]hile the clear meaning of statutory language is not to be ignored . . . it is essential that we place the words of a statute in their proper context by resort to the legislative

11 made no reference to the element of reliance. The post-earnings exception was not contained in Section 11 as originally enacted by Congress in 1933.[106] Section 11 was amended to include this language in 1934, at the same time Congress enacted the Securities Exchange Act.[107] This fact is significant for two reasons. First, the language used in Section 11 can be compared to analogous provisions in the 1934 Act to better understand Congress' intent. Second, a thorough review of the 1934 congressional record reveals that Congress contemplated adding reliance as an element of Section 11 claims and rejected the idea.[108]

Comparing Section 11 to Section 18 of the Securities Exchange Act (hereinafter "Section 18")[109] also provides important insight. Section 18 is the analogous provision to Section 11, imposing liability upon "any person" who makes a materially false or misleading statement in an "application, report, or document filed pursuant to" the Securities Exchange Act.[110] Unlike Section 11, a Section 18 cause of action is predicated upon a showing of reliance.[111] According to the plain language of the statute, a potentially liable party's liability is limited "to any person (not knowing that such statement was false or misleading) who, *in reliance upon such statement,* shall have purchased or sold a security."[112] As one appellate court observed, "The requirements under [S]ection 11 stand in stark contrast to those of [Section 18(a) of] the [Securities Exchange Act] which include a showing of reasonable reliance."[113]

During the House debate, Representative Rayburn[114] explained

history.").

106. *See* 15 U.S.C. § 77k (2006).

107. *See id.*

108. *See* discussion *infra* Part IV.E.

109. 15 U.S.C. § 78r (2006).

110. *Id.*

111. *Id.*; *see also In re* Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 283 (3d Cir. 2006) ("Section 18 creates a private remedy for damages resulting from the purchase or sale of a security in *reliance* upon a false or misleading statement . . . .") (emphasis added); Julie A. Herzog, *Fraud Created the Market: An Unwise and Unwarranted Extension of Section 10(b) and Rule 10b-5*, 63 GEO. WASH. L. REV. 359, 401 (1995) ("Congress expressly permitted investors to recover . . . without a showing of reliance under section 11 of the 1933 Act, but then required under section 18 of the Act that the investor prove direct reliance on the 1934 Act documents filed with the SEC.").

112. 15 U.S.C. § 78(r) (2006) (emphasis added). Section 18 further states that liability is limited to "damages caused by such *reliance*." *Id.* (emphasis added).

113. *In re* Adams Golf, Inc. Sec. Litig., 381 F.3d 267, 273 n.5 (3d Cir. 2004).

114. Samuel Rayburn, a Democratic congressional representative from Texas, served in the United States House of Representatives from 1913 to 1961. *Samuel Rayburn Biography,* BIOGRAPHICAL DIRECTORY OF THE UNITED STATES CONGRESS, http://bioguide.congress.gov/scripts/biodisplay.pl?index=r000082 (last visited Nov. 12,

that, compared to Section 18, "[t]he Securities Act of last year and its liability provisions [e.g., Section 11] go a great deal further."[115] Had Congress intended for reliance to be an element of a Section 11 claim, there would have been no reason to use different language in Section 18.[116] The same Congress passed both Section 11 and Section 18.[117] Had Congress understood Section 11 as requiring proof of reliance, it would have used identical language in Section 18 with the understanding that reliance was required under both Acts. However, Congress chose to use different language in Section 18 that explicitly required proof of reliance. Accordingly, Section 18 illustrates that when Congress desired reliance to be an element of a cause of action, it knew how to state so expressly.[118] Conversely, when Congress

2010). He acted as chairman on the Committee on Interstate and Foreign Commerce during the years the Securities Act and Exchange Act were passed and was later elected as Speaker of the House. *Id.*

115. 73 CONG. REC. 8040 (1934), *reprinted in* 4 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 8, at 8040 (J. S. Ellenberger & Ellen P. Mahar eds., 1973). Representative Rayburn's statements were made in disagreement to an amendment that would have predicated Section 18 liability upon a showing that the defendant knew the materially misleading statement was false. *Id.* at 8039-40. Representative Rayburn stated, "[w]e have been passing laws here which went a great deal further than this." *Id.* at 8039. "A man has to prove [under Section 18] not only that the statement was false and misleading but that he relied on the statement." *Id.* When challenged about what statutes "went a great deal further," Rayburn responded, "The Securities Act of last year and its liability provisions." *Id.* at 8040.

116. Notably, initial bills proposed in both the House and Senate did not include reliance as an element of a Section 18 claim. *See* H.R. 7852, 73d Cong. § 17 (1934), *reprinted in* 10 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 24, at 31-32 (J. S. Ellenberger & Ellen P. Mahar eds., 1973) (stating civil liability for misleading statements would extend to "[a]ny person . . . who shall have purchased or sold a security the price of which may have been affected by such statement"); H.R. 7855, 73d Cong. §17 (1934) *reprinted in* 10 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 25, at 32 (J. S. Ellenberger & Ellen P. Mahar eds., 1973) (same); H.R. 8720, 73d Cong. § 17 (1934), *reprinted in* 10 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 28, at 42-43 (J. S. Ellenberger & Ellen P. Mahar eds., 1973) (providing a cause of action extending to "[a]ny person who shall have purchased or sold a security to which such statement related"); S. 2693, 73d Cong. § 17 (1934), *reprinted in* 11 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 34, at 31-32 (J. S. Ellenberger & Ellen P. Mahar eds., 1973) (creating a cause of action for "[a]ny person . . . who shall have purchased or sold a security the price of which may have been affected by such [misleading] statement").

117. The 73rd Congress served from 1933-1935, the years in which the Securities Act and Securities Exchange Act were passed. *See House History*, OFFICE OF THE CLERK: U.S. HOUSE OF REPRESENTATIVES, http://clerk.house.gov/art_history/house_history/index.html?cong=73 (last visited Nov. 12, 2010).

118. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733-34 (1975) (comparing the language of Section 10(b) to the parallel antifraud provision in the

expressly added reliance as an element of a Section 18 claim, it could have modified the language of Section 11 to mirror that of Section 18, but declined to do so.

E. A Failed Proposition: Congress Rejects Reliance as an Element of a Section 11 Claim

Further review of the congressional history of the Securities Act and the 1934 amendments to the Securities Act makes clear that Congress contemplated, but rejected, the idea of adding reliance as an element to Section 11 claims.

In 1933, there were two proposals that would have included a presumption of reliance in Section 11 claims. The first, House Bill 4314, introduced by Representative Rayburn, contained a provision stating that "the public shall be presumed to rely upon the representation set forth in the said statement."[119] The Investment Bankers Association also proposed an amendment that would have added a rebuttable presumption of reliance to Section 11 claims.[120] Both of these proposals were ultimately rejected in favor of the adopted language, which made no reference to the element of reliance.[121]

In 1934, while crafting the Exchange Act, several members of Congress proposed amendments to alter Section 11. On May 4, 1934, Senator Fletcher[122] proposed amendments to the Senate bill that

Securities Act, Section 17(a), and recognizing that had Congress wanted the two provisions to have the same meaning, it would have adopted the same language used in the Securities Act). In addressing express versus implied rights of action under the securities laws, the Supreme Court again recognized that had Congress desired analogous provisions to reach similar results, it would have adopted similar language. *See* Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 20-21 (1979) ("Congress provided an express damages remedy for misrepresentations contained in an underwriter's registration statement in [Section] 11(a) of the Securities Act of 1933, and for certain materially misleading statements in [Section] 18(a) of the Securities Exchange Act of 1934. 'Obviously, then, when Congress wished to provide a private damages remedy, it knew how to do so and did so expressly.'") (quoting Touche Ross & Co. v. Redington, 442 U.S. 560, 572 (1979)).

119. H.R. 4314, 73d. Cong. § 9 (1933), *reprinted in* 3 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 22, at 19 (J. S. Ellenberger & Ellen P. Mahar 1973).

120. *Securities Act: Hearing on S. 875 Before the S. Comm. on Banking & Currency*, 73d Cong. 335 (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item. No. 21, at 340 (J. S. Ellenberger & Ellen P. Mahar eds., 1973) (purchasers of securities "shall be presumed to have relied upon the representations set forth in the registration statement with respect thereto, unless the contrary is proved").

121. *See* 15 U.S.C. § 77k (2006).

122. Duncan Fletcher, Democratic Senator from Florida, served from 1909 to 1936. *Duncan Fletcher Biography*, BIOGRAPHICAL DIRECTORY OF THE UNITED STATES CONGRESS, http://bioguide.congress.gov/scripts/biodisplay.pl?index=F000200 (last

would have added reliance as an element of Section 11 claims.[123] In an explanatory statement of his proposed amendments, Senator Fletcher stated that the amendment to Section 11 would "limit[ ] recovery . . . to those persons who acquire securities *in reliance on* such misstatements or omissions."[124] Subsequently, on May 12, Senator Fletcher proposed a new set of amendments, which eliminated the reliance requirement and instead added the earnings statement exception.[125] This new set of amendments came with a new explanatory statement that no longer interpreted Section 11 as requiring proof of reliance.[126] Another legislator, Senator Walcott,[127] proposed an amendment that would have altered Section 11 "by striking out 'acquiring' and inserting in lieu thereof 'who, *in reliance on* such registration statement . . . acquires.'"[128] A vote was taken, and Senator Walcott's amendment was rejected in favor of Senator

---

visited Nov. 12, 2010). He served on the Committee on Banking and Currency during the 73rd Congress, the same term the Securities Exchange Act was passed. *Id.*

123. *Senator Fletcher's Proposed Amendment to S. 3420*, 73d Cong. § 206 (1934), *reprinted in* 11 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item. No. 38, at 6 (J. S. Ellenberger & Ellen P. Mahar 1973) (amending the first paragraph of Section 11(a) "by striking out the word 'acquiring' and inserting in lieu thereof 'who in reliance on such statement or omission, acquires'").

124. 78 CONG. REC. 8185 (1934) (emphasis added), *reprinted in* 4 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 10, at 8185 (J. S. Ellenberger & Ellen P. Mahar eds., 1973).

125. *Id.* at 8668.

> SEC. 206. (a) Section 11 (a) of such act is amended by adding, after the last line thereof, the following new sentence:
>
> > If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least 12 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.

Id.

126. *Id.* at 8669 (removing the following paragraph that was present in the May 7, 1934 explanatory statement at 8185: "Amendment to Section 11 (a): This amendment limits recovery under section 11 for damages resulting from misstatements or omissions in registration statements to those persons who acquire securities in reliance on such misstatements or omissions.").

127. Frederic Walcott, Republican Senator from Connecticut, served in the Senate from 1929 to 1935. *Frederick Collin Walcott Biography*, BIOGRAPHICAL DIRECTORY OF THE UNITED STATES CONGRESS, http://bioguide.congress.gov/scripts/biodisplay.pl?index=W000032 (last visited Sept. 27, 2010).

128. 78 CONG. REC. 8702 (1934) (emphasis added), *reprinted in* 4 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 10, at 8702 (J. S. Ellenberger & Ellen P. Mahar eds., 1973).

Fletcher's amendment, which did not condition recovery under Section 11 upon a showing of reliance.[129]

Also printed into the congressional record on May 12 was a letter from James M. Landis,[130] Commissioner of the Federal Trade Commission, addressing several of the proposed amendments.[131] In addressing amendments that purported to include reliance as an element of Section 11, Landis stated, "I do not believe that the requirement of reliance is consonant with the present-day methods of distributing securities in this country."[132] He went on to state that "the requirement of reliance, especially with the burden of proof upon the purchaser, will place altogether too hopeless a burden upon any attempt at recovery by the purchaser of a security."[133] In commenting on suits against responsible parties, such as a subject issuer's directors, officers, or experts, Landis stated that "the only practical object of the provision [including reliance as an element of Section 11] is to relieve responsible persons of the major possibility of a successful action against them."[134]

On May 30, 1934, after much debate, the House and Senate agreed to recommend to their respective Houses an amendment to Section 11 using the language of the Fletcher amendment, which included the post-earnings exception but did not include reliance as an element for Section 11 claims.[135] This language was eventually codified and added to Section 11. Senator Byrnes explained the justification for not requiring reliance until a 12 months' earnings statement is made public:

> When an issue of securities is proposed, a banking house will investigate the financial statement of the corporation. Based upon the statements contained in the registration statement of the corporation, a banking house will offer the securities at a certain

---

129. *Id.* at 8708.

130. James M. Landis was acting Commissioner of the Federal Trade Commission in 1934 when he provided his opinion on the proposed amendments to S. 3420. *James M. Landis Biography*, JFK PRESIDENTIAL LIBRARY & MUSEUM, http://www.jfklibrary.org/Historical+Resources/Archives/Archives+and+Manuscripts/Kennedy.john+F/jfk_prez/whstaff/fa_landis_wh.htm (last visited Nov. 12, 2010). He went on to serve as Chairman of the Securities and Exchange Commission from 1935 to 1937 and then acted as Dean of Harvard Law School. *Id.*

131. 78 CONG. REC. 8714-17 (1934), *reprinted in* 4 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 10, at 8714-17 (J. S. Ellenberger & Ellen P. Mahar eds., 1973).

