

# Analysis & Perspective

## JURISDICTION AND PROCEDURE

### U.S. Court of Appeals for the Fifth Circuit Sharply Curtails Potential Liability Under Section 11 of the Securities Act of 1933

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Since the late 1990's, after the U.S. Supreme Court limited the scope of Section 12 of the Securities Act of 1933 in *Gustafson v. Alloyd Company, Inc.*,<sup>1</sup> and the Private Securities Litigation Reform Act heightened pleading requirements under Section 10(b) of the Securities Exchange Act,<sup>2</sup> securities litigators have noted a marked increase in claims brought as putative class actions under Section 11 of the Securities Act.<sup>3</sup> Section 11 imposes a high standard of liability on participants in public securities offerings, permitting recovery by investors for even innocent material misstatements in public offering registration statements.<sup>4</sup> To enhance the *in terrorem* effect of what has been termed to be essentially a strict liability statute, lead plaintiffs and their counsel have routinely sought certification of huge Section 11 classes that include not only original offering investors but also investors who later purchased in the aftermarket. In a high volume market, such an expansion of a Section 11 class into the aftermarket potentially can add hundreds of millions of dollars in putative damages. However, in its recent decision in *Krim v. pcOrder.com, Inc.*,<sup>5</sup> the U.S. Court of Appeals for the Fifth Circuit sharply curtailed the circumstances under which aftermarket purchasers may claim Section 11 standing.

<sup>1</sup> *Gustafson v. Alloyd Company, Inc.*, 513 U.S. 561 (1995).

<sup>2</sup> 15 U.S.C. § 78u-4(b).

<sup>3</sup> See Marc J. Sonnenfeld and Karen P. Pohlmann, "An Increase in Section 11 Claims Against Companies," *Metropolitan Corporate Counsel* 17 (Feb. 1999); Paul C. Curnin and Christine M. Ford, "The Critical Issue of Standing Under Section 11 of the Securities Act of 1933," 6 *Fordham J. Corp. & Fin. L.* 155 (2001).

<sup>4</sup> *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).

<sup>5</sup> *Krim v. pcOrder.com, Inc.*, \_\_\_ F.3d \_\_\_, 2005 WL 469618 (5th Cir. Mar. 1, 2005).

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**Section 11 Liability and the Limitation on Standing.** Section 11 imposes "a stringent standard of liability"<sup>6</sup> on parties who play a direct role in a registered offering. Plaintiffs are not required to demonstrate intent to defraud, and ordinarily need not prove that they relied on the alleged misstatements or omissions in the challenged registration statement.<sup>7</sup> For corporate issuers, who unlike other potential defendants do not have a statutory "due diligence" defense,<sup>8</sup> Section 11 liability has been described as "virtually absolute."<sup>9</sup> Moreover, statutory damages initially are presumed to have been caused by the alleged misstatements in the registration statement unless the defendants prove otherwise.<sup>10</sup> And, because Section 11 liability does not require fraudulent intent, plaintiffs are not required to comply with the particularized pleading requirements of the PSLRA or Rule 9(b) of the Federal Rules of Civil Procedure except when their claims "sound in fraud."<sup>11</sup>

To avail oneself of the lower burden of proof and almost strict liability of Section 11, however, a plaintiff must surmount several significant procedural obstacles, the most important of which is the restriction on standing to sue.<sup>12</sup> It has long been established that the Secu-

<sup>6</sup> *Herman & MacLean*, 459 U.S. at 381-82.

<sup>7</sup> 15 U.S.C. 77k(a); *Metz v. United Counties Bancorp*, 61 F. Supp. 2d 364, 377 (D.N.J. 1999).

<sup>8</sup> 15 U.S.C. 77k(b); *Herman & MacLean*, 459 U.S. at 382.

<sup>9</sup> *Herman & MacLean*, 459 U.S. at 382; *Lone Star Ladies Investment Club v. Schlitzky's Inc.*, 238 F.3d 363, 369 (5th Cir. 2001).

<sup>10</sup> See 15 U.S.C. § 77k(e); *McMahan & Co. v. Warehouse Entm't, Inc.*, 65 F.3d 1044, 1048 (2d Cir. 1995); *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 341-42 (2d Cir. 1987).

