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REPORT

Registration of Securities

Institutional Buyer Beware: Recent Decisions Reinforce Narrow Range of Remedies Available to QIBs in Rule 144A Offerings

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Rule 144A private placements have become a favored mechanism for cost-effectively and timely placing securities, particularly high-yield and asset-backed securities, in the capital markets. Rule 144A provides generally that securities sold to ''Qualified Institutional Buyers'' (''QIBs'')—typically institutional investors with more than $100 million to invest—will not be deemed to have been sold in a public offering under the Securities Act of 1933. Rule 144A offers involve the private placement to a QIB or QIBs of securities through a quasi–underwriter, known as an ''initial purchaser.''[1] Rule 144A offerings are often followed shortly thereafter by a registered exchange offering, known as an ''A/B exchange,'' involving the issuance of registered securities which are exchanged for the privately placed 144A securities. Rule 144A offerings have grown enormously in popularity since Rule 144A was issued in 1990. Roughly two-thirds to three-quarters of high-yield offerings are now accomplished by a Rule 144A private placement, often followed by an A/B exchange.

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In releasing Rule 144A, the Securities and Exchange Commission recognized that ''certain institutions can fend for themselves and, therefore, offers and sales to such institutions do not involve a public offering.'' *In re Hayes Lemmerz Int'l, Inc. Equity Sec. Litig. v. Cucuz*, 271 F. Supp. 2d 1007 (E.D. Mich. 2003) (quoting SEC Rel. No. 33-6806, 1988 SEC LEXIS 2104, *51 (Oct. 25, 1988)). The question arises, however: What tools are available to QIBs in the event that they wish to fend for themselves through litigation?

Recent judicial decisions have largely reinforced the limited rights and remedies available to QIBs who may have been misled in a Rule 144A offering. In particular, several recent decisions strongly suggest that buyers in a private placement under Rule 144A are left with little

[1] A private placement effected pursuant to Rule 144A is often referred to as a ''144A resale.''

more than Rule 10b-5 (along with its onerous pleading requirements) and state law causes of action, in the event that they are misled by a private placement offering memorandum. Yet, in three recent decisions, courts have permitted QIBs to survive a motion to dismiss on the theory that an ostensible private placement under 144A was, in reality, a public offering and that, as a consequence, a private right of action potentially exists under the '33 Act for misstatements made in a purported 144A offering memorandum. The law in this area nonetheless still remains largely a cautionary tale for QIBs.

144A Offerings and Liability Under the Federal Securities Laws.

For purposes of liability in connection with a Rule 144A resale and A/B exchange, both the Securities Act of 1933, 15 U.S.C. §§ 77a *et seq*. (the "33 Act"), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq*. (the "34 Act"), are relevant. All things being equal, and given a choice, a QIB/plaintiff would prefer to make a claim for defective disclosure in a 144A or A/B exchange transaction under the '33 Act because of the lower standard of proof required to establish a violation for defective disclosure. While the '33 Act imposes liability for defective disclosures on the basis of near strict liability in certain circumstances and mere negligence in others, transactions to which the '33 Act applies are relatively limited. The '34 Act, on the other hand, has wider applicability and generally encompasses a broader array of defendants. Because claims under this statute are based on fraud and require proof of *scienter*, however, the '34 Act erects a higher hurdle of both pleading a claim and proving a violation.

Liability Under the Securities Act of 1933

Section 11. A Rule 144A resale does not involve the preparation or filing of a registration statement, and there should, therefore, be no liability under Section 11 of the Securities Act for misstatements contained in a 144A offering memorandum. Section 11 covers only defective disclosures made in a "registration statement."[2] *See* 15 U.S.C. § 77k. While a Rule 144A offering memorandum often looks like the prospectus portions of a registration statement, the offering memorandum is nevertheless not a "registration statement" within the meaning of the Securities Act. *See In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371, 430 (S.D.N.Y. 2001); *see also In re Worldcom Sec. Litig.* 294 F. Supp. 2d 431, 456 (S.D.N.Y 2003) ("plaintiffs admit they can bring no Section 11 claim based on the December 2000 Offering because it was exempt from registration requirements other than as a private placement"); *In re Safety-Kleen Corp. Bondholders Litig.*, C.A. 3:00-1145-17 Order (March 27, 2002).

