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Robert L. Ortvals Jr.

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# The Continuation of the Tracing Doctrine: Giving Aftermarket Purchasers Standing Under Section 11 of the Securities Act of 1933

*Lee v. Ernst & Young, LLP*<sup>1</sup>

## I. INTRODUCTION

Around the turn of the twentieth century, pressure to regulate the marketing of fraudulently valued securities began to arise.<sup>2</sup> This pressure led states to pass laws regulating securities,<sup>3</sup> but these state laws proved to be relatively ineffective at curing securities fraud.<sup>4</sup> Following the enactment of these state laws, the federal government resisted implementing its own securities legislation.<sup>5</sup>

After the stock market crash of 1929, the federal government could resist no longer.<sup>6</sup> The crash saw the total value of the stock market to go from \$89 billion in October 1929 to \$15 billion in 1932.<sup>7</sup> While the general economic conditions of the time provided some backdrop for the crash, the high number of fraudulently traded stocks at the time was also a major contributor.<sup>8</sup> Under

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1. 294 F.3d 969 (8th Cir. 2002).

2. 1 THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.2 (3d ed. 1995).

3. Security is defined in Section 2(1) of the Securities Act of 1933 as follows: The term “security” means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (2000).

4. 1 HAZEN, *supra* note 2, § 1.2, at 6.

5. 1 HAZEN, *supra* note 2, § 1.2, at 6.

6. 1 HAZEN, *supra* note 2, § 1.2, at 6.

7. James E. Shapiro, Note, Hertzberg v. Dignity Partners, Inc.: *Standing to Sue Under Section 11 of the Securities Act of 1933; Reflections on Gustafson*, 15 BYU J. PUB. L. 117, 117 (2000).

8. 1 HAZEN, *supra* note 2, § 1.2, at 6.

pressure to implement regulations, Congress passed both the Securities Act of 1933 (the “1933 Act”) and the Securities Act of 1934 (the “1934 Act”).<sup>9</sup>

The 1934 Act was designed to apply to all postdistribution securities transactions.<sup>10</sup> The 1933 Act, however, was only concerned with the initial registration of securities.<sup>11</sup> It is this clash between the purposes of the 1933 Act and the 1934 Act that led the Supreme Court to rule in *Gustafson v. Alloyd Co.*<sup>12</sup> that Section 12(2) of the 1933 Act applied only to purchasers of initial public offerings (“IPOs”).<sup>13</sup>

Prior to *Gustafson*, courts had interpreted Section 11 of the 1933 Act to apply both to purchasers of IPOs and to aftermarket purchasers who could “trace” their purchases to reliance on a defective initial registration statement.<sup>14</sup> The *Gustafson* decision has brought into question the viability of the tracing doctrine given the noted purpose behind the 1933 Act. This Note examines the evolution of the tracing doctrine and the impact that *Gustafson* has and will have on that doctrine.

## II. FACTS AND HOLDING

A group of investors brought a class action suit against Ernst & Young, LLP (“E & Y”) and Summit Medical Systems, Inc. (“Summit”), a corporation that provides medical software and related products and services, claiming that Summit’s registration statement, filed in conjunction with its IPO in August 1995, made materially false statements.<sup>15</sup> On August 4, 1995, Summit stock began trading publicly.<sup>16</sup> After the IPO, the stock price increased although no

9. 1 HAZEN, *supra* note 2, § 1.2, at 7; see Brian Murray, *Aftermarket Purchaser Standing Under § 11 of the Securities Act of 1933*, 73 ST. JOHN’S L. REV. 633, 633 (1999).

10. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION § 1(D)(3) (4th ed. 2001); 1 HAZEN, *supra* note 2, § 1.2, at 8; Murray, *supra* note 9, at 633.

11. LOSS & SELIGMAN, *supra* note 10, § 1(D)(2); 1 HAZEN, *supra* note 2, § 1.2, at 7; Murray, *supra* note 9, at 633.

12. 513 U.S. 561 (1995).

13. See *id.* at 572-74. An initial public offering is defined as: “A company’s first public sale of stock; the first offering of an issuer’s equity securities to the public through a registration statement.” BLACK’S LAW DICTIONARY 1111 (7th ed. 1999).