<sup>11</sup> *Lone Star Ladies*, 238 F.3d at 368; *Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994).

<sup>12</sup> *Harden v. Raffensperger, Hughes & Co.*, 933 F. Supp. 763, 766 (S.D. Ind. 1996) (cited approvingly in *Krim*, 2005 WL 469618 at \*3 & n.33). Other procedural hurdles for Section 11 claims include, for example, that a plaintiff affirmatively must plead compliance with the applicable statute of limitations. See 15 U.S.C. § 77m; *Bresson v. Thomson McKinnon Sec., Inc.*, 641 F. Supp. 338, 343 (S.D.N.Y. 1986); *Steiner v. Southmark Corp.*, 734 F. Supp. 269, 278 (N.D. Tex. 1990); *Quantum Overseas, N.V. v. Touche Ross & Co.*, 663 F. Supp. 658, 662 (S.D.N.Y. 1987); see also *Toombs v. Leone*, 777 F.2d 465, 468 (9th Cir. 1985) (plaintiff asserting Section 12 claim, which is governed by the same limitations provision as Section 11, must affirmatively plead compliance with the statute); *Davidson v. Wilson*, 973 F.2d 1391, 1402 n.8 (8th Cir. 1992) (1933 Act plaintiff must "affirmatively plead" with "specificity" facts demonstrating compliance with the statute of limitations); *Auslander*

rities Act generally is concerned solely with "the initial distribution of securities."<sup>13</sup> Early Section 11 decisions therefore made clear that its remedy was restricted to the "narrow class of persons" consisting of "those who purchased securities that are the direct subject of the prospectus and registration statement."<sup>14</sup> Courts attempting to interpret the language of Section 11 have differed, however, as to whether its coverage is restricted solely to investors who purchase directly in the challenged offering, or extends beyond to aftermarket purchasers who later buy those same shares. Decisions in the Third and Seventh Circuits, for example, have limited Section 11 to original purchasers only.<sup>15</sup> A larger number of Circuits, including the Second, Fifth, Eighth, Ninth and Tenth, have endorsed an interpretation that provides for potential Section 11 standing to a plaintiff who can "trace"<sup>16</sup> his aftermarket shares to the challenged offering.<sup>17</sup>

Even Circuits willing in principle to extend Section 11 standing to aftermarket purchasers who can trace have acknowledged, however, that the tracing requirement often will present a "problem of proof."<sup>18</sup> While tracing might be viewed as automatic in a "pure" market where only one offering has occurred and no other shares have become publicly tradable, there has long been a consensus among lower courts and litigants that in a "mixed" market comprised of shares from multiple sources, physical tracing of particular shares is virtually impossible.<sup>19</sup> This is because, since the early 1970s, the

*v. Energy Management Corp.*, 832 F.2d 354, 356 (6th Cir. 1987) (1933 Act plaintiff must "plead affirmatively" compliance with the statute of limitations).

<sup>13</sup> *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 861 (5th Cir. 2003); see also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975) ("The 1933 Act is a far narrower statute chiefly concerned with disclosure and fraud in connection with offerings of securities—primarily . . . initial distributions of newly issued stock from corporate issuers.") (emphasis added).

<sup>14</sup> *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786 (2d Cir. 1951).

<sup>15</sup> See *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 286 (3d Cir.), cert. denied, 506 U.S. 934 (1992); *Warren v. Crown American Realty Trust*, 1998 WL 725946, at \* 2-3 (W.D. Pa. Oct. 15, 1998), aff'd, 229 F.3d 1140 (3d Cir. 2000); *Franklin Life Ins. Co. v. Commonwealth Edison Co.*, 451 F. Supp. 602, 607 n.1 (C.D. Ill. 1978), aff'd, 598 F.2d 1109 (7th Cir. 1979), cert. denied, 444 U.S. 900 (1979).