This lack of any Section 11 liability in connection with a 144A resale contrasts sharply with the disclosure law as it applies to an underwritten public offering of high-yield debt. The market and the participants, the pricing and the discounts, the format and the substance of the disclosure may be the same in a 144A resale and underwritten public offering, but Section 11 liability in all likelihood attaches only to the underwritten public offering and not to the Rule 144A resale.[3]

The A/B exchange, on the other hand, does involve a registration statement and, as a consequence, an issuer would, if it repeated an offering memorandum's defective disclosures in the registration statement or made new defective disclosures, likely have Section 11 "strict liability" for the misstatements contained in the A/B exchange offering materials. 15 U.S.C. § 77k. So, too, an issuer's directors and officers would have liability, subject to the statute's due diligence defense. *Id.* But, ordinarily, the investment bank/initial purchaser that helped prepare the Rule 144A offering memorandum does not participate in any way in the A/B exchange, and it is consequently unlikely that the initial purchaser would have Section 11 liability for defects in the A/B exchange registration statement. *See In re Livent*, 151 F. Supp. 2d at 432 ("Therefore, this court concludes that § 11 liability for securities purchased pursuant to a registration statement does not apply to initial purchasers of unregistered securities who were not directly involved in the preparation of the registration statement or in the subsequent exchange for registered securities of unregistered securities that the initial purchasers no longer held."); *see also* Letter from David M. Becker, General Counsel, Securities and Exchange Commission, to Honorable Joseph M. Anderson dated Aug. 9, 2001, as *amicus curiae*, *In re Safety-Kleen Bondholders Litig.*, C.A. 3:00-1145-17(D.S.C.)(herein the "*Safety-Kleen* Letter").

If liability can be established, Section 11 provides for the recovery of the "amount paid" for the B securities, less the value or price of the B securities either on the day of suit or when sold.[4] 15 U.S.C. § 77k. The inquiry

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[2] Specifically, Section 11 provides as follows: "(a) 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 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 . . . ; and

(5) every underwriter with respect to such security."

[3] It is conceivable—though, as discussed below, unlikely—that a court might integrate the 144A resale with the follow-on A/B exchange and impose Section 11 liability on participants involved in any phase of the entire integrated transaction. *Cf. In re Livent*, 151 F. Supp. 2d. at 431-32; *but see Safety-Kleen* Letter at ¶¶ 11 and 12.

[4] With respect to damages, Section 11 provides generally as follows: "The suit authorized under subsection (a) 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

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then shifts to the ''amount paid'' by a QIB for the B securities at the time of the A/B exchange. A court could take the position that what was ''paid'' for the B security was an A security, the value of which necessarily tracks that of the B security. This view of the A/B exchange effectively would eliminate any recovery of damages, since virtually by definition the ''amount paid'' (*i.e.*, the A security) equals what was received (*i.e.*, the B security). The United States District Court for the District of South Carolina in the *Safety-Kleen* bondholder litigation came to this very conclusion regarding the possible damages arising out of an A/B exchange transaction. *In re Safety-Kleen Bondholders Litig.*, C.A. No. 3:00-1145-17 at 2 (''no [Section 11] damages can be demonstrated because the transaction involves two sets of identical bonds'').

Alternatively, it is possible—but not likely—that a court would integrate the A/B exchange with the 144A resale to find that a 144A resale is essentially the start of a public offering of securities and that damages from the A/B exchange may, therefore, be calculated by reference to the ''amount paid'' for the A securities in the original Rule 144A resale. *Cf. In re Livent*, 151 F. Supp. 2d at 431-32; but *see Safety-Kleen* Letter at ¶11 *ff*. (''We do not agree that because the Rule 144A offering contemplated a subsequent registered exchange offer, those who participated in the Rule 144A offering were underwriters in that exchange offer.'').[5] Viewed from this perspective, for example, a court could determine the ''amount paid'' for the B securities based either on the original purchase price of the A securities or the value of the A securities in the PORTAL Market at the time of the A/B exchange.[6] The *Safety-Kleen* court, for one, specifically rejected this approach. *In re Safety-Kleen Bondholders Litig.*, C.A. No. 3:00-1145-17 at 2.