14. See *Versys, Inc. v. Coopers & Lybrand*, 982 F.2d 653 (1st Cir. 1992); *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967); *Kirkwood v. Taylor*, 590 F. Supp. 1375 (D. Minn. 1984), *aff’d*, 760 F.2d 272 (8th Cir. 1985) (unpublished table opinion).

A registration statement is defined as follows: “A document containing detailed information required by the SEC for the public sale of corporate securities.” BLACK’S LAW DICTIONARY 1288 (7th ed. 1999).

15. *Lee v. Ernst & Young, LLP*, 294 F.3d 969, 971-72 (8th Cir. 2002).

16. *Id.* at 972.

profit was shown, and a secondary public offering was made in June 1996.<sup>17</sup> Therefore, the Summit stock price began to fall and fell below the price of the IPO.<sup>18</sup> On March 3, 1997, Summit disclosed that revenues had been improperly recognized.<sup>19</sup> On April 4, 1997, Summit filed revised statements regarding the revenues for the years 1994, 1995, and the first nine months of 1996.<sup>20</sup> E & Y was the accounting firm that audited and certified Summit's initial registration statement.<sup>21</sup>

Lee, the plaintiff who was head of a class of investors that were aftermarket purchasers of Summit stock based on the allegedly defective registration statement, claimed that his standing to file suit was rooted in Section 11 of the 1933 Act.<sup>22</sup> Lee did not assert that the class members purchased shares of Summit stock during the IPO, but rather had subsequently purchased their shares relying on the information contained in the initial registration statement.<sup>23</sup> E & Y and Summit contended that Section 11 only applied to purchasers who bought stock during the IPO period.<sup>24</sup>

The district court granted E & Y's motion to dismiss for failure to state a claim upon which relief can be granted.<sup>25</sup> The court held that Section 11 applied only to IPO purchasers and not to subsequent purchasers relying on the initial

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.* The revised statements showed revenues to be \$5.6 million (eleven percent) less than originally reported. *Id.*

21. *Id.*

22. *Id.* at 971-72; see 15 U.S.C. § 77k (2000). Section 77k(a) provides the following:

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

. . . .

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him.

23. *In re Summit Med. Sys., Inc.*, 10 F. Supp. 2d 1068, 1069 (D. Minn. 1998).

24. *Id.* at 1069-70.

25. *See id.* at 1069.

registration statement.<sup>26</sup> The court, noting that the Eighth Circuit had yet to rule on this matter,<sup>27</sup> based its decision on the holdings of other jurisdictions<sup>28</sup> and upon the Supreme Court's holding in *Gustafson v. Alloyd Co.*<sup>29</sup>

A three judge panel of the Court of Appeals for the Eighth Circuit unanimously reversed the district court.<sup>30</sup> The court relied on the plain language, "any person acquiring such security,"<sup>31</sup> to interpret Section 11 to apply to aftermarket purchasers as well as IPO purchasers.<sup>32</sup> The court also noted that after *Gustafson*, both the Ninth<sup>33</sup> and Tenth<sup>34</sup> Circuits held that Section 11 applies to aftermarket purchasers.<sup>35</sup> It concluded that standing to pursue a claim under Section 11 of the 1933 Act is available to aftermarket purchasers who can make a prima facie showing that the stock purchased can be traced back to an initial registration statement that is false and misleading.<sup>36</sup>

### III. LEGAL BACKGROUND

Following the collapse of the stock market in 1929, fraudulent securities trading was rampant, and Congress was under pressure to cure this defect.<sup>37</sup> Congress took note of the fact that fifty billion new securities were issued in the United States during the decade following World War I, and that half of those securities had proven worthless.<sup>38</sup> The pervasiveness of fraudulent securities trading led Congress to pass the 1933 and 1934 Acts.<sup>39</sup>

Section 11(a) of the 1933 Act provides standing to bring suit for "any person acquiring such security" issued with a registration statement that contained untrue statements or omissions of material facts.<sup>40</sup> The key issue that this background will explore is whether the language "any person acquiring such security"<sup>41</sup> allows Section 11 to apply to aftermarket purchasers of securities who

26. *Id.* at 1070.

27. *Id.*

28. District courts in Colorado, Nevada, and the Southern District of New York.

29. 513 U.S. 561 (1995) (holding that Section 12(2) of the Securities Act of 1933 applied only to purchasers of IPOs).

30. *Lee v. Ernst & Young, LLP*, 294 F.3d 969, 978 (8th Cir. 2002).

