

HEIGHTENED PLEADING REQUIREMENTS, DUE DILIGENCE, RELIANCE, LOSS CAUSATION, AND TRUTH-ON-THE-MARKET – AVAILABLE DEFENSES TO CLAIMS UNDER SECTIONS 11 AND 12 OF THE SECURITIES ACT OF 1933

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I. INTRODUCTION

This article will discuss Sections 11 and 12 of the Securities Act of 1933 (“Securities Act”).¹ These statutes provide private rights of action for misrepresentations or omissions in a registration statement and prospectus used to register securities with the Securities and Exchange Commission (“SEC”).² The article first focuses on the statute’s legislative history and express and implied defenses. The article next focuses on the heightened pleading requirements and the defenses of due diligence, reliance, constructive knowledge, and loss causation. Finally, the article discusses some additional factual scenarios from cases in which the defenses of reliance, constructive knowledge, or loss causation could provide grounds for early dismissal.

In general, the Securities Act requires that before securities can be offered or sold to the public, the issuer must file a registration statement with the SEC, including a prospectus.³ Sections 11 and 12 are the primary private liability provisions of the Securities Act.⁴ As detailed below, Section 11 provides a right of action for material misstatements or omissions in registration statements,⁵ and

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¹ 15 U.S.C. §§ 77k(a), 77l (2009).

² *Id.*

³ There are various exceptions to the registration requirements found at 15 U.S.C. §§ 77c, 77d and 17 C.F.R. §§ 230.501-508. This article concerns only those securities that are required to be registered.

⁴ 15 U.S.C. §§ 77k(a), 77l.

⁵ 15 U.S.C. § 77k(a).

Section 12 provides a right of action for violations of the registration requirement and for material misstatements or omissions in prospectuses and oral communications in the offer or sale of securities.⁶

There are several defenses to Securities Act claims that are either enumerated expressly in Sections 11 or 12 or have been implied by the courts.⁷ Both Sections 11 and 12 contain an express “due diligence” defense for defendants other than the issuer who exercised due diligence in the relevant offering.⁸ Section 11 also contains an underutilized defense argument relating to the presumption of reliance discussed below,⁹ and both Sections 11 and 12 provide a defense based on knowledge of the plaintiff.¹⁰ As discussed herein, although actual knowledge of the plaintiff will clearly suffice for this defense,¹¹ where the factual circumstances suggest that the plaintiff reasonably should have known of the alleged misrepresentation or omission because the truth was publicly available or the plaintiff had access to such information, liability should be limited based on the plaintiff’s constructive knowledge.¹²

The loss causation defense provided expressly in Sections 11 and 12¹³ should be utilized to a greater degree at earlier procedural postures in the litigation. Loss causation is a defense, and thus it is the defendant’s burden to demonstrate that loss causation is lacking; nonetheless, this argument can and should be used at the motion to dismiss and motion for summary judgment stages where the undisputed facts show that the defendant’s statements did not cause the plaintiff’s loss as a matter of law. Numerous courts, including recently the United States Court of Appeals for the Eleventh Circuit, have discussed these defenses and applied them to pre-trial motions.¹⁴

⁶ 15 U.S.C. § 771.

⁷ 15 U.S.C. §§ 77k(a), 77l.

⁸ See *infra* notes 69-73, 83-84 and accompanying text.

⁹ See *infra* notes 85-97 and accompanying text.

¹⁰ See *infra* notes 64, 80 and accompanying text.

¹¹ *Id.*

¹² See *infra* notes 146-68 and accompanying text.

¹³ See *infra* notes 65, 81 and accompanying text.

¹⁴ See *infra* notes 146-68 and accompanying text, discussing *APA Excelsior III L.P. v. Premiere Tech, Inc.*, 476 F.3d 1261 (11th Cir. 2007) [hereinafter *APA IV*]. The following earlier opinions from the case

Finally, it is well-established that a Section 11 claim that “sounds in fraud” must be pled with particularity, and thus may be subject to dismissal under Federal Rule of Civil Procedure 9(b) if the requisite details are lacking.¹⁵ As discussed below, a recent case out of the United States District Court for the Northern District of Georgia demonstrates proper application of this principle to dismiss a Section 11 claim based on the same allegations used to support a fraud claim under Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”).¹⁶

II. SECTION 11 OF THE SECURITIES ACT OF 1933

A. Statute and Legislative History

Section 11 of the Securities Act provides for liability for false or misleading statements contained within a registration statement.¹⁷ To be actionable, the

are also relevant to this article: *APA Excelsior III L.P. v. Premiere Tech., Inc.*, No. 1:99-cv-1377-JOF (N.D. Ga. Sept. 26, 2003) [hereinafter *APA I*]; *APA Excelsior III L.P. v. Premiere Tech., Inc.*, No. 03-15552 (11th Cir. Sept. 23, 2004) [hereinafter *APA II*]; and *APA Excelsior III L.P. v. Premiere Tech., Inc.*, No. 1:99-CV-1377-JOF (N.D. Ga. Sept. 27, 2005) [hereinafter *APA III*].

¹⁵ See, e.g., *Wagner v. First Horizon Pharm. Corp.*, 464 F.3d 1273, 1277-78 (11th Cir. 2006).

¹⁶ See *infra* notes 36-44, 58-61 and accompanying text, discussing *In re Mirant Corp. Sec. Litig.*, Civil Action No. 1:02-CV-1467-RWS, 2009 WL 48188 (N.D. Ga. Jan. 7, 2009).

¹⁷ 15 U.S.C. § 77k(a). The statute states the following:

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

- (1) every person who signed the registration statement;
- (2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
- (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
- (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been

“misrepresentation or omission must pertain to material information that the defendant had a duty to disclose.”¹⁸ “[T]here must be 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.”¹⁹

If the investor made a purchase pursuant to the registration statement, “he need only show a material misstatement or omission to establish his *prima facie* case.”²⁰ He may then bring a claim under Section 11 against the issuer, its officers, directors, and underwriters, any signatory to the registration statement, and any expert who has consented to being named as having prepared or certified any part of the statement or any report or valuation that is used in connection with the statement.²¹ As discussed below, however, the plaintiff does not need to demonstrate that he relied on the registration statement in order to recover under Section 11 if he bought the security within the presumptive period of reliance in the statute.²² Rather, reliance is presumed as a matter of law during that time period, although there are certain fact patterns described below that can rebut that presumption.²³

named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement, in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

¹⁸ *Benzon v. Morgan Stanley Distribs., Inc.*, 420 F.3d 598, 608 (6th Cir. 2005) (quoting *City of Monroe v. Bridgestone Corp.*, 399 F.3d 651, 669 (6th Cir. 2005)); *see also* *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988).

¹⁹ *Basic Inc.*, 485 U.S. at 231-32 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

²⁰ *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).

²¹ 15 U.S.C. § 77k(a).

²² *See infra* notes 85-89 and accompanying text.

²³ *Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967) (holding that there is a “conclusive presumption of reliance upon the registration statement by ‘every person acquiring any securities specified in such statements and offered to the public.’”) (quoting S. 875, 73d Cong. § 9 (1933); H.R. 4314, 73d Cong. § 9 (1933)). For a more detailed description of the manner in which the presumption of reliance operates, *see infra* Section IV.

Section 11 was implemented primarily to “assure compliance with the disclosure provisions of the [1933] Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering.”²⁴ The two primary objectives of the Securities Act were (i) investor protection through adequate and accurate disclosure and (ii) fraud prevention.

Section 11, along with Sections 12 and 14, implements the second objective by permitting an aggrieved investor to maintain a private right of action against the person or persons who engaged in the fraud.²⁵ As the House of Representatives Report noted with respect to the creation of Section 11, “the 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.”²⁶

The legislative history of the Securities Act is also important to consider when assessing the intended parameters of the liability provisions. As Professor Seligman has noted, “[t]he announced aim of Congress in passing the Securities Act was to inform investors of the facts concerning securities offered for sale and to protect them against fraud and misrepresentation.”²⁷ Representative Greenwood observed of the Securities Act that:

The 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

²⁴ *Herman & MacLean*, 459 U.S. at 381-82.

²⁵ *Id.*

²⁶ Krista L. Turnquist, Note, *Pleading Under Section 11 of the Securities Act of 1933*, 98 MICH. L. REV. 2395, 2405 n.63 (2000) (quoting H.R. REP. NO. 73-85, at 10 (1933)).

²⁷ Joel Seligman, *Gottterdammerung for the Securities Act?*, 75 WASH. U. L.Q. 887, 888 (1997). See also H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 730 (“The overriding purpose of our [n]ation’s securities laws is to protect investors and to maintain confidence in the securities markets . . .”).

facts, and the Government ought to require the issuer of securities to give all the facts, and be honest with the public.²⁸

The focus of the Securities Act, however, is protecting the open market investor, not sophisticated investors with inside information, due diligence rights, or other knowledge not shared by the public.²⁹ As noted by one scholar, “[t]he sale of an issue of securities to . . . a limited group of experienced investors[] was certainly not a matter of concern to the federal government.”³⁰ As discussed below, precluding Section 11 liability when reliance and loss causation are impossible enhances these goals.³¹

In reviewing the need for a proper channel to purchase and sell securities with the attendant comfort that full disclosure was designed to protect, the Senate further noted that the Securities Act was created in order to:

protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.³²

The Securities Act, however, was not intended to be an insurance against losses not caused by wrongdoing.³³ In commenting on the Securities Act, President

²⁸ Turnquist, *supra* note 26, at 2404 n.50 (quoting 77 CONG. REC. 2914 (1933) (statement of Rep. Greenwood)).

²⁹ James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 37 (1959-60).

³⁰ *Id.*

³¹ See *infra* notes 122-30 and accompanying text.

³² Seligman, *supra* note 27, at 888 (quoting S. REP. NO. 73-47 (1933)); see also *Gustafson v. Alloyd Co.*, 513 U.S. 561, 571 (1995) (noting that the meaningful change effected by the Securities Act was “the creation of federal duties—for the most part, registration and disclosure obligations—in connection with public offerings”).