Section 12(a)(2) and the 144A Offering Memorandum. Section 12(a)(2) imposes liability for material misstatements in a ''prospectus'' or related ''oral communication.''[7] Until mid-1995, securities counsel for institutional high-yield purchasers, as well as the SEC and other practitioners, had thought that a Rule 144A offering memorandum might be considered a ''prospectus'' within the meaning of Section 12(a)(2). *See, e.g., Safety-Kleen* Letter at ¶ 9. But, in 1995, the Supreme Court, in *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995), made clear that Section 12(a)(2) applies *only* to a prospectus issued in a transaction registered or required to be registered under the '33 Act and to oral communications directly associated with that prospectus. *Id.* at 569-70.[8] Moreover, ''the word 'prospectus' is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder.'' *Id.* at 584. While this narrow reading of Section 12(a)(2) has been roundly criticized by commentators,[9] it has been widely followed by the lower federal courts so as to preclude claims arising out of transactions previously thought to fall within the scope of Section 12(a)(2). *See e.g. Laser Mortgage Mgmt., Inc. v. Asset Securities Corp.*, No. 00 CIV. 8100 (NRB) 2001 WL 102407 (S.D.N.Y.).

Because Rule 144A resales do not involve the registered public offering of securities, there is likely no liability under Section 12(a)(2) for misstatements con-

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.''

[5] The SEC's position in its *Safety-Kleen* Letter comports with the SEC's established position on A/B exchanges generally, as expressed in the *Exxon Capital* and *Morgan Stanley* No-Action Letters and their progeny. *See* Exxon Capital Holding Corp., SEC No-Action Letter (May 13, 1988); Morgan Stanley & Co. No-Action Letter (June 5, 1991). As General Counsel Becker indicated in the *Safety-Kleen* Letter, the consequences of integrating the Rule 144A resale with the 144 A/B exchange would be to greatly diminish the usefulness of Rule 144A: ''The consequences of accepting plaintiffs' integration argument would be significant, as two-step transactions similar to the one at issue in this case account for the majority of registered high-yield bond offerings and a significant portion of all initial public offerings.'' *Id.*; *see also In re Livent*, 151 F. Supp. 2d at 431-32 (''To import underwriter liability for entities that serve as initial purchasers prior to an Exxon Capital Exchange would render Rule 144A ineffective for a very substantial number of securities transactions and defeat the capital market financing objectives the Rule 144A exemption was designed to achieve, a fact which undoubtedly would have been known and addressed by the promulgation of Rule 144A if such a major exception was intended.'').

[6] The PORTAL [for Private Offerings, Resales and Trading through Automated Linkages] market is an electronic trading platform created and regulated by the NASD to faciliate trasnactions between QIBs in securities privately placed under Rule 144A.

[7] Specifically, Section 12(a)(2) provides as follows: ''Any person who: (1) offers or sells a security in violation of section 5, or (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraphs (2) and (14) of subsection (a) thereof), 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), 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.''

[8] *Gustafson* makes clear that a prospectus is to be understood, not merely by reference to whether an offering is deemed to be a public offering, but also by reference to whether the offering includes the use of a ''registration statement'' within the meaning of the '33 Act: ''[Section 10's] mandate is unqualified: '[A] prospectus . . . shall contain the information contained in the registration statement.' '' *Gustafson*, 513 U.S. at 568-69. Further, ''whatever else 'prospectus' may mean, the term is confined to a document that, absent an overriding exemption [under Section 3], must include the 'information contained in the registration statement.' '' *Id.* at 569.

[9] See, e.g., Therese H. Maynard, The Impact of Gustafson and Its Methodology, 24 Securities Regulation Law Journal, 61 (1996); Ted J. Fiflis, Gustafson vs. Alloyd Co., Inc. Judicial vs. Legislative Power, 23 Securities Regulation Law Journal, 423 (1996).

tained in a 144A offering memorandum. *In re Worldcom Sec. Litig.*, 294 F. Supp 2d at 455-56; *In re Hayes Lemmerz Int'l, Inc. Equity Sec. Litig.*, 271 F. Supp. 2d at 1028-29; *AIG Global Securities Lending v. Banc of America Securities LLC*, 254 F. Supp. 2d 373, 388-89 (S.D.N.Y. 2003). *In re Safety-Kleen Bondholders Litig.*, C.A. No. 3:00–1145-17 at 3.

