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Pleading Under Section 11 of the Securities Act of 1933

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The Securities Act of 1933 ("Securities Act") requires full and fair disclosure of the nature of securities sold in interstate and foreign commerce.[1] Section 11 of the Securities Act prohibits false or misleading registration statements. It also provides buyers a private remedy for false or misleading statements against any signer of the registration statement, any partner or director of the issuer, any professional involved in preparing or certifying the statement, and any underwriter.[2] The rule appears simple: if there is a material misstatement or omission in the registration statement, the buyer may sue the seller.[3]

Courts disagree, however, over how a section 11 plaintiff must plead his or her claim.[4] Because neither fraud nor mistake is an ele-

1. *See* H.R. 5480, 73d Cong. § 1 (1933); *see also* H.R. REP. NO. 73-85, at 1-5 (1933); JACK S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (1973) (containing copies of original documentation regarding the Securities Act and Securities Exchange Act of 1934).

2. 15 U.S.C. § 77(k) (1994) (codifying section 11 of the Securities Act).

3. Although Congress did not define the term "material" for the purposes of determining whether there has been a material misstatement or omission under the Securities Act, the Supreme Court has held that a fact is material if "a reasonable shareholder would consider it important in making an investment decision or if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." TSC Indus. v. Northway, 426 U.S. 438, 449 (1976). The Securities & Exchange Commission ("SEC") has incorporated that definition into its regulations. *See* 17 C.F.R. § 230.405 (1994).

4. *See U.S. Supreme Court: Supreme Court refuses to review procedural challenge to suit over IPO*, SEC. L. DAILY, June 16, 1998. In the 1997 *NationsMart* case, the defendants (the corporation, its officers and directors, and its underwriters) beseeched the Supreme Court to

ment of a section 11 claim, courts have applied the liberal notice pleading standard of Rule 8(a)(2) of the Federal Rules of Civil Procedure.[5] Rule 8(a)(2) states that a plaintiff must plead only "a short and plain statement of the claim showing that the pleader is entitled to relief."[6]

The fear of strike suits, which are groundless claims filed as a pretext for discovery in order to induce settlement, has led some courts to interpret the Federal Rules more stringently.[7] To dissuade potential plaintiffs or to dispose of more complaints at the pleading stage, these courts have required securities plaintiffs to plead their claims with particularity under Rule 9(b) of the Federal Rules of Civil Procedure.[8] Rule 9(b) provides "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."[9]

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resolve the existing disagreement among circuits over whether the heightened pleading standard of Rule 9(b) applies to section 11 complaints. The district court originally dismissed the case, in part, because the plaintiffs (stock purchasers) did not plead fraud with particularity. The Eighth Circuit Court of Appeals reversed in part, stating that "Rule 9(b) does not apply to claims under § 11 of the Securities Act, because proof of fraud or mistake is not a prerequisite to establishing liability under § 11." Carlon v. Thaman (*In re* NationsMart Sec. Litig.), 130 F.3d 309, 314 (8th Cir. 1997).

5. *See, e.g.*, Bernstein v. Crazie Eddie, 702 F. Supp. 962, 973 (E.D.N.Y. 1988) ("Section 11 violations need not be pleaded . . . with the particularity required of fraud claims governed by Federal Rule of Civil Procedure 9(b), which requires that 'averments of fraud or mistake' be stated 'with particularity.' . . . Plaintiffs need only comply with Rule 8(a) of the Federal Rules of Civil Procedure by setting forth a 'short and plain statement of the claim.' "); *see also* 69A AM. JUR. 2d *Securities Regulation* § 1490 (1993). The only instance where fraud is a factor under section 11 is with respect to a defendant's right to contribution from other parties who are liable for the misstatement or omission. *See* 15 U.S.C.A. § 77k(f)(1) (1994) ("Every person who becomes liable to make any payment under this section may recover contribution . . . from any person who . . . would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.").

6. FED. R. CIV. P. 8(a)(2).

7. *See, e.g.*, Melder v. Morris, 27 F.3d 1097, 1100 (5th Cir. 1994) (applying FED. R. CIV. P. 9(b) to a section 11 claim); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741 (1975) (expressing concern that strike suits, which take up the time of a large number of people in the hopes of increasing the settlement value, represent "a social cost rather than a benefit").

8. *See Melder*, 27 F.3d at 1100 (applying FED. R. CIV. P. 9(b) to a section 11 claim "grounded in fraud" and noting that "the heightened pleading standard provides defendants with fair notice of the plaintiff's claims, protects defendants from harm to their reputation and goodwill, reduces the number of strike suits, and prevents plaintiffs from filing baseless claims then attempting to discover unknown wrongs" (quoting Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1067 (5th Cir. 1994)).

9. FED. R. CIV. P. 9(b). Averments of mistake occur only infrequently. This Note, therefore, will only address the relationship between section 11 and claims of fraud. *See* Bankers Trust Co. v. Old Republic Ins. Co., 959 F.2d 677, 683 (7th Cir. 1992) (collecting a mere two cases in the last fifty years in which a court dismissed a complaint for failure to plead *mistake* with particularity); 2 JAMES WM. MOORE ET AL., MOORE'S FEDERAL

The courts that have addressed whether section 11 plaintiffs must plead according to the heightened pleading standard of Rule 9(b) have taken three approaches: (1) Rule 9(b) does not apply to any section 11 claims;[10] (2) Rule 9(b) applies to only those section 11 claims that are "grounded in fraud";[11] and (3) Rule 9(b) applies to all section 11 claims.[12] Whether a section 11 plaintiff must plead his or her claim in accordance with Rule 9(b) affects a buyer's substantive rights under the securities laws and interferes with the regulatory scheme of the securities markets established by Congress.[13]

This Note argues that Rule 9(b) does not apply to claims filed under section 11 of the Securities Act, regardless of whether the claim "is grounded in fraud." Instead, section 11 plaintiffs must comply only with the liberal notice pleading standard stated in Rule 8(a)(2) of the Federal Rules of Civil Procedure. Part I argues that Congress intentionally set a low burden for section 11 plaintiffs because the purpose of the Securities Act is to protect purchasers of securities. The text, history, and purpose of the Securities Act, as well as the text and purpose of the Federal Rules of Civil Procedure, support imposing minimal pleading requirements on section 11 plaintiffs. Because securities lawsuits often contain claims under *both* section 11 of the Securities Act and section 10(b) of the Securities Exchange Act of 1934 ("Ex-

PRACTICE 3d, § 9.03[2] (1999). Furthermore, I have found no securities case that was dismissed for failure to plead mistake with particularity.

10. *See* Carlon v. Thaman (*In re* NationsMart Sec. Litig.), 130 F.3d 309, 314 (8th Cir. 1997). While the Second Circuit has not specifically addressed the issue, several district courts in the Second Circuit have held that Rule 9(b) does not apply to section 11 claims. *See, e.g.*, Feiner v. SS&C Tech., 11 F. Supp. 2d 204 (D. Conn. 1998); *In re* In-Store Adver. Sec. Litig., 878 F. Supp. 645, 650 (S.D.N.Y. 1995); Nelson v. Paramount Comm., Inc. 872 F. Supp. 1242, 1246 (S.D.N.Y. 1994); *In re* Ann Taylor Stores Sec. Litig., 807 F. Supp. 990, 1003 (S.D.N.Y. 1992).

11. *See* Anderson v. Clow (*In re* Stac Elec. Sec. Litig.), 89 F.3d 1399 (9th Cir. 1996); Shaw v. Digital Equip. Corp., 82 F.3d 1194 (1st Cir. 1994); *Melder*, 27 F.3d at 1097 (5th Cir. 1994); Shapiro v. UJB Fin. Corp., 964 F.2d 272 (3d Cir. 1992). These courts generally find that because plaintiffs incorporate section 11 and section 10(b) claims in the same complaint based on the same facts, both claims necessarily sound in fraud. *See Shapiro*, 964 F.2d at 287 ("Although Count II does not allege fraudulent intent or recklessness (a prerequisite to a successful fraud claim), neither does it allege negligence."). On the other hand, some courts have recognized that applying Rule 9(b) to section 11 claims accomplishes nothing except eliminating fraud from the complaint. *See, e.g.*, *NationsMart*, 130 F.3d at 314.