132. *Id.* at 8716.

133. *Id.*

134. *Id.*

135. S. DOC. NO. 185 (1934) (Conf. Rep.), *reprinted in* 4 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 13, at 9941 (J. S. Ellenberger & Ellen P. Mahar eds., 1973).

> price. Therefore, the market value is fixed by the false statement of the corporation. The individual investor relies upon the investigation made by the banker. It is fair to assume that this situation continues until such time as the corporation makes available a statement showing its earnings for 12 months. Then the market value is influenced by the statement of actual earnings and not by the statements contained in the registration statement, which deceived the underwriter or banker and the investor.[136]

These statements illustrate that Congress was not focused on an individual's reliance on the misleading statements or half-truths, but rather on how such statements affect the value of the subject security.

The congressional record reflects an extended debate over whether reliance should be added as an element to all Section 11 claims.[137] The position adopted by both the House and Senate, and subsequently codified, rejected reliance as a requirement for Section 11 claims. Based on the statutory language of Section 11,[138] the traditional interpretation of Section 11 by federal courts,[139] and the detailed congressional history,[140] it is abundantly clear that the Eleventh Circuit, as well as other courts that have followed its lead,[141] is incorrect in holding that reliance is an element of a Section 11 claim.

V. TRACING BACK TO THE INITIAL ATTACK

The addition of reliance as an element of a Section 11 claim is a recent illustration of the judiciary's restrictive interpretation of the securities laws. However, the judiciary's initial attack on Section 11 came over thirty years ago with the introduction of the "tracing" requirement. A claim under Section 11 is available to "any person acquiring *such* security."[142] In 1967, the Second Circuit, after rejecting a broader reading, interpreted this phrase narrowly as limiting the availability of Section 11 to individuals "acquiring a security issued pursuant to the registration statement."[143] As described by one court, Section 11 is available "not only to those who

---

136. 78 CONG. REC. 10186 (1934), *reprinted in* 4 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 14, at 10186 (J. S. Ellenberger & Ellen P. Mahar eds., 1973).

137. *See* sources cited *supra* notes 114-36 and accompanying text.

138. Section 11, *supra* note 6.

139. *See supra* notes 96-99 and accompanying text.

140. *See supra* Part IV.E.

141. *See* cases cited *supra* notes 48-52, 88-92.

142. *See* 15 U.S.C. § 77k(a) (emphasis added).

143. *See* Barnes v. Osofsky, 373 F.2d 269, 271 (2d Cir. 1967) (rejecting the broader interpretation that Section 11 is available to anyone "acquiring a security *of the same nature* as that issued pursuant to the registration statement") (emphasis added).

purchased their stock during the relevant public offerings, but also to aftermarket purchasers as long as the stock is 'traceable' back to the relevant public offering."[144] Virtually every circuit has adopted the tracing requirement for aftermarket purchasers.[145] Thus, to prevail on a cause of action under Section 11, a plaintiff must plead, and eventually prove, that the securities he/she purchased were issued pursuant to the allegedly defective registration statement.[146] Where stock has exclusively entered the securities markets via a single public offering, all holders of that stock will fulfill the tracing requirement as a matter of logic.[147] However, where there is a mixture of pre- and post-registration stock, such as securities issued by means of private offerings or subsequent registered offerings, as well as stock sold pursuant to the subject registration statement, proof of tracing is problematic.[148]

The already burdensome task of proving tracing has become even more onerous as a growing number of courts have rejected the use of statistical evidence to prove tracing.[149] This is true even when the pool of stock on the market contains 99.85% registered stock.[150]

---

144. Krim v. pcOrder.com, Inc., 402 F.3d 489, 492 (5th Cir. 2005).

145. *Accord* APA Excelsior III L.P. v. Premiere Techs, Inc., 476 F.3d 1261, 1271 (11th Cir. 2007) (noting that plaintiffs must be able to "trace" their securities to the defective registration statement); *In re* Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 274 n.7 (3rd Cir. 2006) (agreeing with the applicability of the tracing requirement in Section 11 claims); Krim v. pcOrder.com, Inc., 402 F.3d 489, 498 (5th Cir. 2005) (stating Section 11 is available to aftermarket purchaser whose "shares are traceable to the registration statement in question"); DeMaria v. Andersen, 318 F.3d 170, 178 (2d Cir. 2003) (holding that Section 11 applies to "aftermarket purchasers who can trace their shares to an allegedly misleading registration statement"); Lee v. Ernst & Young, LLP, 294 F.3d 969, 978 (8th Cir. 2002) (holding aftermarket purchasers have standing if they can trace their shares to the registration statement); Joseph v. Wiles, 223 F.3d 1155, 1160 (10th Cir. 2000) (adopting the "tracing" theory for standing to sue under Section 11); Hertzberg v. Dignity Partners, Inc., 191 F.3d 1076, 1080 n.4 (9th Cir. 1999) ("[A] plaintiff must either show that he purchased his stock in the initial offering or trace his later-purchased stock back to the initial offering.").

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

147. *Krim*, 402 F.3d at 496 n.34 (quoting Rosenzweig v. Azurix Corp., 332 F.3d 854, 873 (5th Cir. 2003)) ("[B]ecause there was only *one* offering of Azurix stock, all the plaintiffs' stock is traceable to the challenged registration statement."); Joseph v. Wiles, 223 F.3d 1155, 1160 (10th Cir. 2000) ("[B]ecause [the defendant] made only one debenture offering, the debentures [the plaintiff] purchased are directly traceable to the May offering and registration statement."); *Hertzberg*, 191 F.3d at 1080 (granting aftermarket purchasers standing because "the only Dignity stock ever sold to the public was pursuant to the allegedly misleading registration statement at issue in this case.").

148. *Hertzberg*, 191 F.3d at 1080 n.4; Brian Murry, *Aftermarket Purchaser Standing Under § 11 of the Securities Act of 1933*, 73 ST. JOHN'S L. REV. 633, 635-36 (1999).

149. *See infra* Part V.A.

150. *See infra* notes 155-59 and accompanying text.

This section will (a) discuss a decision from the Fifth Circuit that rejected the use of statistical evidence as a means of fulfilling the tracing requirement; (b) survey other circuits' stance on the use of statistical evidence as a means of fulfilling the tracing requirement; and (c) discuss why statistical evidence should be sufficient to fulfill the tracing requirement.

A. *Plaintiffs Left Without a Leg to Stand on: The Fifth Circuit Rejects the Use of Statistical Tracing to Prove Standing*

Krim v. pcOrder.com involved a Section 11 claim against pcOrder.com alleging materially false and misleading statements made in registration statements filed for two different public offerings.[151] "PcOrder.com conducted an initial public offering ("IPO") of pcOrder.com stock on Feruary 26, 1999, and a secondary public offering ("SPO") on December 7, 1999."[152] All lead plaintiffs purchased their stock in the secondary market, not during the public offerings.[153] Accordingly, the court considered the claims of three lead plaintiffs, Beebe, Burke, and Petrick, to determine if any "could trace their stock back to either of the public offerings."[154]

The Court concluded that at the time Beebe purchased his 1,000 shares of stock, the pool of stock on the market contained only IPO stock.[155] Therefore, Beebe's stock was necessarily IPO stock and the tracing requirement was met.[156] In contrast, the court concluded that Burke and Petrick could not meet the tracing requirement and thus lacked standing.[157] Burke purchased 3,000 shares of pcOrder.com stock in June 1999.[158] At that time, a minute percentage of non-IPO shares, specifically insider shares, had entered the pool of stock on the market, but "IPO shares still comprised 99.85% of the pool."[159] After the SPO, Burke and Petrick purchased additional shares "at a time when IPO and SPO shares (collectively "PO stock") constituted

151. 402 F.3d 489, 491-92 (5th Cir. 2005) ("Plaintiffs alleged that the registration statements were false and misleading by indicating that pcOrder.com had a viable business plan, had an ability to generate and report accurate operating and financial information, and was not competing with Trilogy Software for revenue.").

152. *Id.* at 491. PcOrder filed registration statements with the SEC in connection with both public offerings. *Id.*

153. *Id.* at 492.

154. *Id.* at 492 n.2. For an aftermarket purchaser to have standing, they must be able to 'trace' their securities to the allegedly defective registration statement. *See sources cited infra* notes 157-63 and accompanying text.

155. *Krim*, 402 F.3d at 492.

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.*

91%" of the pool of stock on the market.[160] Plaintiffs offered expert testimony indicating that "the probability that each Lead Plaintiff owned at least one share of PO stock was very nearly 100%."[161] Nonetheless, the court affirmed the district court's holding that Bruke and Petrick lacked standing, explaining that "[t]he task before the district court was to determine, by a preponderance of the evidence, whether and in what amount a plaintiff's shares are tainted" and that "statistical tracing is not up to the task at hand."[162] As the district court noted, "Plaintiffs must demonstrate *all* stock for which they claim damages was actually issued pursuant to a defective registration statement, not just that it might have been, probably was, or most likely was, issued pursuant to a defective statement."[163]

B. *Other Lower Federal Courts: Section 11 Claims Disappearing Without a "Trace"*

The Fifth Circuit appears to be the only appellate court that has ruled on the sufficiency of statistical evidence as a means of proving tracing. Nonetheless, the weight of authority among federal district courts rejects the use of statistical evidence to prove tracing.[164] Prior to *Krim*, district courts that addressed the issue of statistical tracing universally rejected it.[165] One of the earliest and most detailed rejections of statistical tracing was issued in 1984 by a district court

---

160. *Id.*

161. *Id.*

> The expert arrived at the odds of getting at least one PO . . . share using elementary principles of binomial probability. . . . The expert treated the purchase of shares as a series of independent random draws from the stock pool . . . and calculated the probability that at least one of the shares would be tainted according to the following formula: $1\text{-}(1\text{-}PO\%)^{\#\ shares}$, where PO% is the percentage of stock in the market and *# shares* is the number of shares owned.

Id. at 492-93 n.6 (internal citations omitted).

162. *Id.* at 501-02.

163. *Id.* at 493 (quoting Krim v. pcOrder.com, Inc., 210 F.R.D. 581, 586 (W.D. Tex. 2002)).

164. *See infra* notes 165, 173, 175, 182-83 and accompanying text.

165. *See, e.g.*, *In re* Quarterdeck Office Sys., Inc. Sec. Litig., No. CV 92-3970-DWW(GHKx), 1993 WL 623310, at *2-3 (C.D. Cal. Sept. 30, 1993) (holding ninety-seven percent probability that the shares were sold in the public offering insufficient to establish tracing); *In re* Elscint, Ltd. Sec. Litig., 674 F. Supp. 374, 380 (D. Mass. 1987) (stating statistical evidence showing 82% probability plaintiffs shares included some tainted shares was insufficient to meet preponderance of the evidence standard); Kirkwood v. Taylor, 590 F. Supp 1375, 1378-81 (D. Minn. 1984) (summary judgment granted after rejecting "fungible mass" statistical tracing method); Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 874-76 (N.D. Cal. 1986) (rejecting use of "fungible mass" statistical tracing).

in Minnesota.[166] In *Kirkwood*, the public offering at issue consisted of 1.32 million shares of registered stock issued "in the name of Cede & Co., the nominee name of the Depository Trust Company" (hereinafter "DTC").[167] At that time, DTC already held 2.8 million shares of the subject issuer's stock registered in its nominee name from previous registered offerings.[168] "DTC [held] all certificates, both old and new, in its nominee name as . . . [one] fungible mass for the benefit of all its [participating brokers]."[169] Plaintiffs purchased their shares after the public offer date through brokers that were members of DTC.[170] At that time, more than 25 percent of DTC's shares were from the registered offering in question, and since there was no way to differentiate "old" from "new" shares, plaintiffs argued they should be deemed to own a proportionate interest of "new" shares (i.e., 25 percent).[171] The court rejected plaintiffs' argument, dubbed the "fungible mass tracing theory," reasoning that "plaintiffs are showing only that their securities *might* have been issued in the public offering and they are asking the court to presume that a pro rata portion of their shares are new shares."[172]

Adding to these decisions, *Krim* appears to have provided momentum to the trend of rejecting statistical tracing, as other courts have elected to follow *Krim's* lead.[173] Further, district courts

166. *Kirkwood*, 590 F. Supp. at 1378-83.

167. *Id.* at 1378-79. The Depository Trust Company "is a stock clearing house, owned by a number of brokerage firms." *Id.*

168. *Id.* The issuer had a total of 6.9 million shares outstanding from previous offerings at the time of the public offering at issue in this case. *Id.*

169. *Id.* at 1379. Purchases and sales from participating brokers are accomplished through book entries crediting or debiting the brokerage firm's account, which facilitates the transfer of securities by not requiring physical movement or a change in registered name of any certificates. *Id.*

170. *Id.*

171. *Id.*

172. *Id.* at 1380 (emphasis added). The court also agreed with defendant's argument that, under the fungible mass tracing theory, the "[i]ssuer could find itself liable for far more than the number of shares issued in the challenged offering." *Id.* For an explanation of how this argument is misplaced, *see infra* notes 180-84 and accompanying text.

