TESTING THE SUFFICIENCY OF CLAIMS BOUGHT UNDER SECTIONS 11 AND 12(A)(2) OF THE SECURITIES ACT IN THE POST-REFORM ACT ERA

MICHAEL J. CHEPIGA
SIMPSON THACHER & BARTLETT LLP

DECEMBER 15, 2001

Claims brought under sections 11 and 12 of the Securities Act raise different issues from those brought under the Exchange Act. *See Herman & Maclean v. Huddleston*, 459 U.S. 375 (1983). Unlike the typical 10b-5 claim, plaintiffs bringing claims under Section 11 and 12 are not required to plead scienter or reliance. Defendants may nonetheless test the sufficiency of Securities Act claims on a variety of grounds. This outline sets forth these grounds and highlights the key legal issues that must be considered prior to any motion practice. The availability of each ground will of course depend on the facts and circumstances of each individual case.

Part I of this outline sets forth the basic standards of liability under sections 11 and 12. Part II discusses the following issues that should be considered in assessing the sufficiency of claims brought under sections 11 and 12: (1) safe harbor; (2) bespeaks caution doctrine; (3) truthfulness of statements/disclosure of risk; (4) Section 12 "sellers"; (5) standing/traceability; (6) Rule 9; and (7) statute of limitations. Finally, Part III briefly discusses the issue of loss causation.

I. Liability Under Sections 11 and 12

A. Section 11 provides a cause of action for misstatements and omissions in registration statements against an enumerated class of defendants, including, among others, persons signing the registration statement, directors of the registrant, and underwriters. The statute provides that such persons may be liable if the registration statement "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." 15 U.S.C. §77k(a).

1. To state a claim under section 11, a plaintiff must allege that: (1) the plaintiff purchased securities traceable to an effective registration statement; (2) defendant(s) fall within the statutorily enumerated categories; and (3) the registration statement, at the time it became effective, contained a material misstatement or omission. *In re MobileMedia Sec. Litig.*, 28 F.Supp.2d 901, 923 (D.N.J. 1998).

2. Liability against the issuer of a security is "virtually absolute." *Herman & Maclean*, 459 U.S. at 381. A plaintiff need not plead fraud, reliance, motive, intent, knowledge or scienter under section 11. *See MobileMedia,* 28 F.Supp.2d at 923.

3. Defendants other than issuers, such as underwriters and auditors, may assert a due diligence defense. *See* 15 U.S.C. 77k(b). The due diligence defense must be pled and proven by the defendant. *See id.*

B. Section 12(a)(2) provides, in pertinent part, that "[a]ny person who offers or sells a security . . . by means of a prospectus . . . which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances in which they are made, not misleading, is liable." 15 U.S.C. 77l(a)(2).

1. To state a claim under section 12(a)(2), plaintiffs must allege that: (1) defendants offered or sold a security; (2) by use of any means of communication in interstate commerce; (3) through a prospectus or oral communication; (4) by making a false or misleading statement of a material fact or by omitting to state a material fact necessary in light of the circumstances under which they were made, not misleading; (5) plaintiffs did not know of the untruth or omission; and (6) defendants knew, or in the exercise of reasonable care, could have known of the untruth or omission. *See MobileMedia*, 28 F.Supp.2d at 924; *See also Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 n.8 (1983) (observing that section 12 did not become a prominent part of securities litigation until the Court held that 10b-5 claims required proof of scienter).

2. Plaintiffs do not need to prove scienter or reliance. *See Schesinger v. Herzog, et al.*, 2 F.3d 135, 141 (5th Cir. 1993).

II. Grounds For Testing the Sufficiency of Claims Brought Under Sections 11 and 12

A. Claims brought under sections 11 and 12 may be deficient because the allegedly false or misleading statements are protected by the Reform Act's safe harbor provision. *See, e.g. Ehlert v. Singer*, 245 F.3d 1313, 1318 (11th Cir. 2001) (finding that statements regarding issuer's ability to respond to technological changes in marketplace were forward-looking statements protected by the Reform Act).

1. **Generally**. Section 27A of the 1933 Act (15 U.S.C. §77z-2(c)), provides a "safe harbor" for a "forward-looking statement" made in, among other things, a registration statement or prospectus, which is alleged to be false or misleading, if:

a. the statement is

(1) accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement, or

(2) immaterial; or

b. in the context of a statement made by a business entity, "plaintiff fails to prove that the forward-looking statement was made with the approval of an executive officer of that entity with actual knowledge . . . that the statement was false or misleading."