12. *See* Sears v. Likens, 912 F.2d 889 (7th Cir. 1990) (holding that Rule 9(b) applies to section 12(2) of the Securities Act, but not distinguishing between negligent or fraudulent claims); *see also NationsMart*, 130 F.3d at 315 (citing to *Sears* when discussing whether to apply Rule 9(b) to a section 11 claim even though *Sears* dealt with section 12(2)). Like section 11, section 12(a)(2) of the Securities Act creates a private cause of action against sellers for material misstatements or omissions in registration statements. Section 12(a)(2), however, has been strictly limited by the loss causation defense in section 12(b) and the Supreme Court's finding in Gustafson v. Alloyd Co., 513 U.S. 561 (1995) that section 12(a)(2) does not apply to secondary transactions or private offerings.

13. *See infra* notes 21-23, 40-43 and accompanying text.

change Act"),[14] Part II posits that differences in statutory language and policy goals in these sections mandate applying a lower pleading standard to claims filed under section 11 than to those filed under section 10(b).[15] This Note concludes that Rule 8(a)(2) should apply to section 11 claims because applying the heightened requirements of Rule 9(b) would undermine section 11's inducement to carefully prepare registration statements in order to inform buyers of the character of securities.[16]

I. SECTION 11 PLACES A MINIMAL BURDEN ON PLAINTIFFS

The statutory language and legislative history of the Securities Act indicate that Congress intended to minimize plaintiffs' burden of pleading under section 11. Section I.A argues that because section 11 does not specifically mention fraud or mistake, Rule 9(b) does not apply. Section I.B recounts the historical facts that prompted Congress to enact the Securities Act and argues that the purpose behind the Securities Act and section 11 in particular support a minimal pleading standard. Section I.C analyzes the purpose of the Federal Rules of Civil Procedure and concludes that because the policy reasons supporting Rule 9(b) do not apply to section 11 claims, such claims should be pleaded in accordance with Rule 8(a)(2).

A. *Statutory Language of Section 11*

Because the text of section 11 imposes a minimal burden on the buyer, it would contravene congressional intent to read the heightened pleading standard of Rule 9(b) into section 11 claims. This Section argues that there are two reasons on the face of the statute to apply the notice pleading standard of Rule 8(a)(2) to section 11 claims. First, because the plain language of section 11 does not include fraud or mistake as an element of the claim, the heightened pleading standard of Rule 9(b) does not apply; and therefore, by default, the liberal notice pleading standard of Rule 8(a)(2) applies. Second, section 11's inapposite treatment of buyers and sellers also supports imposing the liberal notice pleading standard of Rule 8(a)(2) on section 11 plaintiffs.

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14. *See, e.g., In re* Westinghouse Sec. Litig., 90 F.3d 696 (3d Cir. 1996). Section 10(b) of the Exchange Act provides civil liability for fraudulent statements in connection with the sale of securities. 15 U.S.C. § 78j(b) (1994).

15. Initially, judges unilaterally applied the heightened pleading standard of Rule 9(b) to section 10(b) claims. *See Westinghouse*, 90 F.3d at 710-14. Congress mandated the application of Rule 9(b) to section 10(b) claims in the Private Securities Litigation Reform Act ("PSLRA"). 15 U.S.C.A. § 78u-4 (1934).

16. *See* DAVID L. RATNER & THOMAS LEE HAZEN, SECURITIES REGULATION: CASES AND MATERIALS 251 (5th ed. 1996).

The plain language of section 11 supports requiring a plaintiff to comply with the more liberal notice pleading standard because section 11 does not include fraud or mistake as an element of the claim. When interpreting a statute, the Supreme Court has instructed lower courts that "[w]here . . . resolution of a question of federal law turns on a statute and the intention of Congress, we look first to the statutory language and then to the legislative history if the statutory language is unclear."[17] In this case, the Federal Rules and the statute are clear.[18] Rule 9(b) imposes a heightened pleading standard in only two instances: averments of fraud or mistake.[19] Because section 11 includes neither of these, it does not fall within the scope of Rule 9(b).[20]

To plead a claim under section 11, the plaintiff must allege the following: (1) that the registration statement contained a misstatement or omission when it became effective; (2) that the misstatement or omission was material; and (3) that the plaintiff purchased the security pursuant to such statement.[21] After establishing a prima facie case, the plaintiff may recover damages.[22] The plaintiff must also comply with the statute of limitations.[23]

17. Blum v. Stenson, 465 U.S. 886, 896 (1984), *quoted in* United States v. Rozet, No. C 97-1704 SC, 1998 WL 838888, at *6 (N.D. Cal. Oct. 29, 1998); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) ("The starting point in every case involving construction of a statute is the language itself.").

18. The effort to create the Federal Rules of Civil Procedure began in 1911, but the Rules were not written until the 1930s and did not become effective until 1938. *See* § 62 CHARLES A. WRIGHT, LAW OF FEDERAL COURTS (5th ed. 1994) 426-32, 760. The fact that the Securities Act predated the effective date of the Federal Rules should not impact the application of the Federal Rules to civil actions filed under the Securities Act. Although the Enabling Act of 1934 declares that the rules regulate only "practice and procedure" and do not "abridge, enlarge or modify any substantive rights," 28 U.S.C. § 2072(a)-(b) (1988), the Supreme Court has consistently upheld all rules challenged before it. *See, e.g.*, Hanna v. Plumer, 380 U.S. 460 (1965); Sibbach v. Wilson & Co. 312 U.S. 1, 85 (1941). These cases support applying Rule 8(a)(2) to section 11 claims because application of Rule 9(b) would change the substance of section 11 by requiring a plaintiff to prove more than required to recover under the Act. *See, e.g., In re* First Merchants Acceptance Corp. Sec. Litig., No. 97-C2715, 1998 WL 781118, at *11 n.6. (N.D. Ill. Nov. 4, 1998) ("It is illogical to require plaintiffs to plead more than they would have to prove to succeed on a § 11 claim standing alone.").

19. FED. R. CIV. P. 9(b).

20. 15 U.S.C. § 77k(a) (1994).

21. *Id.*; *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (setting forth the elements of a prima facie case under section 11). In contrast, to state a claim under section 10(b) of the Exchange Act, every plaintiff must plead both scienter and reliance. 15 U.S.C. § 78j (1994).

22. Damages are usually equal to the difference between the price paid for security by the plaintiff and the value of the security at the time the section 11 claim was brought. *See* 15 U.S.C. § 77k(e) (1994); *see also* Beecher v. Able, 435 F. Supp. 397 (S.D.N.Y. 1975).

23. Section 13 of the Securities Act provides the statute of limitations applicable to section 11 claims. 15 U.S.C. § 77m (1994) (providing for a statutory limitations period of one year after discovery of the misstatement or omission, or after discovery should have been made by the exercise of reasonable diligence, but in no event can a section 11 action be brought more than three years after the security was "bona fide offered to the public").

Whether the claim is "grounded in fraud" should not affect what a section 11 plaintiff must plead in the complaint. By definition, fraud is "a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment."[24] Section 11 does not require proof of scienter or reliance;[25] therefore, it is meaningless to distinguish cases upon whether or not they are "grounded in fraud." Allegations of fraud would be mere surplusage and could be deleted from the complaint by the plaintiff before filing the complaint, or by the court upon a motion to dismiss, without affecting the plaintiff's substantive claim.[26] Even if a court dismissed the allegations of fraud from the plaintiff's complaint for failure to plead with particularity under Rule 9(b), the heart of a plaintiff's section 11 claim — that the registration statement contained false or misleading information — should not be dismissed.[27]

Because section 11 does not require a showing of fraud or mistake, applying Rule 9(b) to section 11 claims conflicts with judicial interpretation of the notice pleading standard under the Federal Rules.[28] In *Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit*,[29] the Supreme Court explicitly limited the scope of Rule 9(b) and stated that courts cannot add to the Federal Rules merely for policy reasons.[30] In that case, the Court acknowledged the fact that "[t]he Federal Rules do address in Rule 9(b) the question of the need for greater particularity in pleading certain actions."[31] The Court went on

24. BLACK'S LAW DICTIONARY 670 (7th ed. 1999).

25. 15 U.S.C. § 77k(a) (1994).