173. *See, e.g.*, Grand Lodge of Pa. v. Peters, 550 F. Supp. 2d 1363, 1374 (M.D. Fla. 2008) (adopting *Krim's* position that "[s]tanding cannot be based on statistical likelihoods that all of the securities purchased can be traced to a specific faulty registration statement"); *In re* FleetBoston Fin. Corp. Sec. Litig., 253 F.R.D. 315, 351 n.40 (D.N.J. 2008) (thoroughly discussing *Krim's* rejection of statistical tracing and drawing a distinction between the "uncertain 'statistical tracing'" rejected in *Krim* from the "reliable 'mathematical tracing'" at issue in the case at bar); Davidco Investors, LLC v. Anchor Glass Container Corp., No. 8:04CV2561T-24EAJ, 2006 WL 547989, at *23 (M.D. Fla. Mar. 6, 2006) (relying on *Krim* for the premise that "[s]tanding [in a Section 11 claim] cannot be based on a statistical tracing theory, i.e., by showing a *very high probability* that shares can be traced to the allegedly defective

that have not directly addressed the issue of statistical tracing have implicitly rejected its invocation, following logic similar to that in *Kirkwood*.[174]

C. *Adding it All Up: Why Statistical Evidence Should Be Sufficient to Prove Tracing*

The argument that statistical evidence should be sufficient to establish tracing is supported by three concepts. First, tracing has been framed as an issue of standing.[175] Accordingly, any evidence, direct or circumstantial, that can establish standing by a preponderance of the evidence should be sufficient.[176] Second, allowing statistical tracing closes a loophole that would otherwise provide issuers and other subject defendants, in practical effect, with immunity from Section 11 claims. Third, allowing statistical evidence to establish tracing is consistent with the purpose of the Securities Act and consistent with the use of statistical evidence to prove affirmative defenses under Section 11.

Tracing is a judicially created doctrine.[177] Nevertheless, Section

---

registration statement"); *In re* Alamosa Holdings, Inc., 382 F. Supp. 2d 832, 864 (N.D. Tex. 2005) (applying *Krim* by stating "mere probability that a plaintiff can trace shares is clearly insufficient" to establish standing).

174. *See, e.g., Kirkwood*, 590 F. Supp. at 1380-81; Lorber v. Beebe, 407 F. Supp. 279, 287 (S.D.N.Y. 1975) ("[I]t is insufficient that stock 'might' have been issued pursuant to a defective statement. A plaintiff must show that it actually was so issued.") (internal citation omitted); McFarland v. Memorex Corp., 493 F. Supp. 631, 642 (N.D. Cal. 1980) ("Alleging or proving that the stock, purchased in the open market, might have been issued pursuant to the registration statement [was insufficient].").

175. *See* APA Excelsior III, L.P. v. Premiere Techs, Inc., 476 F.3d 1261, 1276 (11th Cir. 2007) ("[T]o have standing and prevail on a claim under Section 11 a plaintiff must be able to trace his stock to the defective registration statement."); Krim v. pcOrder.com, 402 F.3d 489, 495-96 (5th Cir. 2005) ("[A]ftermarket purchasers seeking standing must demonstrate the ability to 'trace' their shares to the faulty registration."); DeMaria v. Andersen, 318 F.3d 170, 178 (2d Cir. 2003) ("[A]ftermarket purchasers who can trace their shares to an allegedly misleading registration statement have standing under [Section] 11."); Lee v. Ernst & Young, LLP, 294 F.3d 969, 974-78 (8th Cir. 2002) (concluding aftermarket purchasers must be able to trace their stock to the allegedly faulty registration statement to have standing).

176. *See In re* Elscint, Ltd. Sec. Litig., 674 F. Supp. 374, 380 (D. Mass. 1987).

177. The requirement of "tracing" was judicially recognized in 1967 when Judge Friendly interpreted the phrase "any person acquiring *such* security" in Section 11. Barnes v. Osofsky, 373 F.2d 269, 271 (2d Cir. 1967) (emphasis added). Judge Friendly reasoned that since "such" has no referent, the phrase is open to two interpretations: (1) Section 11 applies to any person "acquiring a security issued pursuant to the registration statement" or (2) Section 11 applies more broadly to any person "acquiring a security of the same nature as that issued pursuant to the registration statement." *Id.* After reviewing the purpose and legislative history of the Securities Act, Judge Friendly adopted the narrow reading and thus established what would be known as the "tracing" requirement. *See id*; Hillary A. Sale, *Disappearing Without a Trace: Sections 11 & 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429, 431 (2000).

11's legislative history provides support that Section 11 should not be confined to purchasers who can trace their shares to the allegedly defective registration statement.[178] Prior to the enactment of the Securities Act, the House of Representatives Committee on Interstate and Foreign Commerce set forth a general summary of Section 11, stating: "Inasmuch as the value of a security may be *affected* by the information given in the registration statement . . . the civil remedies accorded by this subsection . . . are given to *all purchasers* regardless of whether they bought their securities . . . at the time of the original offer or at some later date."[179] Additionally, the Committee observed that it is "within the constitutional power of Congress to accord a remedy to *all purchasers* who may reasonably be *affected* by *any statements* in the registration statement."[180] The sweeping language the Committee used, describing Section 11 as applying to "all purchasers" *affected* by "any statement" in the registration statement, indicates that Congress intended Section 11 to apply to anyone acquiring a security of the same nature as that issued pursuant to the registration statement and whose value was *affected* by the material misstatement.[181]

However, in view of the confines of the judicially created tracing requirement, statistical evidence should be deemed sufficient. Tracing has been framed as a matter of standing and thus the appropriate burden of proof is by a preponderance of the evidence.[182] As stated by one district court, "one would expect that a claimant may recover under Section 11 if able to prove, by a preponderance of

---

178. Barnes v. Osofsky, 373 F.2d 269, 273 (2d Cir. 1967).

179. H.R. REP. 73-85, at 22 (1933) (emphasis added), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 18, at 22 (J. S. Ellenberger & Ellen P. Mahar eds., 1973).

180. *Id.* (emphasis added).

181. Both the Senate and House of Representatives had proposed bills that would have provided a civil remedy based on a material misstatement to "*any* persons acquiring *any securities to which such statement relates*, either from the original issuer or from any other person." S. 875, 73d Cong. §9 (1933) (emphasis added), *reprinted in* 3 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 & SECURITIES EXCHANGE ACT OF 1934, Item 28, at 18-19 (J.S. Ellenberger & Ellen P. Mahar eds., 1973); H.R. 4314, 73d Cong. §9 (1933) (as referred to the House Interstate and Foreign Commerce Committee) (emphasis added), *reprinted in* 3 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 & SECURITIES EXCHANGE ACT OF 1934, Item 22, at 19 (J.S. Ellenberger & Ellen P. Mahar eds., 1973). Both bills were rejected in favor of the language ultimately adopted. *See also* SEC v. Tambone, 597 F.3d 436, 444-45 (1st Cir. 2010) (en banc) (interpreting the word "make" in Rule 10b-5 to limit the provision's reach by distinguishing the term "make" from the broader term "use").

182. *See* Krim v. pcOrder.com, 402 F.3d 489, 494 n.21 (5th Cir. 2005); *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 390-91 (1983) (adopting the preponderance-of-the-evidence standard for causes of action under the Securities Acts); *see* Steinberg, *supra* note 44, at 393; *see* Sale, *supra* note 177, at 441.

the evidence, the purchase of some particular number of [ ] shares" pursuant to the allegedly defective registration statement.[183] This proof "may be either direct or circumstantial, or both, and circumstantial evidence may include statistical evidence."[184] With this in mind, a plaintiff should be able to establish tracing by offering statistical evidence that proves by a preponderance of the evidence (i.e. 50.01%) that he/she purchased shares pursuant to the allegedly defective registration statement.

By rejecting the use of statistical evidence to establish tracing, courts open a loophole that allows issuers and insiders to immunize themselves from Section 11 liability with relative ease.[185] Although persons who acquired their securities directly from a subject underwriter or dealer as "initial investor purchasers" in a registered offering clearly have standing, aftermarket purchasers currently face formidable obstacles. Today, industry practice is to issue stock in "street name."[186] With "street name" stock, direct tracing is virtually impossible in all practicality as there is no feasible means to distinguish registered stock from non-registered stock or to determine who purchased a particular share of stock.[187] As such, it only takes one share of non-registered stock on the market to pollute the entire pool and absolve the issuer, and other subject persons, of potential liability under Section 11.[188] Compounding this issue is the ease by which an issuer can introduce such non-registered securities into the market. For example, stock issued pursuant to Rule 506[189] is

183. *In re* Elscint, Ltd. Sec. Litig., 674 F. Supp. 374, 380 (D. Mass. 1987).

184. *Id.*

185. *See Krim*, 402 F.3d at 502 (finding that statistical tracing is not sufficient to "satisfy this traceability requirement").

186. *See Krim*, 402 F.3d at 498 n.42 (recognizing the "widespread practice of holding securities in street name" (quoting Silber v. Mabon, 957 F.2d 697, 700 (9th Cir. 1992))). Under "street name" registration, the security is registered in the name of a brokerage firm on the issuer's books, and the brokerage firm holds the security for the purchaser. *See* SEC, *Holding Your Securities—Get the Facts*, http://www.sec.gov/investor/pubs/holdsec.htm (last visited Nov. 12, 2010). This is opposed to "direct" registration where the security is registered under the purchaser's name on the issuer's books. *See id.*

187. This assumes the registered stock and the non-registered stock are issued in the same "street name."

188. *See Krim*, 402 F.3d at 492 (holding that tracing could not be established when pool of stock on the market contained .15% of non-IPO stock).

189. 17 C.F.R. § 230.506 (2010). SEC Rule 506 acts as a safe harbor for the private offering exemption available under Section 4(2) of the Securities Act. *Id.*; Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 905 (6th Cir. 2007). The Rule 506 safe harbor is attractive to issuers because it has no aggregate offering price limitations, is available to an unlimited number of accredited investors plus thirty-five non-accredited investors, and is preempted from state regulation of offerings pursuant to the National Securities Market Improvement Act of 1996. *See Brown*, 481 F.3d at 905-

exempt from registration and must only be held for at most twelve months prior to being resold.[190] Issuers and insiders desiring to immunize themselves from Section 11 liability can cause a small quantity of these unregistered shares to be sold in the public markets shortly after the time of the registered offering. This would pollute the entire pool of stock and render tracing by non-statistical means, in practical effect, nearly impossible.[191] Without statistical tracing, it only takes one non-registered share to render Section 11 inoperative as to aftermarket purchasers.[192]

Where purchasers are forced to rely on statistical evidence to fulfill the tracing requirement, there must be some appropriate means of allocating the total number of registered shares among the various securities holders. Otherwise, an issuer could be liable for more shares than were issued in the registered offering. The method suggested is two-fold. First, aftermarket purchasers would provide statistical evidence proving by a preponderance of the evidence that they hold at least one share of stock issued pursuant to the allegedly defective registration statement (i.e., "IPO stock").[193] Once standing is established, each plaintiff would be deemed to hold a proportionate number of shares of IPO stock, calculated by taking the total number of shares held by each plaintiff and multiplying that by the ratio of IPO stock/total stock on the market.[194] For example, assume an individual purchased 1000 shares of stock at a time when the market consisted of ninety percent IPO stock and ten percent non-IPO stock. This evidence would establish by nearly 100 percent that a purchaser held at least one share of stock issued pursuant to the registration

---

06; *compare* 17 C.F.R. § 230.506, *with* 15 U.S.C. § 77r (2006).

190. Securities exempt from registration under the Rule 506 safe harbor are restricted securities and are subject to the resale limitations of Rule 144, which regulates the resale of restricted securities and control securities. 17 C.F.R. § 230.144; *see* S.E.C. v. M&A West, Inc., 538 F.3d 1043, 1050-51 (9th Cir. 2008). Subject to certain volume limitations and information requirements, the holding period under Rule 144 is six months for restricted securities of Exchange Act reporting issuers and one year for restricted securities of non-reporting issuers. 17 C.F.R. § 230.144.

191. *See Krim*, 402 F.3d at 492-93.

192. *See id.* at 492.

193. For example, the calculation used in *Krim* was based on elementary principles of binomial probability using the formula: "$1\text{-}(1\text{-}PO\%)^{\#\ shares}$, where PO% is the percentage of PO [IPO] stock in the market and # *shares* is the number of shares owned." 402 F.3d at 493 n.6. For a discussion urging the adoption of proof methods from toxic substance litigation to Section 11 tracing requirements, *see* Sale, *supra* note 177, at 483-494.