31. 15 U.S.C. § 77k(a) (2000).

32. *Lee*, 294 F.3d at 976-77.

33. *See Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999).

34. *See Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000).

35. *Lee*, 294 F.3d at 975.

36. *Id.* at 978.

37. *See supra* notes 6-9 and accompanying text.

38. H.R. REP. NO. 73-85, at 2 (1933).

39. *See id.*; *supra* notes 6-9 and accompanying text.

40. 15 U.S.C. § 77k(a) (2000).

41. *Id.*

can “trace” their purchase to reliance on a defective registration statement<sup>42</sup> or whether Section 11 is limited to those purchasers of the IPO who relied on a defective registration statement.

### A. *The Beginnings of the Tracing Doctrine*

One of the early cases interpreting the scope of Section 11 is *Barnes v. Osofsky*.<sup>43</sup> The issue in *Barnes* was whether the district court had properly ruled that Section 11 only applied to persons that could establish that they purchased securities issued under the registration statement.<sup>44</sup> Appellants argued that requiring purchasers to prove that the shares they purchased were those issued with the registration statement would be impossible, practically speaking, since most trading was done through brokers who did not keep track of whether they were receiving new or old shares.<sup>45</sup> The court recognized that these were practical concerns because it would often be difficult to trace securities back to the registration, but noted that Section 11(g)<sup>46</sup> limited Section 11 to purchasers of registered shares.<sup>47</sup> The court stated that the purpose behind Section 11 was to provide a remedy for purchasers who relied on the registration statement. A requirement that the purchasers prove that the securities purchased were issued with the registration statement would effectuate that purpose.<sup>48</sup> The court, however, did not limit Section 11 actions to those who purchased shares only during the IPO, observing that “the remedies of [Section] 11 were accorded to purchasers regardless of whether they bought their securities at the time of the original offer or at some later date.”<sup>49</sup>

In light of *Barnes*, the District Court for the District of Minnesota considered the actual tracing requirements necessary to prove that the securities purchased were issued with the registration statement in *Kirkwood v. Taylor*.<sup>50</sup> The court considered four different methods of tracing offered by the plaintiffs.<sup>51</sup>

42. A defective registration statement is a registration statement that contains untrue statements or omissions of material facts. *See id.*

43. 373 F.2d 269 (2d Cir. 1967).

44. *Id.* at 271.

45. *Id.* at 271-72.

46. 15 U.S.C. § 77k(g) (2000). Section 77k(g) provides: “In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.”

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

48. *Id.*

49. *Id.* at 273 (quoting H.R. REP. NO. 73-85, at 9 (1933)) (internal quotations omitted).

50. 590 F. Supp. 1375 (D. Minn. 1984), *aff'd*, 760 F.2d 272 (8th Cir. 1985) (unpublished table opinion).

51. *Id.* at 1378.

The first method considered, and ultimately accepted, was the “direct trace method.”<sup>52</sup> Under the “direct trace method,” the plaintiff is required to trace all shares for which damages are claimed to the IPO.<sup>53</sup>

The court rejected the second approach, the “fungible mass method,” which involves shares that have been pooled so that a portion of the shares bought will be attributable to the initial registration statement, but no one share will be directly traceable.<sup>54</sup> The court followed the *Barnes* logic in rejecting this approach, realizing that the plaintiffs could only prove that their shares *might* have been issued in the offering, which would not be consistent with the scheme of Section 11.<sup>55</sup>

The next tracing approach the court rejected was the “contrabroker method,” in which buyers purchase securities directly from the underwriter of the offering. Again, this failed to prove that the securities purchased were issued with the registration statement because it did not automatically follow that just because the shares purchased were from the underwriter, they were *necessarily* new shares.<sup>56</sup>

Finally, the court examined the “heritage method,” where purchasers of stock in the over-the-counter market receive stock certificates registered in their individual names.<sup>57</sup> The purchasers then identify by code number the certificates they received, which allows them to identify the particular certificate that their individual certificates were issued from.<sup>58</sup> This process is continued until the purchasers determine the ultimate origin of their certificates.<sup>59</sup> The plaintiffs argued that this method proved that some of the certificates were issued during the IPO, therefore allowing them to trace their shares back to the IPO.<sup>60</sup> The court, however, rejected this argument because the plaintiffs could not prove that any of the shares were necessarily IPO shares.<sup>61</sup>

The First Circuit interpreted Section 11 to apply to aftermarket purchasers in *Versys, Inc. v. Coopers & Lybrand*.<sup>62</sup> That court noted that “section 11 of the Securities Act of 1933 imposes . . . continuing liability for misstatements or material omissions in registration statements.”<sup>63</sup> In discussing Section 11 the

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52. *Id.*

53. *Id.*

54. *Id.* at 1379-80.