26. *See* Carlon v. Thaman (*In re* NationsMart Sec. Litig.), 130 F.3d 309, 315 (8th Cir. 1997).

27. *See id.*

28. *See* Silver v. New York Stock Exchange, 373 U.S. 341, 357 (1963) (favoring "an analysis which reconciles the operation of both statutory schemes with one another rather than holding one completely ousted"), *quoted in* Herman & MacLean v. Huddleston, 459 U.S. 375, 387 n.23 (1983).

29. 507 U.S. 163 (1993).

30. *See id.* at 168 (discussing municipal liability under section 1983). *But see* Cash Energy, Inc. v. Weiner, 768 F. Supp. 892, 900 (D. Mass. 1991) (applying Rule 9(b) to a CERCLA claim because of the severe consequences of environmental liability and the expense of defending a non-meritorious claim). After *Leatherman*, courts have read Rule 9(b) more narrowly. *See, e.g.*, Warwick Admin. Group v. Avon Products, Inc., 820 F. Supp. 116, 121 (S.D.N.Y. 1993) (stating that "in light of the *Leatherman* decision, we hold that a heightened pleading standard does not apply to CERCLA cases"); United States v. Azrael, 774 F. Supp. 376, 380 (D. Md. 1991) (declining to follow *Cash Energy* and applying Rule 8(a)(2) to a CERCLA claim). In addition, the "recent tendency in some courts to revive fact pleading in an effort to cope with increased litigation . . . [is] inconsistent with the spirit of the federal rules." CHARLES ALAN WRIGHT & ARTHUR R. MILLER, 5 FEDERAL PRACTICE AND PROCEDURE § 1298 (2d ed. 1990).

31. *Leatherman*, 507 U.S. at 168 (holding that homeowners, who brought a civil rights action against municipal officials claiming that a search of their homes for illegal drugs violated the Fourth Amendment, did not need to comply with the heightened pleading standard because courts may impose the heightened pleading standard *only* in circumstances consti-

to say, "perhaps if Rules 8 and 9 were rewritten today, [additional claims] might be subjected to the added specificity requirement of Rule 9(b)."[32] But because Rule 9(b) applies a heightened pleading standard only to averments of fraud or mistake and not to cases involving a material misstatement or omission, it should not be expanded to apply to section 11 claims.[33]

An analysis of the treatment of buyers and sellers under section 11 further supports a minimal pleading standard for section 11 plaintiffs. Section 11 treats buyers and sellers differently by mandating minimal requirements for a plaintiff's prima facie case, but requiring strict compliance with the Securities Act's disclosure provisions and reasonable investigation for a defendant to raise an affirmative defense.[34]

Congress made it easy for buyers to bring a claim under section 11. To state a claim, a buyer must allege that he purchased a security from a seller pursuant to a registration statement containing a material misstatement or omission.[35] A buyer does *not* have to establish reliance, which means that the buyer need not have relied upon the registration statement or even have seen the registration statement to collect damages.[36] Because section 11 does not include a scienter requirement, a

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tuting fraud or mistake). The Court held that Rule 9(b) did not apply to complaints alleging municipal liability under section 1983 because to state a claim under that section, a plaintiff must allege only that a person deprived him of a federal right while that person was acting under color of state or territorial law. 42 U.S.C.A. § 1983 (1994).

32. *Leatherman*, 507 U.S. at 168.

33. *See* Tennessee Valley Auth. v. Hill, 437 U.S. 153, 174 n.18 (quoting Lewis Carroll's advice on the construction of language in LEWIS CARROLL, *Through the Looking Glass*, *in* THE COMPLETE WORKS OF LEWIS CARROLL 196 (1939): " 'When I use a word,' Humpty Dumpty said, in rather a scornful tone, 'it means just what I choose it to mean — neither more nor less.' ").

34. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (stating that section 11 "places a relatively minimal burden on a plaintiff"); *see also id.* at 383 (stating that the liability for the issuer of a materially misleading registration statement is "virtually absolute, even for innocent misstatements" and that anyone else who signed the registration statement must prove, after reasonable investigation, that he or she had reasonable grounds to believe the statement was not materially misleading (footnotes omitted)); H.R. REP. NO. 73-85, *supra* note 1, at 9 (statement of Rep. Samuel Rayburn) (indicating that "[t]he provisions throwing upon the defendant in suits under section[] 11 . . . the burden of proof to exempt himself are indispensable to mak[ing] the buyer's remedies . . . effective").

35. *See* 15 U.S.C. § 77(k)(a) (1994). If contested, the plaintiff must also establish that he brought his claim within the statute of limitations. As noted in Cook v. Avien, Inc., 573 F.2d 685 (1st Cir. 1978):

> [I]t is the general rule in the federal courts that, when the very statute which creates the cause of action also contains a limitation period, the statute of limitations not only bars the remedy but also destroys the liability, and therefore the plaintiff must plead and prove facts showing that he is within the statute. This view has been consistently followed under the Securities Act.

Id. at 695 (alteration in original) (citations omitted).

36. Even if a person purchases the security after it has been made generally available to the public, the added requirement of proof of reliance on the untrue statement in the registration statement "may be established without proof of the reading of the registration state-

buyer may recover damages for an innocent misstatement or omission.[37] Representative Sam Rayburn emphasized the importance of the absence of a scienter requirement in the legislative history of the Securities Act when he stated that, "[e]very lawyer knows that with all the facts in the control of the [seller] it is practically impossible for a buyer to prove a state of knowledge or a failure to exercise due care on the part of the [seller]."[38] Therefore, it would be unreasonable to require a buyer to plead with particularity if the buyer did not even have to read the registration statement to recover in the first place.[39]

In addition, Congress granted buyers procedural control over section 11 litigation. First, a buyer can elect to bring a section 11 claim in law or equity.[40] While the damages sought usually command the decision between law and equity, the choice effectively grants the buyer the choice of trial by judge or jury.[41] A buyer also has the option of suing in federal or state court.[42] Moreover, under an express exception to the general removal statute, a seller may not remove a section 11 claim from state to federal court.[43] Sellers should not be able to undermine buyers' ability to bring their claims in the most favorable jurisdiction by easily having a section 11 claim dismissed for failure to plead with particularity.

The statutory language shows that Congress did not want a seller to be able to evade the disclosure regime of the Securities Act because the buyer did not comply with the pleading requirements of Rule 9(b).[44] Congress divided "sellers" into two categories: the issuer and

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ment by such person." 15 U.S.C. § 77k(a) (1994); *see also* III LOUIS LOSS, SECURITIES REGULATION, 1752 (2d ed. 1961) (stating that section 11 enables a plaintiff to establish reliance "without proof of the plaintiff's reading" of the registration statement). This rule makes perfect sense if one accepts the "efficient market hypothesis (EMH)." The EMH says that the price of a security immediately reflects all disclosed information about the security. *See generally* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970). Therefore, if an issuer discloses a material misstatement of information, the price of the security will reflect this misinformation. The purchaser will pay an unfair price regardless of whether or not she has read the registration statement.

37. *See* 15 U.S.C. § 77k(a) (1994); *see also, e.g.*, Anderson v. Clow (*In re* Stac Elec. Sec. Litig.), 89 F.3d 1399, 1404 (9th Cir. 1996).

38. H.R. REP. NO. 73-85, *supra* note 1, at 9 (statement of Rep. Sam Rayburn).

39. *See* Schoenbaum v. Firstbrook, 405 F.2d 215, 218 (2d Cir. 1968) (stating that there is a concern regarding unfair dismissals for failure to plead with particularity in cases where the defendant has exclusive possession of the facts).

40. *See* 15 U.S.C. § 77(v) (1994) (providing that claims may be brought "in equity [or] at law . . . to enforce any liability or duty created by this subchapter").

41. *See* 69A AM. JUR. 2d, *Securities Regulations* § 1053 (1993).

42. *See* 15 U.S.C. § 77v(a) (1994); Thomas Lee Hazen, *Allocation of Jurisdiction Between the State and Federal Courts for Private Remedies Under the Federal Securities Laws*, 60 N.C. L. REV. 707 (1982).