194. This method has been referred to as the fungible mass tracing theory and has been rejected by several courts. *See* Abbey v. Computer Memories, Inc., 634 F. Supp. 870, 875-76 (N.D. Cal. 1986) (rejecting the "fungible mass theory as a method for tracing"); *see also* Kirkwood v. Taylor, 590 F. Supp. 1375, 1379 (D. Minn. 1984) (rejecting the fungible mass theory); Sale, *supra* note 177, at 488-90.

statement and thus fulfilled the tracing requirement.[195] Applying the ratio above, of the purchaser's 1000 shares, 900 shares would be deemed to have been issued pursuant to the allegedly defective registration statement.[196]

While statistical evidence has not been widely accepted as a means of establishing tracing, the statistical model offered herein furthers the objectives of the Securities Act without expanding a suspect defendant's liability beyond the Act's intent.[197] The civil liabilities imposed by the Securities Act are both "compensatory in nature" as well as *in terrorem*.[198] Section 11 places explicit limitations on the amount of liability a defendant may incur.[199] An appropriate measure of damages in a Section 11 suit is the "difference between the amount paid for the security," not exceeding the public offer price, and the security's subsequent decline in value.[200] In no event can the amount recoverable under Section 11 exceed the security's public offering price.[201] By applying the registered-to-non-registered stock ratio above, an issuer's liability would not exceed the amount prescribed by Section 11. Regardless of how many shares the issuer has on the market, the registered-to-non-registered stock ratio limits an issuer's liability to the number of shares in the registered offering. Further, the issuer's total liability would not increase as damages are capped at the security's registered offering price. As outlined above, without statistical tracing, issuers

---

195. *See Krim*, 402 F.3d at 492-93 n.6 (providing formula used in calculations); *see also* sources cited *supra* note 182 and accompanying text.

196. Calculated as (IPO stock/total stock on the market) multiplied by # *shares*, where # *shares* is the number of shares owned. In this example, (90%) multiplied by 1000 shares, or 900 shares. *See Krim*, 402 F.3d at 493 n.6.

197. *See id.* at 502.

198. William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173 (1933); *see also* Shulman, *supra* note 11, at 227.

199. *See* 15 U.S.C. §77k(e), (g) (2006).

200. *See* 15 U.S.C. §77k(e) (2006). Defining damages as:

> the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought.

Id.; *see, e.g.*, Akerman v. Oryx Commc'ns, Inc., 810 F.2d 336, 342 (2d Cir. 1987) ("The applicable [S]ection 11(e) formula for calculating damages is the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and . . . the value thereof as of the time such suit was brought.") (internal quotation marks omitted).

201. *See* 15 U.S.C. §77k(g) (2006).

and other insiders can avoid Section 11 liability to secondary traders by placing a single share of non-registered stock on the market. Such a result is contrary to Congress' intent, the structure and policy underlying Section 11, and fundamental principles of fairness.

Allowing statistical tracing is also consistent with the stance taken by a number of courts that allow statistical evidence to prove the affirmative defense of "negative causation."[202] Section 11(e) expressly allows a defendant to limit his/her liability by showing that the securities' drop in market price was unrelated to the material misstatement (or half-truth) contained in the registration statement.[203] This affirmative defense, which places a heavy burden of proof on the defendant, has been coined "negative causation" or "lack of loss causation."[204] Unlike tracing, courts allow defendants to establish negative causation through statistical evidence.[205] Frequently, defendants will introduce statistical evidence in the form of an "event study" to distinguish between stock decline in value related to the misstatement and stock decline in value unrelated to the misstatement.[206] To prevail on a summary judgment motion, which seeks dismissal on the ground of negative causation, the

---

202. *See* McMahan & Co., v. Wherehouse Entm't, Inc., 65 F.3d 1044, 1048 (2d Cir. 1995).

203. *See* 15 U.S.C. §77k(e) (2006) ("[I]f the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable."); Akerman v. Oryx Commc'n, Inc., 609 F. Supp. 363, 368-72 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336 (2d Cir. 1987).

204. *McMahan & Co.*, 65 F.3d at 1048 (noting that the Section 11(e) defense is known as the defense of "negative causation"); *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1422 (9th Cir. 1994) (recognizing that the negative causation defense places a "heavy burden" on defendants); *see, e.g.*, Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 234 (5th Cir. 2009) (stating that the burden to prove negative causation is "'heavy' and arises out of Congress' desire to allocate the risk of uncertainty to the defendants").

205. McKowan Lowe & Co., Ltd. v. Jasmine, Ltd., No. Civ. 94-5522 RBK, 2005 WL 1541062, at *12 (D.N.J. June 30, 2005) (finding that defendant's statistical evidence was sufficient to establish "lack of loss causation" affirmative defense under Section 11); *In re* Cendant Corp. Sec. Litig., 109 F. Supp. 2d. 225, 229 (D.N.J. 2000) (finding defendant's statistical evidence sufficient to create a triable issue of fact on the issue of negative causation); Hammond *ex rel.* Hammond v. Hendrickson, No. 85 C 9829, 1986 WL 8437, at *3 (N.D. Ill. July 30, 1986) (stating defendant's NASDAQ statistics may provide a defense under Section 11(e) at trial).

206. Carpe v. Aquila, Inc., No. 02-0388-CV-W-FJG, 2005 WL 1138833, at *3 (W.D. Mo. March 23, 2005) ("An event study is a statistical regression analysis that examines the effect of an event on a dependent variable, such as a corporation's stock price."); *In re* Oracle Sec. Litig., 829 F. Supp. 1176, 1181 (N.D. Cal. 1993) (noting the "use of an event study or similar analysis is necessary" to "distinguish between fraud-related and non-fraud related influences on the stock's price").

defendant must prove that the "decline in value of [ ] stock resulted '*solely*' from factors other than the material omissions [or misstatements]."[207] It seems irreconcilable that statistical evidence is sufficient to meet a defendant's "heavy burden"[208] of establishing negative causation yet insufficient to meet the preponderance of evidence burden necessary to establish standing.

Lastly, without statistical tracing, aftermarket purchasers ordinarily are precluded from participating in Section 11 class action suits. Pursuant to Rule 23(b)(3)'s predominance requirement,[209] class periods for purposes of a Section 11 class action suit must be limited to "periods in which class members's ability to trace their shares is susceptible to common proof."[210] The requirement that aftermarket purchasers directly trace their shares to the defective registration statement is necessarily an individualized inquiry and would be a significant factor in a court's determination whether to disqualify a class under Rule 23(b)(3)'s predominance requirement.[211] As a result, a Section 11 class period, according to the Second Circuit, must end at the time when unregistered shares enter the market.[212] On the other hand, statistical tracing is susceptible to common proof (i.e. total number of shares on the market verses total registered shares) and would meet the predominance requirement of Rule 23(b)(3). By allowing statistical evidence to prove tracing, aftermarket purchasers would be able to participate in Section 11 class action cases.[213]

207. Akerman v. Oryx Commcn's, Inc., 609 F. Supp. 363, 371 (S.D.N.Y. 1984) (citing Collins v. Signetics Corp., 605 F.2d 110, 115-16 (3d Cir. 1979)) (emphasis in original).

208. *See* cases cited *supra* note 204.

209. FED. R. CIV. P. 23(b)(3). In order to prevail on class certification, the court must find that "questions of law or fact common to class members predominate over any questions affecting only individual members." *Id.*; *accord* Amchem Products, Inc. v. Windsor, 521 U.S. 591, 607 n.10, 622 (1997); Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 163-64 (1974).

210. *In re* Initial Pub. Offering Sec. Litig., 227 F.R.D. 65, 118-20 (S.D.N.Y. 2004), *vacated on other grounds sub nom.*, Miles v. Merrill Lynch & Co., 471 F.3d 24 (2d Cir. 2006); *see In re* Initial Pub. Offering Sec. Litig., 260 F.R.D. 81, 118-19 (S.D.N.Y. 2009).

211. *See In re* Initial Pub. Offering Sec. Litig., 227 F.R.D. at 118-20.

212. *See id.* at 119 ("As a result, the [S]ection 11 class periods for each of the focus cases must end at the time when unregistered shares become tradeable."). The court explained that:

> class members who purchased shares once untraceable shares entered the market would, because of the anonymity of fungible bulk storage, almost certainly be unable to satisfy their [tracing] requirement. Thus, common sense requires limitation of Section 11 classes to those periods in which plaintiffs will be able to satisfy their burden to show traceability and to exclude potential plaintiffs whose claims would almost invariably be futile.

Id. at 119 n.402; *see In re* Initial Pub. Offering Sec. Litig., 260 F.R.D. at 116 ("If these cases were proceeding to trial, it would be necessary for the [S]ection 11 class periods to end at the time when unregistered shares became tradeable.").

213. *See generally* Sale, *supra* note 31, at 588-91.

VI. PLEADING FOR THEIR LIVES: PLAINTIFFS FACE NEW OBSTACLES FOR SECTION 11 CLAIMS THAT SOUND IN FRAUD

The objective of narrowing the scope of Section 11 has not been confined to restrictive statutory interpretations of the Securities Act. Rather, in the pleading domain, courts are imposing the heightened pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure (hereinafter "Rule 9(b)") to Section 11 claims that sound in fraud. Conversely, these same claims are being denied the longer statute of limitations available to fraud-based claims under Section 804 of the Sarbanes-Oxley Act of 2002 (hereinafter "SOX").[214] This section provides a brief overview of the application of Rule 9(b) to Section 11 claims and highlights the inequities associated with its application. The section then analyzes recent cases where the courts have subjected Section 11 claims that sound in fraud to Rule 9(b)'s heightened pleading requirements yet have refused to invoke the longer statute of limitation available to such fraud-based claims. Finally, this section argues that granting SOX's longer statute of limitations to Section 11 claims sounding in fraud is consistent with Section 804's plain language and legislative history.

A. *The Sounds of Fraud Reverberate Throughout the Pleading Domain*

Because fraud is not a required element of a Section 11 claim, courts generally apply the relatively more flexible notice pleading standard of Rule 8(a)(2) of the Federal Rules of Civil Procedure.[215] However, the circuits are virtually unanimous in holding that Section 11 claims that sound in fraud are subject to the heightened

---

214. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

215. *See, e.g.*, Romine v. Acxiom Corp., 296 F.3d 701, 704 (8th Cir. 2002) ("[Section] 11 claims do not require proof of fraud and therefore the notice pleading requirements of Rule 8(a) apply."). Based on recent Supreme Court decisions, the Rule 8(a)(2) liberal notice pleading standard in *Conley* is obsolete, replaced by a more stringent "plausibility" standard. *See* Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570 (2007). In *Twombley*, the Court stated that under Rule 8(a)(2), a plaintiff must plead "enough facts to state a claim to relief that is *plausible* on its face." *Id.* (emphasis added). The Court then dismissed because "plaintiffs . . . have not nudged their claims across the line *from conceivable to plausible*." *Id.* (emphasis added). Two years later, the Court clarified that the "plausibility" standard expressed in *Twombly* governs the pleading standard "in all civil actions and proceedings in the United States district courts." *See* Ashcroft v. Iqbal, 129 S. Ct. 1937, 1953 (2009); *see generally* Marc I. Steinberg & Diego E. Gomez-Cornejo, *Blurring the Lines Between Pleading Doctrines: The Enhanced Rule 8(a)(2) Plausibility Pleading Standard Converges with the Heightened Fraud Pleading Standards Under Rule 9(b) and the PSLRA*, 30 U. TEX. REV. LITIG. 1 (2010) (forthcoming).

pleading requirements of Rule 9(b).[216] This is because Rule 9(b) applies to all "averments of fraud."[217] As explained by the Second Circuit, "[t]his wording is cast in terms of the *conduct alleged*," not the required elements of the cause of action.[218] Thus, Section 11 claims that contain allegations of fraud (i.e. "sound in fraud") are subject to the heightened pleading requirements of Rule 9(b).

In addition to the pleading requirement of Rule 9(b), the PSLRA imposes "exacting pleading requirements"[219] for fraud-based causes of action under the Securities Exchange Act.[220] For cases involving a fraudulent misleading statement or omission, a plaintiff must specify in the complaint "each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."[221] Courts thus far have held

---

216. *Accord* Rombach v. Chang, 355 F.3d 164, 170-71 (2d Cir. 2004) (holding that the heightened pleading standard of Rule 9(b) applies to Section 11 and providing cases from other circuits in support of this position); Schwartz v. Celestial Seasonings, Inc., 124 F.3d 1246, 1252 (10th Cir. 1997) (dictum) ("Assuming without deciding" that "the [Section] 11 claim in the case at bar . . . does not trigger Rule 9(b) scrutiny" because it "is not premised on fraud."); *In re* Stac Elecs. Sec. Litig., 89 F.3d 1399, 1404-05 (9th Cir. 1996) ("[T]he particularity requirements of Rule 9(b) apply to claims brought under Section 11 when . . . they are grounded in fraud."); Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1223 (1st Cir. 1996) (dictum) (noting that Rule 9(b) would probably apply to Section 11 claims based on "allegations in a single complaint of a unified course of fraudulent conduct"); Melder v. Morris, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994) (finding that Rule 9(b) applies when "Securities Act claims are grounded in fraud rather than negligence"); Shapiro v. UJB Fin. Corp., 964 F.2d 272, 288 (3d Cir. 1992) (stating Rule 9(b) applies when Section 11 claims are grounded in fraud); Sears v. Likens, 912 F.2d 889, 893 (7th Cir. 1990) (holding that plaintiffs failed to satisfy the Rule 9(b) standard that applied to their Securities Act claim); *but see In re* Nationsmart Corp. Sec. Litig., 130 F.3d 309, 314-15 (8th Cir. 1997) (holding Rule 9(b) does not apply to Section 11 claims, reasoning "a pleading standard which requires a party to plead particular facts to support a cause of action that does not include fraud or mistake as an element comports neither with Supreme Court precedent nor with the liberal system of 'notice pleading'").