³³ Henry Klehm III, *Contractual Shifting of Defense Costs in Private Offering Securities Litigation*, 136 U. PA. L. REV. 971, 974 (1988) (quoting President Franklin D. Roosevelt’s Message to the Senate Concerning Regulation of Securities Issues, 77 CONG. REC. 937 (1933)).

Roosevelt underscored its twin objectives – investor protection and fraud prevention.³⁴ In his report to Congress, he made it apparent that the Securities Act was necessary in order to foster and promote a degree of openness and honesty in the securities market that had theretofore been absent.³⁵

[T]he 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. There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public. This proposal . . . puts the burden of telling the whole truth on the seller The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.³⁶

Under the Section 11 liability construct, the registration statement is intended to provide open market investors with a reserve of reliable information upon which to make investment decisions.³⁷ But it is the authors' view – buttressed by case law and legislative history – that investors who did not rely on the market and instead evaluated investment decisions based on inside information were not intended to fall under the protective umbrella of Section 11 of the Securities Act.³⁸ It was believed by the authors of the legislation that “bureaucracy, untrained in these matters as it was, could hardly equal these investors for sophistication, provided only it was their own money that they were spending.”³⁹

³⁴ *Id.* at 974-75.

³⁵ *Id.* at 974.

³⁶ *Id.* at 974.

³⁷ Elizabeth T. Tsai, Annotation, *What Constitutes a “Public Offering” Within Meaning of § 4(2) of Securities Act of 1933 (15 U.S.C.A. § 77d(2)), Exempting From Its Registration and Prospectus Requirements Transactions by an Issuer Not Involving “Any Public Offering,”* 6 A.L.R. FED. 536, *2a (1971).

³⁸ See United States Securities and Exchange Commission, *The Laws that Govern the Securities Industry*, <http://www.sec.gov/about/laws.shtml>.

³⁹ Landis, *supra* note 29, at 37.

In as much as the Securities Act does not provide a cause of action for fraud, it does create a lower standard for establishing liability than the Exchange Act.⁴⁰ A Section 11 claim, for example, does not require proof of scienter.⁴¹

In light of the comparatively low burden under Section 11 and the intent of the statute, the pool of potential purchasers who would qualify to bring a claim under Section 11 has been defined narrowly.⁴² Because the registration statement and prospectus are “snapshots” of the financial picture of the company at the time of the offering, the Securities Act protects investors who purchase directly in the offering or, as discussed below, “traceable” to the offering.⁴³ Thus, unlike a claim brought under Section 10(b) of the Exchange Act, only certain after-market purchasers have standing.⁴⁴ Artificially expanding the pool of potential plaintiffs chills issuers in a manner inconsistent with the intent of the Securities Act.⁴⁵

Federal case law has routinely recognized the narrow scope of liability under the Securities Act.⁴⁶ Indeed, where fraud has really been committed and where a shareholder plaintiff really has been injured as a direct result of the fraud, Section 10(b) of the Exchange Act would be the typical remedy.⁴⁷

Accordingly, as discussed fully below, the authors believe precedent and legislative history teach that there should be no liability under Section 11 where a plaintiff is a sophisticated investor, has access to insider information, benefits from due diligence rights and obligations, or otherwise should have known of the allegedly

⁴⁰ See, e.g., *In re Unicapital Corp. Sec. Litig.*, 149 F. Supp. 2d 1353, 1363 (S.D. Fla. 2001). The Exchange Act imposes a greater burden of proof on plaintiffs and, as a result, does not demand that the potential class of plaintiffs who may bring claims thereunder be restricted. In particular, claims under the Exchange Act place on plaintiffs the significant onus to prove that a defendant acted with scienter. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007).

⁴¹ See, e.g., *In re Adams Golf, Inc. Sec. Litig.*, 381 F.3d 267, 274 n.7 (3d Cir. 2004).

⁴² 15 U.S.C. § 77k(a) (2009).

⁴³ See *infra* notes 66-68 and accompanying text.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 578 (1995); *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 904 (5th Cir. 1977); *Guenther v. Cooper Life Scis. Inc.*, 759 F. Supp. 1437, 1439 (N.D. Cal. 1990); *APA II*, *supra* note 14, at 16.

⁴⁷ See 15 U.S.C. § 78j(b) (2009).

misleading information. Congress said as much in enacting the statute when it stated that “he should suffer the loss who occupies a position of trust in the issuing corporation toward the stockholders, rather than the buyer of a stock who must rely upon what he is told.”⁴⁸ Furthermore, courts have recognized the sensibility of the premise by holding that “Section 11 [liability] is imposed and justified because members of the public are presumed to be ‘innocent’ and, as compared with the issuers of stock, do not have the ‘opportunity to learn the truth;’ instead, they are merely reliant upon what they are told.”⁴⁹

B. Heightened Pleading Requirements for Section 11 Claims that “Sound in Fraud”

Federal Rule of Civil Procedure 9(b) requires plaintiffs to plead with particularity facts satisfying each element of claims falling within the purview of the rule.⁵⁰ Even before Congress passed the Private Securities Litigation Reform Act⁵¹ in 1995 to heighten the pleading requirements of securities fraud claims, courts held that Rule 9(b) applied to claims where reputational concerns were implicated, including Securities Act claims.⁵²

It is now well established in many federal circuits that Section 11 claims that “sound in fraud” must be pled with particularity in conformance with Rule 9(b).⁵³ A claim “sounds in fraud” where “the facts underlying the misrepresentation at stake in

⁴⁸ S. REP. NO. 73-47, at 5 (1933).

⁴⁹ *APA IV*, *supra* note 14, at 1277 (quoting S. REP. NO. 73-47, at 5 (1933)).

⁵⁰ FED. R. CIV. P. 9(b).

⁵¹ 15 U.S.C. § 78u-4 (2009).

⁵² See *Sears v. Likens*, 912 F.2d 889, 893 (7th Cir. 1990); *DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987); *Sears v. Likens*, 912 F.2d 889 (7th Cir. 1990); *In re Elscint, Ltd. Sec. Litig.*, 674 F. Supp. 374, 384 (D. Mass. 1987); *Fine v. Rubin*, 623 F. Supp. 171, 172 (N.D. Cal. 1985); *Competitive Assocs., Inc. v. Fire Fly Enter., Inc.*, 59 F.R.D. 336, 337 (S.D.N.Y. 1972).

⁵³ See *Wagner v. First Horizon Pharm. Corp.*, 464 F.3d 1273, 1278 (11th Cir. 2006); *Cal. Pub. Employees’ Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 161 (3d Cir. 2004); *Rombach v. Chang*, 355 F.3d 164, 171 (2d Cir. 2004); *Lone Star Ladies Inv. Club v. Schlotzsky’s, Inc.*, 238 F.3d 363, 368 (5th Cir. 2001); *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1404-05 (9th Cir. 1996); *Sears*, 912 F.2d at 892-93. *Cf. In re NationsMart Corp. Sec. Litig.*, 130 F.3d 309, 314-15 (8th Cir. 1997) (recognizing the applicability of Rule 9(b) to Section 11 claims “grounded in fraud,” while holding that Rule 9(b) did not apply in the instant case).

the claim are said to be part of a fraud claim, as alleged elsewhere in the complaint.”⁵⁴ The Eleventh Circuit held as follows:

It is not enough to claim that alternative pleading saves the non-fraud claims from making an allegation of fraud because the risk to a defendant’s reputation is not protected. It would strain credulity to claim that Rule 9(b) should not apply in this allegation: [t]he defendant is a no good defrauder, but, even if he is not, the plaintiff can still recover based on the simple untruth of the otherwise fraudulent statement. Nor is it enough to present a general disclaimer in an attempt to immunize the non-fraud claims from the Rule 9 requirements, for the same common sense reasons. The purpose of the rule is to protect a defendant’s good will and reputation when that defendant’s conduct is alleged to have been fraudulent.⁵⁵

The United States District Court for the Northern District of Georgia recently applied this principle to dismiss a Section 11 claim based on the same facts, which the court held failed to state a Section 10(b) claim.⁵⁶ In *In re Mirant Corporation Securities Litigation*, the plaintiffs’ Section 11 and Section 10(b) claims were based on the allegation that defendants violated the federal securities laws by failing to disclose that Mirant engaged in purported illegal Enron-type energy trading and some accounting errors.⁵⁷

The court held that the heightened pleading standards of Rule 9(b) applied because the Section 11 claims sounded in fraud; for example, the allegations against the Section 11 defendants were “inextricably intertwined with their allegations against the [Section 10(b) defendants].”⁵⁸ Specifically, plaintiffs had incorporated in the Securities Act count “hundreds of pages of mostly fraud allegations before employing the disfavored” general disclaimer of fraud.⁵⁹ Moreover, every single

⁵⁴ *Wagner*, 464 F.3d at 1278.

⁵⁵ *Id.*

⁵⁶ *In re Mirant Corp. Sec. Litig.*, No. 1:02-CV-1467-RWS, 2009 WL 48188, at *17 (N.D. Ga. Jan. 7, 2009). Authors Todd R. David and Jessica P. Corley were defense counsel in the *Mirant* case.

⁵⁷ *Id.*

⁵⁸ *Id.* at *15.

⁵⁹ *Id.*

alleged misstatement or omission on which plaintiffs based their Section 11 claim was also alleged as a fraudulent misstatement or omission against the former officers.⁶⁰ Based in part on this holding, the court dismissed the Section 11 and Section 10(b) claims.⁶¹

Thus, the heightened pleading standards should apply to a Section 11 claim with fraud at its core. As demonstrated by the *Mirant* case, courts continue to take a hard look at the underlying allegations to determine if plaintiffs have met their burden of pleading a misrepresentation or omission of material fact in the relevant offering document.