<sup>16</sup> The term "tracing" was introduced in *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967), which granted standing only to those purchasers who could directly trace their shares to the offering in question, despite plaintiffs' protestations that "it is often impossible to determine whether previously traded shares are old or new, and that tracing is further complicated when stock is held in margin accounts in street names." *Id.* at 271-72. Accordingly, as originally articulated in *Barnes*, "tracing" was not intended as a means of relaxing Section 11's standing requirements, but rather as a method of ensuring its restricted availability.

<sup>17</sup> See *Rosenzweig*, 332 F.3d at 873; *Demaria v. Andersen*, 318 F.3d 170 (2d Cir. 2003); *Lee v. Ernst & Young, LLP*, 294 F.3d 969 (8th Cir. 2002); *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999).

<sup>18</sup> See, e.g., *Hertzberg*, 191 F.3d at 1080 & n.4.

<sup>19</sup> See, e.g., *Barnes*, 373 F.2d at 271-273 (requiring direct tracing despite plaintiffs' argument that "it is often impossible to determine whether previously traded shares are old or new, and that tracing is further complicated when stock is held in

vast majority of public companies' securities have been held in a stock clearing house, the Depository Trust Company (DTC), into which participating brokers have deposited the securities they hold in "street name." Purchases and sales are accomplished by electronic bookkeeping entries crediting or debiting totals of the brokerage firms' accounts, without requiring physical transfer of the shares.<sup>20</sup> Because the stock is held as a fungible mass by the DTC, it is impossible for any purchaser to ascertain the exact "origin" of the stock reflected in his account.

Because of the impossibility of physically tracing shares, Section 11 plaintiffs and their counsel have unsuccessfully attempted at various times to use statistical probabilities in one form or another to demonstrate Section 11 standing. A number of district court decisions in the 1980s and 1990s analyzed and rejected probabilistic theories of Section 11 standing and found them inconsistent with the language and purpose of the statute.<sup>21</sup> Until *Krim*, however, no Court of Appeals had addressed the viability of a statistical substitute for the tracing requirement.

**The *Krim v. pcOrder.com* Case.** *Krim* was filed by purchasers of then-publicly traded pcOrder.com stock, who alleged the company had issued false and misleading registration statements in its February 1999 IPO and December 1999 secondary offering. The plaintiffs asserted claims under Rule 10b-5 and Section 11 based on the same underlying facts. The Rule 10b-5 claims were dismissed with prejudice for failure to state a claim,<sup>22</sup> but given the lower pleading burden, the Section 11 claims survived the defendants' Rule 12(b)(6) motions.<sup>23</sup>

Plaintiffs were denied class certification, however, when the district court found that the proposed representatives and their counsel were not adequate to rep-

margin accounts in street names"); *In re Initial Public Offering Sec. Litig.*, 2004 WL 2297401, at \* 38 n.402 (S.D.N.Y. Oct. 13, 2004) ("The modern practice of electronic delivery and clearing of securities trades, in which all deposited shares of the same issue are held together in fungible bulk, makes it virtually impossible to trace shares to a registration statement once additional unregistered shares have entered the market."); *In re Crazy Eddie Sec. Litig.*, 792 F. Supp. 197, 200 (S.D.N.Y. 1992) ("[P]laintiffs concede that they have been unable to establish tracing, but they say that . . . this is now virtually impossible to meet. They ask the court to modify the tracing requirement so as to rescue their claims under Sections 11 and 12(2). . . . If Congress wishes to ease the burden on security holders such as plaintiffs, it can do so."); *Abbey v. Computer Memories, Inc.*, 634 F. Supp. 870, 875 (N.D. Cal. 1986) (requiring tracing despite argument that it was "unfair" because "many purchasers of stock on the open market will . . . be unable to fulfill the tracing requirement").

<sup>20</sup> See generally *Kirkwood v. Taylor*, 590 F. Supp. 1375, 1378-79 (D. Minn. 1984).

<sup>21</sup> *In re Quarterdeck Office Systems, Inc. Sec. Litig.*, 1993 WL 623310 at \* 2-3 (C.D. Cal. Sept. 30, 1993); *In re Elscint, Ltd. Sec. Litig.*, 674 F. Supp. 374, 379-82 (D. Mass. 1987); *Abbey*, 634 F. Supp. at 874; *Kirkwood*, 590 F. Supp. at 1378-81; see also *McFarland v. Memorex Corp.*, 493 F. Supp. 631, 641-42 (N.D. Cal. 1980); *Lorber v. Beebe*, 407 F. Supp. 279, 286-87 (S.D.N.Y. 1975).