217. FED. R. CIV. P. 9(b); *see Rombach*, 355 F.3d at 171.

218. *See Rombach*, 355 F.3d at 171 (emphasis added).

219. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313-14 (2007).

220. *See* 15 U.S.C. § 78u-4(b)(1) (2006).

221. *Id.* Where a cause of action is predicated upon a showing of a required state of mind (i.e. scienter), a plaintiff must "state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). The Supreme Court interpreted this to mean "an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent" based on a "comparative evaluation" of inferences urged by plaintiff, as well as competing inferences rationally drawn from the facts alleged. *Tellabs, Inc.*, 551 U.S. at 314.

that the exacting pleading requirements of the PSLRA do not apply to Section 11 claims that sound in fraud.[222] However, the level of specificity required by many courts to comply with Rule 9(b) creates a pleading burden that is relatively equivalent to the pleading requirements of the PSLRA.[223] For example, the Second Circuit explained that in order to comply with Rule 9(b), "the complaint must: (1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent."[224] While this standard was initially used to describe the pleading requirement for violations of Section 10(b), courts now apply this same standard to Section 11 claims that sound in fraud.[225]

Courts have expressed varying explanations of when a Section 11 claim is said to "sound in fraud." The issue most frequently arises when a plaintiff uses the exact same factual allegations to allege

---

222. *See* Rubke v. Capital Bancorp Ltd., 551 F.3d 1156, 1161 (9th Cir. 2009) ("Although the heightened pleading requirements of the PSLRA do not apply to [S]ection 11 claims, plaintiffs are required to allege their claims with increased particularity under [Rule 9(b)] if their complaint sounds in fraud.") (internal citations omitted); Cal. Pub. Employees' Ret. Sys. v. Chubb Corp., 394 F.3d 126, 163 (3d Cir. 2004); Romine v. Acxiom Corp., 296 F.3d 701, 704-05 (8th Cir. 2002); *In re* Shoretel Inc., Sec. Litig., No. C 08-00271 CRB, 2009 WL 248326, at *1 (N.D. Cal. Feb. 2, 2009); *In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 338 (S.D.N.Y. 2003).

223. Lerner v. Fleet Bank, N.A., 459 F.3d 273, 290 (2d Cir. 2006); *accord* Swartz v. KPMG LLP, 476 F.3d 756, 764 (9th Cir. 2007) (noting Rule 9(b) requires a plaintiff to identify "time, place, and specific content of the false representations as well as the identities of the parties to the misrepresentations.") (quoting Edwards v. Marin Park, Inc., 356 F.3d 1058, 1066 (9th Cir, 2004)); *In re* Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 270 (3d Cir. 2006) ("Rule 9(b) requires a plaintiff to plead (1) a specific false representation of material fact; (2) knowledge by the person who made it of its falsity; (3) ignorance of its falsity by the person to whom it was made; (4) the intention that it should be acted upon; and (5) that the plaintiff acted upon it to his [or her] damage."); ABC Arbitrage Plaintiffs Group v. Tchuruk, 291 F.3d 336, 349-50 (5th Cir. 2002) ("[A]rticulating the elements of fraud with particularity requires a plaintiff to specify the statements contended to be fraudulent, identify the speaker, state when and where they statements were made, and explain why the statements were fraudulent.") (quoting Williams v. WMX Techs., Inc., 112 F.3d 175, 177 (5th Cir. 1997)); Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir. 1993) (stating that to comply with Rule 9(b) "the complaint must: (1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent").

224. *Lerner*, 459 F.3d at 290 (quoting *Mills*, 12 F.3d at 1175); *see* cases cited *supra* note 223.

225. *See* Lin v. Interactive Brokers Group, Inc., 574 F. Supp. 2d 408, 414-15 (S.D.N.Y. 2008); Miller v. Lazard, Ltd., 473 F. Supp. 2d 571, 580 (S.D.N.Y. 2007); *In re* White Elec. Designs Corp. Sec. Litig., 416 F. Supp. 2d 754, 762, 777-79 (D. Ariz. 2006); *In re* BellSouth Corp. Sec. Litig., 355 F. Supp. 2d 1350, 1364 (N.D. Ga. 2005); *see also* *In re* Suprema Specialties, 438 F.3d at 270 (implying that the five elements required to be plead under the Third Circuit's interpretation of Rule 9(b) would also apply to Section 11 claims that sound in fraud).

violations of Section 11 and Section 10(b).[226] As described by the Ninth Circuit, a Section 11 claim sounds in fraud when it alleges a "unified course of fraudulent conduct and rel[ies] entirely on that course of conduct as the basis of a claim."[227] Notably, the Eleventh Circuit has embraced a harsh view on when Section 11 claims sound in fraud. That circuit applies Rule 9(b)'s heightened pleading requirements to a Section 11 claim where the misrepresentation at issue in the Section 11 claim was "also the beginning of—or otherwise part of—the predicate fraud . . . claim."[228] The court stated that pleading the fraud and non-fraud claims in the alternative is insufficient to relieve the Section 11 claim from the requirements of Rule 9(b).[229] In other words, if the misstatement giving rise to a Section 11 claim "is part and parcel" of the fraud claim, it is subject to Rule 9(b).[230]

Based on the Eleventh Circuit's approach, Section 11 claims properly pled in accordance with Rule 8(a)(2) will fail if the court believes they are sufficiently related to an alternately pled Section 10(b) claim. For example, a situation can arise where a company's registration statement contains a material misstatement that the company's directors knowingly make. These facts give rise to both a Section 11 claim and a Section 10(b) claim. Should the court find that the material misstatement is "the beginning of – or otherwise part of the fraud claim, the Section 11 claim would be subject to Rule 9(b)'s pleading requirements."[231] This is true even if the Section 11 claim is pled in the alternative and explicitly stated as a non-fraud claim.[232] In essence, as seemingly construed, the only way the Section 11 claim can escape the heightened pleading requirements of Rule 9(b) as expounded under this approach is for the plaintiff to abandon the Section 10(b) claim. Given Section 11's onerous tracing requirement, as discussed in the preceding section, this alternative is not feasible in the class action setting.[233]

Circuits that embrace a less rigid approach than the Eleventh

226. *See* Rubke v. Capitol Bancorp ltd., 551 F.3d 1156, 1162 (9th Cir. 2009).

227. *In re* Metro. Sec. Litig., 532 F. Supp. 2d 1260, 1278 (E.D. Wash. 2007) (quoting Vess v. Ciba-Geigy Corp. USA, 317 F.3d 1097, 1103-04 (9th Cir. 2003)); *see also In re* Daou Sys., Inc., 411 F.3d 1006, 1028 (9th Cir. 2005) (stating a Section 11 claim sounds in fraud where it makes a wholesale adoption of the facts underlying the fraud claim).

228. Wagner v. First Horizon Pharm. Corp., 464 F.3d 1273, 1278 (11th Cir. 2006).

229. *Id.*

230. *Id.* ("[I]f the plaintiffs are claiming that the § 11 or §12(a)(2) misrepresentation is part and parcel of a larger fraud, . . . plaintiffs must plead with particularity.").

231. *Id.*

232. *Id.* ("Nor is it enough to present a general disclaimer in an attempt to immunize the nonfraud claims from the Rule 9 requirements . . . .").

233. *See supra* notes 142-50 and accompanying text.

Circuit still leave plaintiffs with little solace. The Fifth Circuit, for example, applies Rule 9(b) to Section 11 claims that sound in fraud, but recognizes that an inadequate averment of fraud does not mean that a Section 11 claim has failed to be stated.[234] "The proper route is to disregard" the inadequate averments of fraud and ascertain if a Section 11 "claim has been stated."[235] However, the "district court is not required to "sift through allegations of fraud in search of some lesser included claim."[236] It may dismiss the Section 11 claim.[237]

The examples above highlight the onerous burden placed on plaintiffs by imposing the heightened pleading requirements of Rule 9(b) to Section 11 claims. Further, applying Rule 9(b) to Section 11 claims is inconsistent with the purpose of the Securities Act and inconsistent with both the text and purpose of the Federal Rules of Civil Procedure.[238] Nonetheless, if courts burden plaintiffs with Rule 9(b) pleading requirements for Section 11 claims that sound in fraud, they should also avail plaintiffs of the longer statute of limitations set forth by SOX.

B. Statute of Limitations: Courts Place Limitations on When a Section 11 Claim Can Sound in Fraud

Generally, Section 11 claims are governed by the one-year statute of limitations and three-year statute of repose set forth in Section 13 of the Securities Act.[239] In 2002, Congress passed SOX, which included, among other provisions, a two-year statute of limitations and five-year statute of repose for securities law violations that involve "a claim of fraud, deceit, manipulation, or contrivance."[240] The substantial weight of authority holds that Section 804 of the Sarbanes-Oxley Act of 2002 (hereinafter "Section 804") is inapplicable to negligence and strict liability causes of action like Section 11.[241] These courts reason that the language of Section

234. Lone Star Ladies Inv. Club v. Schlotzsky's Inc., 238 F.3d 363, 368 (5th Cir. 2001); *accord* Vess v. Ciba-Geigy Corp. USA, 317 F.3d 1097, 1104-05 (9th Cir. 2003).

235. *Lone Star Ladies Inv. Club*, 238 F.3d at 368.

236. *Id.*; *accord In re* Corning Inc. Sec. Litig., No. 04-2845-CV, 2005 WL 714352, at *1 (2d Cir. Mar. 30, 2005); Cal. Pub. Employees' Ret. Sys. v. Chubb Corp., 394 F.3d 126, 162 (3d Cir. 2004).

237. *Lone Star Ladies Inv. Club*, 238 F.3d at 368; *In re Corning Inc. Sec. Litig.*, No. 04-2845-CV, 2005 WL 714352, at *1; *Cal. Pub. Employees' Ret. Sys.*, 394 F.3d at 162.

238. See generally Trunquist, *supra* note 34, at 12 for a discussion of how application of Rule 9(b) to Section 11 claims is inconsistent with the purpose and text of the Federal Rules of Civil Procedure.

239. *See* 15 U.S.C. § 77m (2006).

240. *See* 28 U.S.C. § 1658(b) (2006).

241. *See e.g., In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 402, 414 n.5 (S.D.N.Y. 2005) (citing authority from 11 cases that considered the applicability of Section 804 to claims brought under Sections 11, 12(a)(2), and 15 in finding that Section 804 did not

804 is unambiguous when applied to securities law claims sounding in negligence or strict liability.[242] However, the narrower question that requires further analysis is whether Section 804 should apply to Section 11 claims that sound in fraud.[243]

This section posits that, where a Section 11 claim "sounds in fraud," courts should apply the extended statute of limitations created by SOX. The section will begin by exploring a decision that addressed the applicability of Rule 9(b) and Section 804 to Section 11 claims that sound in fraud. Part two of the section responds to the argument advanced by several courts that Section 804 is limited to causes of action requiring proof of fraud. Part three addresses the related argument that Section 804 is inapplicable to causes of action that have an expressly prescribed statute of limitations. The section concludes with part four, which asserts that Section 804 should apply to Section 11 claims that sound in fraud.

1. The Many Sounds of Fraud: Courts Determine that Section 11 Does Not Sound in Fraud for Purposes of SOX

Section 804 amended 28 U.S.C. § 1658, the general statute of limitations for "civil actions arising under Acts of Congress," by adding the following language:

> (b) Notwithstanding subsection (a), a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), may be brought not later than the earlier of—
>
> (1) 2 years after the discovery of the facts constituting the violation; or
>
> (2) 5 years after such violation.[244]

---

extend to such claims). *Id.*; *see also In re* Able Lab. Sec. Litig., Civil Action No. 05-2681 (JAG), 2008 WL 1967509, at *23 (D.N.J. March 24, 2008) (holding that the statute of limitation set forth in Section 804 is not applicable to Securities Exchange Act Section 18 claims).

242. *See In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d at 414-15; *In re* Global Crossing, Ltd. Sec. Litig., 313 F. Supp. 2d 189, 197 n.6 (S.D.N.Y. 2003) (stating the language of Section 804 is unambiguous so there is no need to resort to the legislative history of SOX); *In re* WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 431, 443 (S.D.N.Y 2003) (noting that legislative history should be used only to resolve ambiguity, "a problem not present by Section 804").