C. *Express Defenses under Section 11*

Section 11 contains several express defenses. First, the defendant can show that there simply was no materially false or misleading statement or omission contained within the registration statement at issue.⁶² Section 11 is not designed to punish something that is not misleading or was disclosed. Second, if the plaintiff knew of the misstatement or omission and made his purchase notwithstanding, no liability can be imposed.⁶³ Another defense to a Section 11 claim is lack of loss causation, which exists when the defendant is able to demonstrate that any damages the plaintiff claims to have sustained were the result of something other than the alleged misstatement or omission in the registration statement.⁶⁴ In addition, the

⁶⁰ *Id.*

⁶¹ *Id.* at *16.

⁶² See 15 U.S.C. § 77k(a) (2009).

⁶³ See 15 U.S.C. § 77k(a)*id.* (“unless it is proved that at the time of such acquisition [the investor] knew of such untruth or omission.”); see also *Miles v. Merrill Lynch & Co.*, 483 F.3d 70, 73 n.1 (2d Cir. 2006) (acknowledging the defense that “the plaintiff knew of the untruth or omission at the time of his or her acquisition of the security.”) (quoting IX LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4528 (3d ed. 2004)). For more discussion on the constructive knowledge aspect of this defense, see discussion *infra* at Section III(C).

⁶⁴ See *Miles*, 483 F.3d at 73 n.1; *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 274 (3d Cir. 2005) (“[D]efendants can limit damages by showing that the plaintiffs’ losses were caused by something other than their misrepresentations.”); *Miles*, 483 F.3d at 73 n.1; *Campbell v. Shearson/Am. Express Inc.*, No. 85-1703, 1987 WL 44742, at *2 (6th Cir. Sept. 9, 1987); *Smith v. Suprema Specialties, Inc.*, No. 02-168 (WHW), 2007 U.S. Dist. LEXIS 30001, at *24WL 1217980, at *6-7 (D.N.J. Apr. 23, 2007); *Campbell v. Shearson/Am. Express Inc.*, No. 85-1703, 1987 WL 44742 (6th Cir. Sept. 9, 1987); see also discussion *infra* at Section V.

plaintiff must be able to “trace” his purchase of the stock to the defective registration statement.⁶⁵ To trace, the plaintiff must be able to prove that the only shares in the market at the time he purchased his shares were those issued pursuant to the allegedly false registration statement.⁶⁶ If, for example, the defendant can show that the investor purchased the stock in a prior offering, and thus *before* the defective registration statement was issued, the plaintiff’s claim under Section 11 will fail.⁶⁷

Section 11 also provides a defense for all defendants (other than the issuer) that acted reasonably and in good faith (the “due diligence” defense).⁶⁸ Specifically, a non-issuer defendant avoids liability under Section 11 if he can prove as to non-“expertized” portions of the registration statement that “he had, after reasonable investigation, reasonable ground to believe and did believe” there were no misstatements or omissions of material facts in such portions of the registration statement.⁶⁹

Section 11 also shields defendants from liability for material misstatements or omissions in information provided by experts.⁷⁰ It is well established that an accountant qualifies as an expert, and audited financial statements are considered “expertized” portions of a registration statement.⁷¹ As to “expertized” portions of the registration statement (such as audited financial statements), a non-issuer defendant avoids liability if he can prove that he “had no reasonable ground to believe and did not believe” that such portions of the registration statement contained misstatements or omissions of material facts.⁷² Thus, a reasonable

⁶⁵ See *APA IV*, 476 F.3d, *supra* note 14, at 1276; *Lee v. Ernst & Young, LLP*, 294 F.3d 969, 977-78 (8th Cir. 2002); *Johnson v. NYFIX, Inc.*, 399 F. Supp. 2d 105, 118 (D. Conn. 2005). Sections 11 and 12 include additional defenses, such as the due diligence defense, that are beyond the scope of this article, and thus not discussed herein.

⁶⁶ See *APA IV*, *supra* note 14, at 1276; *Lee*, 294 F.3d at 978; *Johnson*, 399 F. Supp. 2d at 118.

⁶⁷ See *APA IV*, *supra* note 14, at 1276; *Johnson*, 399 F. Supp. 2d at 118.

⁶⁸ See 15 U.S.C. § 77k(b)(3) (2009); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 211 (1976).

⁶⁹ See 15 U.S.C. § 77k(b)(3)(B).

⁷⁰ See 15 U.S.C. § 77k(b)(3)(C).

⁷¹ See, e.g., *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 623 (9th Cir. 1994).

⁷² *Id.* (quoting 15 U.S.C. § 77k(b)(3)(C)).

investigation standard applies to non-“expertized” portions, while a reasonable reliance standard applies to “expertized” portions.

III. SECTION 12 OF THE SECURITIES ACT OF 1933

A. *Statute and Legislative History*

Section 12 of the Securities Act provides for liability for false or misleading statements contained within prospectuses or as part of oral communications.⁷³ Although the legislative history behind Section 12 is “sparse,”⁷⁴ the statute was enacted primarily for the same reason as Section 11 – i.e., investor protection and fraud prevention. As explained by Senator Duncan Fletcher, the Securities Act was designed to protect:

[p]eople [who] have been persuaded to invest their money in securities without any information respecting them, except the advertisements put forth by the agents or representatives of those

⁷³ See 15 U.S.C. § 77l (2009). The statute provides as follows:

Any person who –

- (1) offers or sells a security in violation of section 77e of this title, or
- (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraphs (2) and (14) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b) of this section, 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. § 77l(a).

⁷⁴ See, e.g., Therese Maynard, *The Future of Securities Act Section 12(2)*, 45 ALA. L. REV. 817, 842-43 (1994).

issuing the securities, and such advertisements have not given full information to the public.⁷⁵

Indeed, the House Report observed as follows:

The character of civil liabilities imposed by this bill [is] described in detail elsewhere. Their essential characteristic consists of a requirement that all those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary. . . . The bill affects only new offerings of securities It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering.⁷⁶

It is clear that Congress was concerned about the negative effects of false or misleading information, particularly given the complexity most often associated with the financial transactions and background surrounding securities offerings in general.

The purpose of these sections is to secure for potential buyers the means of understanding the intricacies of the transaction into which they are invited. The full revelations required in the filed “registration statement” should not be lost in the actual selling process. This requirement will undoubtedly limit the selling arguments hitherto employed. That is its purpose. . . . Any objection that the compulsory incorporation in selling literature and sales argument of substantially all information concerning the issue, will frighten the buyer with the intricacy of the transaction, states one of the best arguments for the provision.⁷⁷

B. Express Defenses Under Section 12

Section 12 defenses are similar to the defenses available under Section 11. For example, the defendant may show that the prospectus or oral communication at

⁷⁵ 77 CONG. REC. 2961, 2982 (1933).

⁷⁶ H.R. REP. NO. 73-85, at 5 (1933) (to accompany H.R. 5480, 73d Congress (1933)).

⁷⁷ *Id.* at *8.

issue did not contain a materially false or misleading statement or omission.⁷⁸ In addition, there is a knowledge defense, i.e., the defendant may demonstrate that the plaintiff was aware of the misstatement or omission in connection with the purchase of the security.⁷⁹ There is also a loss causation defense if the defendant can prove that the damages the plaintiff claims to have sustained were the result of something other than the supposed misstatement or omission in the prospectus or oral communication.⁸⁰

The standing requirement is stricter under Section 12 than under Section 11. Under Section 12, the plaintiff must also show that he purchased the securities directly in the offering and not in the aftermarket.⁸¹

Similar to the due diligence defense of Section 11, Section 12(a)(2) provides a defense of reasonable care for all defendants “that is less demanding than the duty of due diligence.”⁸² This “lack of negligence” defense provides that a defendant shall not be liable if he “sustain[s] 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” which is “necessary in order to make the statements, in light of the circumstances under which they were made, not misleading.”⁸³

As noted above, the defenses in Sections 11 and 12 are rarely used in dispositive motion practice. The next section of the article discusses the application of four specific defenses – reliance, constructive knowledge, loss causation, and truth-on-the-market – that provide useful tools for early dismissal.

⁷⁸ See 15 U.S.C. § 771(a); see also *Gasner v. Bd. of Supervisors*, 103 F.3d 351, 358 (4th Cir. 1996).

⁷⁹ 15 U.S.C. § 771(a).

⁸⁰ See 15 U.S.C. §§ 771(a), (b). Although the plaintiff need not prove loss causation, transaction causation is required. The plaintiff must prove that the misrepresentation caused him to enter into the transaction, even if such causation does not rise to the level of reliance. See *Beloit Corp. v. Emmett & Chandler Cos.*, No. 90-55154, 1991 WL 153459, at *4 (9th Cir. Aug. 14, 1991); *Smolen v. Deloitte, Haskins & Sells*, 921 F.2d 959, 965 (9th Cir. 1990); *Barnes v. Res. Royalties, Inc.*, 795 F.2d 1359, 1366 n.9 (8th Cir. 1986).

⁸¹ See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 571 (1995); see also *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 287 n.16 (3d Cir. 1992).

⁸² *In re Worldcom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 663 (S.D.N.Y. 2004); see also 15 U.S.C. § 771(a)(2); *Royal Am. Managers, Inc. v. IRC Holding Corp.*, 885 F.2d 1011, 1019 (2d Cir. 1989).

⁸³ 15 U.S.C. § 771(a)(2).

IV. THE PRESUMPTION OF RELIANCE UNDER SECTION 11

As noted above, there is a presumption under Section 11 that the investor relied on the false or misleading statement at issue, and therefore he does not need to show independently that he relied on the alleged misstatement in purchasing or selling the securities.⁸⁴ In that regard, a Section 11 claim imposes strict liability on the person or persons responsible for the misstatement. The presumption of reliance operates, however, under a 12-month prescriptive period.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.⁸⁵

Professor O'Hare has noted that this provision "has been interpreted to mean that reliance upon the false or misleading statement appearing in the registration statement is presumed during the initial 12 month period following the effective date of the registration statement."⁸⁶ In other words, "there is a conclusive presumption of reliance for any person purchasing the security prior to the expiration of twelve months."⁸⁷ After that period has concluded, the plaintiff must be able to show reliance in order to prevail on his claims under Section 11.⁸⁸

Thus, Section 11, by its explicit language, contemplates three distinct time periods. First, it implies the pre-presumptive period, i.e., before a registration

⁸⁴ See *supra* notes 20-24 and accompanying text.