The statutory safe harbor is broader than the judicially created bespeaks caution doctrine (*infra*, Section II.B.) because even in the absence of cautionary language, the safe harbor applies where the plaintiffs fail to prove that the officers responsible for making the false or misleading statements acted with actual knowledge of their false or misleading nature. *In re MobileMedia Sec. Litig.*, 28 F.Supp. 2d 901, 930 (D.N.J. 1998).

2. **Applicability of the Safe Harbor.**

a. The safe harbor applies to:

(1) Issuers that are subject to the reporting requirements of sections 13(a) or 15(d) of the 1934 Act;

(2) persons, including outside reviewers retained by such an issuer, acting on behalf of such an issuer; and

(3) underwriters with respect to information provided by such an issuer or derived from such information.

b. The safe harbor has many important exceptions. It does <u>not</u> apply to statements:

(1) made by an issuer that, during the three-year period preceding the time the statement was made, was convicted of a felony or misdemeanor under §15(b)(4)(B) of the 1934 Act, or was the subject of a judicial or administrative decree or order arising out of a governmental action which: (a) determined that the issuer had violated the antifraud provisions of the securities laws; (b) requires that

the issuer cease and desist from such violations; or (c) prohibits future such violations.

(2) made in connection with: (a) a financial statement prepared in accordance with GAAP; (b) an initial public offering; (c) a registration statement issued by an investment company; (d) a tender offer; (e) a rollup transaction; (f) a going private transaction; or (g) an offering by a partnership, limited liability company, a direct participation investment program, or a blank check company.

3. **Categories of statements protected by the safe harbor** (§77z-2(i)(1)):

a. a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;

b. a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;

c. a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by management or in the results of operations included pursuant to rules and regulations of the Commission;

d. any statement of the assumptions underlying or relating to any statement described in a, b or c above;

e. any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer;

f. a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commission.

"[R]epresentations regarding the state of a business' position in a changing market or the soundness of its growth strategies are necessarily forward-looking." *Harris v. IVAX Corp.*, 998 F.Supp.1449, 1453 (S.D. Fla. 1998).

"[A]llegations or omissions of present facts," however, are not forward-looking statements to which the safe harbor may apply. *In re MobileMedia*

Sec. Litig., 28 F.Supp.2d 901, 930 n.18 (D.N.J. 1998); *See also In re Westinghouse Sec. Litig.*, 90 F.3d 696 (3d Cir. 1996); *In re Valujet*, 984 F.Supp.1472, 1479 (N.D. Ga. 1997).

A portion of a prospectus or registration statement may contain some statements that are forward-looking and some statements of present fact. If a plaintiff alleges that such a section is misleading due to a material omission, the court must determine whether the relevant section of the prospectus, *taken as a whole*, is forward-looking. *See Ehlert v. Singer*, 245 F.3d 1313, 1317-18 (11th Cir. 2001). The fact that the statement at issue contains some present tense language is not dispositive. *See id.* at 1318.

4. **Meaningful Cautionary Statements.** An issuer is not required to identify every factor that could cause results to differ from those in the forward-looking statement. Moreover, the safe harbor will apply even if the issuer has not identified the specific factor that actually caused the results to differ materially from the forward-looking statement, so long as the issuer has identified other important factors that could have caused the same result. *Harris v. IVAX Corp.*, 998 F.Supp.1449, 1454 (S.D. Fla. 1998) (rejecting as an "impossible burden" the requirement that defendant warn of every factor that ultimately causes a forward-looking statement not to come true).

   In describing the scope of adequate cautionary statements, the Second Circuit has stated that "disclosure in a prospectus must steer a middle course, neither submerging a material fact in a flood of collateral data, nor slighting its importance through seemingly cavalier treatment." *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759, 762 (2d Cir. 1991) ("What is required is the disclosure of material objective factual matters."); *Castlerock Management Ltd. v. Ultralife Batteries, Inc.*, 114 F.Supp.2d 316, 326 (D.N.J. 2000) (finding the safe harbor applicable where a prospectus explicitly cautioned investors of risks that eventually occurred).