243. *See In re Alstom, SA Sec. Litig.*, 406 F. Supp. 2d at 415 (recognizing the issue of Section 804's applicability to Section 11 claims that sound in fraud is "narrower and unique" and requires consideration of SOX's legislative history).

244. *See* 28 U.S.C. § 1658(b). Subsection (a) reads: "Except as otherwise provided by law, a civil action arising under an Act of Congress enacted after the date of the enactment of this section may not be commenced later than 4 years after the cause of

Courts have held Section 804 inapplicable to various non-fraud causes of action arising under the securities laws, such as Sections 11, 12(a)(2), and 15 of the Securities Act as well as Sections 14(a) and 18(a) of the Securities Exchange Act.[245] However, these cases only addressed non-fraud causes of action that sound in negligence and strict liability, and therefore, did not address the applicability of Section 804 to non-fraud causes of action that sound in fraud.

To date, few courts have directly addressed the applicability of Section 804 to Section 11 claims that sound in fraud. In one of the first cases to directly discuss this issue, *In re Alstom SA* (hereinafter "*Alstom*"),[246] the court held that the Section 804 statute of limitations

action accrues." *Id.* § 1658(a).

245. The following are cases where courts have found Section 804 inapplicable to Sections 11, 12(a)(2), and 15 of the Securities Act and Sections 14(a) and 18(a) of the Securities Exchange Act. As to Section 11 only: *In re* Metro. Sec. Litig., 532 F. Supp. 2d 1260, 1284 (E.D. Wash. 2007); *In re* Almosa Holdings, Inc., 382 F. Supp. 2d 832, 863-64 (N.D. Tex. 2005). As to Section 12(a)(2) only: Cohen v. Northwestern Growth Corp., 385 F. Supp. 2d 935, 942 (D.S.D. 2005); Lieberman v. Cambridge Partners, L.L.C., No. Civ. A. 03-2317, 2004 WL 1396750, at *3 (E.D. Pa. June 21, 2004); Ato Ram, II, Ltd. v. SMC Multimedia Corp., No. 03 Civ. 5569 HB, 2004 WL 744792, at *5 (S.D.N.Y. April 7, 2004). As to Section 11 and 12(a)(2): *In re* FirstEnergy Corp. Sec. Litig., 316 F. Supp. 2d 581, 601 (N.D. Ohio 2004); *In re* WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288(DLC), 2004 WL 1435356, at *4 (S.D.N.Y. June 28, 2004); *In re* Merrill Lynch & Co., Inc. Research Reports Sec. Litig., 272 F. Supp. 2d 243, 265 (S.D.N.Y. 2003); *In re* WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 431, 443 (S.D.N.Y. 2003). As to Sections 11, 12(a)(2), and 15: Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc., No. 02 C 5893, 2004 WL 574665, at *12-14 (N.D. Ill. March 22, 2004); *In re* Enron Corp. Sec., Derivative & ERISA Litig., No. MDL-1446, Civ. A. H-01-3624, 2004 WL 405886, at *9-12 (S.D. Tex. Feb. 25, 2004); Friedman v. Rayovac Corp., 295 F. Supp. 2d 957, 974-75 (W.D. Wis. 2003). As to Section 14(a): *In re* Exxon Mobil Corp. Sec. Litig., 500 F.3d 189, 197 (3d Cir. 2007) (concluding Congress did not intend to include Section 14(a) within the scope of Section 804 because it does not require proof of fraudulent intent); *In re* Marvell Tech. Grp. Ltd. Sec. Litig., No. C-06-06286 RMW, 2008 WL 4544439, at *11 (N.D. Cal. Sept. 29, 2008); *In re* Verisign, Inc. Derivative Litig., 531 F. Supp. 2d 1173, 1212 (N.D. Cal. 2007); *In re* Zoran Corp. Derivative Litig., 511 F. Supp. 2d 986, 1016-17 (N.D. Cal. 2007); Virginia M. Damon Trust v. N. Country Fin. Corp., 325 F.Supp. 2d 817, 822-24 (W.D. Mich. 2004); *In re* Global Crossing, Ltd. Sec. Litig., 313 F. Supp. 2d 189, 197 (S.D.N.Y. 2003). As to Sections 11 and 14: *In re Global Crossing, Ltd. Sec. Litig.*, 313 F. Supp. 2d at 197 (holding Section 804 only extends limitations only for actions under the securities laws that require proof of fraudulent intent). As to Section 18(a): Reese v. Malone, No. C08-1008MJP, 2009 WL 506820, at *8 (W.D. Wash. Feb. 27, 2009); *In re* Able Labs. Sec. Litig., Civ. Action No. 05-2681, 2008 WL 1967509, at *23 (D.N.J. March 24, 2008); *In re* Enron Corp. Sec., 465 F. Supp. 2d 687, 711 (S.D. Tex. 2006) (holding Section 804's statute of limitations is inapplicable to Section 18(a) claims because they do not require proof of fraud); *In re* Hollinger Int'l., Inc. Sec. Litig., No. 04C 0834, 2006 WL 1806382, at *15 (N.D. Ill. June 28, 2006); WM High Yield Fund v. O'Hanlon, No. Civ. A. 04-3423, 2005 WL 1017811, at *11 (E.D. Pa. April 29, 2005). *But see* Shriners Hosp. for Children v. Quest Commc'ns Int'l, Inc., No. 04-CV-0781, 2005 WL 2350569, at *3 (D. Colo. Sept. 23, 2005) (applying Section 804 to a Section 18 claim).

246. 406 F. Supp. 2d 402 (S.D.N.Y. 2005).

did not apply to a Section 11 claim that sounded in fraud despite the claim being subject to the heightened pleading requirements of Rule 9(b). In support of this position, the court looked to the plain language of Section 804, the statutory context in which Section 804 was codified, and the legislative history of SOX.[247]

In analyzing the language of Section 804, the court in *Alstom* noted that Section 804 mirrors the language of Section 10(b), which requires a showing of fraud.[248] Accordingly, the court reasoned that Section 804 is limited to causes of action that require proof of scienter and motive to defraud.[249] The court further supported this conclusion with references to the Supreme Court's *Lampf* decision,[250] handed down prior to SOX's enactment, discussed in Section 804's legislative history.[251] Secondly, the court determined that the statute Congress chose to amend when Section 804 was codified supported a finding that Section 804 does not apply to causes of action with an express statute of limitations.[252] As such, the court held Section 804 does not supplant Section 11's express limitations periods provided in

---

247. *See id.* at 412-18.

248. *Id.* at 412 (citing *In re* Global Crossing Ltd. Sec. Litig. 313 F. Supp. 2d 189, 197 (S.D.N.Y. 2003)). Section 10(b) creates liability for any person who:

> in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (2006). Compare this to the language of Section 804, which extends the statute of limitation for any "right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws." *See supra* note 244-45 and accompanying text.

249. *See In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d at 413.

250. Lampf v. Gilbertson, 501 U.S. 350 (1991).

251. S. REP. NO. 107-146, at 8 n.10 (2002), *reprinted in* 3 CORPORATE FRAUD RESPONSIBILITY: A LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002, Doc. No. 85, at 8 n.10 (William H. Manz ed., 2003) (providing the following explanation of *Lampf*: "In *Lampf,* the 5-4 majority changed the decades old practice of deferring to state limitations period in securities fraud cases, and it adopted a national statute of limitations instead . . . ."); *see Lampf,* 501 U.S. at 361-62. In addition, as opposed to adopting the longer federal limitations period that the SEC and then Solicitor General Kenneth Starr supported from a 1988 securities law . . . the Court held . . . that the shorter '1 and 3' period imported from §9(e) of the 1934 Act (15 U.S.C. §78i(e)) governed, but that fraud victims [could not raise] the customary doctrine of 'equitable tolling.'" *Id.* at 363-64.); *see* sources cited *infra* note 282 for references to *Lampf* contained in the legislative history of SOX.

252. *In re Alstom SA Sec. Litig,* 406 F. Supp. 2d at 414 (basing this conclusion on the fact that Congress chose to amend the general statute of limitations for causes of action arising under acts of Congress and did not specifically amend or repeal Section 13).

Section 13.[253]

Section 14(a) of the Securities Exchange Act,[254] the section that provides an implied private right of action for material misstatements or half-truths in a proxy statement,[255] provides another example of a non-fraud cause of action.[256] The Third Circuit, following arguments similar to those made by the court in *Alstom*, found that Section 14(a) claims do not fall within the scope of Section 804, even where the claim sounds in fraud and is subject to Rule 9(b)'s heightened pleading requirements.[257] Likewise, courts in the Ninth Circuit have routinely found that Section 804 does not apply to Section 14(a) claims because they do not "sound in fraud" under SOX.[258] In an inconsistent manner, these same courts hold that a Section 14(a) claim can "sound in fraud" for purposes of applying Rule 9(b)'s heightened pleading requirements.[259] These cases, along with *Alstom*, demonstrate the apparently irreconcilable lack of consistency in deeming a cause of action to "sound in fraud" for pleading purposes, yet not for statute of limitations purposes.

Courts justify their position that Section 804 does not apply to non-fraud causes of action that sound in fraud with two premises: (1) Section 804 only applies to causes of action under the federal securities laws that require proof of fraud; and (2) Section 804 does not apply to a cause of action that has an express statute of limitations.[260] Subsections two and three below will discuss how these two conclusions are unsupported by either the plain language of Section 804 or its history. Subsection four will posit that applying Section 804's longer statute of limitations is consistent with the text of Section 804 and with the legislative history of Section 804 and

253. *Id.*

254. 15 U.S.C. § 78n.

255. *Id.*; *see* 17 C.F.R. § 240.14a-9 (2010) (prohibiting materially false or misleading statements in a proxy statement). For Supreme Court case law interpreting Section 14(a) and Rule 14a-9, *see* Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1087 (1991); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385-86 (1970); J.I. Case Co. v. Borak, 377 U.S. 426, 435 (1964); *see generally* Marc I. Steinberg & William A. Reece, *The Supreme Court, Implied Rights of Action, and Proxy Regulation*, 54 OHIO ST. L.J. 67 (1993).

256. *See* cases cited *supra* notes 248-50.

257. *See In re* Exxon Mobil Corp. Sec. Litig., 500 F.3d 189, 197-99 (3d Cir. 2007); Rudolph v. UTStarcom, 560 F. Supp. 2d 880, 892 (N. D. Cal. 2008) (discussing the Third Circuit's treatment of *In re ExxonMobil*).

258. *In re* Verisign, Inc. Derivative Litig., 351 F. Supp. 2d 1173, 1212 (N.D. Cal. 2007); *In re* Zoran Corp. Derivative Litig., 511 F. Supp. 2d 986, 1016-17 (N.D. Cal. 2007); *In re* Atmel Corp. Derivative Litig., No. C 06-4592 JF (HRL), 2007 WL 2070299, at *8 (N.D. Cal. July 16, 2007); *In re* Marvell Tech. Group Ltd. Sec. Litig., No. C 06-06286 RMW, 2008 WL 4544439, at *11-12 (N.D. Cal. Sept. 29, 2008).

259. *See, e.g.*, Desaigoudar v. Meyercord, 223 F.3d 1020, 1022-23 (9th Cir. 2000).

260. *See* cases cited *supra* notes 248-57.

Section 11.

2. Falling on Deaf Ears: Was SOX Intended to be Immune to the Sounds of Fraud?

As a threshold matter, Section 804 has been criticized as "hastily passed[,]"[261] "poorly drafted,"[262] and "likely to create significant interpretational difficulties for courts."[263] As such, this analysis looks to both the statutory text and legislative history to properly decipher the intended scope of Section 804.[264]

a. Tuning in to SOX: Is Proof of Fraud Required?

Courts have looked to the similarity in language between Section 804 and Section 10(b) in determining that Section 804 is limited to causes of action that require proof of fraud.[265] However, that the language of Section 804 is similar to that of Section 10(b) supports multiple conclusions. First, that Section 804 was intended to be limited to Section 10(b) causes of action. Second, that Section 804 was intended to be limited to causes of action similar to Section 10(b) that require proof of fraud. Or third, that Section 804 was intended to apply to any cause of action involving a *claim* of fraud, deceit, manipulation, or contrivance. Accordingly, the conclusion that Section 804 "*explicitly* prescribes its application to causes of action . . . requiring proof of scienter and motive to defraud"[266] requires a leap of logic unsupported by the statute's actual text.

---

261. *See In re* Enron Corp. Sec., Derivative, No. MDL-1446, Civ. A. H-01-3624, 2004 WL 405886, at *11 (S.D. Tex. Feb. 25, 2004); *see also* Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002,* 76 ST. JOHN'S L. REV. 671, 672 (2002) ("[SOX] moved with lightening speed through the legislature . . . . Unfortunately, the Act reflects that speed."); John C. Coffee, Jr., *A Brief Tour of the Major Reforms in the Sarbanes-Oxley Act,* SH097 ALI-ABA 151, 171-72 (2002) (noting that SOX was "[p]assed quickly" and likely to contain "ambiguities and yield some unintended consequences").