⁸⁵ 15 U.S.C. § 77k(a) (2009).

⁸⁶ Jennifer O'Hare, *Institutional Investors, Registration Rights, and the Specter of Liability Under Section 11 of the Securities Act of 1933*, 1996 WIS. L. REV. 217, 226 n.36 (1996).

⁸⁷ 2 THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 7.3[4] (6th ed. 2008).

⁸⁸ Reliance may be established without proof of the reading of the registration statement by the investor. See 15 U.S.C. § 77k(a).

statement is issued.⁸⁹ Second, it defines the presumptive period, i.e., between the time a registration statement is issued and the time an “earning statement covering a period of at least twelve months beginning after the effective date of the registration statement” is issued.⁹⁰ Third, it establishes the post-presumptive period, i.e., following the issuance of such an “earning statement covering a period of at least twelve months beginning after the effective date of the registration statement.”⁹¹ During each of these periods, reasonable reliance must either be proven affirmatively or is an affirmative defense and can be refuted.

The presumption of reliance in a Section 11 claim is a universal concept among courts across this country.⁹² It is in keeping with the congressional intent behind passage of the Securities Act and the furtherance of investor protection and fraud prevention that the Securities Act was designed to accomplish. Despite the strict liability nature of a Section 11 claim, however, it is important to bear in mind that the presumption of reliance under Section 11 is just that – a *presumption*. It does not mean that reliance is not an element of a Section 11 claim, nor does it mean that reliance is not part of a court’s consideration of the issues at stake in the claim.

Before considering whether the Section 11 presumption applies, we must address Plaintiffs’ threshold argument. Plaintiffs argue primarily that reliance is not an element of a Section 11 claim and, consequently, reliance is irrelevant to, and plays no role in, this case. That is only partly true. Plaintiffs are correct to the extent that reliance does not need to be *proven* (except post-earnings statement). Reliance is ordinarily *presumed*.⁹³

Congress developed the 12-month prescriptive period primarily as a means of guarding against market forces and fluctuations.

⁸⁹ See *id.*

⁹⁰ See *id.*

⁹¹ *Id.*

⁹² See, e.g., *Alpern v. UtiliCorp United, Inc.*, 84 F.3d 1525, 1541 (8th Cir. 1996); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1223 (1st Cir. 1996); *Barnes v. Osofsky*, 373 F.2d at 269, 272 (2d Cir. 1967); *In re AMF Bowling Sec. Litig.*, No. 99 Civ. 3023 (DC), 2002 U.S. Dist. LEXIS 9076WL 1033826, at *2 (S.D.N.Y. May 21, 2002); *Schwartz v. Celestial Seasonings, Inc.*, 185 F.R.D. 313, 317 (D. Colo. 1999); *Westinghouse Elec. Corp. v. ‘21’ Int’l Holdings, Inc.*, 821 F. Supp. 212, 218 (S.D.N.Y. 1993).

⁹³ See *APA IV*, *supra* note 14, at 1271-72 (emphasis in original).

Congress realized that the price of securities fluctuates with information received by the market about a certain company. Without this provision, there could be an investor who only purchased securities from companies with known faulty registration statements. By doing this, the investor would always be able to recover his purchase price from companies whose stock prices dropped, but keep those stocks whose prices went up.⁹⁴

Assuming that the securities at issue were not purchased beyond the 12-month window, a plaintiff will be able to take advantage of the reliance presumption. Provided he can show that he purchased the security pursuant to a false or misleading registration statement, “[l]iability against the issuer . . . is virtually absolute, even for innocent misstatements.”⁹⁵ In that event, he would not need to prove an independent reliance on the misstatement or other filing in contention.⁹⁶

As discussed below, the Eleventh Circuit’s opinions in the *APA* case are a thorough and well reasoned application of the presumption of reliance to the particular facts at issue.

*A. APA Excelsior III L.P. v. Premiere Technologies, Inc.,
476 F.3d 1261 (11th Cir. 2007).⁹⁷*

This case arose out of a merger in which the plaintiffs were sophisticated “venture” investors and directors of Xpedite Systems, Inc. (“Xpedite”), the publicly

⁹⁴ James E. Shapiro, *Hertzberg v. Dignity Partners, Inc.: Standing to Sue Under Section 11 of the Securities Act of 1933; Reflections on Gustafson*, 15 BYU J. PUB. L. 117, 134-35 (2000).

⁹⁵ *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).

⁹⁶ See, e.g., *In re Am. Cont’l Corp./Lincoln Sav. & Loan Sec. Litig.*, 794 F. Supp. 1424, 1435 (D. Ariz. 1992).

A purchaser’s reliance on the registration statement need not be proven unless the plaintiff “acquired the security after the issuer made generally available to its security holders an earning statement covering a period of twelve months beginning after the effective date of the registration statement.” Section 77k further provides that reliance may be shown without proof that the plaintiff read the registration statement.

Id. (quoting 15 U.S.C. § 77k (2009)).

⁹⁷ The authors of this article were defense counsel in the *APA* case.

traded target corporation. The plaintiffs committed to acquire shares of Premiere Technologies, Inc. (“Premiere”), the acquiring corporation, prior to the public offering of shares in conjunction with the merger. After the merger, when Premiere experienced a temporary downturn, the plaintiffs sued Premiere and its officers under Section 11 and for negligent misrepresentation under state law.⁹⁸

The plaintiffs were all former Xpedite shareholders who each held a large stake in the company.⁹⁹ Certain of the plaintiffs were investment funds in the Alan Patricof family of funds and provided investment fund management services to large, sophisticated institutional investors.¹⁰⁰ Robert Chefitz, an employee of the investment funds, was charged with monitoring the funds’ investment in Xpedite.¹⁰¹ He and another fund employee held seats on Xpedite’s Board of Directors due to the funds’ significant holdings in Xpedite.¹⁰² The remaining plaintiffs, Stuart and David Epstein, were brothers who made substantial venture investments in Xpedite as individual investors and as a result maintained a joint seat on Xpedite’s Board.¹⁰³

In February 1997, Xpedite’s Board established a Special Committee to explore strategic alternatives to achieve liquidity for the large venture investors and value for public market shareholders.¹⁰⁴ Both Chefitz and David Epstein were appointed to the Special Committee, which was assisted by Merrill Lynch, Pierce, Fenner & Smith, Inc. as its financial investment advisor, by Ernst & Young LLP as its audit advisor, and by Paul Hastings, Janofsky & Walker LLP for legal due diligence.¹⁰⁵

⁹⁸ The plaintiffs originally asserted Section 12 claims also, but expressly abandoned them during appellate oral argument. *See APA IV*, *supra* note 14, at 1267 n.3. The Section 15 claim, a derivative liability cause of action, was dismissed with the Section 11 claim. *See id.*

⁹⁹ *See APA IV*, *supra* note 14, at 1263.

¹⁰⁰ *See id.*

¹⁰¹ *See id.*

¹⁰² *See id.*

¹⁰³ *See id.*

¹⁰⁴ *See id.*

¹⁰⁵ *See id.* at 1263-64.

In October 1997, Premiere expressed an interest in acquiring Xpedite.¹⁰⁶ Upon receipt of an offer from Premiere, the Special Committee was obligated to conduct a due diligence investigation into the offer and to make a recommendation to the Board. Chefitz led the Committee's due diligence efforts, and the Committee, including David Epstein as a member, was given access to voluminous amounts of confidential and non-public information regarding Premiere.¹⁰⁷ The Special Committee recommended to Xpedite's Board that the merger offer should be accepted, and the two companies agreed on a stock-for-stock transaction.¹⁰⁸

Separate from and prior to the public offering process that was to be associated with the merger, the plaintiffs executed Stockholder Agreements in November 1997.¹⁰⁹ The Stockholder Agreements granted an irrevocable proxy to Premiere's Board of Directors to vote in favor of the merger, thereby reflecting the plaintiffs' investment decision as to Premiere.¹¹⁰ Also in November 1997, the plaintiffs executed Affiliate Letters, in which they agreed to the placement of a restrictive legend on their Premiere stock certificates.¹¹¹ The Affiliate Letters provided, among other things, that the plaintiffs would be subject to a minimum of a 30-day post-merger lock-up within which they were prohibited from selling their Premiere stock.¹¹² The plaintiffs further agreed that Premiere was "under no obligation to file a registration statement with the [SEC] covering the disposition of [their] shares."¹¹³ Thus, the plaintiffs conceded that their acquisition of shares was separate from the subsequent offering.

In January 1998, Premiere filed a Registration Statement for the Xpedite merger with the Securities and Exchange Commission ("SEC"), which became

¹⁰⁶ See *id.* at 1263.

¹⁰⁷ See *id.* at 1264.

¹⁰⁸ See *id.*

¹⁰⁹ See *id.* at 1264-65.

¹¹⁰ See *id.* at 1264. The SEC has recognized that executing such agreements could constitute an investment decision. See Regulation of Securities Offerings, Securities Act Release No. 33-7606A, 63 Fed. Reg. 67,174-01, 67, 235-67, 236 (proposed Dec. 4, 1998).

¹¹¹ See *APA IV*, *supra* note 14, at 1264-65.

¹¹² See *id.*; *APA I*, *supra* note 14, at 31.