5. **Materiality**

   a. As previously discussed, the safe harbor is available for forward-looking statements that are either: (a) accompanied by meaningful cautionary language; or (b) immaterial. Although materiality is a mixed question of law and fact and is ordinarily decided by the trier of fact, "if the alleged misrepresentations or omissions are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality [it is] appropriate for the district court to rule that the allegations are inactionable as a

matter of law." *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 317 (3d Cir. 1997).

A misleading statement is material if there is a substantial likelihood that the reasonable investor would have viewed the statement or omission "as having significantly altered the 'total mix' of information made available." *Basic, Inc. v. Levinson*, 485 U.S. 224, 231, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988); *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976) (omitted fact is material if there is a "substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder").

A misstated line item in an issuer's financial statements may be immaterial if it affects only an insignificant percentage of the line item *and*, in the total mix of information available, a reasonable investor would consider the information unimportant. *See Ganino v. Citizens Utils. Co.,* 228 F.3d 154 (2d. Cir. 2000); *In re Newell Rubermaid Inc. Sec. Litig.*, 2000 WL 1705279, at *7 (N.D. Ill. 2000).

b. **Puffery.** Courts have repeatedly held that certain statements are so devoid of substantive information that, as a matter of law, such statements cannot constitute the basis for a securities law violation. *See Parnes v. Gateway 2000, Inc.*, 122 F.3d 539 (8th Cir. 1997) (holding that "some statements are so vague and such obvious hyperbole that no reasonable investor would rely upon them"); *Lasker v. New York State Elec. & Gas Corp.*, 85 F.3d 55, 59 (2d Cir. 1996); (statements that amount to puffery are inactionable); *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir. 1995) (noting that some statements "lack[] the requisite specificity to be considered anything but optimistic rhetoric . . . lack of specificity precludes [them] from being deemed material); *Steinberg v. PRT Group, Inc.*, 88 F.Supp.2d 294, 301 (S.D.N.Y. 2000) ("vague expressions of optimism constitute immaterial corporate 'puffery'"); *In re Newell Rubermaid Inc. Sec. Litig.*, 2000 WL 1705279, at *6 (N.D. Ill. 2000) (observing that statements of optimistic rhetoric cannot be considered material).

(1) There is no explicit exemption for statements that amount to "puffery" — such statements are not actionable because they are immaterial. *See Hoxworth v. Blinder, Robinson & Co., Inc.*, 903 F.2d 186, 200 (3rd Cir. 1990).

(2) Such "puffing" statements are not material because they do not artificially inflate the stock price. *See Suna v. Bailey Corp.*, 107 F.3d 64, 72 (1st Cir. 1997)*; Hillson Partners Ltd. v. Adage, Inc.*, 42 F.3d 204, 211 (4th Cir. 1994).

c. Defendants should indicate, if possible, that the allegedly false or misleading statements are of the type the market views with skepticism. *See Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1217 (1st Cir. 1996) ("In particular, courts have demonstrated a willingness to find immaterial as a matter of law a certain kind of rosy affirmation commonly heard from corporate managers and numbingly familiar to the marketplace — loosely optimistic statements that are so vague, so lacking in specificity, or so clearly constituting the opinions of the speaker, that no reasonable investor could find them important to the total mix of information available.").

(1) A recurrent type of puffery includes statements of future performance. Defendants can seek dismissal on the grounds that such statements are immaterial as a matter of law. *See In re MobileMedia Sec. Litig.*, 28 F.Supp.2d 901, 924 (D.N.J. 1998) ("[P]rojections of future performance not worded as a guarantee, are generally found to be immaterial, and thus inactionable, under Federal securities law.").

(2) Examples of "puffery" include:

- "significant growth" (*Parnes)*;
- "commitment to create earnings opportunities" and "business strategies would [lead] to continued prosperity" (*Lasker*);
- "recession-resistant" (*Searls*); "convinced of its business strategy", and "most aggressive goals ever" (*Lasker*);
- "going reasonably well" and "a very healthy company" (*Shaw)*;
- "[management] believes that it will be one of a limited number of companies that will have the resources [to succeed]" (*MobileMedia*);
- the company "could continue to grow net earnings at a faster rate than sales", (*Burlington Coat);*
- "expected annual growth rate of 10% to 30% over the next several years," *Raab v. General Physics Corp.*, 4 F.3d 286, 289 (4th Cir. 1993);
- "exceptional strategic fit" (*Newell Rubermaid);*