43. *See* 15 U.S.C. § 77v(a) (1994); 28 U.S.C. § 1441(c) (1994).

44. *See* H.R. REP. NO. 73-85, *supra* note 1, at 9 (statement of Rep. Sam Rayburn).

everyone else involved in preparing the registration statement.[45] First, the Supreme Court has held that liability of the issuer is virtually absolute.[46] Near absolute liability forces the issuer to assume responsibility for all misstatements or omissions because "to impose a lesser responsibility would nullify the purpose of [the Securities Act]," which is to ensure full disclosure of securities to the public.[47] Second, other individuals preparing or signing the registration statement may absolve themselves of liability only by demonstrating that he or she did not know or could not have discovered, through the exercise of reasonable care, that the registration statement contained a material misstatement or omitted a material fact.[48] The *Congressional Record* noted that "[u]nless responsibility is to involve merely paper liability it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements for the public's reliance."[49] The text of section 11, as well as the legislative history, clearly places the burden of providing disclosure and proving exemption on the seller, not the buyer; and therefore, the liberal notice pleading standard of Rule 8(a)(2) should apply to buyers' claims under section 11.

B. *History and Purpose of the Securities Act*

The legislative history of the Securities Act supports imposing minimal pleading requirements on section 11 plaintiffs. Section I.B argues that the impetus for the creation of the Securities Act and section 11, as well as the combined purpose of the Securities Act and section 11, support applying the liberal notice pleading requirements of Rule 8(a)(2) to section 11 claims.

The events precipitating the enactment of the Securities Act underscore the significance of the protection of buyers through the civil liability provisions of the Act, including section 11. In response to these conditions, President Franklin D. Roosevelt and Congress enacted the Securities Act of 1933 to restore the public's confidence in

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45. *See* 15 U.S.C. § 77k(a) (1994).

46. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983). The issuer may not avail himself of the statutory defenses enumerated in section 11(b). *See* Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 682-83 (S.D.N.Y. 1968). Therefore, the issuer is limited to the common law defenses of plaintiff's knowledge, lack of materiality, or tolling of the statute of limitations. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 7.4 (3d ed. 1995). Note that materiality is a jury question and therefore the issuer cannot use the lack-of-materiality defense at the pleading stage. *See* TSC Indus. Inc. v. Northway, Inc., 426 U.S. 438, 450-53 (1976).

47. H.R. REP. NO. 73-85, *supra* note 1, at 10 (statement of Rep. Sam Rayburn).

48. *See* 15 U.S.C. § 77(k)(b) (1994). The standard of reasonableness is "that required of a prudent man in the management of his own property." 15 U.S.C. § 77(k)(c) (1994).

49. H.R. REP. NO. 73-85, *supra* note 1, at 9 (statement of Rep. Sam Rayburn).

United States' financial markets by imposing high levels of civil liability upon sellers of securities.[50] During the decade following World War I, Americans purchased $50 billion worth of new-issue securities.[51] Unfortunately, one-half of those securities turned out to have little or no value.[52] There were two interdependent causes of this widespread purchase of valueless securities. First, to effectuate securities sales, high-pressure salesmen promised Americans easy wealth without educating them regarding the facts necessary to estimate the value of the securities.[53] Second, sellers convinced industries to meet the high demand for securities by accepting capital for unnecessary expansion purposes.[54] New securities were issued for public consumption, not to finance justifiable industrial growth.[55] As a consequence, many families lost their life savings in the stock market crash of 1929.[56] At that time, the United States was "farther behind than any other civilized nation . . . with respect to preserving the rights of the purchasers of securities."[57]

The goals of the Securities Act in general, and section 11 in particular, favor applying the liberal notice pleading standard to section 11 claims. The Securities Act imposes more responsibility on the

50. "This proposal . . . 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." *Id.* at 2 (President's Message to Congress). *See also* 77 CONG. REC. 2914 (1933) (statement of Rep. Greenwood):

> [T]he necessity for this legislation to help restore confidence in our local banking institutions is great. . . . There is a peculiar fact with respect to such investments in that the corporation that issues the securities knows more about them than anyone else, and the old rule of *caveat emptor*, or the buyer beware, certainly should not apply to this character of investments. The man who sells them ought to give the facts, and the Government ought to require the issuer of securities to give all the facts, and be honest with the public.

51. *See* H.R. REP. NO. 73-85, *supra* note 1, at 2.

52. *See id.*

53. *See id.* Before the stock market crash of 1929, Americans lived in a "gambler's civilization," in which they believed they could make more money gambling in the market than through honest business. *See* 77 CONG. REC. 2914 (1933) (statement of Rep. Greenwood).

54. *See* H.R. REP. NO. 73-85, *supra* note 1, at 2.

55. *See id.*

56. "In spite of many State [securities] statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities." *Id.* at 1 (President's Message to Congress).

57. 77 CONG. REC. 2912 (1933) (statement of Rep. Mapes). Much of the Securities Act was modeled after the English Companies Act of 1929. *See* H.R. REP. NO. 73-85, *supra* note 1, at 9. Although many states had already passed blue sky laws, these laws did not address the concerns of the Securities Act. State laws controlled only the registration of securities and not the registration of offerings of securities. The investigation following the stock market crash of 1929 revealed that the "system as a whole . . . had failed miserably." James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

seller than the buyer of registered securities.[58] The purpose of the Securities Act is to provide greater protection to purchasers of registered securities by requiring sellers to "provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails."[59] In short, the aim of the Securities Act is to protect buyers by discouraging misleading statements. In contrast to the traditional contractual idea of *caveat emptor*, President Franklin D. Roosevelt emphasized that under the Securities Act "the seller [must] also beware."[60] Therefore, placing a lower burden on section 11 plaintiffs effectuates the purpose of the Securities Act: protection of the buyer at the expense of the seller.

To protect buyers through full and accurate disclosure, section 11 imposes civil liability with stringent penalties for false or misleading statements.[61] Section 11 provides for joint and several liability for every person who prepares and/or signs registration statements.[62] Section 11 creates an incentive for sellers to comply with the Securities Act by imposing virtually absolute liability on parties directly involved in a registered offering for misstatements or omissions in the registration statement.[63] According to the economic theory upon which securities regulation is premised, any misstatement or omission tends to over- or understate the price of a security, making all purchasers victims of the misstatement.[64] By imposing more responsibility on sellers and providing for virtually absolute liability for material misstatements, it is clear that Congress intended to discourage material mis-

58. President Franklin D. Roosevelt, in recommending the Securities Act, said that it "puts the burden of telling the whole truth on the seller." H.R. REP. NO. 73-85, *supra* note 1, at 2. Also note that the President did not mention fraud when recommending the Securities Act. *See id.* at 1-2.

59. H.R. 5480, 73d Cong. § 1 (1933). President Franklin D. Roosevelt, however, specifically stated that "the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit." H.R. REP. NO. 73-85, *supra* note 1, at 2.

60. H.R. REP. NO. 73-85, *supra* note 1, at 2.

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

62. *See* 15 U.S.C. § 77k (1994); *see also* Laylin K. James, *The Securities Act of 1933*, 32 MICH. L. REV. 624, 649 (1934). The strict liability characteristics of section 11 created considerable controversy among members of the House of Representatives and Senate. *See* Landis, *supra* note 57, at 48 (noting that the Senate Amendment imposed an insurer's liability upon the seller; whereas the House amendment measured section 11 liability under a reasonable care standard). Nevertheless, the Securities Act passed both houses with no substantial opposition and became law on May 27, 1933. *See* H.R. 5480, *supra* note 1, § 1; *see also* Landis, *supra* note 57, at 49.

63. *See* H.R. REP. NO. 73-85, *supra* note 1, at 10 (stating "[t]he connection between the statements made and the purchase of a security is clear, and, for this reason, it is the essence of fairness to insist upon the assumption of responsibility for the making of these statements").

