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Seller Liability Under Section 12(2) of the Securities Act of 1933

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Seller Liability Under Section 12(2) of the Securities Act of 1933: A Proximate Cause-Substantial Factor Approach Limited by a Duty of Inquiry

I. Introduction

The 1929 stock market crash and the consequent Great Depression directly precipitated comprehensive legislation to realign the economy and restore public confidence in investment institutions.[1] In his 1933 letter to Congress in which he requested effective securities legislation, President Roosevelt stated,

> There is . . . 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.
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> This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.
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> The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.[2]

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1. *See Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 1 (1933) [hereinafter cited as *1933 House Hearings*]. In his remarks to the House, Representative Sabbath emphatically challenged Congress to take action to correct the nation's woes and stated in part:

> We must act. We must have legislation, not only to protect the people in the future, but to bring about the punishment of the men who brought about ruin to 20,000,000 American people, who are responsible for thousands upon thousands of suicides; who brought about a condition that has destroyed the value of the property of the men, women, and children of America; a condition that has brought about destruction of the property of widows and orphans; and that has closed the banks, ruined business men and manufacturers in every section of the Nation.

Id. at 207; *see* Comment, *"Reasonable Care" in Section 12(2) of the Securities Act of 1933*, 48 U. Chi. L. Rev. 372, 379 n.33 (1981).

2. Letter from President Franklin D. Roosevelt to Congress (March 29, 1933), *reprinted in 1933 House Hearings, supra* note 1, at 1. Following President Roosevelt's call for legislative action, Representative Huston Thompson, a former member of the Federal Trade Commission, drafted legislation that provided strict controls over investment institutions and the securities handled by them. *See* H.R. Rep. No. 4314, 73d Cong., 1st Sess. § 6 (1933). Members of both Houses of Congress, however, rapidly began to oppose the Thompson bill on two grounds. First, the congressmen viewed the Thompson bill as "totally inconsistent with the President's expressed desires." Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 31 (1959). Although President Roosevelt recognized the need for full publicity and information about "every issue of new securities to be sold in interstate commerce," the Thompson bill would have given the federal government "extensive powers to control the issu-

Reflecting this theme of "let the seller also beware," the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act) provide for a comprehensive scheme to protect securities investors.[3] While section 10(b) of the 1934 Act[4] and Securities Ex-

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ance and sale of securities." *Id.* at 30-31. Second, the congressmen also recognized the unworkability of the Thompson bill because it imposed strict controls on the registration of virtually all securities, rather than more properly protecting the public interest by instituting a system of controls on the offering of only selected securities. Moreover, the Thompson bill failed to exempt sales of outstanding securities and limited the exemption only to certain isolated transactions. *Id.* at 31-32. Therefore, at President Roosevelt's instigation, a small group of legal scholars assembled to draft a new bill. *See id.* at 33. Since this group formulated and drafted the bill largely in private, little legislative history exists to explain many of the finer points of the legislation. *See id.* at 33-39. The report of the conference committee, regarding the new bill, H.R. REP. No. 152, 73d Cong., 1st Sess. (1933), "deliberately contained language commenting upon the meaning of certain of the most contentious provisions of the bill in the hope that the language as an expression of the 'intent' of Congress would control the administrative and judicial interpretation of the act." Landis, *supra* note 2, at 47. The *House Report*, however, did not mention the scope of "seller" under § 12(2).

3. Herman & MacLean v. Huddleston, 103 S. Ct. 683, 687-90 (1983). Congress recognized that the Securities & Exchange Commission (Commission or SEC) practicably could not review and consequently could not guarantee the information contained in a registration statement or prospectus. *See 1933 House Hearings*, *supra* note 1, at 57-58; Landis, *supra* note 2, at 32-35. Therefore, §§ 6, 7, and 10 require disclosure of information, *see* 15 U.S.C. §§ 77f, 77g, 77j (1976), and §§ 11, 12, and 17 impose liability for misstatement or nondisclosure of a material fact about securities entering the marketplace for the first time, *see* 15 U.S.C. §§ 77k, 77*l*, 77q (1976). Congress apparently intended to provide the purchasers of speculative securities with the same informational advantages available to the issuers. Congress did not intend for the Commission to have the responsibility of verifying and approving the securities. *See 1933 House Hearings*, *supra* note 1, at 57-58; SEC Rule 425, 17 C.F.R. § 230.425 (1982). Other remedial sections of the securities acts provide for criminal liability, *see, e.g.*, Securities Act of 1933 § 17, 15 U.S.C. § 77q (1976), or for SEC enforcement actions, *see, e.g.*, *id.* § 20, 15 U.S.C. § 77t (1976) (SEC can seek injunctions against actions that violate the Securities Act of 1933).

The Supreme Court recently resolved an old dispute about whether § 10(b) and rule 10b-5 of the Securities Exchange Act of 1934 (1934 Act) can apply to the Securities Act of 1933 (1933 Act). *See* Herman & MacLean v. Huddleston, 103 S. Ct. 683 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); *infra* notes 143-50 and accompanying text; *cf., e.g.*, McFarland v. Memorex Corp., 493 F. Supp. 631, 653 (N.D. Cal. 1980) ("The courts are sharply divided, however, on the question whether a plaintiff can pursue a 10b-5 remedy for misstatements that appear in a registration statement governed by the 1933 Act."). Therefore, § 10(b) and rule 10b-5 may be the basis for a private cause of action, criminal liability, and an SEC enforcement action under the 1934 Act. *See* Herman & MacLean v. Huddleston, 103 S. Ct. 683 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

4. 15 U.S.C. § 78j (1976). Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, 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.

change Commission (SEC) rule 10b-5[5] provide a "catchall" for fraud in connection with the purchase or sale of any security under either the 1933 Act or the 1934 Act,[6] section 12(2) expressly provides a private cause of action[7] for misstatements in or omissions from a prospectus or oral communication. Section 12 most importantly imposes liability for mere negligence instead of the more stringent requirement of scienter under section 10(b).[8] A purchaser of securities may bring a section 12(2) action against any person[9] who offered or sold the security[10] only if this seller makes "an untrue statement of a ma-

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Id.

5. 17 C.F.R. § 240.10b-5 (1982). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statements of material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

6. *See* Herman & MacLean v. Huddleston, 103 S. Ct. at 687-90.

7. 15 U.S.C. § 77*l* (1976). Section 12(2) provides in part:

> Any person who—
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> . . . .
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> (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . , and who shall not sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known, of such untruth or omission,
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> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Id.

8. *See infra* notes 93, 102-03, & 152 and accompanying text.

9. Section 15 provides a purchaser the right to seek a remedy against anyone who "controlled" the seller. 15 U.S.C. § 77o (1976); *see infra* note 29.

10. Section 12 originally stated, "Any person who sells . . . ," but in 1954 Congress amended the section to state, "Any person who offers or sells . . . ." Act of Aug. 10, 1954, Pub. L. No. 577, § 9, 68 Stat. 686. The probable purpose of the amendment was to harmonize the "sale" language of § 12 with the definition of "sale" in § 2(3), *see infra* note 12, and to complement the changes in § 5 of the 1933 Act that permitted certain offers after the filing of a registration statement but before its effective date. *See* 15 U.S.C. § 77e (1976). The amendment hence was necessary to preserve existing law and to reflect more accurately the extent of liability under § 12(1) of the 1933 Act. H.R. REP. No. 1542, 83d Cong., 2d Sess. 26 (1954). This Note refers to persons subject to § 12 liability as "persons who sell" or "sellers."

terial fact or omits to state a material fact" in a prospectus or oral communication[11] and the statement or omission injures the purchaser. The section expressly provides two remedies: recovery of consideration paid plus interest, or damages if the purchaser no longer owns the security. Although section 2(3) of the 1933 Act[12] expressly defines "sale," "sell," "offer to sell," and "offer for sale," the 1933 Act nowhere defines whom a court may hold liable as a "seller." Moreover, no legislative history exists to provide guidance for defining section 12 seller status, and the courts also have not uniformly defined this term.

The courts historically have followed five approaches, three of which they still employ, to interpret the scope of "seller" under section 12. The three major approaches—strict privity,[13] proximate cause-substantial factor,[14] and aiding and abetting[15]—represent the range from a literal to an extremely liberal construction of the term "seller." The courts no longer employ the remaining two approaches—participation[16] and duty.[17] In *Cady v. Murphy*,[18] one of the earliest cases concerning section 12(2) seller liability, the United States Court of Appeals for the First Circuit employed a strict privity approach and identified as a seller only the titleholder or his broker-agent. Deciding to interpret the 1933 Act liberally and thereby to promote its "remedial purposes," various district courts have abandoned this strict privity approach of *Cady* and have instituted a much broader participation[19] or duty[20] approach. The United States Court of Appeals for the Fifth Circuit, however, recognized that although the participation and duty approaches are overly broad, the strict privity approach is too restrictive; therefore, it has adopted an

11. Compare § 11, which allows, with certain qualifications, a purchaser to sue persons who provided a false registration statement. 15 U.S.C. § 77k (1976).

12. *Id.* § 77b(3). Section 2(3) provides in part:

> The term "sale" or "sell" shall include every contract of sale or disposition of a security or interest in a security, for value. The term "offer to sell", "offer for sale", or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.

Id.

13. *See infra* notes 25-36.

14. *See infra* notes 50-81.

15. *See infra* notes 82-114.

16. *See infra* notes 37-47.

17. *See infra* notes 48-49.

18. 113 F.2d 988 (1st Cir.), *cert. denied,* 311 U.S. 705 (1940).

19. *See, e.g.,* Freed v. Szabo Food Serv., Inc., [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,317 (N.D. Ill. 1964); Wonneman v. Stratford Sec. Co., [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 90,923 (S.D.N.Y. 1959).

20. *See, e.g.,* Gould v. Tricon, Inc., 272 F. Supp. 385 (S.D.N.Y. 1967).

intermediate position—the "proximate cause-substantial factor" approach.[21] While some district courts have expanded the participation approach further by creating secondary liability under section 12(2),[22] other courts[23] have rediscovered the strict privity approach. Although the United States Supreme Court has not yet ruled on the scope of liability under section 12(2), the Supreme Court recently expressed its conviction not only that courts strictly must construe statutes according to the "clear language" if no legislative history exists to guide the interpretation of the statutory language, but also that they coextensively should apply the 1933 Act and the 1934 Act to promote the broad remedial purposes of the securities laws.[24]

This Note discusses which persons courts should deem to be "sellers" under section 12(2) according to their relationships to the challenged transaction. Part II examines the divergent approaches that courts have developed to identify seller status in the absence of legislative history. Part III analyzes the three major approaches and compares the scope of liability under each analysis. Last, part IV concludes that significant differences exist among these approaches and that courts uniformly should adopt a modified version of the proximate cause-substantial factor analysis.

II. The Scope of Section 12(2)

A. *Strict Privity Required Between Purchaser and Seller*

Courts initially interpreted section 12(2) to require strict contractual privity between the purchaser and the seller.[25] Interpreting

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21. *See, e.g.*, Junker v. Crory, 650 F.2d 1349 (5th Cir. 1981); Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981), *aff'd in part & rev'd in part*, 103 S. Ct. 683 (1983); Croy v. Campbell, 624 F.2d 709 (5th Cir. 1980); Pharo v. Smith, 621 F.2d 656 (5th Cir. 1980); Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969); Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964).

22. *See, e.g.*, deBruin v. Andromeda Broadcasting Systems, 465 F. Supp. 1276 (D. Nev. 1979); Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F. Supp. 440 (N.D. Ohio 1975); Lorber v. Beebe, 407 F. Supp. 279 (S.D.N.Y. 1975); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 336 (S.D.N.Y. 1973).

23. *See, e.g.*, Collins v. Signetics Corp., 605 F.2d 110 (3d Cir. 1979); Cady v. Murphy, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); McFarland v. Memorex Corp., 493 F. Supp. 631 (N.D. Cal. 1980); Barlas v. Bear, Stearns & Co., [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,674 (N.D. Ill. 1966); Nicewarner v. Bleavins, 244 F. Supp. 261 (D. Colo. 1965).

24. *See infra* notes 134-50 and accompanying text.

25. *See* First Trust & Savings Bank v. Fidelity-Philadelphia Trust Co., 214 F.2d 320, 324 (3d Cir. 1954); Cady v. Murphy, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); *see also* Schillner v. H. Vaughan Clarke & Co., 134 F.2d 875, 879 (2d Cir. 1943) (one who "participates" in sales transactions, whether principal or broker, liable under § 12).