- "optimistic" about earnings and "expected" to perform well, *(San Leandro).*

6. **Actual Knowledge of Falsity**. To remove the protections of the safe harbor, plaintiffs must establish that the forward-looking statement was made with *actual knowledge* of its false or misleading nature. *See In re Advanta, Corp.*, No. Civ. A. 97-CV-4343, 1998 WL 387595 at *8 (E.D. Pa. July 9, 1998); *Harris v. IVAX Corp.,* 998 F.Supp.1449, 1454-55 (S.D. Fla. 1998); *Clark v. TRO Learning, Inc.*, No. 97 C 8683, 1998 WL 292832 at *5 (N.D. Ill. May 20, 1998).

   To survive a motion to dismiss on the ground that the statement at issue is a forward-looking statement protected by the safe harbor, plaintiffs must plead facts sufficient to create a "strong inference" that defendant knew that the statements were false or misleading when made. *Kensington Capital Mgmt. v. Oakley, Inc.*, No. SACV97-808GLTEEX, 1999 WL 816964 (C.D. Cal. Jan. 14, 1999); *Ehlert v. Singer*, 85 F.Supp.2d 1269, 1274 (M.D. Fla. 1999); *In re Stratosphere Corp. Sec. Litig.*, 1 F.Supp.2d 1096, 1109 (D. Nev. 1998).

   Allegations that defendants "knew or should have known" that the challenged forward-looking statement was misleading, allege at best recklessness, and fail to satisfy the "actual knowledge" test as a matter of law. *Advanta*, 1998 WL 387595 at *8; *Harris*, 998 F.Supp. at 1454-55.

7. Section 27A(d) provides that "[n]othing in this section shall impose upon any person a duty to update a forward-looking statement." *See Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1332 (7th Cir. 1995). However, when a statement that is not specifically identified as forward-looking is later discovered to have been inaccurate at the time it was made, the person making the statement may have a duty to update its prior disclosure. *Weiner v. Quaker Oats Co.*, 129 F.3d 310 (3d Cir. 1997) (action under §10b of 1934 Act).

B. Claims brought under sections 11 and 12 may be deficient because the allegedly false or misleading statements are protected by the bespeaks caution doctrine.

1. The "bespeaks caution" doctrine, which is similar to the safe harbor, provides an alternative, independent basis to test the sufficiency of claims under sections 11 and 12. The bespeaks caution doctrine has been adopted in some fashion by almost every circuit court that has addressed the issue. *See Grossman v. Novell*, 120 F.3d 1112, 1120 (10th Cir. 1997) (listing cases). This doctrine serves to "minimize the chance that a plaintiff with a largely groundless claim will bring suit and conduct

extensive discovery in the hopes of obtaining an increased settlement." *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1408 (9th Cir. 1996) (quoting *In re World of Wonders Sec. Litig.*, 35 F.3d 1407, 1415 (9th Cir. 1994)).

2. The bespeaks caution doctrine provides that "when an offering document's forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities claim if those statements did not affect the 'total mix' of information . . . provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law." *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371 (3d Cir. 1993).

3. A dismissal of a securities complaint should be granted where "the documents containing defendants' challenged statements include enough cautionary language or risk disclosure that reasonable minds could not disagree that the challenged statements were not misleading." *Fecht v. The Price Co.*, 70 F.3d 1078, 1082 (9th Cir. 1995). The prospectus must be read "as a whole" and "the central issue . . . is not whether the particular statements, taken separately, were literally true, but whether defendants' representations, taken together and in context, would have misled a reasonable investor about the nature of the [securities]." *Olkey v. Hyperion 1999 Term Trust, Inc.* 98 F.3d 2, 5 (2d Cir. 1996); *See also Castlerock Management Ltd. v. Ultralife Batteries, Inc.*, 114 F.Supp.2d 316, 325-26 (D.N.J.) (finding that disclosures in the registration statement rendered the alleged omission immaterial); *Recupito v. Prudential Securities, Inc.*, 112 F.Supp.2d 449, 454-57 (D. Md. 2000) (same).