64. *See* Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1009-11 (1984).

statements. The application of a heightened pleading standard is diametrically opposed to Congress's stated purpose.[65]

C. *The Policies Behind F.R.C.P. Rule 9(b)*

Not only do the history and purpose of section 11 favor a lesser pleading standard, but the policy goals of the Federal Rules of Civil Procedure also dictate that the notice pleading standard of Rule 8(a)(2), not the heightened pleading requirements of Rule 9(b), apply to section 11 claims. Section I.C argues that because the policy rationales behind Rule 9(b) are not relevant to section 11 claims and because the policy rationales for Rule 8(a)(2) do apply, Rule 8(a)(2) should govern section 11 claims.

None of the policy arguments justify applying a heightened pleading standard to section 11 claims. Traditionally, courts state that a heightened pleading requirement serves the following functions: (1) to provide notice to the defendant and allows the defendant to prepare a response; (2) to protect a defendant's reputation from the damage of charges involving some degree of moral turpitude; and (3) to minimize the impact of strike suits.[66]

The first argument, that a heightened pleading standard provides the defendant with sufficient notice to prepare an effective response, is not persuasive. Rule 9(b) would be mere surplusage if its only function were to notify defendants of the plaintiff's claims, which Rule 8(a) already requires.[67] While the heightened requirements of Rule 9(b) provide more specific notice, courts have not required more particularized notice in a section 11 action.[68] For example, in *In re BankAmerica Corporation Securities Litigation*,[69] the plaintiff alleged that the issuer (a bank) violated section 11 by falsely characterizing its merger with another bank as a "merger of equals" in its registration statement.[70] The court allowed the plaintiffs to support their claim —

65. *See* H.R. REP. NO. 73-85, *supra* note 1, at 3-10 (indicating that the purpose of the Securities Act was to provide investors with information necessary to make an informed purchase decision).

66. *See* WRIGHT & MILLER, *supra* note 30, § 1296; *see also* Melder v. Morris, 27 F.3d 1097, 1100 (5th Cir. 1994) (applying Rule 9(b) to a section 11 claim because the heightened pleading standard provides notice of the plaintiff's claims to the defendant, protects defendants' reputation, and reduces the number of strike suits); Bernstein v. Crazy Eddie, Inc., 702 F. Supp. 962, 976 (E.D.N.Y. 1988) (explaining the three policy reasons for requiring section 10(b) plaintiffs to plead their claims with particularity).

67. *See* Decker v. Glenfed, Inc. (*In re* Glenfed, Inc. Sec. Litig.), 42 F.3d 1541, 1547 (9th Cir. 1994) ("Rule 9(b) would clearly be superfluous if its only function were to ensure that defendants are provided with that degree of notice which is already required by Rule 8(a).").

68. *See* Carlon v. Thaman (*In re* NationsMart Sec. Litig.), 130 F.3d 309, 315 (8th Cir. 1997).

69. 78 F. Supp. 2d 976 (E.D. Mo. 1999).

70. *See id.* at 986.

that the banks never intended the transaction to be a "merger of equals" — with anonymous quotes from *The Wall Street Journal*.[71] Very little is required to comply with Rule 8(a)(2). Therefore, the notice requirement does not support requiring section 11 plaintiffs to plead their claims with particularity.[72] Rule 8(a)(2) provides a defendant with sufficient notice of the charges against him.[73]

Furthermore, other Federal Rules of Civil Procedure provide protection for the defendant if the complaint fails to provide adequate notice. The defendant may move for a more definite statement under Rule 12(e).[74] The defendant may also file a Rule 12(b)(6) motion to dismiss for failure to state a claim, which would force the plaintiff to explain her claim or have the case dismissed.[75] Finally, the defendant could file a Rule 56(c) motion for summary judgment that would compel the plaintiff to respond or lose her claim.[76]

Likewise, the second argument that is typically given to support a heightened pleading standard, protecting the defendant's reputation, does not support applying this standard to section 11 claims for two reasons. First, a section 11 claim does not involve the type of moral turpitude that may tarnish a defendant's reputation.[77] Because a defendant may be found liable under section 11 for a completely *innocent* misstatement or omission,[78] section 11 does not harm a defendant's reputation sufficiently to justify the application of Rule 9(b).[79]

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71. *See id.* at 985 (quoting *The Wall Street Journal*).

72. *See* Carlon v. Thaman (*In re* NationsMart Corp. Sec. Litig.), 130 F.3d 309, 315 (8th Cir. 1997) (stating that it would be superfluous to require plaintiffs to plead more than what is required to recover under section 11); *see also* First Merchants Acceptance Corp. Sec. Litig., No. 97-C2715, 1998 WL 781118, at *11 n.6 (N.D. Ill. Nov. 4, 1998) ("It is illogical to require plaintiffs to plead more than they would have to prove to succeed on a § 11 claim.").

73. *See* Conley v. Gibson 355 U.S. 41, 47 (1957) (stating that Rule 8(a)(2) requires a statement "that will give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests"); *see also* Maty v. Grasselli Chem. Co., 303 U.S. 197, 200 (1938) (rejecting pleading as a game of skill and accepting that the purpose of pleading is to facilitate a proper decision on the merits).

74. FED. R. CIV. P. 12(e).

75. FED. R. CIV. P. 12(b)(6).

76. FED. R. CIV. P. 56(c).

77. *See* WRIGHT & MILLER, *supra* note 30, § 1296 (explaining the rationale for imposing a heightened pleading standard for averments of fraud or mistake).

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

79. Rule 9(b) has been applied to a variety of lawsuits, including claims under the False Claims Act, Patent Act, and Racketeer Influenced and Corrupt Organizations Act (RICO). *See, e.g.*, Brannon v. Boatmen's Bancshares, Inc. 952 F. Supp. 1478, (W.D. Okla. 1997) (requiring all elements of a RICO to be plead according to Rule 9(b) because of the potential damage to a defendant's reputation and the possibility of treble damages); EMC Corp. v. Storage Tech. Corp., 921 F. Supp. 1261 (D. Del., 1996) (applying Rule 9(b) to averments of inequitable conduct in obtaining patent); United States *ex rel.* DeCarlo v. Kiewit/AFC Enters., 937 F. Supp. 1039 (S.D.N.Y. 1996) (dealing with the False Claims Act).

Second, even if a section 11 lawsuit causes damage to the defendant's reputation, any harm that accrues to a defendant's reputation from a violation of the Securities Act is an effect implicitly intended by Congress to further compliance with the securities laws.[80] Because every lawsuit has the potential to tarnish the defendant's reputation, the mere possibility of harm to a defendant's reputation does not support applying the heightened pleading standard to section 11 claims.[81] Courts have held that "only a defendant facing the particular threat that is posed by an accusation of fraud may invoke the protection of Rule 9(b)."[82] Congress intended section 11 to ensure compliance with the disclosure requirements of the Securities Act and to make the public aware of sellers who did not comply with its requirements.[83]

The third and final common rationale for applying a heightened pleading standard, deterring strike suits, must also fail because Congress designed section 11 to encourage meticulous preparation of registration statements.[84] Because Congress addressed the possibility of strike suits in the context of a section 11 claim by providing for attorneys' fees and costs, imposition of the heightened pleading standard of Rule 9(b) would be redundant.[85] Further, because section 11 provides other procedural protections against strike suits,[86] imposing a heightened pleading standard would do nothing more than place a more onerous burden on plaintiffs than Congress intended. In enacting section 11, Congress did not seek to minimize frivolous lawsuits, but instead wanted to ensure compliance with its disclosure requirements by placing virtually absolute liability on sellers in order to discourage misleading disclosures.[87]

General public policy considerations also favor applying Rule 8(a)(2) rather than Rule 9(b) to section 11 claims. Since Rule 9(b) does not provide an explicit standard for determining what details must be included in a complaint, applying the heightened pleading

80. The stock market crash of 1929 caused the public to lose faith in the securities industry; Congress intended civil liability under section 11 to restore the public's faith in the financial system. *See* H.R. REP. NO. 73-85, *supra* note 1, at 9-10.

81. *See* Consumers Power Co. Sec. Litig., 105 F.R.D. 583, 595 (E.D. Mich. 1985).

82. *Consumers Power*, 105 F.R.D. at 595.

83. *See* H.R. REP. NO. 73-85, *supra* note 1, at 9-10.

84. *See* WRIGHT & MILLER, *supra* note 30, § 1296 (2d ed. 1990) (explaining the rationale behind imposing a heightened pleading standard for averments of fraud or mistake).