'Public' Private Placements. Recent decisions, however, have questioned whether or not a Rule 144A private placement might nonetheless be considered a public offering within the meaning of *Gustafson*. In *AAL High Yield Bond Fund v. Ruttenberg*, C.A. No. 00-C-1404-S (Oct. 1, 2001) (hereinafter "*Ruttenberg*"), the court refused to dismiss a count under Section 12(a)(2) arising out of a 144A resale, holding that:

> The line between public offerings and private placements is neither well-defined nor easily decipherable. Even after *Gustafson*, this distinction remains hotly debated by the plaintiffs' and defendants' bars, and has not been entirely resolved by the courts. Ultimately the question is one of fact and demands an inquiry into factors such as the marketing strategies employed, the scope of the Offering and the 'sophistication' of the offerees. . . . The 'private placement' argument as a bar to Plaintiffs' entitlement to present evidence on this claim is rejected.

Id. at 15-16.

Likewise, the court in *Steed Finance LDC v. Nomura Securities I'ntl, Inc.*, 00 CIV 8058 (NRB), 2001 WL 1111508, *1, *6 (S.D.N.Y.), refused to dismiss a complaint alleging (i) that a private placement nevertheless constituted a public offering of securities; and (ii) that a simultaneous public offering should be integrated with a private placement (under Section 4(2)) and the entire transaction considered a registered public offering for Section 12(a)(2) purposes. On the first point, the court stated that "[a]lthough it appears unlikely that the Private Certificates at issue were sold in a manner constituting a public offering, we can, of course, form no conclusions at this stage." *Id.* On the second point, the court stated, "[s]imilarly, whether the alleged simultaneous public and private offerings may be considered a single integrated offering is likewise unsuitable for resolution at this stage." *Id.* (citing cases); *but cf. Safety-Kleen* Letter at ¶¶ 11-16.[10]

More recently, the court presiding over the Enron securities litigation refused to dismiss a § 12(a)(2) count based on alleged misstatements in a 144A offering memorandum. *See In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 310 F. Supp. 2d, 819, 861-866 (S.D. Tex. 2004). In *Enron*, the court held that "what constitutes a public offering turns on a number of factors and requires a fact-specific analysis on a case by case basis." *Id.* at 862. The Court then pointed to several factors concerning the offering in question that brought it within the letter of Rule 144A. *Id*. The Court, however, refused to rule that, because the offering appeared to fall within the ambit of Rule 144A, it was necessarily a private placement foreclosing Section 12(a)(2) liability: "[T]he law is not clear as to whether an offering memorandum that is not exempt under § 4(2) but that falls under Rule 144A or Regulation S is necessarily a private offering." *Enron* raises the prospect that a QIB could avoid early dismissal of a '33 Act claim alleging misrepresentations in the 144A offering memorandum by challenging whether a 144A sale was in fact a *bona fide* private placement under Section 4(2) of the '33 Act.

The holdings in *Ruttenberg*, *Steed Financial* and *Enron* appear to overlook the importance placed by *Gustafson* on the relationship between a '33 Act "prospectus," on the one hand, and the registration statement, on the other hand. *Gustafson* evidently requires a prospectus and a *registered* public offering before Section 12(a)(2) comes into play. *See Gustafson*, 513 U.S. at 568-69.[11] Unless the transaction at issue involves a prospectus, understood as "a document that, absent an overriding exemption [under Section 3], must include the 'information contained in the registration statement,' " Section 12(a)(2) is likely not applicable under *Gustafson*.[12] Because a Rule 144A resale does not involve a transaction registered under the '33 Act, Section 12(a)(2) does not apply to any defective disclosures that may be made in the offering memorandum or any oral communications associated therewith. *Cf. id.*

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[10] Along similar lines, the SEC has argued that the circumstances of the transaction at issue in *Gustafson* were quite distinct from the circumstances of the typical 144A resale, and have raised the possibility that the Supreme Court might, therefore, find a Rule 144A offering memorandum to be sufficiently akin to a statutory prospectus to give rise to liability under Section 12(a)(2). As General Counsel Becker noted in the *Safety-Kleen* Letter:

> There are significant differences between the Rule 144A transaction . . . and the private transaction that was held not to be subject to Section 12(a)(2) in *Gustafson*. The sale in *Gustafson* was indisputably a private one in which three shareholders sold their stock to a single corporate buyer, pursuant to a negotiated contract. . . . [T]he offering memorandum in the [the *Safety Kleen*] Rule 144A offering was an important part of the entire transaction, and it was understood by all parties that the memorandum would likely form the basis for the registration statement and prospectus in the subsequent [A/B] exchange offer. Perhaps in light of the factual distinctions between [the *Safety-Kleen* 144A resale] and *Gustafson*, the Supreme Court might have accepted plaintiffs' theory in this case that the offering memorandum was a prospectus.