4. Present Status of the "Bespeaks Caution" Doctrine. The Reform Act, which as previously noted, provides a safe harbor for certain forward-looking statements, did not end judicial development of the "bespeaks caution" doctrine. *See* Jonathon L. Booze, Comment, *A Comparative Analysis of the Application of the Bespeaks Caution Doctrine to Forward-Looking Statements*, 47 Kan. L. Rev. 495, 500 (1999). Although the development of the legislative safe harbor was based on aspects of the judicially-created "bespeaks caution" doctrine, the safe harbor was not meant to replace the doctrine. *See* Erin M. Hardtke, Comment, *What's Wrong with the Safe Harbor for Forward-Looking Statements? A Call to the Securities and Exchange Commission to Reconsider Codification of the Bespeaks Caution Doctrine*, 81 Marq. L. Rev. 133, 151-52 (1997) (citing H.R. Conf. Rep. No. 104-369, at 46, *reprinted in* 1996 U.S.C.C.A.N. 730, 745); *See also* Jennifer O. Hare, *Good Faith and the Bespeaks Caution Doctrine: It's Not Just a State of Mind*, 58 U. PITT. L. REV. 619, 640-642 (1997) (listing the

many differences between the safe harbor and "bespeaks caution" doctrine).

a. Although there has not been an explicit ruling on the issue, since the enactment of the Reform Act in 1995, many circuit courts have continued to apply the bespeaks caution doctrine. *See Finkel v. Putnam Convertible Opportunities & Income Trust, et al.*, No. 97-7901, 1998 U.S. App. LEXIS 22389, at *4 (2d Cir. March 26, 1998) (holding that the cautionary language contained in the prospectus rendered the challenged statements immaterial under the bespeaks caution doctrine and affirming the lower court's dismissal of the §11 claim); *In re NationsMart Corp. Sec. Litig. v. Thaman*, 130 F.3d 309, 319 (8th Cir. 1997) (analyzing claim under the "bespeaks caution" doctrine); *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 548 (8th Cir. 1997) (holding that the plaintiff's sections 11 and 12 claims were properly dismissed because cautionary statements rendered the alleged misrepresentations immaterial); *In re Stacs Elecs. Sec. Litig.*, 89 F.3d 1399, 1408 n.5 (9th Cir. 1996) (stating that the "bespeaks caution" doctrine applies to both §10(b) and §11 claims); *Gasner v. Board of Supervisors of Dinwiddie*, 103 F.3d 351, 358-60 (4th Cir. 1996) (affirming summary judgment of a section 12(a)(2) claim under the "bespeaks caution" doctrine); *In re Westinghouse Secs. Litig.*, 90 F.3d 696, 707-10 (3d Cir. 1996) (reversing lower court's decision to dismiss §11 and §12(a)(2) claim under the "bespeaks caution" doctrine because the cautionary language did not sufficiently counter the alleged misrepresentations).

b. In *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194 (1st Cir. 1996), the First Circuit analyzed the §11 and §12 claims under the bespeaks caution doctrine and ultimately held that the doctrine did not preclude the claim. In a footnote, however, the court stated that the bespeaks caution doctrine was codified in the Reform Act. *Id.* at 1213 n.23. A recent law review article argues that the court erred in stating that the safe harbor is a codification of the bespeaks caution doctrine. *See* Erin M. Hardtke, Comment, *What's Wrong with the Safe Harbor for Forward-Looking Statements? A Call to the Securities and Exchange Commission to Reconsider Codification of the Bespeaks Doctrine*, 81 MARQ. L. REV. 133, 152 (1997).

5. Since the enactment of the Reform Act, most district courts have analyzed motions to dismiss a §11 or §12 claim separately under the legislative safe harbor provision and also under the judicially created bespeaks caution

doctrine. *See, e.g., In re World Access, Inc.*, No. 1:99-CV-43-ODE, 2000 U.S. Dist. LEXIS 4245, at *29-30 (N.D. Ga. 2000); *In re BankAmerica Corp. Sec. Litig.*, 78 F.Supp.2d 976, 997 n.10 (E.D. Mo. 1999); *Kensington Capital Mgmt. v. Oakley, Inc.*, 1999 U.S. Dist. LEXIS 385, at *6-11 (C.D. Ca. 1999).