85. *See* 15 U.S.C. § 77(k)(e) (1994). One court noted that "the principal purpose of § 11(e) is to deter plaintiffs from bringing meritless actions solely to procure a favorable settlement." Shapiro v. UJB Fin. Corp., 964 F.2d 272, 290 (3rd Cir. 1992) (citations omitted).

86. *See infra* note 119 and accompanying text.

87. *See* H.R. REP. NO. 73-85, *supra* note 1, at 9; *see also* Silver v. New York Stock Exchange, 373 U.S. 341, 357 (1963) (favoring "an analysis which reconciles the operation of both statutory schemes with one another rather than holding one completely ousted"), *quoted in* Herman & MacLean v. Huddleston, 459 U.S. 375, 387 n.23 (1983).

standard may create confusion.[88] Plaintiffs' lawyers may produce prolix complaints that would increase costs and burden the courts.[89] More importantly, judicial uncertainty may lead to unfair dismissals, undermine the purpose of the Securities Act, and allow issuers to sell securities with materially misleading registration statements, which in turn will decrease the faith of investors in the United States' securities markets.[90]

The text and purpose of the Securities Act and the policies embedded in the Federal Rules support imposing the liberal notice pleading standard on section 11 plaintiffs. Because the plain language of section 11 does not include fraud or mistake, courts should not apply the heightened pleading standard to section 11 claims. Furthermore, the purpose of section 11 — to ensure compliance with the disclosure requirements of the Securities Act — mandates a minimal pleading standard for the plaintiff and a correspondingly heavier burden for the defendant. Finally, the policy rationales behind Rule 9(b) do not apply to section 11 claims because the Securities Act provides other procedural protections to serve these goals.

II. COMPARISON OF SECTION 11 WITH SECTION 10(b)

A comparison between section 11 of the Securities Act and section 10(b) of the Exchange Act demonstrates that Rule 9(b) should not apply to section 11 claims. The differences between these distinct causes of action are important because securities lawsuits often encompass claims under both sections.[91] Although the two sections represent interrelated components of federal securities regulation, Congress and President Franklin D. Roosevelt intended them to address different types of wrongdoing.[92] Section II.A argues that the statutory

88. *See, e.g.*, DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990) (attempting to provide a standard for what is required in a securities pleading).

89. *See* Decker v. Glenfed, Inc. (*In re* Glenfed, Inc. Sec. Litig.) 42 F.3d 1541, 1555-57 (9th Cir. 1994) (Norris, J., concurring).

90. *See* H.R. REP. NO. 73-85, *supra* note 1, at 9; *see also The Common Sense Legal Reform Act: Hearings on H.R. 10 Before the Subcomm. on Telecomm. And Fin.*, 104th Cong. 280 (1995) (statement of Mark J. Griffin, Director, Securities Division, Utah Department of Commerce).

91. *See, e.g.*, Carlon v. Thaman (*In re* NationsMart Sec. Litig.), 130 F.3d 309 (8th Cir. 1997); *In re* Westinghouse Sec. Litig., 90 F.3d 696 (3d Cir. 1996); Shaw v. Digital Equip. Corp., 82 F.3d 1194 (1st Cir. 1994); *In re* Glenfed, Inc. Sec. Litig., 42 F.3d at 1546; Shapiro v. UJB Fin. Corp., 964 F.2d 272 (3d Cir. 1992).

92. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 381 (1983). President Roosevelt commented that the Securities Act was "but one step in [the] broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations." H.R. REP. NO. 73-85, *supra* note 1, at 2. The Exchange Act was enacted the following year and was primarily directed at disclosure *after* securities have been

language of sections 11 and 10(b) requires application of different pleading standards. Section II.B contends that applying a lower pleading standard to section 11 claims than to section 10(b) claims comports with recent congressional activity regarding the pleading standard for claims filed under section 10(b).

A. *Section 11 and Section 10(b) Address Different Wrongs*

A comparison of the statutory language of section 11 and section 10(b) demonstrates congressional intent to treat the two sections as independent causes of action. First, section 11 applies to a more limited number of potential claims than does section 10(b). While a heightened pleading standard may be needed to limit section 10(b) claims, it is not required to limit section 11 claims. Second, unlike those of section 10(b), section 11 claims do not require proof of scienter and reliance; therefore, courts should not impose the heightened pleading standard of Rule 9(b) on section 11 plaintiffs. Finally, because section 11 provides additional procedural protections that perform the same screening functions as a heightened pleading standard, it makes sense to apply a heightened pleading standard to claims filed under section 10(b) but not to those filed under section 11.

The statutory language of section 10(b) and section 11 supports the argument that Federal Rule of Civil Procedure 9(b) should apply only to section 10(b) claims. First, section 11 provides an express private action, whereas under section 10(b), the cause of action is implied.[93] The express-versus-implied distinction is important because courts interpret the statutory language of section 11 to limit claims in three ways: (1) to constrain the range of potential plaintiffs; (2) to limit the reach of possible defendants; and (3) to lessen the kinds of documents covered by the rule.[94] By contrast, the judicially created cause of action under section 10(b) and Rule 10b-5[95] constitutes a "catchall" antifraud provision.[96] Courts, accordingly, imply a broad range of claims under section 10(b),[97] including fraudulent transactions,[98]

issued. *See* GEORGE D. CAMERON III & PHILLIP J. SCALETTA, JR., BUSINESS LAW AND REGULATORY ENVIRONMENTS 821 (5th ed. 1996).

93. *Compare* 15 U.S.C. § 77k(a) (1994), *with* 15 U.S.C. § 78j(b), *and* 17 C.F.R. § 240.10b-5. *See also* Herman & MacLean v. Huddleston, 459 U.S. 375, 381 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200 (1976) (stating that section 10(b) is "a judicially implied liability").

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

95. *See* 17 C.F.R. § 240.10b-5 (1999). Pursuant to Section 10(b) of the Exchange Act, Congress authorized the Securities and Exchange Commission ("SEC"), which is a federal agency charged with administering the securities laws, to promulgate Rule 10b-5. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (explaining the relationship between Section 10(b) and Rule 10b-5).

96. *See* Chiarella v. United States, 445 U.S. 222, 234-35 (1980).

churning,[99] unsuitable investment,[100] insider trading,[101] and tipping.[102] Because Rule 9(b) pleading is meant to limit the number of claims that can be brought, its protections should be applied only to broad causes of action. Because courts already interpret section 11 to encompass a limited sphere, Rule 8(a)(2) serves to effectuate the purpose of section 11: to provide full and complete disclosure of registered securities.

Section 11 grants a private cause of action to a different class of plaintiffs than section 10(b) covers. Section 11 grants *purchasers* of securities an express civil cause of action for material misstatements and omissions in registration statements.[103] In contrast, a wide range of potential purchasers may bring a claim under the judicially implied cause of action under section 10(b).[104] Any purchaser of a security may bring a section 10(b) action against any person who has used "any manipulative or deceptive device" in connection with the sale of a security.[105] The different scope of potential plaintiffs justifies applying variant pleading standards to the sections. Rule 9(b) serves to limit the ability of a wide range of plaintiffs to bring claims under section 10(b). The statutory scope of section 11 already performs this limiting function; and therefore, Rule 8(a)(2), not Rule 9(b), should apply to section 11 claims. Applying Rule 9(b) to section 11 claims would

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97. *See* CAMERON & SCALETTA, *supra* note 92, at 822 (stating that section 10(b) "covers much more than just common law fraud, including such things as failure to comply with other securities law requirements, arbitrary withholding of dividends, breaches of fiduciary duty, and disclosure of too much or too little information").

98. *See, e.g., In re* Westinghouse Sec. Litig., 90 F.3d 696 (3d Cir. 1996).

99. *See, e.g.,* Armstrong v. McAlpin, 699 F.2d 79, 90 (2d Cir. 1983) (defining churning as a "synonym for 'overtrading' ").

100. *See, e.g.,* Clark v. John Lamula Investors, Inc., 583 F.2d 594, 600 (2d Cir. 1978) (suggesting that an unsuitable investment constitutes a section 10(b) violation).