55. *Id.* at 1380.

56. *Id.* at 1381.

57. *Id.* at 1382.

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. 982 F.2d 653 (1st Cir. 1992).

63. *Id.* at 654 (internal citation omitted).

court found that liability was imposed “for the benefit even of purchasers after the original offering.”<sup>64</sup>

### B. *The Gustafson Decision*

The 1995 Supreme Court ruling in *Gustafson v. Alloyd Co.*<sup>65</sup> has threatened the earlier interpretations of Section 11. In *Gustafson*, the Court was asked to determine whether a purchase agreement for the sale of securities was a prospectus under Section 12(2)<sup>66</sup> of the 1933 Act.<sup>67</sup> Under Section 12(2), a party would have a right to rescission if material misstatements of fact were made “by means of a prospectus or oral communication.”<sup>68</sup> In order to define what a prospectus was under Section 12(2), the Court turned to Section 10 of the 1933 Act,<sup>69</sup> which provides that “a prospectus . . . shall contain the information contained in the registration statement.”<sup>70</sup> The Court concluded that under Section 10 a prospectus had to consist of documents that were related to public offerings.<sup>71</sup> The Court also noted that it did not use Section 10 as a definitional section but rather for guidance to give a term in the Act a consistent meaning.<sup>72</sup>

Next, the Court turned to Section 2(10) of the 1933 Act,<sup>73</sup> which states that “[t]he term ‘prospectus’ means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.”<sup>74</sup> *Alloyd* focused on the word “communication” and argued that any written communication offering sale of a security was a “prospectus.”<sup>75</sup> The Court rejected the focus on the word “communication,” however, and instead looked at the statute as a whole and determined that the term “prospectus” referred to a document that solicited the public to acquire securities.<sup>76</sup> The Court concluded that the purchase agreement

64. *Id.* at 657.

65. 513 U.S. 561 (1995).

66. 15 U.S.C. § 771(a)(2) (2000). Section 771(a)(2) provides that any person who: “[O]ffers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . shall be liable . . . to the person purchasing such security from him.”

67. *Gustafson*, 513 U.S. at 564.

68. *Id.* at 567 (quoting 15 U.S.C. § 771(a)(2) (1994)).

69. 15 U.S.C. § 77j (2000).

70. *Gustafson*, 513 U.S. at 569 (quoting 15 U.S.C. 77j(a)(1) (1994)).

71. *Id.*

72. *Id.* at 570.

73. 15 U.S.C. § 77b(a)(10) (2000).

74. *Id.*

75. *Gustafson*, 513 U.S. at 574.

76. *Id.*



between the two parties could not be a prospectus because a prospectus was confined to public offerings and not private transactions.<sup>77</sup>

Some of the language used in *Gustafson* also cast doubt as to whether Section 11 would also only apply to public offerings. In discussing Section 17(a) of the 1933 Act<sup>78</sup> the Court noted that it was the “one provision of the Act that extends coverage beyond the regulation of public offerings.”<sup>79</sup> The Court also discussed, “The primary innovation of the 1933 Act was the creation of federal duties . . . in connection with public offerings.”<sup>80</sup> Given the Court’s position that the 1933 Act was specifically designed for public offerings, the viability of the tracing doctrine was called into question by *Gustafson*.

### C. Post-Gustafson Interpretation of Section 11

Since *Gustafson*, there has been a divergence in views as to whether Section 11 only applies to purchasers during the IPO, or whether the tracing approach is still a viable approach under Section 11. In *Gannon v. Continental Insurance Co.*,<sup>81</sup> a district court in New Jersey refused to apply the tracing approach, ruling that stock purchased on the open market by definition is not an IPO and does not give rise to a cause of action under Section 11.<sup>82</sup> Prior to the instant decision, however, the two appellate courts<sup>83</sup> that had ruled on Section 11 found that the Section was not limited to only IPOs.