262. *See In re Enron Corp. Sec., Derivative,* No. MDL-1446, Civ. A. H-01-3624, 2004 WL 405886, at *11 (quoting Bruce Vanyo, Stuart Kagan & John Claassen, *The Sarbanes-Oxley Act of 2002: A Securities Litigation Perspective,* 1332 PLI/CORP 89, 119-20 (2002)); Perino, *supra* note 261, at 693 (noting that Section 804 is "poorly drafted," "inconsistent with express statutes of limitations already contained in the federal securities laws[,] and is likely to create significant interpretational difficulties for courts").

263. *See In re* Enron Corp. Sec., Derivative, No. MDL-1446, Civ. A. H-01-3624, 2004 WL 405886, at *11; Vanyo, Kagen & Classen, *supra* note 262, at 119-20 (quoting Perino, *supra* note 261, at 4) (internal quotation marks omitted); Coffee, *supra* note 261, at 171-72.

264. *See supra* notes 100-01, 105.

265. *See In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 402, 412 (S.D.N.Y. 2005); *see* cases cited *supra* note 245 and accompanying text.

266. *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d. at 413 (emphasis added).

Section 804 can be broken down into three requirements: "(1) a private right of action, (2) arising under the securities laws as defined in Section 3(a)(47) of the Securities Exchange Act of 1934,[267] [and] (3) involv[ing] a claim of fraud, deceit, manipulation, or contrivance."[268] It is clear that all Section 11 claims, whether sounding in fraud or negligence, meet the first two requirements.[269] The debate focuses on whether the term "claim" in the third requirement is to be narrowly defined. In other words, does the term "claim" mean that "fraud, deceit, manipulation, or contrivance" must be a required element of the private right of action or is it sufficient that the private right of action (which may or may not require proof of scienter) allege one or more of these elements?[270]

The plain language of Section 804 indicates that the more flexible interpretation is appropriate. The term "claim" has been defined as "the aggregate of operative facts which give rise to a right enforceable in the courts."[271] A "claim" includes "all legal grounds that are based on closely related facts."[272] These definitions evidence that the word "claim" is couched largely in terms of the facts alleged, not in terms of the elements required to be proven under the applicable cause of action. As such, a Section 11 claim that includes an allegation of fraud should suffice to fulfill the requirements of Section 804. As one court recognized, application of Section 804 to Section 11 claims "appears to depend upon whether the particular *claim* involves 'fraud, deceit, manipulation, or contrivance.'"[273]

Notably, the language used to describe when a Section 11 claim sounds in fraud fits squarely into the definition of a "claim." A claim is defined to include "operative facts."[274] The term "operative facts" is

---

267. *See* 15 U.S.C. 78c(a)(47) (defining "securities laws" to include the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Sarbanes-Oxley Act of 2002, the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b et seq.) [15 U.S.C.A. § 80b-1 et seq.], and the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.)).

268. *See* Amy Grynol-Gibbs, Note, *It's About Time: The Scope of Section 804 of The Sarbanes-Oxley Act of 2002*, 38 GA. L. REV. 1403, 1427 (2004).

269. *Id.*

270. *See generally In re* Exxon Mobil Corp. Sec. Litig., 500 F.3d 189, 197-98 (3d Cir 2007); Grynol-Gibbs, *supra* note 268, at 1428.

271. McNellis v. Merchants Nat. Bank & Trust Co. of Syracuse, 385 F.2d 916, 919-20 (2d Cir. 1967) (defining the term "claim" as used in the Federal Rules of Civil Procedure); BLACK'S LAW DICTIONARY (9th Ed. 2009) 281 (defining "claim" as "[t]he aggregate of operative facts giving rise to a right enforceable by a court").

272. Greenwell v. Aztar Indiana Gaming Corp., 268 F.3d 486, 490 (7th Cir. 2001) (defining "claim" for purposes of FED. R. OF CIV. P. 54(b)).

273. *In re* Enron Corp. Sec., Derivative, No. MDL-1146, 2004 WL 405886, at *11 (S.D. Tex. Feb. 25, 2004) (quoting 29 U.S.C. § 1658(b)).

274. *See* sources cited *supra* notes 270-71.

broader than the "elements of proof necessary" to prove a legal theory.[275] Similarly, "[a] Section 11 claim sounds in fraud when it alleges 'a unified course of fraudulent conduct and rel[ies] entirely on that course of conduct as the basis of a claim.'"[276] In this example, while the fraudulent conduct is broader than the elements of the cause of action, it is nevertheless relevant to the claim as a whole as it represents a unified course of conduct. A claim has also been defined as including all causes of action based on closely related facts.[277] Compare this to Section 11 causes of action that sound in fraud because the same facts are asserted to support a Section 11 claim and a fraud claim.[278] Here the two causes of action are based on such closely related facts that the two theories of recovery are simply different manifestations of the same underlying claim.[279]

b. History Speaks

In addition to the textual analysis, the legislative history of SOX supports the conclusion that Section 804 should apply to Section 11 claims that sound in fraud. Courts have interpreted SOX's legislative history as evidencing Congress's intent that Section 804 should be limited to Section 10(b) claims and other claims requiring proof of fraudulent intent.[280] This contention is typically supported by remarks in the congressional record referencing "fraud actions"[281] and the *Lampf* decision.[282] Nonetheless, as acknowledged by a

---

275. Tohono O'odham Nation v. United States, 559 F.3d 1284, 1294 (Fed. Cir. 2009) (defining "operative facts" as broader than the "elements of proof necessary" to prove a legal theory); BLACK'S LAW DICTIONARY (9th Ed. 2009) (defining "operative" as "[h]aving principal relevance; essential to the meaning of the whole").

276. *In re* Metro. Sec. Litig., 532 F. Supp. 2d 1260, 1278 (E.D. Wash. 2007) (quoting Vess v. Ciba-Geigs, Corp. USA, 317 F.3d 1097, 1103 (9th Cir. 2003)).

277. *See* case cited *supra* note 261 and accompanying text.

278. *In re* Enron Corp. Sec., Derivative, 465 F. Supp. 2d 687, 713 (S.D. Tex. 2006).

279. *See generally* Grinnin v. United States, 85 Fed. Cl. 179, 185-186 (2008). This case involved alleged violations of the Equal Pay Act and of the Fair Labor Standards Act. *Id.* at 182-83. The court recognized that "the two claims arose out of the same set of operative facts, reasoning that '[t]he difference between the two theories . . . are but different manifestations of the same underlying claim . . . .'" *Id.* at 185 (quoting Harbuck v. United States, 378 F.3d 1324, 1328 (Fed. Cir. 2004)).

280. *See In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 402, 412 (S.D.N.Y. 2005).

281. *See id.* at 415 (citing 148 CONG. REC. S7418-01, S7419 (daily ed. July 26, 2002) (remarks of Sen. Leahy)).

282. S. REP. NO. 107-146, at 8 n.10 (2002), *reprinted in* 3 CORPORATE FRAUD RESPONSIBILITY: A LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002, Doc. No. 85, at 8 (William H. Manz ed., 2003) (citing the dissenting justices opinion in *Lampf* that a "one and three" limitations period makes securities fraud actions "all but a dead letter for injured investors"); *Id.* at 8-9 (noting that in reacting to the *Lampf* decision, the last two SEC chairmen, Arthur Levitt and Richard Breeden, previously testified before the Congress in favor of extending the statute of limitations in securities fraud cases. Additionally, both the FDIC and state securities regulators

number of federal courts, the legislative history of Section 804 is vague and the same facts referenced above support the opposite conclusion.[283]

Like the textual argument above, the references to "fraud actions" and *Lampf* in Section 804's legislative history support multiple interpretations with respect to the scope of Section 804:[284] first, that Section 804 is intended to be limited to Section 10(b) claims; second, that Section 804 was intended to be limited to securities claims that require proof of fraud as an element of the cause of action; or third, that Section 804 was intended to apply to any claim under the securities laws based on allegations of a fraudulent course of conduct.[285]

The first conclusion, that Section 804 was intended to be limited to claims brought under Section 10(b), is misplaced. The congressional record highlights that Section 804 was charged with the broader goal of protecting "defrauded investors," not just defrauded investors who bring their claims under Section 10(b).[286] Additionally, Congress rejected language that would have explicitly limited the longer statute of limitations to claims brought under implied rights of action like Section 10(b).[287] House Bill 3818, which was ultimately rejected, contained the following statute of limitations that would have acted as a direct amendment to the Securities Exchange Act:

> SEC. 37. STATUTE OF LIMITATIONS.
>
> (a) In General—Except as otherwise specifically provided in this title, and notwithstanding section 9(e), an implied private right of action arising under this title may be brought not later than the earlier of—
>
> (1) 5 years after the date on which the alleged violation

---

joined the SEC in calling for a legislative reversal of the *Lampf* decision in 1991.); *id.* at 29 (stating that the new statute of limitations addresses the *Lampf* holding).

283. *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d at 416.

284. *See* legislative history cited *supra* notes 251-52.

285. *See supra* notes 246-52 and accompanying text.

286. *See* S. REP. NO. 107-146, at 8 (2002), *reprinted in* 3 CORPORATE FRAUD RESPONSIBILITY: A LEGISLATIVE HISTORY OF THE SARBONES-OXLEY ACT OF 2002, Doc. No. 85, at 8-9 (William H. Manz ed., 2003) ("*[D]efrauded investors* attempting to recoup their losses face unfair time limitations under current law; . . . extending the statute of limitations is warranted because many *securities frauds* are inherently complex. . . . The one year statute of limitations is . . . particularly harsh on innocent *defrauded investors*; . . . in many *securities fraud* cases the short limitations period under current law is an invitation to take sophisticated steps to conceal the deceit." (emphasis added)).

287. *See* H.R. 3818, 107th Cong. § 37 (2002), *reprinted in* 3 CORPORATE FRAUD RESPONSIBILITY: A LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002, Doc. No. 63, at 79 (William H. Manz ed., 2003).

occurred; or

(2) 3 years after the date on which the alleged violations was discovered.[288]

This language would have limited the application of the longer statute of limitations to Section 10(b) claims and certain other private rights of action under the Exchange Act.[289] Unlike the statute above, Section 804 is not limited to causes of action arising under the Exchange Act, but applies more broadly to causes of action arising under eight different Congressional Acts.[290] Additionally, Section 804 was not limited to implied private rights of action like the proposed statute of limitations above. Had Congress intended Section 804 to be limited to Section 10(b) claims, it would have adopted narrow language consistent with the proposed statute above.[291]

The challenging question is whether Section 804 was meant to apply only to securities claims requiring proof of fraud, or whether it extends to any claim under the federal securities laws based on allegations of fraud. The congressional record does not specifically answer this question.[292] However, a review of the progression of Section 804 provides insight. The language ultimately adopted as Section 804 was contained in Senate Bill 2010, the Corporate and Criminal Fraud Accountability Act of 2002.[293] This bill was originally introduced by Senator Patrick Leahy and extended the statute of limitations for "private right[s] of action that involve[ ] a *claim* of fraud, deceit, manipulation, *or* deliberate or reckless disregard of a

288. *Id.*

289. Courts have found implied rights of action in Section 13(d), 14(a), 14(d), and 14(e) of the Securities Exchange Act. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 171 (1994) ("[I]nvestors may . . . sue under private rights of action we have found to be implied by the terms of § 10(b) and § 14(a) of the 1934 Act."); Edelson v. Ch'ien, 405 F.3d 620, 626 (7th Cir. 2005) (recognizing that Section 13(d), in certain contexts, provides an implied right of action); Field v. Trump, 850 F.2d 938, 946 (2d. Cir. 1988) (holding that Section 14(d)(7) affords plaintiffs an implied right of action); Polaroid Corp. v. Disney, 862 F.2d 987, 1003 (3d Cir. 1988) (recognizing plaintiff's standing to sue under Section 14(e)'s implied right of action); *see generally* MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES §§ 9.02-9.03 (Law Journal Seminars-Press 1994) (1984).

290. *See* cases cited *supra* note 257.

291. *See* cases cited *supra* note 118.

292. *See In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 402, 415 (S.D.N.Y. 2005) (recognizing that Senator Leahy did not specify whether references "to 'fraud actions' was meant to encompass only securities claims that require proof of fraud as an element of the cause of action, or whether it extended as well to any claim under the securities laws based more broadly on allegations of a fraudulent . . . conduct").