Safety-Kleen Letter at ¶ 7. *Cf. Ruttenberg,* C.A. No. 00-C-1404-S at 15-16.

[11] The court in *Ruttenberg* quotes *Gustafson* for the following "principle": " '[L]iability imposed by § 12(a)(2) has nothing to do with the fact of registration,' but rather with 'whether a prospectus is a document soliciting the public to purchase securities from the issuer.' " *Ruttenberg* at 12; *compare Gustafson,* at 568-69 ("[W]hatever else 'prospectus' may mean, the term is confined to a document that, absent an overriding exemption, must include the 'information contained in the registration statement.' "); *see also Id*. at 581 ("It will be recalled that as to private transactions, such as the Alloyd purchase, there will never have been a registration statement. If § 12(2) liability were imposed here, it would cover transactions not within the contemplated reach of the statute."); *Id*. at 583 ("Nothing in the legislative history, moreover, suggests Congress intended to create two types of prospectuses, a formal prospectus required to comply with both § § 10 and 12, and a second, less formal prospectus, to which only § 12 would be applicable.").

[12] Section 12(a)(2) also imposes liability for misstatements contained in an "oral communication." *See* 15 U.S.C. § 77l(2). The law is well settled, however, that the term "oral communication" in Section 12(a)(2) applies only to oral communications that relate to a statutory prospectus. *See Gustafson*, 513 U.S. at 567.

Section 12(a)(2) and the A/B Exchange. The application of Section 12(a)(2) in the context of an A/B exchange is more complicated. Although we are not aware of any case so holding, there is a significant possibility that Section 12(a)(2) would apply to the prospectus issued in an A/B Exchange notwithstanding that an A/B exchange is not itself a public offering. *Cf. Gustafson*, 513 U.S. at 568-69. The prospectus in the typical A/B exchange is intended to be a disclosure document to facilitate the resale of the securities and ''contain[s] the information contained in the registration statement.'' *Gustafson*, 513 U.S. at 568-69. Consequently, an issuer that repeats defective disclosures from the offering memorandum or introduces new defective disclosures in the A/B exchange prospectus is at significant risk of Section 12(a)(2) liability.[13] *Cf. In re Livent*, 151 F. Supp. 2d at 432.

Section 12(a)(2) provides for liability *only* on the part of one who ''offers or sells a security.'' 15 U.S.C. § 77l(a)(2). This restriction has been applied to limit liability *only* to those who actually sold or offered to sell the security or to one who was ''directly involved in the actual solicitation of a securities purchase.'' *See Pinter v. Dahl*, 486 U.S. 644, n. 21 (1988). It is, accordingly, unlikely that an initial purchaser would face liability under Section 12(a)(2) because a 144A initial purchaser is rarely, if ever, a ''seller'' in the A/B exchange. The result might be different, however, if it could be shown that the initial purchaser was directly involved in the solicitation efforts leading up to the A/B exchange. *See In re Livent*, 151 F. Supp. 2d at 432 (''CIBC may stand in a very different position from PaineWebber and Furman Selz because the Noteholders indicate in their opposition memorandum that CIBC sold notes directly to them.''); *cf. Pinter*, 486 U.S. at 643-46. In the typical A/B exchange, the ''seller'' of the B securities is the issuer. A QIB acquiring B securities issued based on a prospectus containing a material misstatement would most likely be able to proceed against the issuer under Section 12(a)(2) to the extent the issuer's prospectus for the ''B'' exchange contained a material misstatement or omission in connection with the offering of a security. As with the Section 11 claim, moreover, a QIB would not have to plead or prove that the issuer/seller acted intentionally or with recklessness. *See* 15 U.S.C. § 771 (a)(2).