"seller" according to its plain meaning, these courts held liable only the person who actually passed title of the security to the purchaser. For example, in *Cady v. Murphy*[26] the First Circuit intuitively held that strict privity exists in two cases: (1) between the titleholder of the security and the purchaser, and (2) between the purchaser and a broker-dealer[27] who sells the securities as an agent for another.[28] This holding comports with the well-accepted view that section 12(2), given restrictive application, applies only to the immediate seller or to one who controls[29] the immediate seller.[30]

Similarly, the court in *Nicewarner v. Bleavins*[31] strictly interpreted "seller" and declined to hold liable under section 12(1)[32] an attorney who performed the legal services required to effect a sale of fractional interests in invention royalties. The attorney did not actually sell the royalties, and he was not a party to the sale. The court declared that it would not hold the attorney liable as a seller even though

> [he] had reason to anticipate a public offering; he knew that no registration statement was in effect; he should have known that the assignments were securi-

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26. 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940).

27. Section 2(12) provides: "The term 'dealer' means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the husiness of offering, buying, selling, or otherwise dealing or trading in securities issued by another person." 15 U.S.C. § 77b(12) (1976).

28. Cady v. Murphy, 113 F.2d at 990-91. The court held tbat the broker-dealer nevertheless is in strict privity even if he acts in a dual capacity as agent for both the owner and purchaser. *Id.* at 991.

29. Section 15 provides:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77*l* of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o (1976).

30. *See, e.g.*, E.L. Aaron & Co. v. Free, 55 F.R.D. 401, 402 (S.D.N.Y. 1972); Nicewarner v. Bleavins, 244 F. Supp. 261, 266 (D. Colo. 1965); Newman v. Baldwin, 13 Misc. 2d 897, 901, 179 N.Y.S.2d 19, 23 (Sup. Ct. 1958).

31. 244 F. Supp. 261 (D. Colo. 1965).

32. Section 12(1) provides:

> Any person who—
>
> (1) offers or sells a security in violation of section 77e of this title . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77*l*(1) (1976).

> ties; he knew that the [purchasers] were from Illinois and [he] could have foreseen the use of the mails or of interstate facilities; and he could see that the [purchasers] needed the protection of the Act.[33]

Recognizing that the attorney's services were critical to consummate the sale,[34] the court nevertheless expressly declined to expand the strict privity approach[35] to find that the attorney was a seller under section 12(1).[36]

B. *Expansion of the Strict Privity Approach*

1. Participation Approach

Although courts initially defined "seller" strictly according to the "plain meaning" of the term, some courts began to expand the meaning of "seller" to include individuals other than the contractual seller. In 1959 the United States District Court for the Southern District of New York in *Wonneman v. Stratford Security Co.*[37] analyzed the scope of section 12(2) seller liability from a novel perspective. Noting

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33. Plaintiff also sued under § 12(2), but the court ruled that defendants did not make any untrue statements or omit to state material facts. 244 F. Supp. at 263-64.

34. *Id.*

35. The court refused to inject a causation analysis, *see infra* part II(*B*)(3), into the section to determine seller liability. *See* 244 F. Supp. at 266. In Dorfman v. First Boston Corp., 336 F. Supp. 1089, 1092 (E.D. Pa. 1972), the court dismissed plaintiff's complaint because plaintiff failed to allege that defendants "played any role in bringing about plaintiff's purchases much less the kind of active solicitation involved in [Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964)]," *see infra* note 61. In *Lennerth* the seller's agent directly negotiated a sale for the seller but did not actually sign the sales contract. *See, e.g.*, Jackson Tool & Die, Inc. v. Smith, 339 F.2d 88 (5th Cir. 1964); Russell v. Travel Concepts Corp., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,230 (M.D. Tenn. 1975).

36. Nicewarner v. Bleavins, 244 F. Supp. at 266. See Barlas v. Bear, Stearns & Co., [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,674 (N.D. Ill. 1966), in which the court reaffirmed the requirements of strict privity between a seller, defined as the passer of title, and a purchaser. The *Barlas* court hence dismissed in part plaintiff's action against defendant and stated:

> The only allegation made by plaintiff . . . with regard to the movants is a bare assertion . . . that all defendants "aided and abetted" Karl Hope and Bear, Stearns & Co. Such an allegation is not sufficient, inasmuch as plaintiff has failed to invoke the "control" provisions of section 77[o] and the Securities Act makes no provision for liability of parties on conspiracy grounds. . . .
>
> We must therefore rely on the clear language of the Statute at issue [section 12(2)] and the prevailing case law which holds that, in the absence of "control" allegation, a defendant shall only be liable "to the person *purchasing* such security *from him.*"

Id. at 95,477-78 (emphasis in original). Thus, since plaintiff in *Barlas* alleged only that defendant "aided and abetted" the § 12(2) violation, a cause of action not previously recognized by the court, the Illinois district court dismissed the allegation. The *Barlas* court, however, conspicuously refrained from discussing in dictum the outcome if plaintiff had alleged aiding and abetting in conjunction with an allegation of primary liability against his immediate seller.

37. [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 90,923 (S.D.N.Y. 1959).

that the intended purpose of the 1933 Act was to remedy the questionable practices of investment institutions during the 1920's and to restore public confidence in those institutions, the court broadly interpreted section 12(2) to hold liable anyone who in any way "participated" in the securities transaction.[38] On rehearing, the same court restricted the scope of this broad participation test by requiring "some degree of privity"[39] between the purchaser and the seller.[40] This expanded concept of liability under section 12(2) marked a significant departure from the more conservative strict privity analysis of *Cady v. Murphy*.[41]

In *Freed v. Szabo Food Services, Inc.*[42] the United States District Court for the Northern District of Illinois substantively followed the broad participation approach enunciated in *Wonneman*. In *Freed* plaintiffs alleged that defendants had violated not only section 12(2) of the 1933 Act but also section 17(a) of the 1933 Act,[43] and section 10(b)[44] and rule 10b-5[45] of the 1934 Act. The court ruled that plaintiffs sufficiently stated a cause of action under section 12(2) despite

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38. The court stated that individual defendants must show that they did not participate in the sale and not merely show that they actually did not sell the securities. *Id.*

39. The court refused to extend § 12 seller liability to an attorney who partly had induced a sale by stating to a controlling person of the issuer that the shares the issuer would offer were exempt from § 5 registration. *Id.*

40. *Id.*; *accord*, Zackman v. Ervin, 186 F. Supp. 681 (S.D. Tex. 1959) (ruling on motions); *id.* at 691 (S.D. Tex. 1960) (further rulings on motions).

41. 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); *see supra* notes 26-28 and accompanying text.

42. [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,317 (N.D. Ill. 1964). *But cf.* Barlas v. Bear, Stearns & Co., [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,674, at 95,477 (N.D. Ill. 1966) (confining holding in *Freed* to the facts before the court: defendant issuing corporation employed an underwriter to sell the securities to avoid liability for its own misstatements). A more logical reason for the *Barlas* court's holding is that "[t]he concept of civil aiding and abetting in the securities law setting and the expansion of the section 12 privity element were simply not sufficiently developed at that time to permit their transfer to the section 12 analysis." Rapp, *Expanded Liability Under Section 12 of the Securities Act: When is a Seller Not a Seller?*, 27 CASE W. RES. L. REV. 445, 486 (1977).

43. Section 17(a) provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or hy the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
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> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1976).

44. *See supra* note 4.

45. *See supra* note 5.

the lack of privity between plaintiffs and defendants "as long as plaintiffs' alleged purchase was in reliance upon misrepresentation and participation in these misrepresentations by the defendant."[46] Although the *Freed* court failed to distinguish among the privity requirements of sections 12 and 17(a) of the 1933 Act and section 10(b) and rule 10b-5 of the 1934 Act, the court emphatically declared that the remedial purposes of the securities laws dictate that courts liberally construe the statutes. Thus, the court noted that courts no longer should require strict privity between seller and purchaser to find seller liability.[47] The *Freed* court enunciated a standard of liability so broad that a court could characterize as a section 12 seller virtually anyone even remotely associated with the sale of securities who made a misrepresentation about that security but who had no direct interest in the sale.

2. Duty Approach

Continuing the trend of holding liable as seller one who is not the actual titleholder or its broker-agent, the court in *Gould v. Tricon, Inc.*[48] recognized that section 12(2) applies to anyone who has a "duty" to ensure that the purchaser receives no material misstatements or omissions of material fact. In *Gould* plaintiff successfully argued that defendant's failure to state particular facts in a prospectus was sufficient to hold the company liable under section 12(2). The

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46. *See* Freed v. Szabo Food Serv., Inc., [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) at 94,365.

47. Concerning privity under §§ 12, 17(a), and 10(b) and rule 10b-5, the court stated:

> As regards the general question as to whether or not there has to be privity between the plaintiff and defendant as buyer and seller, I think the cases are clear that such privity is not required. The requirement of privity is no longer strictly enforced, and instead the courts are requiring rather that the plaintiff allege that he has relied upon misleading statements uttered by the defendant concerning the securities in question; that he bas purchased the securities from whatever source, relying upon these misleading statements; and that through such purchase he has suffered damage.
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> This seems wise, as it has been held repeatedly that the securities laws are remedial and are to be construed liberally in order to achieve tbe congressional purpose.
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> . . . .
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> This policy, as applied to the question of privity, means that if a purchaser bought securities, relying upon misrepresentations of a third party not connected directly with his purchase, nevertheless, the third party may be held accountable if the plaintiff can show reliance and misrepresentations of the third party on which he relied. To hold otherwise would allow a corporation whose stock is issued publicly to make misrepresentations concerning the stock without any fear of liability as long as its stock was only sold to the public in the market by underwriters of others. Such a rule would ignore the realities of the public securities market, and such was certainly not the intention of Congress.

Id. at 94,363-65; *see* Rapp, *supra* note 42, at 484.

48. 272 F. Supp. 385 (S.D.N.Y. 1967).

court, however, additionally held liable under section 12(2) Akers, who was a board director, vice president, and secretary of the company, even though Akers' only connection with the offering was his signature on the prospectus. Explaining its reasoning for holding Akers liable, the court stated:

> When Akers became a director of Tricon, Inc. and allowed his name to appear on the prospectus, he warranted that any statements in the prospectus . . . were accurate. If he [were] uncertain as to whether the [representations were correct], he had a duty to make further inquiry before allowing his name to appear on a prospectus setting forth such facts. His failure to do so makes him liable under section 12(2).[49]

Although the court held Akers liable as a section 12(2) seller because he breached the duty that he owed to the public as a director, the court did not describe the parameters of this duty of further inquiry under section 12.

3. Proximate Cause-Substantial Factor Approach

Rejecting the strict privity, participation, and duty approaches, many courts employ a proximate causation test to delineate the scope of section 12(2) seller liability.[50] In *Lennerth v. Mendenhall*,[51] one of the earliest section 12(2) proximate cause cases, defendant Roger played an instrumental role in organizing a sale of securities but did not actually distribute the unregistered securities. Roger had secured prospective purchasers, outlined the details of the proposed venture to them, and represented on two separate occasions that the issuer was "a national operation, extremely successful and heavily financed."[52] Roger subsequently introduced plaintiffs to an officer of the issuer corporation, who advised plaintiffs that the board of direc-

49. *Id.* at 392-93. Several courts of appeals once evaluated § 10(b) and rule 10b-5 liability by ascertaining whether the defendant, in light of all the facts and circumstances, owed some duty to the plaintiff and whether the defendant breached that duty. *See* White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Chris Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973). Courts, however, no longer may use the duty analysis in § 10(b) and rule 10b-5 proceedings. The Supreme Court in Aaron v. SEC, 446 U.S. 680 (1980), held that the SEC must establish scienter as an element of § 10(b) and rule 10b-5 liability. The Court hence expanded Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), which required proof of scienter in a private cause of action alleging § 10(b) and rule 10b-5 violations, to require proof of scienter in *any* civil enforcement action alleging § 10(b) and rule 10b-5 violations.

50. *See, e.g.*, Junker v. Crory, 650 F.2d 1349 (5th Cir. 1981); Croy v. Campbell, 624 F.2d 709 (5th Cir. 1980); Pharo v. Smith, 621 F.2d 656 (5th Cir. 1980); Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964).

51. 234 F. Supp. 59 (N.D. Ohio 1964).

52. *Id.* at 64.

tors had confirmed them as suitable investors.

The court held that it could not hold Roger liable as an "agent for the vendor"[53] because he actually did not consummate the sale. Although the court did not desire to reject completely the requirement of privity between purchaser and seller, it also did not want to adopt the broad participation approach advocated in *Wonneman*.[54] The court explained:

> It is implicit in the [*Wonneman*] [c]ourt's reasoning, when it rejects [the contention that liability should attach to all who participate in any phase of the overall plan of marketing securities] and yet states that it would hold liable one who negotiates the sale, that liability must lie somewhere between the narrow view, which holds [liable] only the parties to the sale, and the too-liberal view which would hold [liable] all who remotely participated in the events leading up to the transaction. We think that the line of demarcation must be drawn in terms of cause and effect: To borrow a phrase from the law of negligence, did the injury to the plaintiff flow directly and proximately from the actions of this particular defendant? If the answer is in the affirmative, we would hold him liable. But for the presence of the defendant Roger in the negotiations preceeding the sale, could the sale have been consummated? If the answer is in the negative, and we find that the transaction could never have materialized without the efforts of that defendant, we must find him guilty.[55]

Applying this causation standard, the court found Roger liable as a section 12 seller because he had done "everything but draw and sign the contract."[56]

A proximate cause test determines liability by examining the defendant's actions throughout the entire selling process[57] rather than at the mere transfer of title, which is the focal point of the strict privity test. Although *Lennerth* did not clearly define the level of

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53. *Id.*; *see* Whittaker v. Wall, 226 F.2d 868 (8th Cir. 1955) ("agent for the vendor" negotiated and closed sales transaction and then signed contract on bebalf of issuer corporation).