<sup>22</sup> *Alcina v. pcOrder.com, Inc.*, 230 F. Supp. 2d 732 (W.D. Tex. 2002)

<sup>23</sup> *Krim v. pcOrder.com, Inc.*, 2002 WL 1185913 (W.D. Tex. April 12, 2002).

resent the putative class.<sup>24</sup> The district court further found that two of the three proposed representatives lacked Section 11 standing because they could not trace their shares to the offerings.<sup>25</sup> Although otherwise deemed inadequate to represent the class, the only candidate found to have Section 11 standing had purchased shares in the aftermarket at a time when the trial court determined that only pcOrder.com IPO shares comprised the available pool.<sup>26</sup>

The putative class representatives ultimately found to lack standing admitted that stock in the modern aftermarket is virtually impossible to trace to a particular offering. Using binomial statistics, however, they sought to establish Section 11 standing by demonstrating that there was high probability, greater than 99 percent in some instances, that each had purchased at least some shares attributable to the challenged offerings. After hearing evidence, including the testimony by the plaintiffs and proffered experts from both sides on tracing aftermarket shares, the district court found the claimants lacked Section 11 standing.<sup>27</sup>

Following denial of class certification, defendants made an offer of judgment to the sole plaintiff found to have standing for his maximum statutory damages of \$14,625, rendering his claims moot, and moved to dismiss the claims of the remaining individual plaintiffs for lack of standing. In opposition, as they had at the certification stage, plaintiffs offered only statistical evidence with respect to their aftermarket shares. For the same reasons articulated in its class certification denial, the district court rejected plaintiffs' arguments and dismissed their claims.<sup>28</sup>

On appeal, the Fifth Circuit confirmed its view that aftermarket purchasers "do not inevitably lack standing" and noted, for example, that tracing under Section 11 "is satisfied, as a matter of logic, when stock has only entered the market via a single offering."<sup>29</sup> The Court of Appeals strongly rejected, however, the plaintiffs' suggestion that simple calculations of probability demonstrate Section 11 standing by a preponderance of the evidence. The Court was "persuaded that accepting such 'statistical tracing' would impermissibly expand the statute's standing requirement."<sup>30</sup> The Court noted:

The fallacy of Appellants['] position is demonstrated with the following analogy. Taking a United States resident at random, there is a 99.83% chance that she will be from somewhere other than Wyoming. Does this high statistical likelihood alone, assuming for whatever reason there is no other information available, mean that she can avail herself of diversity jurisdiction in a suit against a Wyoming resident? Surely not.<sup>31</sup>

<sup>24</sup> *Krim v. pcOrder.com, Inc.*, 210 F.R.D. 581, 587-89, 589-91 (W.D. Tex. 2002). The Fifth Circuit denied a request for an interlocutory appeal on class certification. *Krim v. pcOrder.com, Inc.*, No. 03-00001 (5th Cir. Mar. 18, 2003).

<sup>25</sup> *Krim*, 210 F.R.D. at 586-87.

<sup>26</sup> *Krim*, 210 F.R.D. at 586.

<sup>27</sup> *Krim*, 210 F.R.D. at 587.

<sup>28</sup> *Krim v. pcOrder.com, Inc.*, 2003 WL 21076787, at \*2 & n.1 (W.D. Tex. May 5, 2003).

<sup>29</sup> This holding was consistent with the Fifth Circuit's earlier decision permitting tracing in Section 11 cases, *Rosenzweig*, 332 F.3d at 873, where only one public offering had occurred.

<sup>30</sup> *Krim*, 2005 WL 469618, at \* 4.