101. *See* United States v. O'Hagan, 521 U.S. 642, 651 (1997).

102. *See* Dirks v. SEC, 463 U.S. 646, 650-52 (1983).

103. *See* 15 U.S.C. § 77(k)(a) (1994); *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 381 (1983). Section 11 includes a tracing requirement (to be decided at trial by the fact finder), which requires plaintiffs to demonstrate that their shares were issued pursuant to the ostensibly defective public offering. *See* Bernstein v. Crazy Eddie, Inc., 702 F. Supp. 962, 972 (E.D.N.Y. 1988). *Cf.* Versyss Inc. v. Coopers & Lybrand, 982 F.2d 653 (1st Cir. 1992) (stating that a corporation that acquired securities through a merger did not "purchase" the securities within the meaning of section 11). In contrast, section 10(b) does not contain a tracing requirement. *See* 17 C.F.R. § 240.10b-5 (1999).

104. 17 C.F.R. § 240.10b-5 (1999).

105. *Herman & MacLean*, 459 U.S. at 382. "While the 1933 Act regulates the initial sales of securities, the 1934 Act regulates the 'secondary market' — trades that occur after the issuer sells the stock to the public." WILLIAM A. KLEIN & J. MARK RAMSEYER, BUSINESS ASSOCIATIONS: AGENCY, PARTNERSHIPS, AND CORPORATIONS 442 (3d ed. 1997). Presumably, a wider range of individuals purchase securities in the second-hand market than through initial public offerings.

overrestrict relief to buyers, thus frustrating congressional intent in enacting section 11.

Section 11 enumerates a limited range of potential defendants,[106] while section 10(b) does not.[107] Because the heightened pleading requirements of Rule 9(b) may be required to provide adequate notice to defendants, it is significant that section 11 lists all possible defendants and their connection to the registration statement.[108] Because the class of defendants is limited, a complaint complying with the requirements of Rule 8(a)(2) provides sufficient notice to all defendants. Section 10(b), however, provides a vague reference to conceivable defendants.[109] A section 10(b) plaintiff may have purchased the security in the second-hand market, and may even have a claim against someone other than the issuer.[110] Therefore, Rule 9(b) is necessary to ensure adequate notice to section 10(b) defendants.

The statute limits section 11 claims to material misstatements or omissions in registration statements.[111] Section 10(b) claims, however, may be based on material misstatements or omissions in other documents, or oral communications.[112] The Exchange Act requires section 10(b) plaintiffs alleging a misleading statement or omission to "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading."[113] The broader range of po-

106. 15 U.S.C. § 77k(a) (1994) provides a cause of action against:

> (1) every person who signed the registration statement; (2) every person who was a director of . . . or partner in the issuer at the time of the filing . . . (3) every person who, with his consent, is named in the registration statement as being or about to become a director . . . or partner; (4) every accountant, engineer, or appraiser . . . who has with his consent been named as having prepared or certified any part of the registration statement . . . [and] (5) every underwriter with respect to such security.

Id.

107. *See* 15 U.S.C. § 78j (1994) (stating that "[i]t 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 . . . [t]o 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 . . .") (emphasis added).

108. *See* 15 U.S.C. § 77k (1994).

109. 15 U.S.C. § 78j (1994).

110. *See* 15 U.S.C. § 77j (1994).

111. *See* 15 U.S.C. § 77k(a) (1994).

112. *See* 15 U.S.C. § 78j (1994); *see also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968) (noting the wide applicability of section 10(b) to "the device employed, whatever it might be").

113. 15 U.S.C.A. § 78u-4 (1999) (codifying section 22D of the Exchange Act covering private securities litigation). Section 27 of the Securities Act closely parallels section 22D of the Exchange Act; however, it does not contain provisions setting forth the heightened pleading requirements or those providing for dismissal of the complaint for failure to comply with the pleading requirements. *Compare* 15 U.S.C.A. § 77z-1 (1994), *with* 15 U.S.C.A. § 78u-4 (1994).

tential bases for a section 10(b) claim may justify applying the heightened pleading standard. It is easier to determine the merits of a section 11 complaint because it requires a court to focus on only the registration statement and not on other documents or forms of communication.

Not only is there a difference in scope between the sections, the elements comprising section 11 and section 10(b) claims differ. Because section 11, unlike section 10(b), does not require the plaintiff to specify "the reason or reasons why the statement is misleading,"[114] pleading with particularity under Rule 9(b) should be limited to section 10(b) claims. Section 11 does not require proof of reliance[115] because the Securities Act presumes causation between a material misstatement or omission and the market price, so section 11 plaintiffs do not have to specifically plead that they read the registration statement.[116] Section 10(b), in contrast, requires the plaintiff to prove reasonable reliance and causation; therefore, application of a heightened pleading standard is important to ensure compliance with these elements.[117] Finally, section 11 does not include a scienter requirement, while section 10(b) does.[118] Because a section 11 plaintiff does not have to show intent to defraud, Rule 9(b) does not apply.

A final distinction between the two sections is that section 11 and section 10(b) provide different procedural protections against frivolous lawsuits. Accordingly, it is reasonable to apply different pleading requirements to the plaintiffs. Instead of using a heightened pleading standard to deter frivolous lawsuits, courts, in their discretion, may require section 11 plaintiffs to post bond to cover the costs of the lawsuit.[119] The bond requirement may deter frivolous suits because plaintiffs will not post bond for cases that they cannot win. This procedural

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114. 15 U.S.C.A. § 78u-4 (1999). *See* Kensington Capital Management v. Oakley, Inc., No. SA CV 97-808-GLT(EEx), 1999 U.S. Dist. LEXIS 385, at *2 (C.D. Cal. Jan. 14, 1999).

115. *See, e.g.*, 15 U.S.C. § 77k (1994); *see also* Anderson v. Clow (*In re* Stac Elec. Sec. Litig.), 89 F.3d 1399, 1404 (9th Cir. 1996).

116. *See* H.R. REP. NO. 73-85, *supra* note 1, at 10.

117. *See* 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5; Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682, 689 (3d Cir. 1991).

118. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) ("[A] Section 10(b) plaintiff carries a heavier burden than a Section 11 plaintiff. Most significantly, he must prove that the defendant acted with scienter.").

119. *See id.* at 384 n.18 (noting that "each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct [as opposed to requiring proof of scienter] is subject to procedural restrictions not applicable to a § 10(b) action"). Similarly,

> the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit.

15 U.S.C. § 77K(e) (1994).

restriction serves the same purpose as a heightened pleading standard: to deter frivolous lawsuits.

In sum, even though section 11 and section 10(b) overlap in some respects, they represent distinct causes of action;[120] and therefore, it is reasonable to apply a different pleading standard to each section.

B. *Impact of Recent Congressional Activity*

Congress specifically addressed the pleading standard for claims brought under section 10(b) in both the Private Securities Litigation Reform Act of 1995 ("PSLRA") and the Securities Litigation Uniform Standards Act of 1998 ("SUSA").[121] Neither of the two recent Acts affect the pleading standard for claims filed under section 11 of the Securities Act.[122] Because the legislative history of the PSLRA and SUSA illustrates congressional awareness of judicial confusion over the pleading standard for securities cases, it is significant that Congress addressed the pleading standard under section 10(b) but not under section 11.[123] The PSLRA altered the procedure, but not the substance, of securities *fraud* cases.[124] While legislative inaction has been criticized as a canon of statutory construction, "legislative action by amendment . . . with respect to other parts of a law which have received a contemporaneous and practical construction may indicate approval of interpretations pertaining to the unchanged and unaf-

120. *See Herman & MacLean*, 459 U.S. at 383.

121. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at various sections of 15 U.S.C.); Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. § 77(p) and § 78(bb)).

122. The PSLRA added section 27 to the Securities Act and section 21D to the Exchange Act. Section 27 and section 21 D are similar in that they include provisions regarding private actions under both Acts. While section 21D specifically addresses the heightened pleading requirement for section 10(b) claims, section 27 does not contain a parallel provision regarding the pleading standard for section 11 claims. *Compare* 15 U.S.C.A. § 77z-1, *with* 15 U.S.C.A. § 78u-4. *See generally* 140 CONG. REC. S3695 (daily ed. Mar. 24, 1994 (statement of Sen. Dodd) (examining the purpose of the PSLRA); *see also* Matthew Roskoski, Note, *A Case-By-Case Approach to Pleading Scienter under the Private Securities Litigation Reform Act of 1995*, 97 MICH. L. REV. 2265, 2267 (1999) (discussing the pleading requirements for section 10(b) claims).