54. *See supra* notes 37-41 and accompanying text.

55. Lennerth v. Mendenhall, 234 F. Supp. at 65; *see* Rapp, *supra* note 42, at 464.

56. 234 F. Supp. at 65. Chastising defendant for his actions, the court added: "The hunter who seduces tbe prey and leads it to the trap he has set is no less guilty than the hunter whose hand springs the snare." *Id.*

57. *See, e.g.*, Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969). In *Katz* the Second Circuit reversed in part the lower court's dismissal of several defendants from a § 12(1) action. The Second Circuit upheld a cause of action against tbe issuer's brokerage firm, the president of the firm, an employee of a customer of the brokerage firm, and tbe special counsel for the issuer who also was the attorney for the brokerage firm concerning its proposed underwriting of the issuer's stock. This holding exemplifies the Second Circuit's desire to broaden the scope of the seller's liability to include those other than the titleholder or the titleholder's broker-agent. For example, the Second Circuit noted tbat the attorney never initiated conversation with plaintiff regarding a sale of securities prior to a proposed public issue by the brokerage firm. It nonetheless beld that because the attorney had reassured plaintiff that the proposed issue was "a good one and I know it is okay" and tbat "it would be all rigbt" to pay tbe brokerage firm the balance of the money for the stock before the public issue, be was "a party to a solicitation" and liable under § 12(1) for nonregistration of the securities. *Id.* at 1052-53.

participation required to meet the "but for" test, a series of Fifth Circuit cases[58] has focused on the distinction between a necessary party to a transaction and an insignificant participation in the selling process. These cases attempt to delineate the outer boundaries of seller liability under section 12(2).

In 1971 in *Hill York Corp. v. American International Franchises, Inc.*[59] the Fifth Circuit for the first time specifically adopted the proximate cause test for determining section 12 liability.[60] Describing the causation test, the court stated,

> [W]e adopt a test which we believe states a rational and workable standard for imposition of liability under [section 12]. Its base lies between the antiquated "strict privity" concept and the overbroad "participation" concept which would hold all those liable who participated in the events leading up to the transaction.[61]

In *Hill York* defendants played a substantial role in the transaction,[62] but in *Lewis v. Walston & Co.*[63] the Fifth Circuit began to find liability under the proximate cause test in situations in which the defendant's participation in the transaction was more attenuated. In *Lewis* defendants were a stock broker and its registered representative. Acting initially within the scope of her employment,[64] the representative heavily promoted certain unregistered securities to plaintiffs and arranged the original meeting between plaintiffs and the issuers at which plaintiffs purchased the first of several blocks of stock. Evaluating the potential liability of the broker and its repre-

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58. *See supra* authorities cited note 50.

59. 448 F.2d 680 (5th Cir. 1971).

60. In *Hill York* the court found that defendants were the "motivating force" behind the promotion of a nationwide franchise operation and thus held them liable as sellers under section 12(2). *Id.* at 693. Particularly, the court found that defendants

> sought out the original incorporators of Florida Franchise and then trained them to solicit additional capital for the corporation. They provided the sales brochures designed to secure this additional capital. They rendered advice on every aspect of the corporate formation and subsequent development. In fact, the defendants did everything but effectuate the actual sale.

Id. Asking whether "the injury to the plaintiff flow[ed] directly and proximately from the actions of [the] particular defendant," the Fifth Circuit found that the facts of the case indeed suggested that defendants had proximately caused plaintiff's injury. *Id.*

61. *Id.* at 692. The court emphasized that plaintiffs need not prove that they relied in any way on the alleged misrepresentations or omissions. *Id.* at 695; *see* Gilbert v. Nixon, 429 F.2d 348, 356 (10th Cir. 1970); Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1129 (4th Cir. 1970).

62. 448 F.2d at 693.

63. 487 F.2d 617 (5th Cir. 1973).

64. *Id.* at 623 (citing RESTATEMENT (SECOND) OF AGENCY § 229 (1957)). For an interesting exposition of *Lewis* and the similarity of analysis under respondeat superior and § 20(a), see Note, *Rule 10b-5—The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a)—Imposing a Benefit Requirement on Apparent Authority*, 35 VAND. L. REV. 1383 (1982).

sentative, the court listed the following salient facts. First, the broker at no time dealt[65] in unregistered securities. Second, plaintiffs did not place their orders through the brokerage house. Third, the broker never stood to receive nor did it receive any financial benefit from the sale that its representative had arranged. Fourth, although the manager of the broker's office advised the representative to discontinue promoting the unregistered securities, he never actually forbade her actions. Last, the representative regularly used the broker's offices to arrange the transactions, and she used her position in the brokerage firm to recruit the purchasers of the stock.[66] The Fifth Circuit held that the lower court reasonably could have inferred that the actions of both defendant broker and its representative[67] were a "substantial factor"[68] in causing plaintiffs to purchase the stock.

After *Lewis* the Fifth Circuit carefully has refined the elements of its proximate cause-substantial factor approach.[69] In *Pharo v.*

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65. *See supra* note 27.

66. 487 F.2d at 623-24.

67. The court appropriately found the broker's representative liable as a § 12 seller because the "instrumentality by which the harm was done was furnished by the master to the servant." *Id.* at 623.

68. The inclusion of a "substantial factor" formula into the general proximate causation standard is a concept previously introduced by Dean Prosser in his discussion of tort law. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 41 (4th ed. 1971). According to Dean Prosser, the traditional "but for" concept explains many cases, but it fails in many complex situations.

> If two causes concur to bring about an event, and either one of them, operating alone, would have been sufficient to cause the identical result, some other test is needed. Two motorcycles simultaneously pass the plaintiff's horse, which is frightened and runs away; either one alone would have caused the fright. A stabs C with a knife, and B fractures C's skull with a rock; either wound would be fatal, and C dies from the effects of both. . . . In such cases it is quite clear that each cause has in fact played so important a part in producing the result that responsibility should be imposed upon it; and it is equally clear that neither can be absolved from that responsibility upon the ground that the identical harm would have occurred without it, or there would be no liability at all. [I]n a case of this type . . . a broader rule, which has found general acceptance [is applied]: The defendant's conduct is a cause of the event if it was a material element and a substantial factor in bringing it about. . . .
>
> Such a formula, for it can scarcely be called a test, is clearly an improvement over the "but for" rule. It disposes of the cases mentioned above, and likewise of the difficulties presented by two other types of situations which have proved troublesome. One is that where a similar, but not identical result would have followed without the defendant's act; the other where one defendant has made a clearly proved but quite insignificant contribution to the result . . . . [N]o case has been found where the defendant's act could be called a substantial factor when the event would have occurred without it . . . .

Id. at 239-40 (footnotes omitted); *see* Rapp, *supra* note 42, at 464.

69. In Pharo v. Smith, 621 F.2d 656 (5th Cir. 1980), the court limited the ambit of seller status under section 12

> (i) to those in privity with the purchaser and (ii) to those whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place. Mere par-

Smith[70] the Fifth Circuit recognized that the degree of participation in a transaction plays a significant role in assessing section 12 liability but does not determine conclusively whether the participant caused the transaction to take place. Similarly, in *Croy v. Campbell*[71] the court ruled that a defendant's occupation alone does not determine liability under section 12(2); rather, a court must consider the defendant's particular actions to demonstrate sufficiently that the defendant proximately caused the plaintiff's injuries.[72] Plaintiffs in *Croy* contended that defendant negligently failed to investigate the veracity of figures in an investment brochure before giving plaintiffs tax advice that proximately caused their loss. The Fifth Circuit denied plaintiffs' claim and explained that despite defendant's failure to investigate the financial data in the brochure, his informing plaintiffs that the data were merely estimates and his advice to them to

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ticipation in the events leading up to the transaction is not enough.

Id. at 667; *see* SEC v. Murphy, 626 F.2d 633, 650 (9th Cir. 1980).

The Fifth Circuit in Croy v. Campbell, 624 F.2d 709, 714 n.6 (5th Cir. 1980), notes that not all courts which have applied the proximate cause-substantial factor approach of *Hill York* and *Lewis* have reached similar conclusions, despite utilizing comparable factors. *See, e.g.*, Ayers v. Wolfinbarger, 491 F.2d 8, 13 (5th Cir. 1974) (one who sold stock to a person who then violated securities laws was not a seller of securities in the secondary sale); Plunkett v. Francisco, 430 F. Supp. 235, 241 (N.D. Ga. 1977) (defendant corporate owner who signed warranty letter was proximate cause of injury); Wassel v. Eglowsky, 399 F. Supp. 1330, 1361 (D. Md. 1975) (defendants who informed plaintiff that stock would soon be available and would increase in value and who obtained stock for sale to plaintiff were sellers who proximately caused injury), *aff'd*, 452 F.2d 1235 (4th Cir. 1976); Canizaro v. Kohlymeyer & Co., 370 F. Supp. 282, 287 (E.D. La. 1974) (broker who acted as plaintiff's agent in executing a purchase order and who neither solicited the order nor recommended the stock was not proximate cause of injury), *aff'd*, 512 F.2d 484 (5th Cir. 1975); *cf.* Wasson v. SEC, 558 F.2d 879, 885-86 (8th Cir. 1977) (Fifth Circuit's causation test does not focus upon disclosure policies of the 1933 Act).

70. 621 F.2d 656, *remanded on rehearing on other grounds*, 625 F.2d 1226 (5th Cir. 1980).

71. 624 F.2d 709 (5th Cir. 1980).

72. The court noted that Campbell, the attorney for the issuers, caused plaintiffs' injury by erroneously using certain figures to arrive at depreciable basis for the realty investment. Nonetheless, the court decided that Campbell's failure to investigate the veracity of the figures was not a substantial factor causing plaintiffs' loss. *Id.* at 714; *see also* SEC v. Seaboard Corp., 677 F.2d 1301 (9th Cir. 1982) (attorney may be § 12(2) seller); *In re* Wickes Co. Sec. Litig., [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,056 (S.D. Cal. 1983) (accountant may be § 12(2) seller); *In re* North Am. Acceptance Corp., 513 F. Supp. 608 (N.D. Ga. 1981) (attorney not seller simply because he advised seller that stock was exempt from registration). In Westlake v. Abrams, 504 F. Supp. 337 (N.D. Ga. 1980), the court found that an attorney who acted as general counsel to the seller-broker of commodities futures options was not a § 12(2) seller despite the attorney's knowledge of "boiler room tactics." The court added that the attorney's diligent efforts on behalf of the seller to arrange a sale did not proximately cause plaintiff to purchase the options. The court, however, could have deemed that the attorney "controlled" the broker because he wielded indirect control over the broker's staff in their selling strategies and day-to-day operations. *See* Ferland v. Orange Groves of Fla., Inc., 377 F. Supp. 690, 705 (M.D. Fla. 1974).

seek an independent investigation of the quality of the investment did not place defendant in a position to be a substantial factor in plaintiffs' investment decision.[73]

Satisfied with its proximate cause-substantial factor test, the Fifth Circuit expressly has rejected secondary liability[74] under section 12.[75] Most recently, the Fifth Circuit in *Junker v. Crory*[76] affirmed a lower court decision that denied application of the theory of aiding and abetting but held an attorney who was not the issuer of securities primarily liable as a section 12(2) seller.[77] The facts are useful for later analysis. In *Junker* an attorney, Heisler, represented Road Equipment Company (ROAD)[78] Reco Investment Corporation (RECO),[79] and Croy, who was the sole shareholder of ROAD and the

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73. Specifically, the Fifth Circuit noted that the district court found that Campbell participated in the sale as follows:

> (1) Campbell made no representations "concerning any of the operational or construction aspects of the project," and he had "nothing to do with the preparation of the brochure"; (2) he did deliver the brochure to the Croys [the purchasers], but in doing so, he was acting on their behalf, not on behalf of Simpkins [who held a general partnership interest in the [real estate investment] project and who sold that interest to the Croys]; (3) he did not attempt to persuade the Croys to purchase the [realty]; (4) the statement which he did make, referring to the project as the "best investment" he had ever seen, referred only to the beneficial tax results which he thought would be obtained, based upon the figures he had seen; [and] (5) the plaintiffs made a decision to invest in the project, only after viewing the project itself, talking with Simpkins, and obtaining independent advice.