<sup>31</sup> *Id.*

The Fifth Circuit acknowledged that at the time of the Securities Act's enactment Congress "was not confronted with the widespread practice of holding stock in street name."<sup>32</sup> The Court found, however, that even if "present market realities, given the fungibility of stock held in street name, . . . render Section 11 standing ineffective as a practical matter . . . it is an issue properly addressed by Congress."<sup>33</sup> The Court noted the absence of any lower court authority adopting probabilities as a substitute for direct tracing, and commented:

Given that the [Securities Act] has been in existence for over 70 years and such elementary statistical calculations have been around for centuries, it is difficult to conclude that this is a coincidence.<sup>34</sup>

The Court rejected the appellants' attempted analogies to standing thresholds under other federal statutes, such as the Clean Water Act, which expressly provides standing for persons "having an interest which is or may be adversely affected."<sup>35</sup> The Court noted that Section 11 standing, by contrast, is limited to "those who actually purchased the tainted stock, not on the whole class of those who possibly purchased tainted shares—or, to put it another way, are at risk of having purchased tainted shares."<sup>36</sup> The Fifth Circuit also rejected appellants' comparisons with DNA evidence, noting that (i) in most trials, DNA evidence does not stand alone, and (ii) DNA is "more particularistic than the statistics here."<sup>37</sup> The Court noted, for example, that while DNA evidence serves to narrow the universe of possible sources, the statistics offered by plaintiffs could not conclusively eliminate potential Section 11 claimants. Indeed, in many cases, the statistics would confer Section 11 standing on all aftermarket purchasers regardless of which shares they actually purchased. Such a result, the Fifth Circuit said, "cannot be squared with the statutory language—that is, with what Congress intended."<sup>38</sup> The Court "decline[d] the invitation to reach further than the statute."<sup>39</sup>

**The Future Implications of *Krim*.** The Fifth Circuit's decision in *Krim*, being the first of its kind among appellate courts, carries with it important implications for participants in public offerings. As a practical matter, the decision means that once shares from a public offering become commingled with shares from other sources—such as other public offerings, registration-exempt sales, or option exercises—investors who purchased in the aftermarket ordinarily will not have a Section 11 claim. Such purchasers will be relegated to their remedies under Rule 10b-5 and will be held to the attendant higher standards of pleading and proof. Moreover, even in putative class actions where the named plaintiff has standing as an original purchaser in the challenged offering, the *Krim* decision's rejection of statistical probabilities strongly suggests that any attempt to obtain certification of a Section 11 class that includes aftermarket purchasers will fail in most cases, as the threshold issue of standing will not be susceptible to

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at \* 5.

<sup>35</sup> *Id.* at \* 6 (emphasis added).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at \* 4.

<sup>39</sup> *Id.*

common proof.<sup>40</sup> The resulting exclusion of aftermarket purchasers as Section 11 claimants potentially may decrease a plaintiff-style damage analysis by hundreds of millions of dollars—a not insubstantial figure for any public company.

Just as Section 12 claims have waned in the wake of the Supreme Court's decision in *Gustafson*, issuers may

<sup>40</sup> See *In re Initial Public Offering Sec. Litig.*, 2004 WL 2297401, at \* 38.

### Note to Readers

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see a decline in Section 11 filings as the Fifth Circuit's holding in *Krim* takes root in other Circuits. Meanwhile, the procedural history of *Krim* suggests that Section 11 defendants should consider raising the standing issue early and often. At the pleading stage, defense counsel should challenge in appropriate circumstances the customary, conclusory allegation that a Section 11 plaintiff's stock is "traceable" to the offering in question.<sup>41</sup> Section 11 defendants also may consider putting a plaintiff to his proof on the standing issue as soon as possible, either through an early summary judgment motion or in opposition to class certification. In addition to the possibility of reducing or eliminating a defendant's Section 11 exposure, pursuing an early standing ruling provides an opportunity to avoid burdensome merits discovery on a Section 11 claim that, while perhaps deemed adequately pled, is ultimately doomed to fail because of the absence of a named plaintiff with standing or the lack of a certifiable class.

<sup>41</sup> See *Brody v. Homestore, Inc.*, 2003 WL 22127108, at \* 3 (C.D. Cal. Aug. 8, 2003) (dismissing Section 11 claim; conclusory allegation that plaintiff purchased stock "pursuant to and traceable to" registration statement was insufficient to establish standing).