¹¹³ *APA IV*, *supra* note 14, at 1265.

effective on January 28, 1998, and thereby initiated the public offering process.¹¹⁴ Upon consummation of the merger on February 27, 1998, the plaintiffs enjoyed a 500% return on their initial investment in Xpedite.¹¹⁵

Later that year, in June 1998, “Premiere announced that it would have a shortfall in its revenues, and that it would be taking a charge against its bad debt reserves.”¹¹⁶ On the day of the announcement, the price of Premiere stock dropped by 28%, and the lawsuit was filed shortly thereafter.¹¹⁷

After the completion of discovery, the defendants moved for summary judgment because the plaintiffs had made their investment decision to acquire the relevant shares before the allegedly fraudulent registration statement was issued.¹¹⁸ In addition, the defendants argued that the plaintiffs lacked standing under the Securities Act because they had not acquired stock pursuant to a public offering, but had instead made their decision to invest based on access to inside information and advice from their lawyers and investment bankers.¹¹⁹ The defendants also asserted that, because the plaintiffs had failed to conduct effective due diligence, they could not justifiably rely on any representations by Premiere and, therefore, could not bring a claim for negligent misrepresentation.¹²⁰

Analyzing “the entire context of the transaction,”¹²¹ the United States District Court for the Northern District of Georgia held that the plaintiffs’ negligent misrepresentation claim failed.¹²² The Court held as follows:

Plaintiffs cannot establish reasonable reliance on Defendants’ alleged misrepresentations because Plaintiffs had notice of risk factors

¹¹⁴ *See id.*

¹¹⁵ *See id.* at 1265 n.1.

¹¹⁶ *See id.* at 1265.

¹¹⁷ *See id.*

¹¹⁸ *See APA I, supra* note 14, at 6.

¹¹⁹ *See id.* at 7.

¹²⁰ *See id.*

¹²¹ *Id.* at 12 (quoting *Emergent Capital Inv. Mgmt. LLC v. Stonepath Group, Inc.*, 2003 WL 22053957, at *4 (2d Cir. Sept. 4, 2003)).

¹²² *Id.* at 25.

related to the areas in which they contend Defendants provided inaccurate information; Plaintiffs [were] sophisticated parties and were represented by sophisticated legal and financial advisors; and Plaintiffs had access to information through the due diligence process, but did not seek information related to the areas of concern and did not negotiate specific warranties or representations from Premiere concerning these issues.¹²³

The Court also dismissed the Securities Act claims because “it would not serve the purposes of the 1933 Act to allow sophisticated investors who had access to significant confidential and inside information through the exercise of due diligence rights to convert their acquisition of securities into a public offering by mere fact that Defendants provided a Registration Statement.”¹²⁴

The plaintiffs appealed.¹²⁵ As discussed below, the Court of Appeals for the Eleventh Circuit was the first to recognize the impossibility of reliance defense under Section 11.¹²⁶ The Court held that the logical scope of the presumption framework in Section 11 dictates that no liability may be imposed in any situation in which reliance would have been impossible, including where the plaintiffs made their investment decisions before the registration statement was issued or they should have known of the alleged misstatement at issue.¹²⁷

The Court analogized the factual circumstances before it to those of a plaintiff who acquires a security pursuant to a registration statement, but knows at the time of the acquisition of the untruths or omissions contained therein.¹²⁸ Because Section 11 permits an affirmative defense against such a plaintiff if reliance would have been unreasonable, the Court held that “[i]n a case like the one currently before the Court, the purchaser committed to the sale before the alleged misstatements or omissions were made and therefore before such statements or

¹²³ *Id.*

¹²⁴ *Id.* at 31.

¹²⁵ *See APA IV*, *supra* note 14, at 1266.

¹²⁶ *See id.*

¹²⁷ *See APA II*, *supra* note 14, at 12-17.

¹²⁸ *See id.* at 12-13.

omissions could have affected the price and played any role in the purchase decision.”¹²⁹

The Court noted that an argument asserting that “due to the tim[ing] of their investment decision, Plaintiffs could not possibly have relied on the registration statement and therefore should not be entitled to maintain their claims under Section 11” was an “attractive argument.”¹³⁰ The Court held as follows.

Thus, the statute prevents recovery even during the initial period covered by the statute if reliance would have been unreasonable. It is conceivable, therefore, that if a plaintiff committed to an acquisition prior to the filing of a registration statement – if reliance were a complete impossibility under any theory – he too should not be permitted to recover under Section 11.¹³¹

The Eleventh Circuit affirmed the dismissal of the negligent misrepresentation claim, but reversed and remanded the dismissal of the Section 11 claim because it did not reach the merits of the application of the reliance defense and it rejected the defendants’ argument that the Section 11 claim failed because there was no public offering.¹³²

On remand, the defendants renewed their motion for summary judgment.¹³³ The defendants argued that the Eleventh Circuit’s guidance on the impossibility of reliance based on the timing of the plaintiffs’ investment decision precluded their Section 11 claims.¹³⁴ The district court followed the Eleventh Circuit’s “roadmap,” held that reliance was impossible, and dismissed the Section 11 claim.¹³⁵

The plaintiffs appealed again.¹³⁶ The Eleventh Circuit held that reliance was impossible and that no Section 11 claim could be asserted under the set of facts

¹²⁹ *Id.* at 15.

¹³⁰ *Id.* at 12.

¹³¹ *Id.* at 13.

¹³² *See id.* at 23-24.

¹³³ *See APA III, supra* note 14, at 6.

¹³⁴ *See id.*

¹³⁵ *See id.* at 14.

¹³⁶ *See APA IV, supra* note 14, at 1267.

presented.¹³⁷ In affirming the district court's opinion, the Eleventh Circuit stated initially that the "statutory language must be read in the context of the purpose it was intended to serve."¹³⁸ The Court rejected at the outset the plaintiffs' position that the timing of the investment decision was irrelevant.¹³⁹ Instead, it deemed the plaintiffs to have conceded that the relevant investment decision was made before the registration statement was issued.¹⁴⁰

The Eleventh Circuit held that the insider plaintiffs did not reasonably rely on the allegedly false registration statement and squarely rejected the notion that reliance is not an element of Section 11.¹⁴¹ The Court held that, "as a matter of common sense, Plaintiffs are not entitled to the presumption in light of the timing of their investment decision and commitment. To hold otherwise would mean that an impossible fact will be presumed in Plaintiffs' favor."¹⁴²

The Court also held that the plaintiffs were not entitled to the presumption of reliance because of their status as insiders and due diligence rights.¹⁴³

Plaintiffs had access to a wide range of information and knew of the stock issuance months before the registration statement was filed. They had the opportunity to learn (and, in fact, were on notice) of the potential problems with certain of Premiere's business relationships, its telephone calling card business, and the Orchestrate product of which they now complain. Congress has noted that liability under Section 11 is imposed and justified because members of the public are presumed to be "innocent" and, as compared with the issuers of stock, do not have the "opportunity to learn the truth;" instead, they are merely reliant upon what they are told. *See* S. Rep. No. 47 at 5. Plaintiffs do not appear to fit that characterization. . . .

¹³⁷ *See id.* at 1277.

¹³⁸ *Id.* at 1268 (quoting *United States v. Ballinger*, 395 F.3d 1218, 1237 (11th Cir.) (en banc), *cert. denied*, 546 U.S. 829 (2005)).

¹³⁹ *See id.* at 1269-70.

¹⁴⁰ *See id.*

¹⁴¹ *See id.* at 1277.

¹⁴² *Id.* at 1273.

¹⁴³ *Id.* at 1277.

In sum, we hold that the Section 11 presumption of reliance does not apply in the limited and narrow situation where sophisticated investors participating in an arms-length corporate merger make a legally binding investment commitment months before the filing of a defective registration statement.¹⁴⁴

Thus, where reliance is an impossibility due to the timing of the plaintiff's investment decision, a Section 11 claim should fail as a matter of law under the *APA* case.

B. *Constructive Knowledge Defense Under Section 11*

Another important aspect of the *APA* case was the extent to which constructive knowledge of the alleged misstatement provides a defense under Section 11. As discussed above, both Sections 11 and 12 provide a defense based on knowledge of the plaintiff.¹⁴⁵ Actual knowledge is an obvious concept, but it is difficult to prove in reality because one cannot “get in the mind” of the plaintiff.

Constructive knowledge is the more practical notion and, thus, is espoused widely in the law. Constructive knowledge is defined as “[k]nowledge that one using reasonable care or diligence should have, and therefore is attributed by law to a given person.”¹⁴⁶ Constructive knowledge exists for the following two essential purposes: (1) it prevents individuals from turning a blind eye to initial signs of trouble; and (2) it recognizes that proving actual knowledge is next to impossible.¹⁴⁷

¹⁴⁴ *Id.* The court also noted correctly that the concept of “tracing” substantiates this reading of Section 11. See *id.* at 1276. In other words, under Section 11, a plaintiff must be able to trace the security and purchase to the defective registration statement in order to induce liability. See *DeMaria v. Andersen*, 318 F.3d 170, 176 (2d Cir. 2003); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 873 (5th Cir. 2003); *Barnes v. Osofsky*, 373 F.2d 269, 269 (2d Cir. 1967). Where the plaintiff had actual or constructive knowledge, such necessary links to the registration statement are impossible.

¹⁴⁵ See *supra* notes 62-64, 76-78 and accompanying text.

¹⁴⁶ BLACK'S LAW DICTIONARY 876 (7th ed. 1999).

¹⁴⁷ See Alan C. Michaels, *Acceptance: The Missing Mental State*, 71 S. CAL. L. REV. 953, 957, 978-79 (1998); Robert B. Edesess, Jr., *The End of Innocence: An Actual Knowledge Threshold for Intermediaries Holding Fiduciaries'/Clients' Assets*, 2 DEPAUL BUS. & COM. L.J. 377, 406-07 (2004).

This concept of constructive knowledge, however, is rarely used in defending against a Section 11 claim.¹⁴⁸ Defendants should recognize the role of such constructive knowledge in Section 11 and advocate against liability where reliance, as a result, would be unreasonable.