624 F.2d at 714. The appellate court affirmed the district court's finding that these circumstances were *not* a "substantial factor" in causing plaintiffs to purchase the securities. Significantly, the Fifth Circuit expressly noted that "[t]his conclusion should not be interpreted to mean that a lawyer who participates in the transaction can never be a seller for purposes of section 12." *Id.; see In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 377-82 (S.D.N.Y. 1973).

74. Primary wrongdoers include those persons who actually commit the violation and who therefore owe "direct duties to the public." Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* in Pari Delicto, *Indemnification, and Contribution,* 120 U. PA. L. REV. 597, 600 (1972). Professor Ruder has characterized secondary wrongdoers as persons "whose liabilities arise only because another has violated the law," *id.*, and whose relationship to that violation arises from an agreement, conduct, or otherwise. *Id.* at 628.

75. *See* Junker v. Crory, 650 F.2d 1349 (5th Cir. 1981). Explaining the reluctance to apply the doctrine of secondary liability in § 12 suits, one commentator has stated:

> A conceptual barrier to the adoption of aiding-abetting and conspiracy notions for § 12(2) is that the provision merely imposes a liability. It does not (like SA § 17(a) or Rnle 10b-5) define a violation or make an act unlawful. Aiding-abetting and conspiracy, with their criminal origins, are more conformable to a violation section than to an express liability section.

3 A. BROMBERG, SECURITIES FRAUD AND COMMODITIES FRAUD § 8.5(315), at 206.7 (1981).

76. 650 F.2d 1349 (5th Cir. 1981).

77. *Id.* at 1360.

78. Road Equipment Company (ROAD) was a Louisiana corporation engaged in selling construction equipment. Junker was vice president and general sales manager of ROAD at the time of its incorporation. *Id.* at 1353.

79. Reco Investment Corporation (RECO) was a Louisiana corporation engaged in acquir-

largest shareholder of RECO. After Heisler explained at a RECO shareholder's meeting that RECO either must borrow funds to pay an outstanding debt to ROAD or must liquidate, the shareholders voted to liquidate and appointed Heisler as liquidator. Junker, the only dissenting shareholder, notified RECO's board of directors that liquidation was unnecessary because RECO's assets were undervalued and because the rent charged ROAD was inadequate. The shareholders upon Heisler's suggestion unanimously voted to rescind the liquidation order, and again only Junker opposed Heisler's subsequent proposal that RECO merge into ROAD to extinguish the debt.[80] After the merger Crory, who retained control of ROAD, advised the shareholders of an impending annual operating loss that was almost two-thirds of the prior year's earnings. Crory attributed the loss to ROAD's failure to sell large inventory purchases made before the merger. Heisler and Crory apparently knew of the purchases before Heisler presented the plan of merger to the ROAD stockholders, and they knew that the company could not sell those items. Before the merger neither Heisler nor Crory presented the information concerning ROAD's lack of sales or its potential effect on ROAD's net income to the RECO shareholders. Junker filed suit, claiming in part that Heisler and the former officers and directors of RECO had violated section 12(2).

The Fifth Circuit affirmed the trial court's finding of section 12(2) liability against the officers and directors of RECO and discussed whether it also could hold Heisler liable as a section 12(2) seller. Reviewing Heisler's actions before and after the merger, the appellate court stated:

> The evidence of Heisler's involvement in the effort to bring about the merger supports the trial court's finding that he was a key participant in the transaction. His role was not that of a passive advisor as was that of the attorney in *Croy*; rather, he was an active negotiator in the transaction, acting as agent-in-fact as well as attorney-at-law, implementor not counsellor. Therefore, we agree with the trial court's conclusion that Heisler's actions brought him within the scope of the seller definition under Section 12(2).[81]

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ing, improving, and leasing industrial property. All shareholders except Junker were directors and officers of both RECO and ROAD at the time Junker filed suit. *Id.*

80. Since the shareholders who owned 83.8% of the voting power had approved the merger, Junker could not demand under state law the fair cash value of his shares upon delivering them to RECO. *Id.* at 1354.

81. *Id.* at 1360; *see also* Mathews v. Fisher, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,336 (S.D. Ohio 1978) (name on issuer's prospectus without some indicia of participation in sales transaction insufficient to find § 12(2) liability).

C. Secondary Liability—Aiding and Abetting Approach

The Fifth Circuit's continuing effort to expand the scope of seller liability pursuant to the proximate cause-substantial factor approach has evoked criticism from some courts[82] that the effort is merely "semantic hairsplitting." Consequently, to promote the "remedial purposes" of the 1933 Act, these courts have expanded the scope of section 12(2) to include not only primary liability for sellers but also secondary liability for aiders and abettors. Section 12(2), of course, does not expressly provide for aiding and abetting liability, which courts have carried over from cases under section 10(b) and rule 10b-5 of the 1934 Act.[83]

Although courts uniformly cite *Katz v. Amos Treat & Co.*[84] as implicitly laying the foundation for secondary liability under section 12(2), *Katz* merely suggested a strictly objective privity analysis by defining a section 12(1) seller to include active participants in a solicitation that culminates in a transaction.[85] Nonetheless, subsequent courts used *Katz'* expanded definition of "seller" to infer secondary liability from the statute.[86]

In one of the first cases after *Katz* to discuss whether courts may recognize claims against secondary parties under section 12, the United States District Court for the Southern District of New York in *In re Caesars Palace Securities Litigation*[87] recognized that "persons who do no more than conspire in or aid and abet a [section 12] violation . . . are not necessarily excluded from the imposition of § 12(2) liability."[88] The court further defined aiders and abettors and conspirators[89] as persons who are "aware of and, to some lesser de-

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82. *See, e.g.*, deBruin v. Andromeda Broadcasting Systems, 465 F. Supp. 1276 (D. Nev. 1979); Lorber v. Beebe, 407 F. Supp. 279 (S.D.N.Y. 1975); Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F. Supp. 440, 444 (N.D. Ohio 1975); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 380 (S.D.N.Y. 1973).

83. *See, e.g.*, Stokes v. Lokken, 644 F.2d 779 (8th Cir. 1981); IIT v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980); Woodward v. Metro Bank, 522 F.2d 84, 94-97 (5th Cir. 1975). For a comprehensive discussion of the differences and similarities between § 12(2) of the 1933 Act and § 10(b) and rule 10b-5 of the 1934 Act, see Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5*, 13 Hous. L. Rev. 231 (1976).

84. 411 F.2d 1046 (2d Cir. 1969).

85. *See id.* at 1052-53.

86. *See supra* authorities cited note 22.

87. 360 F. Supp. 366 (S.D.N.Y. 1973).

88. *Id.* at 378.

89. *See* Pinkerton v. United States, 328 U.S. 640, 649 (1946) (Rutledge, J., dissenting) ("The gist of conspiracy is the agreement; that of aiding, abetting or counseling is in consciously advising or assisting another to commit particular offenses, and thus becoming a party to them. . . ."); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 678-80 (N.D. Ind. 1966), 286 F. Supp. 702, 708 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert.*

gree, participate in a violation of the securities laws and either enter into an agreement with or give assistance to the primary wrongdoers. . . ."[90] Thus, a defendant may be held liable as a section 12(2) aider and abettor or conspirator if he knowingly or recklessly provides aid to or assists in conduct that violates section 12(2). Moreover, the court refused to hold liable as a seller under section 12(2) *every* party who participated in the events culminating in the sale and hence rejected the broad participation approach for determining seller liability.[91]

The United States District Court for the Northern District of Ohio in *Sandusky Land, Ltd. v. Uniplan Groups, Inc.*[92] followed this expansive interpretation of section 12(2) by recognizing a cause of action for aiding and abetting if the defendant possesses the requisite scienter.[93] *Sandusky Land* concerned in part a section 12(2) allegation against a national accounting firm that had disseminated misleading information in an opinion letter regarding the sale of interests in a limited partnership.[94] The court characterized the claim against the accounting firm in terms of both section 12(2) primary seller liability and section 12(2) secondary aiding and abetting liability. Implicitly accepting the view that secondary liability is the threshold level for primary liability, the court imposed liability upon

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denied, 397 U.S. 989 (1970).

90. 360 F. Supp. at 383; *see supra* notes 37-40 and accompanying text; *cf.* Wonneman v. Stratford Sec. Co., [1957-1961 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 90,923 (S.D.N.Y. 1959) (court examines level of participation to find primary liability).

91. 360 F. Supp. at 383.

92. 400 F. Supp. 440 (N.D. Ohio 1975).

93. The injection of the scienter requirement into a § 12 liability action is a carryover from judicial interpretations of § 10(b) and rule 10-5 of the 1934 Act. Since neither § 10(b) nor rule 10b-5 prescribes the scope of liability from which causes of action may arise, the judiciary naturally looked to the common-law actions of fraud and deceit for guidance. Scienter, an inherent component of the common-law torts of fraud and deceit, hence became a means by which courts could define the scope of liability. *See* Aaron v. SEC, 446 U.S. 680 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1975); SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978); Rapp, *supra* note 48, at 478. *But see* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

Section 12(2), however, expressly provides an affirmative defense: a defendant may escape liability if he can demonstrate "that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." 15 U.S.C. § 77*l*(2) (1976). Thus, adding the element of scienter may conflict with this defense of reasonable care. *See infra* notes 102-04 and accompanying text.

94. Specifically, plaintiffs alleged (1) that the accounting firm issued to the partnership an opinion, which the partnership subsequently disseminated to the prospective purchasers, on the tax benefits and consequences that would inure to a purchaser of an interest in the limited partnership; (2) that the opinion contained misrepresentations or omissions of which the firm knew or should have known; and (3) that plaintiffs detrimentally relied on the opinion to purchase their interest in the limited partnership. 400 F. Supp. at 443-44.

the accounting firm and explained:

> To some extent *any* accounting firm issuing an opinion as to a particular partnership, corporation or company facilitates securities transactions in that makers of investments normally review such opinions before entering into investment transactions. Yet not all accountants will be found to be sellers under § 12(2). It is only when the evidence establishes that there was an *aiding* or *abetting* of the seller of the security or offeror of an investment that liability will be found to exist.[95]

Although the court in *Sandusky Land* failed to define the degree of scienter necessary for liability as a section 12(2) aider and abettor, the court implied that the plaintiff can establish scienter hy demonstrating that the defendant knew or had reasonable cause to know that he had misstated or omitted to state a material fact.[96] *Sandusky Land*'s threshold level of scienter thus is similar to a "breach of duty of inquiry" standard.[97] This breached duty of inquiry may establish the requisite scienter even though the defendant possesses no *actual* knowledge of the material misrepresentation or omission of material fact. Once the plaintiff demonstrates scienter, a court will hold the defendant liable under section 12 if it finds that the defendant's breach actually facilitated the completion of the sale.[98] Thus, even if the defendant only passively participates in the actual selling process, he will be culpable under section 12 if he has the requisite degree of scienter and facilitates the transaction.

In 1975 in *Lorber v. Beebe*[99] the Southern District of New York recognized as a matter of law aiding and abetting liability under section 12(2),[100] but modified *Sandusky Land* by stating that only a knowing and deliberate assistance or facilitation of violative conduct in the course of a sale would give rise to this secondary liability.[101] The *Lorber* court's criteria, however, preclude the statutory defense

95. *Id.* at 444 (emphasis in original) (footnotes omitted); *see* Rapp, *supra* note 42, at 469.

96. The court cited several authorities that support this requisite degree of scienter. *See* 400 F. Supp. at 444; Hochfelder v. Midwest Stock Exch., 503 F.2d 364 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366 (S.D.N.Y. 1973).

97. *See* Gould v. Tricon, Inc., 272 F. Supp. 385 (S.D.N.Y. 1967); Rapp, *supra* note 42, at 473-78; *supra* notes 48-49 and accompanying text.

98. Thus, the court examines neither the defendant's character nor the causal proximity of his conduct to the sale, elements that the Fifth Circuit employs to ascertain whether § 12(2) primary seller liability exists. *See supra* notes 59-81 and accompanying text.

99. 407 F. Supp. 279 (S.D.N.Y. 1975).

100. *Id.* at 287-88; *see* Miller v. Mackey Int'l, Inc., 452 F.2d 424, 427-30 (5th Cir. 1971) (likelihood of purchaser's success on the issue of aiding and abetting is not proper basis for denial of class certification), *cited with express approval in* Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 178 (1974); Frankel v. Willie & Thornhill, Inc., [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,672 (W.D. Va. 1972).