123. *See* NORMAN J. SINGER, 2A SUTHERLAND STAT CONS § 49.10 (4th ed. 1984); *see also* Edmonds v. Compagnie General Transatlantique, 443 U.S. 256, 266-267 (1979) (describing "silence" as "most eloquent, for such reticence while contemplating an important and controversial change in existing law is unlikely"); Marksman Partners, L.P. v. Chantal Pharm. Corp. 927 F. Supp. 1297, 1311 (C.D. Cal. 1996) (stating that Congress knows how to "supplant a judicially-created rule . . . explicitly").

124. *See* S. REP. NO. 104-98, at 66 (1995). Section 10(b) cases are thought to be "fraud" cases. *See* KLEIN & RAMSEYER, *supra* note 105, at 442.

fected parts of the law."[125] In enacting the PSLRA and SUSA, Congress could have, but did not, address the pleading standard applicable to claims filed under section 11.

Some courts have indicated that the same policy considerations that favor applying Rule 9(b) to section 10(b) claims apply to section 11.[126] When Congress altered the requirements for pleading a section 10(b) securities fraud claim under the Exchange Act, it did not change the pleading standard under section 11.[127] The changes included the following section:

> Requiring that scienter be pled with particularity.
>
> The objective: To provide filter at the pleading stage to screen out allegations that have no factual basis; To provide clearer statement of plaintiffs' claims and scope of the case; To encourage attorneys to use greater care in drafting their complaints; Make it easier to win motions to dismiss frivolous cases by requiring that scienter be pled with particularity. Eliminate the split among Circuits dealing with pleading requirements for scienter. To codify the requirements in the 2nd and 7th Circuits.[128]

Congress's explicit invocation of Rule 9(b) in section 10(b), coupled with the failure to similarly address section 11, demonstrates that Congress did not intend Rule 9(b) to apply to section 11 claims.[129] As stated in the text of the Act, the PSLRA was designed, in part, to resolve disagreement among circuits over the pleading requirements for section 10(b) claims.[130] During this same time period, and in many of

125. *See* Pierce v. Underwood, 487 U.S. 552, 567 (1988) ("Quite obviously, reenacting precisely the same language would be a strange way to make a change."); *Edmonds*, 443 U.S. at 266-267.

126. *See* Melder v. Morris, 27 F.3d 1097, 1100 (5th Cir. 1994) (finding that plaintiff's allegations of issuer's, accountants', and underwriters' purposeful misrepresentations for the purpose of making money were insufficient to sustain a motion to dismiss plaintiffs' section 11 and section 10(b) claims for failure to plead with particularity). In securities fraud cases, "[a]t a minimum Rule 9(b) requires allegations of the particulars of time, place, and contents of the false representations, as well as the identity of the person making the misrepresentation and what he obtained thereby." Shushany v. Allwaste, Inc., 992 F.2d 517, 520 (5th Cir. 1993); *see also* DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990) (stating that the particularity requirement "means the who, what, when, where, and how: the first paragraph of any newspaper story").

127. *Compare* 15 U.S.C.A. § 77z-1 (1994), *with* 15 U.S.C.A. § 78u-4 (1994).

128. 140 CONG. REC. S3695 (daily ed. March 24, 1994) (statement of Sen. Dodd).

129. *See* Braden v. 30th Judicial Circuit Court of Kentucky, 410 U.S. 484, 510 (1973).

> Legislative "inaction" in amending a statute to comport with this Court's evaluation of "[s]ound judicial administration" hardly warrants the disingenuous reading of a previous decision to achieve the result that Congress, despite judicial prodding, has refused to mandate. However impatient we may be with a federal statute which sometimes may fail to provide a remedy for every situation, one would have thought it inappropriate for the Court to amend the statute by judicial action.

Id. (citations omitted) (alteration in original). *See also* SINGER, *supra* note 123, § 49.10.

130. *See* 140 CONG. REC. S3695 (daily ed. Mar. 24, 1994) (statement of Sen. Dodd); *see also* Roskoski, *supra* note 122, at 2267-68 (listing various interpretations of the application of Rule 9(b) to section 10(b) claims, including *In re* Burlington Coat Factory Sec. Litig., 114

the same cases, a circuit split existed regarding the application of Rule 9(b) to section 11.[131] Because scienter is not an element of a section 11 claim, and the PSLRA does not affect section 11, judges should not read fraud into section 11 claims by requiring plaintiffs to plead with particularity.[132]

Similarly, in November 1998, Congress enacted SUSA to resolve the continuing confusion regarding the pleading standard for section 10(b) claims.[133] Like the PSLRA, SUSA did not address the pleading standard for section 11 of the Securities Act.[134] Until Congress specifically addresses the pleading standard applicable to section 11 claims, plaintiffs need only plead according to Rule 8(a)(2).

As illustrated in this Part, section 11 and section 10(b) differ greatly in both statutory language and purpose. These differences dictate that the liberal notice pleading standard should continue to apply to section 11 claims, while the heightened pleading standard should apply to section 10(b) claims as mandated by the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998.

CONCLUSION

Section 11 plaintiffs should be required to plead their claims according to the liberal notice pleading standard enumerated in Rule 8(a)(2). Congress intentionally placed a low burden on section 11 plaintiffs to facilitate full and fair disclosure of securities. Without civil liability, issuers will not comply with the Securities Act and the United States financial markets will suffer. Defendants should not be

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F.3d 1410, 1418 (3d Cir. 1997); Decker v. Glenfed, Inc. (*In re* Glenfed, Inc. Sec. Litig.) 42 F.3d 1541 (9th Cir. 1994); Greenstone v. Cambex Corp., 975 F.2d 22, 24 (1st Cir. 1992); and O'Brien v. Nat'l Prop. Analysts Partners, 936 F.2d 674, 676 (2d Cir. 1991)). The section 11 circuit split was between the Seventh and Eighth circuits, on the one hand, and the First, Third, Fifth and Ninth circuits, on the other. *See supra* notes 10 through 12 and accompanying text. Notably, the Second Circuit has yet to rule on the issue. *See supra* note 10. Therefore, it would be impossible to resolve a section 11 circuit split by "codify[ing] the requirements in the 2nd and 7th Circuits." 140 CONG. REC. S3695 (daily ed. March 24, 1994) (statement of Sen. Dodd).

131. *Compare* Carlon v. Thaman (*In re* NationsMart Sec. Litig.), 130 F.3d 309, 315 (8th Cir. 1997) (holding that Rule 9(b) does not apply to section 11 claims), *with* Melder v. Morris, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994) (holding that Rule 9(b) applies to section 11 claims that are "grounded in fraud").

132. *See* Pierce v. Underwood, 487 U.S. 552, 564 (1988) ("[W]e make clear . . . that we do not think it appropriate to substitute for the formula that Congress has adopted any judicially crafted revision of it.").

133. *See* S. REP. 105-182, at 6-7 (1998). More specifically, SUSA enacted the same pleading standard for section 10(b) claims filed in state courts as in federal courts. *See id.*

134. Rather, SUSA amended section 16 of the Securities Act, which deals with additional remedies and limitations on remedies. *See* 144 CONG. REC. H6119-01 (1998). Section 16, however, does not address the pleading requirement under section 11.

able to avoid liability by easily dismissing a section 11 complaint for failure to plead with particularity.

The differences in statutory language and legislative history of section 11 and section 10(b) support applying a lower pleading standard to section 11 than to section 10(b) claims. Congress expressly directed section 10(b) of the Exchange Act, but not section 11 of the Securities Act, at fraudulent securities transactions. Congress recently reemphasized the fact that the heightened pleading standard applies to securities fraud cases under section 10(b) but not to claims under section 11 when it enacted the PSLRA and SUSA. To protect investors and the integrity of the regulatory scheme, Rule 8(a)(2) should apply to section 11 claims.