In *Hertzberg v. Dignity Partners, Inc.*, the Ninth Circuit distinguished Section 11 from Section 12(2) and refused to use *Gustafson* to limit the scope of Section 11.<sup>84</sup> The court observed that the language “any person” who purchased “such security” was sufficiently broad that as long as the security was purchased under the registration statement the purchaser was not required to purchase it during the IPO.<sup>85</sup> The court also noted that Section 11(e) uses “the amount paid for the security (not exceeding the price at which the security was offered to the public)”<sup>86</sup> as the measure of damages, and that this provision would be redundant if the only people who could recover damages were those who bought during the

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77. *Id.* at 581-82.

78. 15 U.S.C. § 77q(a) (2000).

79. *Gustafson*, 513 U.S. at 576.

80. *Id.* at 571.

81. 920 F. Supp. 566 (D.N.J. 1996).

82. *Id.* at 575.

83. See *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999).

84. *Hertzberg*, 191 F.3d at 1076.

85. *Id.* at 1080.

86. *Id.* (quoting 15 U.S.C. § 77k(e) (1994)) (internal quotations omitted).

public offering at the price initially offered to the public.<sup>87</sup> After relying on statutory construction to determine that Section 11 applied to aftermarket purchasers, the court distinguished Section 11 from the ruling in *Gustafson*.<sup>88</sup>

The *Hertzberg* court first noted that the Supreme Court did not give any indication that it intended *Gustafson* to apply to Section 11.<sup>89</sup> The court then distinguished between the language of Section 11 and Section 12(2) regarding those qualified to bring suit.<sup>90</sup> The court compared the Section 11 “any person acquiring such security” language to that of Section 12(2) which allows suit against a seller of a security prospectus by “the person purchasing such *security from him*.”<sup>91</sup> The court reasoned that the “express privity” requirement of Section 12(2) required that a plaintiff must have purchased the security directly from the person who issued the prospectus, but that Section 11 had no such requirement and was not bound by the reasoning in *Gustafson*.<sup>92</sup> The court also reiterated the same legislative history the *Barnes* court used to support its holding regarding the scope of Section 11.<sup>93</sup> Finally, the court noted that the tracing concerns of *Barnes* were not an issue because all of the stock publicly issued was sold in a single offering that gave rise to the case.<sup>94</sup>

In *Joseph v. Wiles*,<sup>95</sup> the Court of Appeals for the Tenth Circuit followed much of the same reasoning used in *Hertzberg*, including the plain language of Section 11 and the language of the damages provision under Section 11(e), to conclude that Section 11 was not limited to IPOs as long as the securities purchased could be traced back to the initial registration statement.<sup>96</sup>

#### IV. INSTANT DECISION

In *Lee v. Ernst & Young, LLP*,<sup>97</sup> the Court of Appeals for the Eighth Circuit resolved a dispute that involved aftermarket purchasers bringing suit under Section 11 of the 1933 Act.<sup>98</sup> The issue before the court was whether Section 11 of the 1933 Act gave standing only to purchasers of the IPO or also to aftermarket purchasers who could trace their securities back to the initial

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87. *Id.*

88. *Id.* at 1081.

89. *Id.*

90. *Id.* at 1081.

91. *Id.* (quoting 15 U.S.C. §§ 77k(a), 77l(a)(2) (1994)).

92. *Id.*

93. *Id.*

94. *Id.* at 1082.

95. 223 F.3d 1155 (10th Cir. 2000).

96. *Id.* at 1159-60.

97. 294 F.3d 969 (8th Cir. 2002).

98. *Id.* at 971.

registration statement.<sup>99</sup> In an opinion authored by Circuit Judge McMillian, the court held that Section 11 did give aftermarket purchasers standing to sue.<sup>100</sup>

The court began its discussion by examining Lee's argument that aftermarket purchasers can bring a claim under Section 11 if they can trace their securities to the public offering under the registration statement at issue.<sup>101</sup> Lee also argued that the district court was in error in relying upon *Gustafson* to dismiss the claim and that *Gustafson* was not applicable to Section 11 because of the difference in language between Section 11 and Section 12(2).<sup>102</sup> E & Y argued that the district court properly applied *Gustafson* to Section 11 given the overall structure of the 1933 Act.<sup>103</sup> E & Y also argued that the real distinction between Section 11 and Section 12(2) is not who can sue, but who can be sued.<sup>104</sup>