Upon establishing liability, the remedy available under Section 12(a)(2) would depend upon whether the QIB/plaintiff still owned the B securities. If the QIB had already sold the B securities, the QIB essentially would be entitled to recover the price it paid for the securities, less the price received when the securities were sold. As with the Section 11 damages discussed above, it is not clear how a court would determine exactly what a QIB would be entitled to receive as damages in this situation. In other words, a court would need to determine what the ''price'' was for the B securities, facing all the uncertainties discussed above. *See In re Safety-Kleen Bondholders Litig.*, C.A. No. 3:00 1145-17 at 2 (holding that under Section 11, ''no damages can be demonstrated because the transaction involves two sets of identical bonds''). If, on the other hand, the QIB/plaintiff still held the B securities in question, it would only be entitled to rescission under the terms of the statute. 15 U.S.C. § 771 (a)(2). Such a rescissionary remedy, however, could prove hollow if ''rescission'' were applied formalistically to the A/B exchange: The QIB would merely be entitled to the return of the restricted A securities. Accordingly, if the QIB brought a claim under Section 12(a)(2) while still holding the B securities, it would have to argue that the court should, in essence, look back to the 144A resale and rescind that part of the overall transaction as well. Only in that way, by recovering the amount originally paid for the A securities, would the QIB obtain effective relief. The case law in this specific area has not been developed, and it is difficult to predict whether any such ''look back'' argument for damages would hold sway with the courts. What discussion of this general approach is found in the relevant authorities is not encouraging for QIB/plaintiffs. *See In re Safety-Kleen Bondholders Litig.*, C.A. No. 3:00 1145-17 at 2; *In re Livent*, 151 F. Supp. 2d at 430-32.

144A Offerings and Liability Under the Exchange Act Section 10(b), along with Rule 10b-5 promulgated by the SEC, imposes liability where (1) a defendant has made a materially false or misleading statement or omitted to state a material fact necessary to make a statement not misleading; (2) the defendant acted with an intent to defraud; (3) the plaintiff relied on the misstatement; and (4) the plaintiff was injured as a result.[14] 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. Any person who actually ''uses or employs'' a manipulative or fraudulent device in connection with the purchase or sale of a security may be liable for a violation of the '34 Act. In this way, the '34 Act does not restrict who may be held liable as do Sections 11 and 12(a)(2) of the '33 Act.

Of course, while Section 10(b) does not restrict the field of potential defendants to narrowly drawn catego-

[13] There is an argument under *Gustafson* that Section 12(a)(2) would not apply to the A/B exchange, since the exchange was not a sale ''to the public'' even though a '33 Act prospectus was used in the exchange. *Gustafson* dealt with whether representations made in connection with a stock purchase agreement between two private parties exposed the selling party to liability under Section 12(a)(2), 513 U.S. at 564-65, a factual setting quite different from that present in an A/B exchange. The Supreme Court's decision is not entirely consistent in its reasoning, at times describing the ''determinative question'' as whether the contract at issue was a ''prospectus,'' *id.* at 568, while at others phrasing the key inquiry in terms of whether the transact

ion was a ''public offering'' using a prospectus. *Id.* at 583. In an A/B exchange, a prospectus under the '33 Act is used, but not in connection with a ''public offering'' *per se*. Instead, the prospectus is used to facilitate an exchange of securities in which unregistered ''A'' securities are exchanged for the registered and tradable ''B'' securities. Thus, the impact of *Gustafson* on this specific transaction is not clear.

[14] Specifically, Section 10(b) provides as follows: ''It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.''

ries as does the '33 Act, its reach does not extend to those who merely aided or abetted someone else in connection with a Section 10(b) violation. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (rejecting ''aiding and abetting'' liability under Section 10(b)). To be liable, a defendant must have itself *actually* engaged in the prohibited conduct. *See, e.g., In re Enron Corp. Sec. Litig.*, C.A. No. H-01-3624, 2002 WL 31854963, *1, *16-1 24 (S.D. Tex. Dec. 20, 2002). Moreover, the standard for liability under Section 10(b) is substantially higher than that required under the '33 Act. In addition to proving the added substantive elements of fraud and reliance, a plaintiff must meet the heightened pleading standards of Fed. R. Civ. P. 9(b) requiring the plaintiff to describe the alleged fraud in the complaint with ''particularity.'' 15 U.S.C. § 78u-4(b)(1).