101. Lorber v. Beebe, 407 F. Supp. at 287-88.

of reasonable care.[102] Section 12(2) imposes liability upon any seller who sells securities using untrue statements of a material fact or omissions of material facts, *and* who cannot demonstrate that he did not know and in the exercise of reasonable diligence[103] could not have known of the untruth or omission.[104] The express statutory definition thus places the two requisite elements of privity and lack of knowledge in the conjunctive; the *Lorber* court, however, places its two key elements—a knowing and deliberate assistance *or* faciliation of violative conduct—in the disjunctive.[105] Hence, the *Lorber* court not only introduces a secondary level of liability to an express primary liability statute, but also defines aiding and abetting in a manner directly inconsistent to the language of section 12(2).[106]

Following *Lorber*, many courts have continued to erode section 12 primary liability in favor of secondary liability for persons who "actively participate" in the transaction.[107] In *deBruin v. Andromeda Broadcasting Systems*,[108] for example, the court stated that section 12 liability encompassed defendants who actively had participated in a fraudulent scheme as aiders and abettors because they knew of the fraudulent scheme or "acted so recklessly that knowledge may be imputed to [them]."[109] Defendant Sowers, a public accountant who formerly had prepared financial statements for Andromeda Broadcasting Systems, Inc. accepted a request from Andromeda to find investors who would contribute new capital to finance the acquisition of a radio station. Sowers never was a shareholder, director, or officer of Andromeda, and Andromeda never compensated him for procuring the investors. When plaintiff subsequently contacted Sowers for in-

102. Section 12(1) imposes strict liability on individuals who sell unregistered securities contrary to § 5. 15 U.S.C. § 77*l*(1) (1976). Although § 12(2) affords the defense of "reasonable care," it does not define that term. Furthermore, courts do not define "reasonable care" uniformly. For a discussion of "reasonable care" as employed in § 12, see Comment, *supra* note 1. *Cf.* 15 U.S.C. § 77k(b)(3) (1976) (regarding the use of "reasonable investigation" and "reasonable ground to believe" in § 77k(b)(3)); *id.* § 77k(c) (section 77k(c) defines standard of reasonableness as that "required of a prudent man in the management of his own property").

103. For a comparison of "reasonable diligence" with "reasonable care," see Comment, *supra* note 1, at 945-49.

104. 15 U.S.C. § 77*l*(2) (1976).

105. *See* Rapp, *supra* note 42, at 479-80.

106. *Id.*

107. *See, e.g., In re* Itel Sec. Litig., 89 F.R.D. 104, 117 (N.D. Cal. 1981); deBruin v. Andromeda Broadcasting Systems, 465 F. Supp. 1276, 1280 (D. Nev. 1979); Brick v. Dominion Mortgage & Realty Trust, 442 F. Supp. 283, 292 (W.D.N.Y. 1977); Stern v. American Bankshares Corp., 429 F. Supp. 818, 826 (E.D. Wis. 1977); Lorber v. Beebe, 407 F. Supp. 279, 295-96 (S.D.N.Y. 1976).

108. 465 F. Supp. 1276 (D. Nev. 1979).

109. *Id.* at 1280.

vestment advice, Sowers naturally recommended investing in Andromeda because he knew of its plans for expansion and believed from his work experience that most broadcasting corporations were profitable. Weeks later Sowers again suggested to plaintiff that she invest in Andromeda stock and represented to her that she would receive a modest annual return even though at that time he knew that Andromeda historically had net income losses and never had paid dividends. After plaintiff had purchased Andromeda stock, Andromeda cancelled its plans to acquire the radio station because of misrepresentations by the seller. Plaintiff sued Sowers in part under Section 12 as either a seller or an aider and abettor for making untrue statements of material facts or omitting to state material facts concerning the sale of Andromeda stock.[110]

Although the *deBruin* court recognized the general rule that a section 12(2) action encompasses only a purchaser's immediate seller,[111] it noted that courts had created exceptions to attach liability "to persons acting as the immediate seller's agent, to defendants who are alleged to be controlling persons of the immediate seller, and to those who have actively participated in the fraudulent sale, either as an aider or abettor or as a coconspirator."[112] The court absolved Sowers of any secondary liability because it found no evidence that Sowers knew of a "fraudulent scheme" or even that a fraudulent scheme had existed in the sale of Andromeda stock.[113] Moreover, since Sowers did not actually sell the stock and was not Andromeda's agent because his relationship with the company was purely gratuitous, the court held he was not primarily liable as a section 12(2) seller.[114]

D. Apparent Trend—Return to Strict Privity Approach

While some courts have liberalized the purview of section 12(2) to include secondary liability,[115] other courts[116] have advocated a strict privity requirement similar to that originally espoused in *Cady*

110. *Id.* at 1278-79. Plaintiff also sued for violation of § 5 because Sowers knew that Andromeda never had registered its securities. *Id.* at 1279. The court ruled that Sowers was not liable under § 5 because he was not an issuer, underwriter, or dealer under tbe 1933 Act. *Id.* Plaintiff must have brought the suit under § 12(1), altbougb the court never specified it.

111. *See supra* notes 25-36.

112. deBruin v. Andromeda Broadcasting Systems, 465 F. Supp. at 1280.

113. *Id.*

114. *Id.*

115. *See supra* part II(C).

116. *See* Steinberg, *Section 17(a) of the Securities Act of 1933 After* Naftalin *and* Redington, 68 GEO. L.J. 163 (1979).

v. Murphy.[117] These latter courts reject the premise of many courts that interpret the 1933 Act liberally "to promote its remedial purposes";[118] rather, they advocate a literal construction of the 1933 Act according to its "plain meaning"[119] because the legislative history does not demonstrate a contrary intention.

In *Collins v. Signetics Corp.*[120] the United States Court of Appeals for the Third Circuit held in a section 12(2) action that "unless some special relationship exists between the issuer and the *actual* seller of securities, such as control of the seller by the issuer, a purchaser not in privity with the issuer has no claim under § 12(2) against the seller."[121] Plaintiffs in *Collins* appealed from a summary judgment for Corning Glass Works and Signetics Corporation. Plaintiffs had purchased Signetics stock in a public offering from underwriters, who had bought the stock from Signetics under a "firm commitment" underwriting agreement.[122] Plaintiffs alleged that the registration statement and the prospectus failed to disclose the material fact that Corning, which controlled Signetics before and after the offering, intended to divest completely its subsidiary and that Signetics officers knew of this intention and helped Corning find a buyer. This material omission, plaintiffs maintained, caused them to lose over half their investment when the acquiring corporation redeemed plaintiffs' shares at a substantial discount from plaintiffs' purchase

117. *See supra* notes 26-28 and accompanying text.

118. *See, e.g.*, Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); deBruin v. Andromeda Broadcasting Systems, 465 F. Supp. 1276 (D. Nev. 1979); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366 (S.D.N.Y. 1973); Wonneman v. Stratford Sec. Co., [1957-1961 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,034 (S.D.N.Y. 1961).

119. *See* Collins v. Signetics Corp., 605 F.2d 110, 113 (3d Cir. 1979); McFarland v. Memorex Corp., 493 F. Supp. 631, 648 (N.D. Cal. 1980).

120. 605 F.2d 110 (3d Cir. 1979).

121. *Id.* at 112 (emphasis added); *see* Turner v. First Wis. Mortgage Trust, 454 F. Supp. 899, 912-13 (E.D. Wis. 1978); Kramer v. Scientific Control Corp., 452 F. Supp. 812, 814-15 (E.D. Pa. 1978); B & B Inv. Cluh v. Kleinert's, Inc., 391 F. Supp. 720, 725-26 (E.D. Pa. 1975); Kramer v. Scientific Control Corp., 365 F. Supp. 780, 791 (E.D. Pa. 1973).

122. A "firm commitment" underwriting agreement is one in which the issuer sells the securities outright to an underwriter who, either on its own or with the assistance of other underwriters, sells the securities to the public usually at a higher price. 1 L. Loss, SECURITIES REGULATION 164 (1961).

The Third Circuit may have held Signetics, the issuer, liable as a § 12(2) seller under the strict privity approach had Signetics contracted with the lead underwriter on a "best efforts" basis. With a "best efforts" underwriting agreement the issuer does not actually relinquish title to the securities, and the underwriter sells the securities to the public as an agent for the issuer. *Id.* at 171; *see* Annot., 56 A.L.R. FED. 659, 661 & n.8 (1982). The Third Circuit thus would have ample grounds to hold Signetics liable as a seller through the activities of its agent under § 12(2).

price.[123] Although plaintiffs purchased their stock from various underwriters who had participated in the offering, plaintiffs did not name any underwriters as defendants in the suit. Additionally, plaintiffs did not challenge defendants' affidavits stating that defendants did not control and never had controlled any of the underwriters used in the offering.[124] The Third Circuit affirmed the trial court's summary judgment against plaintiffs and agreed with the trial court that because the "unambiguous language" of section 12(2) primarily reflects congressional intent,[125] "a purchaser not in privity with the issuer has no claim under § 12(2) against the issuer."[126] The court emphasized:

> This section is designed as a vehicle for a purchaser to claim against his immediate seller. Any broader interpretation would not only torture the plain meaning of the statutory language but would also frustrate the statutory schema because Congress has also provided a specific remedy for a purchaser to utilize against the issuer as distinguished from the seller of a security [section 11 of the 1933 Act].[127]

A strict privity requirement under section 12(2) necessarily precludes any claim alleging aiding and abetting or conspiracy liability under that section.[128] In *McFarland v. Memorex Corp.*[129] plaintiff brought a section 12(2) action against Memorex Corporation, the underwriters who sold the stock, the individual officers and directors of Memorex at the time of the stock offering, the certified public accountant identified in the prospectus, and various warrantholders who sold warrants to the underwriters before the offering. Plaintiff primarily alleged that defendants fraudulently had misrepresented

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123. Corning merged Signetics into a subsidiary of United States Philips Corporation, which redeemed Signetics' outstanding shares for $8.00 per share. Plaintiffs paid $17.00 per share in the public offering. 605 F.2d at 112-13.

124. *Id.*

125. *Id.* at 113. Quoting the Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200 (1976), the court stated tbat "[a]scertainment of congressional intent . . . must 'rest primarily on the language of that section' [of the 1933 Act]."

126. *Id.* at 112 (footnote omitted).

127. *Id.* at 113; *see* Benoay v. Decker, 517 F. Supp. 490, 494 (E.D. Micb. 1981) (quoting Collins v. Signetics Corp., 605 F.2d 110, 113 (3d Cir. 1979)). Section 11 imposes civil liability upon certain persons enumerated in § 11(a) for "an untrue statement of a material fact or [omission] to state a material fact required to be stated" in a registration statement. *See* 15 U.S.C. § 77k(a) (1976). These persons include: every person who signed the registration statement, each director of a partner in the issuer, any professional who certified any part of or report in the registration statement, and every underwriter with respect to the security. *Id.*; *see* 605 F.2d at 113. Plaintiffs also had sued under § 11, but the jury found against them and the Third Circuit upheld the verdict. 605 F.2d at 116.

128. *See* McFarland v. Memorex Corp., 493 F. Supp. 631, 648 (N.D. Cal. 1980); Lorber v. Beebe, 407 F. Supp. 279, 287-88 (S.D.N.Y. 1975).

129. 493 F. Supp. 631 (N.D. Cal. 1980).

the overall financial condition of Memorex to the securities purchasers by failing to disclose material information.[130] Strictly interpreting section 12(2) to allow a cause of action only against the immediate seller, the court dismissed the claim[131] because plaintiff did not state a claim for primary liability against any defendant and, more particularly, did not identify his direct seller.[132] Moreover, the court recognized that because no control or proven agency arrangement existed between Memorex and the underwriters, the only defendants that could be liable under a literal reading of section 12 were the underwriters who had sold the stock.[133]

Both *Collins* and *McFarland* rely upon recent Supreme Court non-section 12 and nonsecurities cases[134] in which the Court emphatically has stated that the standard of liability must rest on the express language of the statute when little or no legislative history ex-

130. *Id.* at 634-36.

131. Since the complaint sounded entirely in fraud and its allegations were merely conclusory, the court dismissed the complaint under FED. R. CIV. P. 9(b), which requires complaints to state allegations of fraud with particularity. *See* 493 F. Supp. at 640. The court continued its analysis, however, and declared the complaint defective under § 12(2) for all defendants. *Id.* at 647.

132. 493 F. Supp. at 648. Specifically, the court ruled that plaintiff bad failed to state a cognizable claim under FED. R. CIV. P. 12(b)(6). 493 F. Supp. at 636. *Cf.* Competitive Assoc., Inc. v. International Health Sciences, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,966, at 97,334 (S.D.N.Y. 1975) (plaintiffs sued underwriters under § 12(2) but the court dismissed the claim because underwriters were not plaintiff's immediate sellers).

133. 493 F. Supp. at 647-48. Explaining its rationale for not adopting a broad standard of liability for section 12(2), the court stated:

> The Court recognizes that a literal reading has not been adopted by all courts. Even under a broader standard, however, a mere allegation of co-conspiracy or of aiding and abetting will not suffice. Congressional intent is paramount in interpreting the reach of the statute. If it appears that Congress intended to place certain limits on liability, as here where it made only sellers liable, then those limits cannot be ignored by resort to theories of conspiracy or aiding and abetting. . . .
>
> To the extent that *In re Caesars Palace Securities Litigation* . . . and *Hill York Corp. v. American Int'l Franchises* . . . take a broader view, this Court declines to follow them.