A defense under Section 11 for a plaintiff's actual or constructive knowledge of an alleged misrepresentation would not be an anomaly. There are several parallels in the law. Actual knowledge and constructive knowledge, contemplating an objective reasonable person standard, appear in several facets of commercial and securities law.

The concept of knowledge plays a role in securities fraud actions under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.¹⁴⁹ Severe recklessness, which suggests that an individual should have known of an act or statement, is enough to make the required showing of scienter, or knowledge, under those provisions.¹⁵⁰ The Eleventh Circuit held as follows:

Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.¹⁵¹

Section 20(e) of the Securities Exchange Act, under which the SEC can bring aiding and abetting actions, provides another example.¹⁵² That section expressly provides that

[a]ny person that *knowingly* provides substantial assistance to another

¹⁴⁸ Courts have held that constructive knowledge cannot be used as a defense to a Section 12 claim. *See, e.g.,* Casella v. Webb, 883 F.2d 805, 809 (9th Cir. 1989) (“Constructive knowledge cannot bar a purchaser’s recovery under section 12(2).”); Parkhurst v. N. Am. Fin. Servs. Cos., 919 F. Supp. 270, 275 (E.D. Mich. 1996).

¹⁴⁹ *See generally* Keith A. Rowley, *Cause of Action for Securities Fraud Under Section 10(b) of the 1934 Securities Exchange Act and/or Rule 10b-5*, 9 CAUSES OF ACTION 2D 271 (2006).

¹⁵⁰ *See* Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1283 (11th Cir. 1999).

¹⁵¹ *Id.* at 1282 n.18 (quoting Broad v. Rockwell Int’l Corp., 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc)).

¹⁵² *See* 15 U.S.C. § 78t(e) (2009).

person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.¹⁵³

Courts have interpreted this to mean that, under certain circumstances, “‘recklessness is enough’ to satisfy the knowledge element.”¹⁵⁴ In the same vein, the statute of limitations for securities fraud claims starts to run upon either actual or constructive knowledge of the alleged misstatement by the plaintiff. To trigger the running of the statute, inquiry notice is the same as actual notice.¹⁵⁵ “Inquiry notice” is “‘the term used for knowledge of facts that would lead a reasonable person to begin investigating the possibility that his legal rights had been infringed.’ . . . Inquiry notice is triggered by evidence of the *possibility* of fraud, not full exposition of the scam itself.”¹⁵⁶ Therefore, even though a person does not have actual knowledge of a fraudulent act, the statute of limitations for securities fraud is triggered when she should have known of it. Section 13 of the Securities Act, which codifies the limitation, provides that the statute of limitations starts to run upon either “discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence.”¹⁵⁷

State law fraud or negligent misrepresentation cases also turn on due diligence and constructive knowledge.¹⁵⁸ “Each party to a transaction is under a duty to exercise reasonable diligence to protect himself and to make proper inquiry to ascertain the truth.”¹⁵⁹ In *APA II*, the Court held that the plaintiffs failed to exercise their due diligence rights “in a meaningful way” because they failed to ask the right questions, did not negotiate for warranties, and failed to probe the technology

¹⁵³ *Id.* (emphasis added).

¹⁵⁴ See *SEC v. Treadway*, 430 F. Supp. 2d 293, 339 (S.D.N.Y. 2006) (quoting *Armstrong v. McAlphin*, 699 F.2d 79, 91 (2d Cir. 1983)); see, e.g., *SEC v. Iannelli*, No. 74 Civ. 3417, 1975 WL 348, at *1, 5 (S.D.N.Y. Jan. 29, 1975).

¹⁵⁵ See *Franze v. Equitable Assurance*, 296 F.3d 1250, 1254 (11th Cir. 2002).

¹⁵⁶ *Theoharous v. Fong*, 256 F.3d 1219, 1228 (11th Cir. 2001) (quoting *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 670 (7th Cir. 1998)) (emphasis in original).

¹⁵⁷ 15 U.S.C. § 77m (2009).

¹⁵⁸ See *APA II*, *supra* note 14, at 18-19.

¹⁵⁹ CHARLES R. ADAMS III, *GEORGIA LAW OF TORTS* § 32-4 (2009-10 ed.).

products upon which the acquiring corporation was built.¹⁶⁰ The Court also held that the plaintiffs should have been on notice of potential problems, which were disclosed by the acquiring corporation in its public filings.¹⁶¹

These examples illustrate that knowledge includes both actual knowledge and constructive knowledge in many facets of the law. Absent such a comprehensive concept of knowledge, parties would be substantially prejudiced by the inherent difficulty of entering into an individual's mind to determine what she or he actually knew. Limiting actual knowledge also would facilitate the shunning of responsibility. Such practical concerns warrant limitation of Section 11 liability where either actual or constructive knowledge exists.

As discussed above, the constructive knowledge defense to Section 11 liability was presented to the Eleventh Circuit in *APA II* and *APA IV*.¹⁶² The defendants argued that the plaintiffs were corporate insiders who failed to thoroughly exercise due diligence rights prior to making any decision to invest in Premiere stock.¹⁶³ The Court agreed and held that “a plaintiff may not recover under Section 11 if it ‘knew [of] *or had available*’ information that would have revealed the untruth or omission contained in the registration statement.”¹⁶⁴

Incorporating a constructive knowledge defense into Section 11 and precluding liability where the plaintiff knew or should have known of the alleged misrepresentation is also consistent with recent public policy articulations as to the additional “gatekeeping” responsibilities shouldered by those who typically find themselves foreclosed by this defense, such as insiders.¹⁶⁵ Under both the Sarbanes-Oxley Act and its subsequent applications, fiduciary duties have surpassed a simple monitoring model to encompass an increased emphasis on active gatekeeping and engagement.

¹⁶⁰ *APA II*, *supra* note 14, at 19-20.

¹⁶¹ *See id.* at 20-23.

¹⁶² *See* discussion *supra* Section IV(B).

¹⁶³ *APA II*, *supra* note 14, at 16-17, 19-24.

¹⁶⁴ *APA IV*, *supra* note 14, at 1277 (quoting *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 575 (E.D.N.Y. 1971)) (emphasis in original).

¹⁶⁵ *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

Today, businesses operate in an environment of raised professional, legal, and ethical standards. In the SEC chairman's own words, directors

must redefine corporate governance with practices that go beyond mere adherence to new rules and demonstrate ethics, integrity, honesty, and transparency Directors must ensure that they remain the true stewards of corporate accountability, and their actions must demonstrate their dedication to this stewardship without undue interference¹⁶⁶

Indeed, recent corporate governance principles align greatly with the purposes of the Securities Act, and individuals tasked with due diligence need do far more than a mere formalized check and balance on corporate transactions.

As discussed above, inside, sophisticated, or due diligence-empowered investors are not the type to whom the Securities Act affords protection. To the contrary, these are corporate actors upon whom the SEC relies to be the stewards of corporate governance, to establish an ethical "tone at the top[,]" and to protect the interests of public market shareholders.¹⁶⁷ The goal is to achieve a value-based system that moves beyond technical compliance with the law and towards directors acting in an intellectually independent and diligent manner to promote the spirit of the securities laws.

There has also been a recent spate of high profile cases in which the Delaware courts and others have struggled with the issue of directors' fiduciary duties to the shareholders of public companies.¹⁶⁸ Limiting the scope of Section 11 liability for constructive knowledge would support these corporate governance trends. It would remove any artificial incentives for inside investors to abandon their

¹⁶⁶ William H. Donaldson, Chairman, SEC, Remarks Before the Directors Education Institute (Mar. 16, 2005), *available at* <http://www.sec.gov/news/speech/spch031605whd.htm>.

¹⁶⁷ William H. Donaldson, Chairman, SEC, Remarks Before the Foreign Policy Association, 2003 WL 23638628 (Sept. 25, 2003); *see also* Cynthia A. Glassman, Commissioner, SEC, Remarks Before the Aspen Institute Italia Seminars for Leaders, 2003 WL 23638648 (Nov. 7, 2003); William H. Donaldson, Chairman, SEC, Remarks from Directors College at Stanford University Law School, 2004 WL 1571974 (June 20, 2004).

¹⁶⁸ *See, e.g.*, *Beam v. Martha Stewart Living Omnimedia, Inc.*, 845 A.2d 1040 (Del. 2004); *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 258 F. Supp. 2d 576 (S.D. Tex. 2003).

obligations to access sufficient information in order to protect public shareholders. These interpretations would enhance the private policing system that the SEC is actively promoting and strengthening.

V. LOSS CAUSATION UNDER SECTIONS 11 AND 12

A. *Statutory Framework*

As noted above, lack of loss causation is an affirmative defense under Section 11.¹⁶⁹ “[D]efendants can limit damages by showing that the plaintiffs’ losses were caused by something other than their misrepresentations.”¹⁷⁰ In other words,

[u]nder § 11, defendants are liable only for the losses caused by material misrepresentations or omissions in the registration statement. Once the plaintiff has established damages, the defendant may prove that all or part of those damages were caused by factors other than those misrepresentations or omissions. Thus, while in the

¹⁶⁹ The statute states:

The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: *Provided, that if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable.*

15 U.S.C. § 77k(e) (2009) (emphasis added).

¹⁷⁰ See *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 274 (3d Cir. 2005); see also *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990); *Smith v. Suprema Specialties, Inc.*, No. 02-168(WHW), 2007 WL 1217980, at *6-7 (D. N.J. Apr. 23, 2007) (“Loss causation is a statutory affirmative defense for Section 11 and Section 12(a)(2) claims, and so is not an element of a prima facie case.”); *Madden v. Deloitte & Touche, LLP*, 118 F. App’x 150, 153-54 (9th Cir. 2004) (“Lack of causation of loss is an affirmative defense to § 11 claims.”).