The court noted that it had yet to rule upon standing under Section 11 in a published opinion.<sup>105</sup> The court did, however, point out that it had affirmed *Kirkwood v. Taylor*,<sup>106</sup> which upheld an interpretation of Section 11 that allowed aftermarket purchasers to trace their securities to the registration statement.<sup>107</sup>

The court then examined the impact that *Gustafson* has had on Section 11 interpretation.<sup>108</sup> The court noted that since *Gustafson* there had been a split between the district courts as to whether the tracing doctrine was still viable, and that the two appellate courts that had decided Section 11 cases since *Gustafson* had determined that aftermarket purchasers still had standing under Section 11 if they could trace their securities to the defective registration statement.<sup>109</sup> The court also recognized that prior to *Gustafson*, the First and Second Circuits had taken a similar approach to Section 11 claims.<sup>110</sup>

The court's analysis began by looking at the plain language of Section 11, with particular emphasis on the phrase "any person acquiring such security."<sup>111</sup> Noting the broad language of Section 11, the court compared the language of Section 12(2) which provides that any person who "offers or sells a security"

99. *Id.* at 972.

100. *Id.*

101. *Id.* at 974.

102. *Id.*

103. *Id.* at 975.

104. *Id.*

105. *Id.*

106. 590 F. Supp. 1375 (D. Minn. 1984), *aff'd*, 760 F.2d 272 (8th Cir. 1985) (unpublished table opinion).

107. *Lee*, 294 F.3d at 975.

108. *Id.*

109. *Id.*

110. *Id.* at 975-76.

111. *Id.* at 976 (quoting 15 U.S.C. § 77k(a) (2000)).

shall be liable “to the person purchasing such security from him.”<sup>112</sup> The court concluded that the express privity requirement of Section 12, compared to Section 11 which had no express privity requirement, indicated Congress’s intent that Section 11 have a broader meaning.<sup>113</sup> The text of Section 11 was construed to “state unambiguously that a cause of action exists for any person who purchased a security that was originally registered under the allegedly defective registration statement—so long as the security was indeed issued under *that* registration statement.”<sup>114</sup>

The court also took note of the Section 11(e) language that calculates damages by the difference between the amount paid (not exceeding the price offered to the public) and the price at the time of the suit.<sup>115</sup> If only purchasers of the IPO were allowed to bring suit, then there would be no point in limiting the price.<sup>116</sup>

Next, the court looked to see if its interpretation of Section 11 was consistent with legislative intent finding that “[t]he purpose and scope of the 1933 Act was to regulate the initial distribution of securities.”<sup>117</sup> The court then noted that the importance of the registration statement was indicated by the fact that liability could be imposed under Section 11 without a scienter requirement.<sup>118</sup> By interpreting Section 11 to provide a cause of action to “anyone who purchased stock that was originally issued under the registration statement in question,” the incentive for compliance is enhanced.<sup>119</sup> To prevent abuses, however, the statute included a requirement that aftermarket purchasers relied on the registration statement.<sup>120</sup> The court then reiterated that requiring aftermarket purchasers to trace their securities to a defective registration statement further ensured the statutory purpose.<sup>121</sup>

The court concluded that under Section 11 of the 1933 Act, standing to sue existed for aftermarket purchasers who could make a *prima facie* showing that the securities purchased could be traced to the allegedly defective registration statement.<sup>122</sup>

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112. *Id.* (quoting 15 U.S.C. § 77l(2) (2000)).

113. *Id.*

114. *Id.* at 976-77.

115. *Id.* at 977.

116. *Id.*

117. *Id.* at 977-78.

118. *Id.* at 978.

119. *Id.*

120. *Id.*

121. *Id.* at 978.

122. *Id.*

## V. COMMENT

In *Lee v. Ernst & Young, LLP*, the Court of Appeals for the Eighth Circuit held that Section 11 of the 1933 Act gave aftermarket purchasers of securities standing to bring suit if they could trace the securities purchased to the registration statement alleged to contain material misstatements or omissions.<sup>123</sup> The holding of the Eighth Circuit is consistent with both the pre- and post-*Gustafson* trend in the appellate courts to distinguish Section 11 from Section 12.<sup>124</sup> Barring intervention by the Supreme Court, it appears that this trend will continue given the weight of the authority in support of the tracing doctrine.<sup>125</sup>

The legislative history to the 1933 Act provides a number of policy considerations that support the notion that Section 11 applies to aftermarket purchasers.<sup>126</sup> President Roosevelt stated that the purpose behind the 1933 Act was to ensure “full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public. . . . It puts the burden of telling the whole truth on the seller.”<sup>127</sup> The desire for open and full disclosure of information to the public would be best served by applying the tracing doctrine to aftermarket purchasers because the specter of liability is greatly increased.