493 F. Supp. at 647 (footnote and citations omitted); *see* Swenson v. Engelstad, 626 F.2d 421, 424 (5th Cir. 1980); Hagert v. Glickman, Lurie, Eiger & Co., 520 F. Supp. 1028, 1034 (D. Minn. 1981); *In re* Equity Funding Corp. of Am. Sec. Litig., 416 F. Supp. 161, 181 (C.D. Cal. 1976).

134. *See, e.g.*, Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) (Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1976)) (no implied cause of action exists pursuant to Investment Advisors Act based on statutory language, purpose, and history); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) (no implied cause of action under § 17(a)); Southeastern Community College v. Davis, 442 U.S. 397 (1979) (Rehabilitation Act of 1973 § 504, 29 U.S.C. § 794 (Supp. V 1981)) (although agency's interpretation of statute under which it operates is entitled to some deference, courts must honor clear meaning of statute by considering its language, purpose, and history); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (language, purpose, and legislative history of § 10(b) and rule 10b-5 require scienter as standard for liability).

ists to identify congressional intent. In *Touche Ross & Co. v. Redington*,[135] for example, the Supreme Court held that no implied private cause of action exists under section 17(a) of the 1934 Act.[136] In reaching its decision, the Court initially examined the stautory construction of section 17(a)[137] and found that the three traditional factors for determining legislative intent—the statute's express language and focus, its legislative history, and its purpose—militated against implying a private cause of action.[138] The Court found that the "plain language" of the section does not "purport to confer private damages rights or, indeed, any remedy in the event the regulatory authorities are unsuccessful in achieving their objectives . . . ."[139] Recognizing that the legislative history of the 1934 Act is completely silent regarding a private cause of action under section 17(a), the Court therefore stated that to imply "a private right of action on the basis of congressional silence is a hazardous enterprise, at best."[140] Moreover, the Court found that the absence of any suggestion in the legislative history of this private cause of action reinforced the Court's holding.[141] The Court, therefore, emphasized that "generalized references to the 'remedial purposes' of the 1934 Act

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135. 442 U.S. 560 (1979), *opinion after remand,* 612 F.2d 68 (2d Cir. 1979).

136. *Id. But see* Kirshner v. United States, 603 F.2d 234 (2d Cir. 1978), *cert. denied,* 442 U.S. 909 (1979); Fund of Funds, Ltd. v. Arthur Andersen & Co., 545 F. Supp. 1314 (S.D.N.Y. 1982). Section 17(a) provides:

> (1) Every national securites exchange, member thereof, broker or dealer who transacts a business in securities . . . shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this chapter.
>
> (2) Every registered clearing agency shall also make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports, as the appropriate regulatory agency for such clearing agency, by rule, prescribes as necessary or appropriate for the safeguarding of securities and funds in the custody or control of such clearing agency or for which it is responsible.
>
> (3) Every registered transfer agent shall also make and keep for prescribed periods such records, furnish such copies thereof, and make such reports as the appropriate regulatory agency for such transfer agent, by rule, prescribes as necessary or appropriate in furtherance of the purposes of section 78q-1 of this title.

15 U.S.C. § 78q(a) (1976).

137. In interpreting a statute, a court first must examine the express language of the statute itself. Cannon v. University of Chicago, 441 U.S. 677, 689 (1979); Teamsters v. Daniel, 439 U.S. 551, 558 (1979); Santa Fe Indus. v. Green, 430 U.S. 462, 472 (1977); Piper v. Chris-Craft Indus., 430 U.S. 1, 24 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).

138. Touche Ross & Co. v. Redington, 442 U.S. at 575-76; *see* Cort v. Ash, 422 U.S. 66, 78 (1975).

139. 442 U.S. at 570.

140. *Id.* at 571.

141. *Id.*

will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.' "[142]

This term the Supreme Court in *Herman & MacLean v. Huddleston*[143] demonstrated that a flexible, yet literal interpretation of the securities acts to effect their remedial purposes continues to be proper. In *Herman & MacLean* plaintiffs alleged that defendants fraudulently misrepresented in or omitted from the registration statement facts regarding the issuer's financial condition.[144] Although this allegation is actionable under section 11 of the 1933 Act,[145] plaintiffs sued under section 10(b) and rule 10b-5 of the 1934 Act.[146] The Court held that the section 11 remedy does not preclude an action under section 10(b) because section 11 has a minimal negligence standard against specific persons, whereas section 10(b) has a rigid scienter standard against a more general class of persons—the two sections hence are independent but not mutually exclusive antifraud provisions.[147] The Court emphasized that the securities acts require a cumulative construction to further their "broad remedial purposes."[148] In reaching this conclusion, the Court noted that if section 11 were to preclude an action under section 10(b), individuals not specified in section 11[149] "who play a part in preparing the registration statement . . . would be immune from federal liability for fraud-

142. *Id.* at 578 (quoting SEC v. Sloan, 436 U.S. 103, 116 (1978)); *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200 (1976); *see generally* Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80 (1981) (theory of secondary liability is no longer viable in light of recent Supreme Court decisions strictly interpreting federal securities laws). The Supreme Court recognizes that it has implied a private cause of action for damages under § 10(b) of the 1934 Act. *See* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971). The Court, however, has added that its decision in *Superintendent* was merely an "[explicit acquiesence] in the 25-year-old acceptance by the lower federal courts of an implied action under § 10(b)." Touche Ross & Co. v. Redington, 442 U.S. at 577-78 n.19; *see* Cannon v. University of Chicago, 441 U.S. 677, 690-93 (1979); Ernst & Ernst v. Hocbfelder, 425 U.S. 185, 196 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975). "There is no similar history of longstanding lower-court interpretation" implying a private cause of action under § 17(a) of the 1934 Act. 442 U.S. at 578 n.19. Moreover, tbe *Touche Ross* Court realized that its holding might cause hardship, but it stated tbat "we are not at liberty to legislate." *Id.* at 579.

143. 103 S. Ct. 683 (1983).

144. *Id.* at 685-86.

145. *See supra* note 127.

146. 103 S. Ct. at 685-86; *see supra* notes 4-5.

147. 103 S. Ct. at 687-90.

148. *Id.* at 689-90.

149. Those individuals who would escape liability "include corporate officers otber tban those specified in [§ 11(a)], lawyers not acting as 'experts,' and accountants with respect to parts of a registration statement which they are not named as having prepared or certified." *Id.* at 690 n.22.

ulent conduct . . . ."[150]

As a result of *Herman & MacLean*, the express remedy of section 12(2) against a seller for material misrepresentations or omissions does not preclude a separate action under section 10(b) of the 1934 Act. Moreover, no provision of the securities acts other than section 12(2)[151] provides a buyer with an express right of action for material misrepresentations or omissions in a prospectus or oral communication. The two sections, however, differ in their standards for liability—section 12(2) requires mere negligence while section 10(b) demands scienter.[152] Hence, the negligence standard of section 12(2) places a lower burden of proof on the plaintiff than does the section 10(b) scienter standard, but it is more restrictive in scope than section 10(b). Notwithstanding *Herman & MacLean*, however, a key question remains: What is the compass of "seller" under section 12(2)?

III. Analysis

Although the Supreme Court in *Herman & MacLean* emphasized the cumulative remedial nature of the securities acts and in *Touche Ross* demonstrated a trend toward strict construction of the securities laws,[153] the Supreme Court has not yet determined whether the term "seller" in section 12 encompasses only the person who actually sold the securities or some broader category of persons. The various courts of appeals and district courts consequently have developed and still employ three approaches to this question: a strict privity approach,[154] a broader proximate cause-substantial factor approach,[155] and an extremely liberal aiding and abetting approach.[156]

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150. *Id.*

151. *Cf.* Securities Act of 1933 § 11, 15 U.S.C. § 77k (1976) (material misrepresentations in registration statement); *id.* § 12(1), 15 U.S.C. § 77*l*(1) (1976) (material misrepresentations in registration statement); *id.* § 17, 15 U.S.C. § 77q (1976) (fraud). Nevertheless, § 17 may not imply a private right of action. *See* McFarland v. Memorex Corp., 493 F. Supp. 631, 649-50 (N.D. Cal. 1980).

152. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208-10 (1976); *supra* notes 93 & 103-04 and accompanying text.

153. *See supra* part II(*D*).

154. *See, e.g.*, Collins v. Signetics Corp., 605 F.2d 110 (3d Cir. 1979); Cady v. Murphy, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); McFarland v. Memorex Corp., 493 F. Supp. 631 (N.D. Cal. 1980); Barlas v. Bear, Sterns & Co., [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,674 (N.D. Ill. 1966); Nicewarner v. Bleavins, 244 F. Supp. 261 (D. Colo. 1965); *supra* parts II(*A*) & II(*D*).

155. *See, e.g.*, Junker v. Crory, 650 F.2d 1349 (5th Cir. 1981); Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981), *aff'd in part & rev'd in part*, 103 S. Ct. 683 (1983); Croy v. Campbell, 624 F.2d 709 (5th Cir. 1980); Pharo v. Smith, 621 F.2d 656 (5th Cir. 1980); Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); Hill York Corp. v. American Int'l Franchises,

This part examines each of the three approaches in particular situations and compares the results under each approach. This comparison shows first, that the strict privity approach is too narrow and does not sufficiently meet the needs of purchasers; second, that the aiding and abetting approach is too broad and violates the express language of the statute; and last, that the proximate cause-substantial factor approach is the most reasonable and practicable standard for the courts to employ if properly refined.

A. *Strict Privity Approach versus Proximate Cause-Substantial Factor Approach*

Following the Supreme Court's non-section 12 decisions[157] that strictly construe the language of the securities acts, the Third Circuit in *Collins v. Signetics Corp.*[158] dismissed plaintiffs' section 12(2) claim against all defendants because plaintiffs failed to assert section 12(2) liability against the underwriters who actually sold them the securities under a firm commitment underwriting agreement.[159] Although plaintiffs alleged that they had purchased Signetics stock from various underwriters, they failed to name any underwriter as a defendant. They further alleged that the registration statement and the prospectus did not disclose that Corning, which owned a majority interest in Signetics both before and after the offering, intended entirely to divest itself of Signetics stock after the public issue and that the officers of Signetics knew of Corning's planned divestiture before the issue.[160] Plaintiffs claimed that the divestiture caused the market value of the Signetics stock to fall. Deciding the issues under sections 11(a) and (e),[161] the jury found that the prospectus omitted material facts but that natural economic factors, rather than the facts omitted from the registration statement and prospectus, caused the stock

Inc., 448 F.2d 680 (5th Cir. 1971); Katz v. Amos Treat & Co., 411 F.2d 1046 (1969); Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964); *supra* part II(*B*)(3).

156. *See, e.g.*, deBruin v. Andromeda Broadcasting Systems, 465 F. Supp. 1276 (D. Nev. 1979); Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F. Supp. 440 (N.D. Ohio 1975); Lorber v. Beebe, 407 F. Supp. 279 (S.D.N.Y. 1975); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366 (S.D.N.Y. 1973); *supra* part II(*C*).

157. *See supra* note 134.

158. 605 F.2d 110 (3d Cir. 1979).

159. *See supra* note 122.

160. Collins v. Signetics Corp., 605 F.2d at 112.

161. *See supra* note 127. Section 11(e) contains an affirmative defense to § 11(a) violations—if the defendant proves that any portion or all of the plaintiff's damages resulted from causes other than the facts misrepresented in or omitted from the registration statement, the plaintiff cannot recover that portion or all of the damages. 15 U.S.C. § 77k(e) (1976).

price to drop.[162]

If the court had decided the case under section 12, it would have had to choose between the proximate cause-substantial factor approach or the aiding and abetting approach. Under the proximate cause-substantial factor approach, the court would examine whether the actions of Signetics and Corning collectively were a substantial factor in causing plaintiffs to purchase the securities.[163] Unlike under section 11, the jury's finding under section 12 that natural economic factors caused the decline in the value of the stock does not affect the court's analysis. The court first must find whether Signetics had made a material omission or misrepresentation in the prospectus or in an oral communication. The jury in *Collins* found such an omission in the prospectus. The court then must ascertain whether the omission is a substantial factor in causing plaintiff to purchase the stock—but for Signetics' failure to disclose Corning's incipient sale of Signetics' stock, plaintiffs would not have bought the stock. The court conceivably could resolve this factual question in plaintiffs' favor. Signetics could not avail itself of the reasonable care defense under section 12(2) because the jury found that Signetics in fact did know of the omission.

Moreover, the situation in *Collins* demonstrates consequences under the strict privity approach that the drafters of the securities acts surely could not have intended. Plaintiffs bought Signetics stock from the underwriters, who had bought the shares directly from Signetics under a firm commitment underwriting agreement—the underwriters buy the stock from the corporation without recourse if they cannot sell the entire block of shares.[164] A strict privity approach, as *Collins* advocates, would allow a cause of action under section 12(2) only against the underwriters. Presumably, the underwriters would seek indemnification from the corporation for the omission.[165] These artificial contractual relationships, however,

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162. Collins v. Signetics Corp., 605 F.2d at 115-16.