The difficulties inherent in bringing a claim under Section 10(b) were further increased when Congress passed the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67 (the ''Reform Act''), which imposed stricter pleading requirements for claims under 10(b), stayed discovery during the pendency of motions to dismiss, and provided for certain ''safe harbors'' for forward-looking statements. *See, e.g.*, 15 U.S.C. § § 78u-4 and 78u-5. The practical effect of these amendments has been to erect an even higher hurdle for asserting a '34 Act claim and to slow or possibly preclude pursuing discovery to support such a claim. These additional factors simply underscore the attractiveness of asserting claims under the '33 Act when possible.[15]

If a plaintiff/purchaser establishes a violation of Section 10(b), it is entitled to recover its damages caused by the violation. Although the '34 Act itself is silent as to the appropriate measure of damages for a violation of Section 10(b), it is likely that a plaintiff will be able to recover ''the excess of what he paid over the value of what he got.'' *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971); *see also Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997) (same). In other words, the plaintiff can recover the difference between the price paid for the security and the true value of the security on the day of purchase ''but for'' the fraud.

[15] In view of the legal hurdles facing QIBs under the '33 Act, Section 10(b) may well be the only federal securities remedy available for alleged misstatements in an offering memorandum. Thus after dismissing a Section 11 and Section 12(a)(2) count for the reasons discussed herein, the Court in the *Safety-Kleen* litigation allowed the QIB-plaintiffs to proceed on their claim under Section 10(b) and Rule 10b-5. *In re Safety-Kleen Bondholders Litig.*, C.A. No. 3:00-1145-17 at 3.

144A Offerings and Liability Under Blue Sky Laws and Common Law

When facing an actual situation of defective disclosure in connection with a Rule 144A resale and an A/B exchange, it is not sufficient to analyze the matter only under the federal securities laws. There is an entire separate body of law—state law—that may provide an attractive avenue for recovery for such defective disclosures. *See Northwestern Mutual Life Ins. Co. v. Banc of America Securities, LLC*, 254 F. Supp. 2d. 390, 392-93 (S.D.N.Y. 2003). Moreover, the threshold for establishing liability is often lower under state ''blue sky'' anti-fraud/civil liability provisions as compared with rights of action under federal law. For example, state blue sky statutes typically do not require proof of either scienter or reliance.[16] The common law count of negligent misrepresentation might provide a similarly effective vehicle for pursuing claims in the 144A context. Additionally, a monetary recovery, enhanced by multiple damages and attorney fees, may also be available under relevant state consumer protection laws. *Cf. Twin Fires Investment LLC v. Morgan Stanley Dean Witter & Co.*, C.A. No. 00-00751-F. 2002 WL 31875204 (Mass. Super.) (applying Massachusetts's Ch. 93A to a securities transaction).

State blue sky laws are not often used, or even seriously considered, in connection with defective disclosure claims brought by class action plaintiffs attorneys. Ordinarily, the lawyers representing the plaintiffs in such actions have an incentive to ''recruit'' the largest class of ''victims'' possible in order to drive up the amount that can be recovered in settlement. There is a significant limitation on the availability of a state law cause of action in the class action context, however. The Securities Litigation Uniform Standards Act, 15 U.S.C. § 78bb(f) (''SLUSA''), provides for ''the removal of state court securities class actions to federal court and abolishes state law causes of action in securities fraud [class action] cases involving securities covered by the federal statutes.'' *See In re Livent*, 151 F. Supp. 2d. at 442. As a result, these plaintiffs' lawyers are not inclined to look to state laws that require less in the way of individualized proof in order to prevail. However, an institutional investor or even a handful of institutional investors who find that they were misled in the 144A resale might find it economical to avail themselves, without running afoul of SLUSA, of state blue sky anti-fraud provisions in a non-class action against the issuer and initial purchaser. *See Northwestern Mutual Life Ins. Co.*, 254 F. Supp. 2d at 392. Remedies under state law should, in any event, always be considered by a wronged QIB.

[16] The Uniform Securities Act of 1956, which has been adopted by a number of states, holds civilly liable anyone ''who offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, the buyer not knowing of the untruth or omission, and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.'' *See e.g.* Mass. Gen. Laws, Ch. 110A, § 410(a)(2).

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