§ 10(b) context it is the plaintiff who must prove loss causation, in the § 11 context it is the defendant who has the burden of proving that his misdeeds were not the cause of the losses.¹⁷¹

In reality, the loss causation requirement under Section 11 represents a shifting of the burden from the plaintiff's proof to an affirmative aspect of the issuer's defense. The requirement enables the defendant to take stock of the circumstances surrounding the issuance of the securities, and to account for other potential causes of the loss that the plaintiff claims to have sustained. If the defendant can prove that the loss "did not result from his misconduct," the plaintiff's claim under Section 11 is fatally flawed.¹⁷²

The concept of loss causation itself stems from the language contained directly within the text of Section 11. To prevail on the affirmative defense, the issuer or other defendant must be able to show that the loss sustained by the plaintiff, such as a decline in stock prices, resulted from factors other than the alleged false or misleading registration statement.¹⁷³ This may be demonstrated in the form of expert testimony, including market valuations, analyses, stock trends, purchasing history, adjustments, and other related areas. It may also be proven based on the undisputed facts of public record regarding, *inter alia*, the information in the market, the reasons for the stock price decline, or the lack of a stock price reaction. Thus, loss causation is an appropriate ground for dismissal at the motion to dismiss or summary judgment stage where it is lacking as a matter of law based on the undisputed facts.¹⁷⁴

Section 12 is similar to Section 11. As noted previously, unlike Section 10(b), Section 12 also does not require the plaintiff to prove loss causation. "The buyer

¹⁷¹ Hayes v. Arthur Young & Co., No. 91-15531, 1994 WL 463493, at *10 (9th Cir. Aug. 26, 1994).

¹⁷² Campbell v. Shearson/Am. Express, Inc., No. 85-1703, 1987 WL 44742, at *2 (6th Cir. Sept. 9, 1987) ("[A] defendant is not liable for damages which he can prove did not result from his misconduct.").

¹⁷³ See *Madden*, 118 F. App'x at 154.

¹⁷⁴ See, e.g., *Azzolini v. Corts Trust II for Provident Fin. Trust I*, No. 103CV1003, 2005 WL 3448053, at *5-6 (E.D. Tenn. Dec. 14, 2005); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 253-55 (S.D.N.Y. 2003); *Cats v. Protection One, Inc.*, No. CV99-3755-DTRCX, 2001 WL 34070755, at *11 (C.D. Cal. June 4, 2001), *rev'd on other grounds*, *Garbini v. Protection One, Inc.*, 49 F. App'x 169 (9th Cir. 2002); *In re Fortune Sys. Sec. Litig.*, 680 F. Supp. 1360, 1364-68 (N.D. Cal. 1987); see also *APA IV*, *supra* note 14, at 1277 n.8.

need not show any causal connection between the misrepresentation and his damage; indeed, he need not even show that he has been damaged.”¹⁷⁵ However, as with Section 11, the defendant can defeat a claim under Section 12 if he can show that the loss sustained by the plaintiff was not the result of the alleged misrepresentations or omissions.

In an action described in subsection (a)(2) of this section, if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.¹⁷⁶

Moreover, although the plaintiff does not have an obligation to plead loss causation in the complaint, dismissal of a securities action under Section 12 is appropriate when it is apparent as a matter of law that the loss is not attributable to the alleged misrepresentations or omissions.¹⁷⁷ Beyond the dismissal stage, the defendant also can make use of expert testimony to demonstrate the absence of a link between the alleged misstatement or omission and the subsequent decline in the value of the plaintiff's securities.¹⁷⁸ As discussed below, the Supreme Court held in *Dura Pharmaceuticals, Inc. v. Broudo* that there often are several possible explanations for a decline in the value of securities, and thus it is not necessarily true that the

¹⁷⁵ *Beloit Corp. v. Emmett & Chandler Cos.*, No. 90-55154, 1991 WL 153459, at *4 (9th Cir. Aug. 14, 1991) (quoting LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 873 (2d ed. 1988)); *Casella v. Webb*, 883 F.2d 805, 808 (9th Cir. 1989); LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1200-01 (15th ed. 2003) [hereinafter LOSS].

¹⁷⁶ 15 U.S.C. § 771(b) (2009).

¹⁷⁷ See *Azzolini*, 2005 WL 3448053, at *5; see also *Pani v. Empire Blue Cross Blue Shield*, 152 F.3d 67, 74-75 (2d Cir. 1998); *Hoover v. Langston Equip. Assocs., Inc.*, 958 F.2d 742, 745 (6th Cir. 1992); *In re WRT Energy Sec. Litig.*, No. 96 Civ. 3610 (JFK), 2005 WL 323729, at *12 (S.D.N.Y. Feb. 9, 2005); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 253-54 (S.D.N.Y. 2003); 5 CHARLES ALAN WRIGHT & ARTHUR MILLER, *FEDERAL PRACTICE AND PROCEDURE* § 1277 (3d ed. 2004).

¹⁷⁸ See, e.g., *Carpe v. Aquila, Inc.*, No. 02-0388-CV-W-FJG, 2005 WL 1138833, at *2-4 (W.D. Mo. Mar. 23, 2005).

alleged misstatement or omission was the actual cause of the loss.¹⁷⁹ In some instances, the defendant may even be able to show that the plaintiff did not actually sustain a loss at all, but instead experienced a gain on the value of his securities.¹⁸⁰ In either event, the affirmative defense of loss causation is an effective tool to combat a Section 12 claim.

B. *Loss Causation under Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005)*

In *Dura*, the Supreme Court confirmed that an inflated purchase price alone will not *ipso facto* amount to or proximately cause the economic loss needed to allege and prove loss causation under a Section 10(b) claim.¹⁸¹ Rather, the plaintiff must show that the defendant's misrepresentation, or other fraudulent conduct, proximately caused the economic loss.¹⁸²

As set forth above, Section 11 and Section 12 plaintiffs do not have to plead or prove loss causation as part of a *prima facie* case.¹⁸³ Instead, the burden shifts to the defendant to show that the loss was the result of something other than the defendant's misrepresentations or omissions.¹⁸⁴ In that regard, the rule set forth in *Dura* would have no technical bearing on claims brought under Section 11 and Section 12, but *Dura* nevertheless is instructive for the guidance it can offer to defendants in formulating their affirmative defense. Notably, the Supreme Court observed as follows:

For one thing, as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated

¹⁷⁹ See *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 342-43 (2005).

¹⁸⁰ See, e.g., *Hicks v. Morgan Stanley & Co.*, No. 01 Civ. 10071 (HB), 2003 WL 21672085, at *4-5 (S.D.N.Y. July 16, 2003).

¹⁸¹ *Dura Pharms., Inc.*, 544 U.S. at 346-47.

¹⁸² See *id.* at 346.

¹⁸³ See *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 274 (3d Cir. 2005); *Madden v. Deloitte & Touche, LLP*, 118 F. App'x 150, 153-54 (9th Cir. 2004); *Beloit Corp. v. Emmett & Chandler Cos.*, No. 90-55154, 1991 WL 153459, at *4 (9th Cir. Aug. 14, 1991); *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990); *Casella v. Webb*, 883 F.2d 805, 808 (9th Cir. 1989); *Smith v. Suprema Specialties, Inc.*, No. 02-168 (WHW), 2007 WL 1217980, at *6-7 (D. N.J. Apr. 23, 2007); *Loss*, *supra* note 175, at 873.

¹⁸⁴ See, e.g., *In re Merck*, 432 F.3d at 274 (“[D]efendants can limit damages by showing that the plaintiffs’ losses were caused by something other than their misrepresentations.”).

purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value. Moreover, the logical link between the inflated share purchase price and any later economic loss is not invariably strong. Shares are normally purchased with an eye toward a later sale. But if, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss. If the purchaser sells later after the truth makes its way into the market place, an initially inflated purchase price *might* mean a later loss. But that is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price. (The same is true in respect to a claim that a share's higher price is lower than it would otherwise have been – a claim we do not consider here.) Other things being equal, the longer the time between purchase and sale, the more likely that this is so, *i.e.*, the more likely that other factors caused the loss.¹⁸⁵

Dura acknowledges the existence of many different possible causes of a decline in stock price, and the defendant has these alternate causes at his disposal in defending against a plaintiff's charge that the defendant's misrepresentations or omissions resulted in the stock price decline. Shifts in economic circumstances or investor expectations may have been the proximate cause of the ultimate decline in share price, or it may have been attributable to a fundamental change in the industry itself. Whatever the reason, the decline in stock price does not necessarily have to result from a defendant's misrepresentation or omissions, as the Supreme Court in *Dura* acknowledges.

C. *Loss Causation Defense Applied in APA*

The principles espoused by *Dura* were presented to the district court in *APA* in the Section 11 context. The defendants argued that there had been no financial restatement, and the plaintiffs had proffered no evidence to link the stock price drop

¹⁸⁵ *Dura Pharms., Inc.*, 544 U.S. at 342-43 (emphasis in original).

and their purported damages to any alleged misstatement.¹⁸⁶ The plaintiffs argued in response that loss causation was not their burden, and that disproving it was the defendants' burden.¹⁸⁷ The defendants responded that, regardless of whose burden it was, the court should grant summary judgment, because loss causation was impossible as a matter of law because the plaintiffs made their investment decision before the registration statement was issued, and thus before the alleged misstatements were made.¹⁸⁸

The district court agreed with the defendants, holding that because the plaintiffs made their investment decision before the allegedly misleading registration statement was issued, and because they had due diligence rights, the alleged misstatements could not have caused their loss.¹⁸⁹ The district court granted summary judgment in favor of the defendants because the “[p]laintiffs’ [Section] 11 claim suffer[ed] from an impossibility of reliance and inability to establish loss causation.”¹⁹⁰

APA demonstrates that loss causation under Section 11 follows the same rationale as *Dura*.¹⁹¹ Although loss causation is a defense, rather than an affirmative element, under Section 11, it is an appropriate basis for dismissal if it is lacking as a matter of law.