293. Corporate & Criminal Fraud Accountability Act of 2002, S. 2010, 107th Cong. § 4 (2002), *reprinted in* 3 CORPORATE FRAUD RESPONSIBILITY: A LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002, Doc. No. 79, at 17 (William H. Manz ed., 2003).

regulatory requirement concerning the securities laws . . . ."[294] This bill was referred to the Committee on the Judiciary where it was amended to its current form.[295] While the language in unamended Senate Bill 2010 was rejected, it suggests that Section 804 was intended to apply broadly and that each word in the disjunctive phrase was intended to have meaning.[296]

Congress defined the scope of Section 804 as applying to *claims—not statutes*—that involve "fraud, deceit, manipulation, *or* contrivance in contravention of a regulatory requirement concerning the securities laws."[297] Canons of statutory construction suggest that "terms connected by a disjunctive be given separate meanings, unless the context dictates otherwise."[298] In some cases, a second word or phrase will be added in the disjunctive "simply to make the meaning of the first phrase 'unmistakable.'"[299] The context of Section 804 gives no indication that it should be given any meaning other than its literal meaning.[300] Additionally, the disjunctive phrase in Section 804 goes much farther than simply adding a qualifier designed to make the meaning of "fraud" unmistakable.[301] It contains four nouns in the disjunctive and each word should be given its separate meaning (i.e. "fraud, deceit, manipulation, or contrivance").[302] A claim involving any one of these nouns should fulfill the requirements of Section 804.[303]

---

294. Corporate & Criminal Fraud Accountability Act of 2002, S. 2010, 107th Cong. § 5(b) (2002), *reprinted in* 3 CORPORATE FRAUD RESPONSIBILITY: A LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002, Doc. No. 78, at 5 (William H. Manz ed., 2003) (emphasis added).

295. *See* Corporate & Criminal Fraud Accountability Act of 2002, S. REP. NO. 107-146, 107th Cong., 2d Sess., at 17 (2002), *reprinted in* 3 CORPORATE FRAUD RESPONSIBILITY: A LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002, Doc. No. 85, at 1 (William H. Manz ed., 2003).

296. For the actual language of Section 804, see *supra* text accompanying note 244. The language ultimately adopted in Section 804 also contains the disjunctive term "or." *See* 28 U.S.C. § 1685(b) (2006). Congress contemplated various alternatives to serve as the last term in the disjunctive phrase. *See* legislative history cited *supra* note 282. This supports the conclusion that each word in the disjunctive phrase was intended to have independent meaning.

297. 28 U.S.C. § 1658 (emphasis added).

298. AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366, 409 (1999) (quoting Reiter v. Sonotone Corp., 442 U.S. 330, 339 (1979)).

299. Hawaiian Airlines, Inc. v. Norris, 512 U.S. 246, 253 (1994) (citing McNally v. United States, 483 U.S. 350, 358-59 (1987)).

300. *See supra* text accompanying note 244.

301. *See supra* text accompanying note 244.

302. *See supra* text accompanying note 244.

303. *See* Horne v. Flores, 129 S. Ct. 2579, 2597 (2009) (stating the disjunctive "or" in Rule 60(b)(5) "makes it clear that each of the provision's three grounds for relief is independently sufficient").

3. An Unheard of Restriction: Express Statutes of Limitations

Similarly, neither the text of Section 804 nor its legislative history limit its application to causes of action that have an express statute of limitations. On its face, Section 804 contains no language that confines its scope to causes of action without an express statute of limitations. Courts, however, have looked to the placement of where Section 804 was codified in reaching the conclusion that it is inapplicable to causes of action that have an express statute of limitations.[304] Section 804 amended 28 U.S.C. § 1658 which provides limitations periods for causes of action arising under acts of Congress.[305] That Congress chose to amend this statute and did not amend or repeal Section 13 of the Securities Act has been offered as evidence that Section 804 should not apply to Section 11 claims.[306] However, the placement of Section 804 is not, in and of itself, necessarily pertinent with respect to its scope.

First, 28 U.S.C. § 1658 is titled "Time Limitations on the Commencement of Civil Actions Arising Under Acts of Congress."[307] This title gives no indication that the statute's provisions are intended to be confined to acts of Congress that contain statutes having no express statute of limitations. Only subsection (a), not subsection (b)—the statute at issue here—contains such limiting language.[308] Second, Section 804 begins with the introductory phrase "[n]otwithstanding subsection (a)."[309] This language clearly disconnects Section 804 from the scope limitations contained in the language of subsection (a).[310] Third, interpreting Section 804 as applying only to causes of action without an express statute of limitations does not comport with the judicial interpretation that Section 804 applies to all causes of action requiring proof of fraud.[311]

---

304. *See In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 402, 414-15 (S.D.N.Y. 2005) (arguing that Congress's choice to amend 28 U.S.C.A. § 1658 rather than amending the Securities Act provided evidence that Section 804 should not apply to causes of action with an express statute of limitations); *see also In re* Enron Sec., Derivative, No. MDL-1446, Civ. A. H-01-3624, 2004 WL 405886, at *11 (S.D. Tex. Feb. 25, 2004); *In re* Global Crossing Ltd. Sec. Litig., 313 F. Supp. 2d 189, 197 n.6 (S.D.N.Y. 2003).

305. 28 U.S.C. § 1658(a) (2006); *see In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d at 414-15.

306. *See* 28 U.S.C. § 1658(a).

307. *Id.*

308. *See id.* ("Except as otherwise provided by law, a civil action arising under an Act of Congress enacted after the date of the enactment of this section may not be commenced later than 4 years after the cause of action accrues.").

309. *Id.*

310. *Id.*

311. *See* cases cited *supra* note 245.

Notably, a number of fraud-based causes of action under the securities laws have express statutes of limitations.[312] As such, Section 804 would not be applicable to these fraud-based claims. In this regard, Section 10(b) is the primary private right of action that requires proof of fraud and does not have an express statute of limitations.[313] Thus, by limiting Section 804 to causes of action requiring proof of fraud and to causes of action without an express statute of limitations, courts effectively limit Section 804 to claims brought under Section 10(b). As discussed above, had this been Congress's intent, there would have been no need to use such broad language or to make an amendment that affects eight different acts.

C. *Striking a Chord: The Case for Applying Section 804 to Section 11 Claims that Sound in Fraud*

The preceding discussion explains why Section 804 should be applied flexibly to any violation of the securities laws based on allegations of fraud, deceit, manipulation, or contrivance irrespective of whether the cause of action has an express statute of limitations. Since Section 11 causes of action that sound in fraud come within this criteria, they should be afforded the longer statute of limitations provided by Section 804. As the Report from the Senate Committee of the Judiciary recognized, The Corporate and Criminal Fraud Accountability Act of 2002 was designed to "prevent and punish corporate and criminal fraud, protect the victims of such fraud, . . . and hold wrongdoers accountable for their actions."[314] Defrauded investors who choose to bring their claims under Section 11 qualify as victims of corporate fraud and fall within the category of victims the Act is designed to protect.[315]

Further support for applying Section 804's longer statute of limitations to Section 11 claims that sound in fraud is found in the legislative history of Section 11's express statute of limitations.[316] As originally enacted, Section 13, which supplies the statute of limitations for Section 11, provided a two-year statute of limitations

312. *See, e.g.*, 15 U.S.C. § 78i(e) (providing the statute of limitations pertaining to the willful manipulation of security prices); Lampf v. Gilbertson, 501 U.S. 350, 360-61 (1991).

313. *See* Section 14(e), which applies to tender offers, likewise requires proof of fraud and has no express statute of limitations. *See* Panter v. Marshall Field & Co., 646 F.2d 271, 283-85 (7th Cir. 1981).

314. S. Rep. No. 107-146, at 8 n.10 (2002), *reprinted in* 3 CORPORATE FRAUD RESPONSIBILITY: A LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002, Doc. No. 85, at 2 (William H. Manz ed., 2003).

315. *Id.*

316. *See* Section 11, *supra* note 6.

and a ten year statute of repose.[317] In 1934, Congress shortened the limitations periods under Section 13 to its current form, in part, to deter strike suits[318] and to protect prospective Section 11 defendants from being subject to litigation for an unduly prolonged period.[319] Likewise, the particularity requirement of Rule 9(b) serves in part to discourage "fishing expeditions and strike suits."[320] Accordingly, Rule 9(b)'s heightened pleading requirements protect against the same fears that induced Congress to shorten Section 11's statute of limitations. With these fears addressed by the application of Rule 9(b), it would comport with congressional intent to provide Section 804's longer statute of limitations to Section 11 claims that sound in fraud.

VII. CONCLUSION

The magnitude of the federal interest in protecting the integrity and efficiency "of the market for nationally traded securities cannot be overstated."[321] Since the disastrous stock market collapse in 1929, and the Great Depression that followed, the Securities Acts "have anchored federal regulation" of securities markets—a vital element of the United States economy.[322] The Acts function as a crucial link between investors and the securities markets, providing investors with confidence that they will receive accurate information necessary to make informed investment decisions, and further providing an avenue for financial redress of corporate wrongdoings. Nonetheless, the judiciary's growing concern over the potential for vexatious litigation has resulted in a thirty-five-year trend of judicial constriction of the securities laws.[323]

Since its inception, Section 11 has played an integral role in the Securities Act's regulatory regime. Section 11's minimal pleading

---

317. *See* 15 U.S.C. § 77m.

318. *E.g.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975).

319. *See In re* Alstom SA Sec. Litig., 406 F. Supp. 2d 402, 417 (S.D.N.Y. 2005); 78 CONG. REC. S10185-10186 (daily ed. June 1, 1934) (statement of Sen. Byrnes), *reprinted in* 4 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item No. 13, at 10186 (J. S. Ellenberger & Ellen P. Mahar eds., 1993).

320. *See, e.g.,* U.S. *ex rel.* SNAPP, Inc. v. Ford Motor Co., 532 F.3d 496, 504 (6th Cir. 2008) (quoting United States *ex rel* Bledsoe v. Cmty. Health Sys., Inc., 501 F.3d 493, 510 (6th Cir. 2007)).

321. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 78 (2006).

322. *See id.;* Cent. Bank of Denver, N.A. v. First Int'l Bank of Denver, N.A., 511 U.S. 164, 170-71 (1994); United States. v. Naftalin, 441 U.S. 768, 775-76 (1979); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-95 (1976).

323. *See generally Blue Chip Stamps*, 421 U.S. at 740; *Cent. Bank of Denver,* 511 U.S. at 189; Stoneridge Inv. Partners v. Scientific Atlanta, 552 U.S. 148, 161-63 (2008); legislative history cited *supra* notes 34-38.

requirements and stringent standard of liability make it a powerful tool for injured investors. However, as expounded in this article, the judiciary, through restrictive interpretations, is altering the very nature of Section 11. Courts have looked to so-called principles of common sense and questionable assessments of legislative history in order to supersede the straight forward, unambiguous language of Section 11. This has resulted in a cause of action that extends to fewer investors, no longer applies to certain classes of investors, and is riddled with uncertainty at the pleading stage.

APA Excelsior III and its lineage introduced the "impossibility of reliance" as an unprecedented ground for dismissing a plaintiff's Section 11 claim. Frightfully, this line of cases evolved into the broader restriction that investors cannot recover under Section 11 "where it is certain that their purchases were motivated by factors other than the registration statement."[324] These cases have already precluded investors participating in Rule 144A/*Exxon Capital* exchange transactions, a common capital raising technique, from asserting claims under Section 11. Whether other classes of investors will be denied the protection of Section 11 based on the holdings in these cases is unknown. However, one can readily rely on these cases for introducing two new affirmative defenses—"impossibility of reliance" and that a plaintiff's investment decision was motivated by factors other than the registration statement; neither of these defenses appear in the text nor statutory history of Section 11.

Likewise, the rejection of statistical tracing has, in essence, made Section 11 relief generally unattainable for aftermarket purchasers. Cases like *Krim* represent a second generation of restrictive judicial interpretation of Section 11. The first generation, the introduction of the judicially created tracing doctrine, was the first to narrow the class of investors who could obtain relief under Section 11. Now, courts have further restricted the already restrictive tracing requirement by deeming statistical evidence insufficient to meet the preponderance of evidence standard applicable to tracing. With the current securities market practice of registering stock in "street name," statistical evidence, in all practicality, is the only proof available to aftermarket purchasers to establish tracing. Now, if even one share of unregistered stock enters the market at the same time or before the registered offering, aftermarket purchasers are precluded from asserting a successful Section 11 claim. Such a result does not comport with either the consumer protection or *in terrorem* functions of the Securities Act.

Before either of these obstacles come into play, plaintiffs must

---

324. *See, e.g.*, *In re* Healthsouth Corp. Sec. Litig., 261 F.R.D. 616, 647 (N.D. Ala. 2009), discussed, *supra* notes 88-92 and accompanying text.

first face the uncertainty of pleading their Section 11 claim. The relatively more liberal pleading requirements of Rule 8(a)(2) are applicable to Section 11 claims, but if the court deems that the claim "sounds in fraud," the heightened pleading requirements of Rule 9(b) apply. In many cases, this consequence will compel plaintiffs to choose between subjecting themselves to the heightened pleading requirements of Rule 9(b) or abandoning an alternatively pled fraud claim. Not only has this approach introduced inconsistency in the pleading domain, but it also creates inconsistency between legal principles whereby a claim can "sound in fraud" for pleading purposes but not for statute of limitations purposes. This irreconcilable inconsistency highlights the courts' willingness to impose new limitations on the federal securities laws and their disinclination to interpret these laws in a manner favorable to plaintiffs, even where such an interpretation is consistent with statutory text and legislative history.

***