Further, it seems that Congress intended for Section 11 to apply to aftermarket purchasers. Legislative history reveals that Section 11 “entitle[s] the buyer of securities sold upon a registration statement including an untrue statement or omission of a material fact, to sue for recovery of his purchase price, or for damages not exceeding such price.”<sup>128</sup> This language does not indicate that the buyer must be an IPO purchaser, but merely must have relied on the registration statement. In describing who has standing under Section 11, Congress stated that it was:

[A]ll purchasers regardless of whether they bought their securities in an interstate or intrastate transaction, and regardless of whether they bought their securities at the time of the original offer or at some later

123. *Id.*

124. See *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999); *Versyss, Inc. v. Coopers & Lybrand*, 982 F.2d 653 (1st Cir. 1992); *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967); *Kirkwood v. Taylor*, 590 F. Supp. 1375 (D. Minn. 1984), *aff'd*, 760 F.2d 272 (8th Cir. 1985) (unpublished table opinion).

125. See *supra* note 124; 1 HAZEN, *supra* note 2, § 7.3; Murray, *supra* note 9, at 636.

126. See H.R. REP. NO. 73-85 (1933).

127. *Id.* at 2.

128. *Id.* at 9.

date, provided of course, that the remedy is prosecuted within the period of limitations provided by section 13.<sup>129</sup>

The language that Congress used in this legislative history definitely seems to support the notion that Section 11 applies to aftermarket purchasers; there really is no other plain reading.

There may be some temptation to interpret Section 11 to apply only to purchasers of IPOs. Certainly, such an interpretation would provide a certain degree of uniformity to the 1933 Act, but such a desire for uniformity probably does not outweigh the policy interests of interpreting Section 11 broadly. By interpreting Section 11 broadly to apply to aftermarket purchasers, the Eighth Circuit provides more incentive to those filing a registration statement for an IPO to ensure that the statement contains accurate information. Although this interpretation of Section 11 is considered broad, it should be noted that the tracing requirement will not open up a flood of liability since direct tracing is required and can in practice be incredibly difficult to prove.<sup>130</sup>

The *Lee* opinion followed the very logical progression of its pre- and post-*Gustafson* predecessors. As a result, and barring intervention from the Supreme Court, it is likely that future appellate decisions will follow the same reasoning.

## VI. CONCLUSION

At the turn of the twentieth century, fraudulent trading of securities was a problem that states unsuccessfully attempted to address.<sup>131</sup> It took the stock market crash of 1929 for Congress to realize that it needed to act against the rampant securities fraud in this country.<sup>132</sup> As a result, Congress passed the Securities Act of 1933 and the Securities Act of 1934.<sup>133</sup> Given that the 1933 Act was primarily concerned with IPOs,<sup>134</sup> it is understandable that some question existed about whether Section 11 only applied to IPO purchasers.

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129. *Id.* at 22. Section 13 provides:

No action shall be maintained to enforce any liability created under section 77k . . . of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . . In no event shall any such action be brought to enforce a liability created under section 77k . . . more than three years after the security was bona fide offered to the public.

15 U.S.C. § 77m (2000).

130. *See Barnes v. Osofsky*, 373 F.2d 269, 272-73 (2d Cir. 1967).

131. *See supra* notes 2-4 and accompanying text.

132. *See supra* notes 6-9 and accompanying text.

133. *See supra* notes 6-9 and accompanying text.

134. *See supra* note 11 and accompanying text.

Given the language of Section 11, however, and the legislative history that accompanies it, courts have consistently upheld the tracing doctrine in applying it to aftermarket purchasers. Since the policy considerations behind both the 1933 Act and the 1934 Act were to provide a market in which consumers could openly trade securities with full knowledge and understanding, it is likely that the tracing doctrine will continue to be accepted by the circuits. And, barring some unforeseen split on the matter, it is unlikely that the Supreme Court would limit the applicability of Section 11 to only IPO purchasers.

ROBERT L. ORTBALS, JR.