VI. TRUTH-ON-THE-MARKET DEFENSE

A. *The Truth-on-the-Market Doctrine*

The “truth-on-the-market” doctrine serves as the inverse counterpart to the “fraud-on-the-market” theory, which is commonly used to establish the reliance element for a claim brought under Section 10(b) of the Securities Act.¹⁹² In its most

¹⁸⁶ See *APA III*, *supra* note 14, at 6.

¹⁸⁷ See *id.*

¹⁸⁸ See *id.* at 6, 15.

¹⁸⁹ See *id.* at 15-16.

¹⁹⁰ *Id.* at 16.

¹⁹¹ See *APA IV*, *supra* note 14, at 1277 n.8.

¹⁹² The “fraud-on-the-market” theory provides that a misrepresentation or omission will affect the price of securities that are traded in an efficient market, and an investor will be able to rely on the

basic form, the doctrine provides that a misrepresentation cannot be considered “material” for purposes of establishing liability under Section 10(b) if the information constituting the misrepresentation is already known to the market.¹⁹³

The typical fact pattern in securities fraud cases involves either an overly inflated or significantly undervalued stock price caused by the misrepresentation or omission that the defendant placed into the market through public disclosures, such as a registration statement, conference call, or SEC filings. The market reacts to the fraudulent statement, and the stock price is based on the extent of the “misinformation” in the market; when the truth ultimately is revealed, the market again reacts, and the stock price declines.¹⁹⁴ Even if the defendant made misstatements, it can avoid liability by demonstrating that the stock price decline was not the result of its misstatements, but was due to other causes, such as a shift in economic circumstances or investor expectations.¹⁹⁵

The “truth-on-the-market” doctrine operates under the same reasoning, but results in a different outcome. In the truth-on-the-market scenario, the stock price in the market is based on truthful information that is publicly available.¹⁹⁶ If investors elect to purchase or sell their stock, and they suffer a loss as a result of a stock price decline or inflation, there should be no liability because all of the information surrounding the company was truthful and fully available in the market.¹⁹⁷

The defendant can demonstrate that the alleged misrepresentations did not affect the market price of the securities, and thus the market could not have relied on the misrepresentations, because the truth of the matter was already known.¹⁹⁸ The main inquiry in assessing the impact of the doctrine is the manner in which the

integrity of the market in purchasing the securities. *See* Lipton v. Documation, Inc., 734 F.2d 740, 745-46 (11th Cir. 1984).

¹⁹³ *See* Ganino v. Citizens Utils. Co., 228 F.3d 154, 167 (2d Cir. 2000); Provenz v. Miller, 102 F.3d 1478, 1492 (9th Cir. 1996); Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208, 213-14 (7th Cir. 1993).

¹⁹⁴ *See, e.g.*, Dura Pharms. v. Broudo, 544 U.S. 336, 338-40, 347 (2005).

¹⁹⁵ *See id.* at 338, 347.

¹⁹⁶ *See* Ganino, 228 F.3d at 167.

¹⁹⁷ *See id.*

¹⁹⁸ *See id.*; Provenz, 102 F.3d at 1492; Associated Randall Bank, 3 F.3d at 213-14.

“truth” found its way into the market. “Prompt incorporation of news into stock price is the foundation for the fraud-on-the-market doctrine and therefore supports a truth-on-the-market doctrine as well.”¹⁹⁹ To avail himself of the doctrine, the defendant must be prepared to show the extent of the efforts that were made to introduce the “truth” to the public.²⁰⁰

Even in a fraud on the market case, corporate insiders are not relieved of their duty to disclose material information where that information has received only brief mention in a few poorly-circulated or lightly-regarded publications. The investing public justifiably places heavy reliance on the statements and opinions of corporate insiders. In order to avoid Rule 10b-5 liability, any material information which insiders fail to disclose *must be transmitted to the public with a degree of intensity and credibility sufficient to effectively counter-balance any misleading impression created by the insiders’ one-sided representations.*²⁰¹

B. *Truth-on-the-Market Defense Applied to Section 11 Cases*

As discussed above, the truth-on-the-market doctrine precludes liability where the purportedly injured party knew or should have known of the information that allegedly resulted in the injury. This fundamental principle plays an explicit and implicit role in Section 11’s liability scheme.

Section 11’s presumption of reliance stems from the notion that a misleading registration statement is considered to constitute fraud on the market due to the immediate spread of information.²⁰² Thus, proof of reading a registration statement may not be required in certain circumstances, because even those who did not read the registration statement would have suffered an impact when the misleading disclosure affected the value of the stock.²⁰³

¹⁹⁹ *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989); *accord In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1114-15 (9th Cir. 1989); *Flamm v. Eberstadt*, 814 F.2d 1169, 1179-80 (7th Cir. 1987); *Rodman v. Grant Found.*, 608 F.2d 64, 70 (2d Cir. 1979).

²⁰⁰ *In re Apple Computer*, 886 F.2d at 1116.

²⁰¹ *Id.* (emphasis added); *see also Ganino*, 228 F.3d at 167.

²⁰² *See APA IV*, *supra* note 14, at 1275, 1277.

²⁰³ *See id.*

The necessary corollary of this rationale is that there are instances in which the fraud-on-the-market theory is inapplicable. Such instances include those in which (1) the truthful information is already in the market, i.e., the truth-on-the-market scenario; (2) an individual was not entitled to rely on the efficient market; or (3) an individual could not have read the registration statement because it did not exist. In such instances, true reliance is impossible, and any presumption is foreclosed.

In addition, if the information relating to the alleged misstatement is in the public domain via other sources, including the issuer's disclosures or the media, either the truth-on-the-market or the constructive knowledge defense may apply.²⁰⁴ One can envision several factual scenarios where "soft information" related to the issuer's business, which the plaintiff claims was not disclosed by the issuer, was in the market already, thus precluding a claim. As discussed below, several real world case examples are illustrative as to how these defenses may work to foreclose a Section 11 claim.

As discussed above, in *In re Mirant Corp. Securities Litigation*, the plaintiffs alleged that Mirant's initial public offering registration statement and prospectus were misleading because they failed to disclose Mirant's alleged misconduct in the California energy crisis during the summers of 2000 and 2001.²⁰⁵ The California energy crisis and the resulting governmental proceedings and private lawsuits were widely publicized in the media and fully disclosed in Mirant's public filings.²⁰⁶ In an early opinion regarding the first round of motion-to-dismiss briefing, the court assessed whether the plaintiffs' claims were time barred by the statute of limitations.²⁰⁷ In doing so, the court discussed at length Mirant's disclosures, articles in the media, and other information in the public domain regarding the California energy crisis and Mirant's alleged role in it.²⁰⁸ Such a factual scenario, where the pertinent information was widely disclosed as alleged by the complaint, would be one

²⁰⁴ See *Ganino*, 228 F.3d at 167.

²⁰⁵ Order, *In re Mirant Corp. Sec. Litig.*, No. Civ. A. 1:02-CV-1467, 2009 WL 48188, at *1 (N.D. Ga. Jan. 7, 2009); *In re Mirant Corp. Sec. Litig.*, No. Civ. A. 1:02-CV-1467, 2003 WL 24027927, at *1 (N.D. Ga. July 14, 2003).

²⁰⁶ See *In re Mirant Corp.*, 2003 WL 24027927, at *7, 9-11.

²⁰⁷ See *id.* at *4-17.

²⁰⁸ See *id.* at *7-14.

in which a truth-on-the-market defense could apply to preclude a Section 11 claim because any alleged misstatements by Mirant could not have been relied on by the market because the truth was already known.²⁰⁹ Moreover, the plaintiffs' constructive knowledge of the facts in the public domain should also bar their Section 11 claim under the knowledge defense in Section 11(e).²¹⁰ Assuming *arguendo* that Mirant's disclosures were false as to its manipulation of the energy markets, the allegations in the governmental proceedings, private lawsuits, and the press would have provided a reasonable investor with knowledge of the misstatement.

Another example of where the truth-on-the-market and constructive knowledge defenses may be applicable is presented by the facts of *In re Prestige Brands Holdings, Inc.*²¹¹ In *Prestige Brands*, the plaintiffs alleged that the defendants failed to disclose that sales of a particular product were declining.²¹² In fact, the prospectus disclosed the declining sales in detail in several places.²¹³ The court dismissed the plaintiffs' Section 10(b) fraud claims based on the alleged declining sales because "[a]ny reasonable investor or potential investor reading the Prospectus thus knew, or reasonably should have known, that *Comet* products had not been performing as profitably as they once did."²¹⁴ Accordingly, the detailed disclosures precluded the plaintiffs' claims.²¹⁵

The *Prestige Brands* court reached the correct result and it confirmed the notion that disclosures about the alleged misstatement will bar a securities claim.²¹⁶ The truth-on-the-market and constructive knowledge defenses, however, would also work to preclude Section 11 claims where the information was in the market by way of the company's detailed disclosures.

²⁰⁹ See *Ganino*, 228 F.3d at 167.

²¹⁰ See *id.*

²¹¹ No. 05 CV. 06924(CLB), 2006 WL 2147719 (S.D.N.Y. July 10, 2006).

²¹² *Id.* at *2.

²¹³ *Id.* at *2-3.

²¹⁴ *Id.* at *6.

²¹⁵ *Id.* at *7.

²¹⁶ See, e.g., *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 9 (2d Cir. 1996).

VII. CONCLUSION

Section 11 claims that sound in fraud should be dismissed if they are not pled with particularity under Rule 9(b). After the motion to dismiss stage, however, claims under Sections 11 and 12 of the Securities Act are sometimes viewed as difficult to get dismissed via dispositive motion before trial because they have a lower burden of proof with regard to the substantive elements than do fraud claims under Section 10(b) of the Exchange Act. There are, however, several explicit and implicit defenses available under the statutes or relevant precedent that should be considered at summary judgment, or even earlier procedural stages of the litigation, if the undisputed facts in the complaint or the public domain support the defenses. As recognized by the Eleventh Circuit in the *APA* case, the defenses of lack of reliance, constructive knowledge, and loss causation are not foreclosed to defendants until a trial on the merits.