163. *See* Junker v. Crory, 650 F.2d 1349 (5th Cir. 1981); Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981), *aff'd in part & rev'd in part,* 103 S. Ct. 683 (1983); Pharo v. Smith, 621 F.2d 656 (5th Cir. 1980); Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973).

164. *See supra* note 122.

165. Until 1982 the SEC required as a prerequisite to acceleration of the effective date under § 8(a) that the issuer acknowledge in the registration statement that it knew of the SEC's opposition to indemnification of directors, officers, and controlling persons, that it would submit the indemnification issue to a court to determine whether the indemnification is against public policy, and that it would abide by the court's ruling on the issue. *See* SEC Rule 460, 17 C.F.R. § 230.460 (superseded). In Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970), the Second Circuit upheld the district court's decision

should not defeat the remedial purposes of the securities laws. Signetics was the de facto seller in *Collins*—it was the issuer and it raised capital through the sale.

The cumulative nature of the remedies provided by the securities acts discussed in *Herman & MacLean*[166] supports an interpretation of "seller" that is broader than the strict privity approach. Section 12 is unique because it alone provides a remedy specifically for negligent misrepresentations in or omissions from a prospectus or oral communication.[167] For example, if in an oral communication to plaintiffs one of Signetics' financial accountants had misrepresented a fact about the corporation or neglected to state a fact that would not have made his statement misleading, then under the *Collins* strict privity approach the financial accountant would not be liable because he never actually sold the security to plaintiffs. Indeed, the underwriter as the immediate seller would not be liable for the oral misrepresentation or omission made by someone other than the underwriter. Plaintiff would have no remedy under the securities acts for this oral misrepresentation or omission if the accountant did not have the requisite scienter to support an action under rule 10b-5.[168] The proximate cause-substantial factor test obviously would attach liability on the speaker; plaintiff would have to prove only that the misrepresentation or omission played a substantial role in his decision to buy the securities.

The court in *McFarland v. Memorex Corp.*[169] confronted a similar situation concerning a failure to disclose material information concerning the financial condition of the corporation in the prospectus. Plaintiff asserted section 12 liability not only against the underwriter, who was plaintiff's immediate seller because of a firm commitment underwriting agreement with the issuer, but also against the issuer, its individual officers and directors, and the certified public accountants identified in the prospectus. In ruling that section 12(2) applies only to the immediate seller, the court relied on the unambiguous language of the statute.[170] The court favorably noted the accountants' argument that because "rescission" is the express remedy

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to deny an underwriter indemnification from an issuer pursuant to an indemnification agreement, but reversed the award of punitive damages.

166. 103 S. Ct. 683 (1983). The plaintiff's other statutory recourses for alleging civil liability are § 10(b) of the 1934 Act, *see id.*; *supra* text accompanying notes 143-52, and § 11 of the 1933 Act, provided the issuer files a registration statement, *see supra* note 127.

167. *See supra* note 3.

168. *See supra* note 152 and accompanying text.

169. 493 F. Supp. 631 (N.D. Cal. 1980); *see supra* notes 129-33 and accompanying text.

170. 493 F. Supp. at 647-48.

under the section, "it would indeed be strange . . . if a victorious plaintiff could present to the accountants for repurchase securities that they never owned. And the same can be said of every defendant *except* the immediate seller."[171] Although the section expressly provides that the plaintiff may recover the consideration paid for the securities upon the tender of those securities, this result is not altogether "strange" if applied to a party who never actually held the stock. The plaintiff has bought securities under misleading circumstances—he bought them without full disclosure of all true material facts.

Thus, the drafters of the securities acts wished to reverse the old rule of *caveat emptor* and place the burden on those who have greater control of and access to correct information. If the accountants provide misleading information and are responsible for a misrepresentation or omission, a reasonable solution is that they buy the securities from the plaintiff because they originally were a substantial factor in inducing the plaintiff to buy. Moreover, the drafters provided a defense if the defendants "did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission . . . ."[172]

B. Aiding and Abetting Approach versus Proximate Cause-Substantial Factor Approach

Courts developed the aiding and abetting approach to promote the remedial purposes of the 1933 Act by expanding the scope of section 12 liability. The aiding and abetting approach incorporates a secondary level of liability that requires the secondary party knowingly to have advised or assisted the primary wrongdoer in committing the section 12 violations.[173] Although both the proximate cause-substantial factor and the aiding and abetting approaches hold liable as sellers persons who actually did not pass title to the buyer, the element of knowledge differentiates the two approaches. The proximate cause-substantial factor approach focuses upon the relationship between the defendant's actions and their effect upon the buyer. The aiding and abetting approach, however, focuses upon the defendant's knowledge of the intended effect of his actions upon the buyer and whether his actions in fact assisted the immediate seller to effect the

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171. *Id.* at 648 (emphasis in original).

172. 15 U.S.C. § 77*l*(2) (1976).

173. *See* Pinkerton v. United States, 328 U.S. 640, 649 (1946) (Rutledge, J., dissenting in part); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 388 (S.D.N.Y. 1973).

sale. A court therefore need only find that a material misrepresentation or omission has made the prospectus or oral communication misleading and that the defendant knowingly assisted in perpetrating the misrepresentation or omission or was so reckless that the court may impute knowledge to him.[174]

In *deBruin v. Andromeda Broadcasting Systems*[175] plaintiff claimed defendant Sowers was liable under section 12, as either a seller or an aider and abettor. Sowers had recommended that plaintiff purchase Andromeda stock because Sowers believed the stock would provide a fair annual return, even though he knew that Andromeda had a history of operating losses and never had paid a dividend.[176] The court stated that the company did not compensate Sowers for his actions and that Sowers had no interest in the transaction or in the company.[177] Although the court determined that Sowers' recommendation to plaintiff was bad advice, the court found that the advice was not part of a fraudulent scheme to sell the stock to plaintiff and that no fraudulent scheme in fact existed.

Assume, however, that the court had found a fraudulent scheme designed to procure investors for Andromeda. If plaintiff could prove that Sowers knew of the fraudulent scheme and made the misleading statements to further the scheme or acted so recklessly in making the statements that the court would impute knowledge to him, then the court obviously should hold Sowers liable as an aider and abettor. Applying a strict privity approach, the court probably still would not hold Sowers liable as a seller, irrespective of his knowledge of the fraudulent transaction, because he was not the immediate seller.[178]

Employing a proximate cause-substantial factor approach, however, the court could hold Sowers liable as a section 12 seller regardless of his knowledge of the fraudulent scheme because his actions obviously influenced plaintiff's decision to purchase the Andromeda stock.[179] Sowers would have only two defenses: (1) that he did not know or in the exercise or reasonable care could not have known that the statements he made to plaintiff[180] were untrue; and (2) that those

174. *See* deBruin v. Andromeda Broadcasting Systems, 465 F. Supp. 1276, 1280 (D. Nev. 1979).

175. *Id.*; *see supra* notes 108-14 and accompanying text.

176. 465 F. Supp. at 1278.

177. *Id.*

178. *Id.* at 1279; *see, e.g.*, Collins v. Signetics Corp., 605 F.2d 110 (3d Cir. 1979); McFarland v. Memorex Corp., 493 F. Supp. 631 (N.D. Cal. 1980).

179. *See, e.g.*, Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); *supra* note 68 and accompanying text.

180. Sowers falsely told plaintiffs that "owning stock in Andromeda would be a good in-

statements were not a substantial factor in causing plaintiff to purchase the securities. These defenses, however, likely would fail because Sowers knew or in the exercise of reasonable care should have known that his assurance of a fair annual return was groundless because Andromeda never paid any dividends and consistently had yearly operating losses. Although the Fifth Circuit expressly has refused to recognize the secondary liability theories of aiding and abetting and conspiracy in the context of section 12 litigation,[181] other courts[182] maintain that the Fifth Circuit is engaging in mere semantic hairsplitting by extending the purview of seller liability without implying the secondary liability theory of aiding and abetting.

In *Junker v. Crory*[183] the Fifth Circuit found Heisler, an attorney, liable as a section 12(2) seller because his actions motivated the merger of RECO into ROAD.[184] The court found that Heisler played a substantial role in the merger and he knew or with reasonable diligence should have known that he had provided inaccurate and misleading information to RECO shareholders.[185] Under these facts Heisler probably should be liable either as a seller under the proximate cause-substantial factor approach or as an aider and abettor. He probably should not be liable, however, under a strict privity approach since he never actually sold any securities.

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vestment" and that plaintiffs "should receive approximately eight-to-ten percent per year return." 465 F. Supp. at 1278; *see supra* text accompanying notes 108-10.

181. The Fifth Circuit in Croy v. Campbell, 624 F.2d 709 (5th Cir. 1980), and subsequently in Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981), *aff'd in part & rev'd in part,* 103 S. Ct. 683 (1983), expressly refused to recognize the secondary liability theories of aiding and abetting and conspiracy in the context of § 12 litigation. Predictably, the *Croy* and *Huddleston* courts followed the well-accepted standard that anyone "in privity with the purchaser and . . . whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place[,]" 640 F.2d at 551 n.27 (emphasis supplied), may be liable as a § 12 seller, hence obviating any reason to recognize a secondary theory of liability that directly would conflict with the express language of the statute. *See* Stokes v. Lokken, 644 F.2d 779, 785 (8th Cir. 1981) (any allegation of aiding and abetting must bring the alleged defendant within scope of § 12, which applies only to sellers); Briggs v. Sterner, 529 F. Supp. 1155 (S.D. Iowa 1981); Gilbert v. Bagley, 492 F. Supp. 714, 732 (M.D.N.C. 1980); *In re* Equity Funding Corp. of Am. Sec. Litig., 416 F. Supp. 161, 181 (C.D. Cal. 1976). Without discussing the outer limits of § 12 seller liability, the *Stokes* court noted

> that the term "seller," for purposes of determining § 12 liability, is not limited to one who actually transfers title, . . . but *is* limited to one who is in privity with the purchaser or one whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place.

644 F.2d at 785 (footnotes omitted) (emphasis in original).

182. *See supra* note 22.

183. 650 F.2d 1349 (5th Cir. 1981).

184. *Id.* at 1360; *see supra* notes 76-81 and accompanying text.

185. 650 F.2d at 1361; *see supra* text accompanying note 81.

Under the strict privity approach, only ROAD should be liable as seller under section 12(2) because under the merger agreement RECO shareholders surrendered their shares in consideration for ROAD stock.[186] Thus, ROAD should be liable for misrepresentations or omissions made by its officers or directors in a prospectus or oral communication. Indeed, the *Junker* court found that the officers and directors of ROAD failed to disclose to plaintiff material facts regarding ROAD's financial condition.[187] Heisler, however, was not an officer or director, and unless the court were to find that ROAD "controlled" him through an agency relationship as its lawyer,[188] ROAD would not be liable for oral misrepresentations made by Heisler. Therefore, on different facts in which Heisler was not an agent of ROAD and ROAD officers and directors did not know and reasonably should not have known of Heisler's oral misrepresentations or omissions, a court following the strict privity approach could hold Heisler liable only under rule 10b-5 because he would not have been a seller under section 12(2). Moreover, if Heisler, did not have the requisite degree of scienter, plaintiff could not recover even under rule 10b-5 for Heisler's oral misrepresentations or omissions.

Indeed, this requirement of scienter highlights the difference between the Fifth Circuit's proximate cause-substantial factor approach and the aiding and abetting approach. Even if Heisler had not known that the merger was part of a fraudulent scheme to offset losses of ROAD, the Fifth Circuit still should have found Heisler liable as a section 12 seller unless he could establish the reasonable care defense because his misrepresentations were a substantial factor in causing the transaction to take place. Under the aiding and abetting approach, if Heisler had no knowledge of the fraudulent transaction nor acted recklessly in failing to discover it, the court should not hold him liable as a seller or an aider and abettor. As the *Junker* court noted, however, even if Heisler did not know of the untruth or omission, the exercise of reasonable care should have led him to discover the misrepresentation. Therefore, a court could find that Heisler acted recklessly and thus hold him liable as an aider and abettor.

The Supreme Court's decision in *Herman & MacLean* suggests the elimination of aiding and abetting liability in a section 12(2) cause of action. The court recognizes that although courts strictly should construe securities laws according to the "plain language" of

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186. 650 F.2d at 1359.
187. *Id.* at 1361-62.
188. *See supra* notes 27-29 and accompanying text.

that section, they also should read the laws cumulatively to effect their remedial purposes. Section 12(2) requires that the plaintiff prove the defendant acted negligently and restricts liability to a limited class of persons. The Supreme Court now construes section 10(b) of the 1934 Act to provide the plaintiff with the means to hold liable *any* person associated with the same fraudulent sales transaction to which section 12(2) liability attaches, provided that person possesses the requisite degree of scienter regarding his misstatements or omissions. Because the Court recognizes coextensive application of the laws of the 1933 Act and the 1934 Act, no basis for implying secondary liability—aiding and abetting—under an express primary liability statute exists. Section 12 thus attaches only primary liability for a material misstatement in or an omission from a prospectus or oral communication.

C. *Refining the Proximate Cause-Substantial Factor Approach: Duty of Inquiry*

Although the Fifth Circuit's proximate cause-substantial factor approach is the most reasonable method of determining who may be liable as a section 12(2) seller, a key refinement of the approach is necessary to make this approach the most workable as well. Presently, under the proximate cause-substantial factor approach the scope of seller liability is nearly as broad as that under the aiding and abetting approach. The scope of section 12(2) seller liability requires further restriction in light of the Supreme Court's decision in *Herman & MacLean* to permit a plaintiff to bring a fraud action under both an express liability section of the 1933 Act and the "catchall" liability section of the 1934 Act, section 10(b).

The refinement of the proximate cause-substantial factor approach with a duty of inquiry standard is not entirely novel. In *Gould v. Tricon, Inc.*[189] the court recognized that section 12(2) applies to anyone who has a "duty" to ensure that he makes no material misstatements or omissions to the plaintiff. The court, however, failed to describe the parameters of this duty under section 12. Subsequently, the court in *Sandusky Land, Ltd. v. Uniplan Groups, Inc.*[190] em-

189. 272 F. Supp. 385 (S.D.N.Y. 1967); *see supra* notes 48-49 and accompanying text.

190. 400 F. Supp. 440 (N.D. Ohio 1975); *see supra* notes 92-98 and accompanying text. *Cf.* Chiarella v. United States, 445 U.S. 222 (1980), in which the Court relied on tort law to define the duty to disclose under rule 10b-5 by stating that "the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or similar relation of trust and confidence between them.' " *Id.* at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

ployed a duty of inquiry standard to establish scienter and thereby allow section 12 to include the secondary liability theory of aiding and abetting. The primary flaw in *Sandusky Land* is that the court introduces a new element—scienter—to the express language of section 12; taking this extra step to find scienter is unnecessary under section 12(2), which expressly imposes primary liability for mere negligence.

The foundation for prescribing the scope of the duty of inquiry standard as a limiting feature of the proximate cause-substantial factor approach lies in the express statutory defense of reasonable care. The issue of who has a duty of inquiry is based on a person's relationship to the purchaser or that person's degree of association with the sales transaction. If that relationship or participation is sufficiently close, then that person has a duty to exercise reasonable care and a breach of that duty must be a substantial factor in causing the plaintiff to purchase the securities before liahility will attach.

A comparison of the defendant's actions in *Croy v. Campbell*[191] and *Junker v. Crory*[192] illustrates the utility of the duty of inquiry limitation. In *Croy* the Fifth Circuit refused to hold defendant attorney liable as a section 12 seller because the court found he had participated in the sales transaction only as a "passive advisor" to plaintiffs and was not a substantial factor in causing the transaction to take place. Defendant advised plaintiffs of a real estate deal in which to invest for tax shelter purposes. Defendant based his advice on financial estimates contained in a sales brochure concerning the realty; defendant did not prepare any of the information in the brochure. Moreover, defendant told plaintiffs that the figures in the brochure were estimates only and "advised [plaintiffs] to make an independent business judgment about the advisability of [the] investment . . . ."[193] Thus, even though defendant breached his duty of inquiry based on his attorney-client relationship with plaintiffs, his breach was not a substantial factor in causing plaintiffs to make the investment.

In *Junker*, however, the Fifth Circuit found that Heisler's omissions in his oral communications were material misstatements that proximately caused the RECO shareholders to approve a merger into ROAD. Heisler, as corporate attorney for both RECO and ROAD, failed to present information that he knew concerning ROAD's lack

191. 624 F.2d 709 (5th Cir. 1980); *see supra* notes 71-73 and accompanying text.
192. 650 F.2d 1349 (5th Cir. 1981); *see supra* notes 76-81 and accompanying text.
193. Croy v. Campbell, 624 F.2d 709, 711 (5th Cir. 1980).

of sales and the potentially significant detrimental effect of ROAD's net income to the RECO shareholders before the merger vote. Because of Heisler's proximity to the merger and his relationship to the shareholders as corporate counsel, his actions were a substantial factor in causing the RECO shareholders to approve the merger.

Heisler's actions differ in several respects from those of defendant in *Croy*. In *Junker* Heisler not only recommended the merger but also actively lobbied the RECO shareholders for its passage. Heisler also knew of the potentially damaging economic effect to the RECO shareholders of a merger but failed to inform them of that effect prior to the merger vote. Thus, Heisler was an active participant in the fraudulent merger scheme. He knew of his material misrepresentations yet failed to apprise the shareholders of the true financial condition of ROAD. By comparison, defendant in *Croy* merely played a passive role as an advisor to plaintiffs concerning the quality of the realty investment based on speculative information contained in a sales brochure. Defendant had no part in preparing the brochure and made no representations regarding any aspect of the investment. Defendant even advised plaintiffs to seek independent advice concerning the investment. Defendant in *Croy*, however, had a duty of inquiry based on his attorney-client relationship with plaintiffs concerning the financial data contained in the sales brochures. Even though he did not check the veracity of the financial data, defendant exercised his duty by notifying plaintiffs that the information in the brochure was merely an estimate and that they should seek independent advice.

The following hypothetical demonstrates the imposition of a "duty of inquiry" standard upon those persons found to be a substantial factor in proximately effecting the transaction. Assume, for example, that Mr. Mason, a securities attorney, overhears in a public place two individuals whom he does not know discussing a possible public offering for ABC Company, which they represent. Mason has heard rumors recently that the company plans a major diversification, and he assumes that the company will use the issue to fund that expansion. Mason therefore has no reason to believe that what he has heard is inside information. Mason later tells his friend, Dr. Bonz, that he "understands" that the ABC Company soon will have a public stock issue. Mason then proceeds to inform Bonz about the development of ABC Company and says that the company's future "appears bright" and that purchase of its stock should be a "great investment." Two days later Mason again touts the investment merits of ABC Company stock. Bonz knows that Mason has no direct or indirect interest in ABC Company nor any formal connection with the company. The following day Bonz purchases $25,000 worth of ABC Company stock primarily because of Mason's representations concerning the potential profitability of the company. One month later, with no public offering in the interim, ABC Company declares bankruptcy and Bonz loses his entire investment. Bonz then files suit against Mason alleging that Mason's oral communications to him were a substantial factor in causing him to purchase the ABC Company stock and therefore a violation of section 12(2). Bonz seeks damages of $25,000 plus attorney's fees.

Employing a proximate cause-substantial factor approach to determine Mason's status as a section 12(2) seller, a court first could determine that Mason substantially caused Bonz to purchase the stock. Next, the court would have to determine whether Mason knew or in the exercise of reasonable care should have known that his representations to Bonz concerning the great investment quality of the stock were a misstatement of material fact. If Mason did not actually know of his material misstatement, he easily could have obtained ABC Company's annual reports and, with his securities expertise, quickly recognized the company's precarious financial condition.Thus, a court could conclude that if Mason had exercised reasonable care, he would have known of his material misstatement to Bonz. If a reasonable, prudent person would consider Mason's statement material and if it in fact played a substantial role in Bonz' decision to purchase the stock, a court applying a proximate cause-substantial factor analysis should deem Mason a section 12(2) seller.

Characterizing Mason as a section 12(2) seller would be inequitable in this hypothetical situation unless Mason also owed some duty of care to Bonz to inquire into the financial operations of ABC Company prior to his discussions with Bonz. If a court exclusively employs the proximate cause-substantial factor approach, the court could impose liability upon almost anyone who makes material misstatements and thereby substantially causes another to purchase securities. A court should hold Mason to this high duty of inquiry only if Mason had been a major participant in the sale of ABC Company stock. Thus, the court should deem Mason a section 12(2) seller only if he had participated in the sales process to such an extent that he would have had a reasonable opportunity to become apprised of material information. Also, the court might require an ongoing attorney-client relationship between Mason and Bonz or at least Mason's active association with the operations of ABC Company.

V. Conclusion

Although the Supreme Court has not yet determined how broadly courts should interpret the term "seller" under section 12, recent cases construing other statutes reflect a trend toward a literal interpretation of the securities acts. In *Touche Ross*, for example, the Supreme Court settled the longstanding debate over whether section 17(a) of the 1934 Act affords a private right of action.[194] Strictly construing this section, the Court denied this private right of action because of the statute's express language, its legislative history, and its purpose.[195]

The same three-part test of *Touche Ross* is applicable to determine the scope of seller liability under section 12(2). Most district and appellate courts have fashioned seller liability under section 12 according to the "remedial purposes" of the 1933 Act. The Supreme Court in *Touche Ross*, however, cautioned against a liberal construction of the securities acts merely to further their "remedial purposes."[196] Instead, the Court emphasized adherence to the clear and "plain language"[197] of the statute and declared that the Court has no power to legislate.[198]

Applying a strict privity standard in section 12, however, may destroy rather than promote public confidence in the investment community. Employment of a strict privity standard necessarily reduces the number of persons whom courts may hold primarily liable as sellers. Moreover, the strict privity standard places a tremendous burden of responsibility on the party who passes title or that party's broker-agent to ensure that no prospectus or oral communication contains an untrue statement of a material fact or omits a material fact. Therefore, the strict privity standard may preclude a court from imposing liability upon the party who made the untrue statement of a material fact or who failed to state a material fact. This result especially is likely if that party were, for example, an attorney or accountant who did not actually pass title but who conveyed to the buyer misleading information that included an untrue statement of a material fact or who omitted to state a material fact.

Courts that promote the "remedial purposes" of the 1933 Act follow two approaches to determine who may be liable as a section 12

194. *See supra* notes 135-42 and accompanying text.
195. *See* Cort v. Ash, 422 U.S. 66, 78 (1975).
196. Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979); *see supra* note 142 and accompanying text.
197. 442 U.S. at 571.
198. *Id.* at 579.

seller: the aiding and abetting approach, which infers secondary liability under section 12, and the proximate cause-substantial factor approach, which is a test used to define the scope of primary liability borrowed from tort law. Both approaches achieve similar results in many cases, although the means employed by each differ dramatically. Courts and commentators that criticize the extension of section 12 to include aiders and abettors uniformly cite as the major flaw in the aiding and abetting approach the unwarranted extension of an express primary liability statute to include a secondary level of liability, which by definition requires scienter by the aider and abettor.[199]

The Supreme Court's current trend toward literally construing the language of the securities statutes and recognizing coextensive application of the antifraud sections of the 1933 Act and the 1934 Act renders questionable the soundness of the implied remedy of aiding and abetting under section 12. The Supreme Court's decision in *Herman & MacLean* that an express remedy under section 11 of the 1933 Act does not preclude the plaintiff from suing under section 10(b) of the 1934 Act is analogous to a plaintiff maintaining either or both a section 12 and section 10(b) cause of action. Section 12 is an express private civil liability section that requires the plaintiff merely to prove that the defendant acted negligently. Section 10(b), however, requires that the plaintiff demonstrate that the defendant acted with scienter, a much heavier burden. The Court's current trend to construe strictly the express language of statutes strongly suggests that section 12 is purely a primary liability section whereas section 10(b) is a "catchall" antifraud section that courts may use to find either primary or secondary liability. Because the securities laws are cumulative a defendant not primarily liable as a seller under section 12 thus may be secondarily liable as an aider and abettor under section 10(b), provided the plaintiff proves the defendant acted with scienter.

The Supreme Court's apparent limitation of section 12 to include only primary liability still affords courts the opportunity to employ a modified version of the proximate cause-substantial factor approach to find primary seller liability. The proximate cause-substantial factor approach expands the class that a court may hold primarily liable as a seller, but this approach presently has no defined parameters. A modified version of this approach should limit liability to those whose actions were a substantial factor in causing the transaction to take place, and whose relationship to the plaintiff

199. *See supra* note 75.

or to the overall sales transaction demands a duty of inquiry into the veracity of any material statements made in or omissions from a prospectus or oral communication.

The pitfalls associated with application of either the strict privity or aiding and abetting approach to determine whom a court may hold liable as a section 12(2) seller thus demonstrate that the Fifth Circuit's proximate cause-substantial factor approach is the most reasonable standard. Unlike other standards for determining section 12(2) seller liability, the Fifth Circuit's proximate cause-substantial factor approach by definition imposes liability both upon the defendant who passed title or his broker-agent and upon the defendant whose actions were a substantial factor in fraudulently causing the plaintiff to purchase the securities. Indeed, a modified version of the Fifth Circuit's approach that includes a duty of inquiry would describe more clearly the ambit of that approach and make it not only a reasonable approach but also a workable, uniform standard.

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