C. Claims brought under sections 11 and 12 may be deficient because the complaint does not adequately identify a misrepresentation or omission. This deficiency exists if: (1) based on certain materials outside the four corners of the complaint that a court may consider on a motion to dismiss, the statements are truthful and accurate; (2) plaintiffs rely on conclusory allegations; (3) the allegedly misleading material was not known at the time of the offering; or (4) the allegedly omitted risk was actually disclosed.

1. The complaint must set forth a misrepresentation of an existing material fact, or an omission of an existing material fact necessary in order to make the statements not misleading. *See In re International Business Machines, Corp. Sec. Litig.*, 163 F.3d 102, 106-07 (2d Cir. 1998); *In re Westinghouse Sec. Litig.*, 90 F.3d 696 (3d Cir. 1996); *In re Trump Casino Sec. Litig.*, 7 F.3d 357, 368 (3d Cir. 1993). As noted above, an omitted fact is material if a reasonable investor would consider disclosure of that fact to have significantly altered the total mix of available information. *See In re AMF Bowling Sec. Litig.*, 2001 WL 286758, *3 (S.D.N.Y. March 23, 2001). A court may determine that a misstatement or omission is immaterial on a motion to dismiss if the misstatement or omission is so obviously unimportant that reasonable minds could not disagree on their insignificance. *See id.*

   a. Statements in offering documents may sometimes be taken out of context. *See, e.g., Suna v. Bailey Corp.*, 107 F.3d 64 (1st Cir. 1997) (noting that numerous statements that plaintiffs alleged to be false were mischaracterized). Defendants' motion to dismiss must place the alleged misstatements in context and make a proper characterization of the statements.

   b. On the motion to dismiss, defendants may introduce material from outside the complaint to show the true context and meaning of the allegedly misleading statements. Without converting the motion into one for summary judgment, a court may consider (1) any part of the prospectus or registration statement, *see Brass v. American Film Tech., Inc.*, 987 F.2d 142, 150 (2d Cir. 1993); *DeMaria v. Andersen*, 2001 WL 303725, *4 (S.D.N.Y. March 29, 2001); (2) official public documents, *see Kramer v. Time Warner Inc.*, 937 F.2d 767, 774 (2d Cir. 1991); (3) SEC filings, *see San Leandro Emergency Medical Group Profit Sharing Plan v. Phillip Morris Cos., Inc.*, 75 F.3d

801, 808 (2d Cir. 1996); and (4) any material relied on in the complaint and integral to the plaintiff's claim, s*ee Cortec Indus., Inc. v. Sum Holding L.P.*, 949 F.2d 42, 47; *Pache v. Wallace,* No. CIV A. 93-5164, 1995 WL 118457, at *1-2 (E.D. Pa. March 20, 1995). In addition, a court may of course take judicial notice of material, such as the closing share price of a publicly traded company, pursuant to Fed. R. Evid. 201(b). *See Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 167 n.8 (2d Cir. 2000).

2. To establish that a statement is false or misleading, plaintiffs must allege **specific facts** and cannot rely on bald assertions and legal conclusions.

   a. Plaintiffs must allege "specific facts" to indicate how or why the alleged misrepresentations were false. *See Castlerock Management Ltd. v. Ultralife Batteries, Inc.*, 114 F.Supp.2d 316, 323-24 (D.N.J. 2000) (finding that complaint failed to allege that any statements in the registration statement were actually false); *In re Union Carbide Class Action Sec. Litig.*, 648 F.Supp. 1322, 1326 (S.D.N.Y. 1986) (noting that plaintiffs cannot "assert vaguely that a false and misleading impression was created"); *See also Sheldon v. Vermonty*, 31 F.Supp.2d 1287, 1292 (D. Kan. 1998). Defendants can move to dismiss on the ground that mere conclusory allegations of falsity are insufficient. *See Grossman v. Novell, Inc.*, 120 F.3d at 1112, 1124 (10th Cir. 1997).

   b. The degree of specificity with which plaintiffs must plead may depend on whether Rule 9 applies. *See § II.G, infra.*

   c. This particular issue is most often presented in the context of the standards of a Rule 12(b)(6) motion, where the court must accept all "well-pled" allegations in the complaint as true. But courts need not accept bald assertions, unsupported legal conclusions, unwarranted inferences or deductions, and legal conclusions cast in the form of factual allegations. *See Morse v. Lower Merion School Dist.*, 132 F.3d 902, 906 (3d Cir. 1997); *EP Medsystems, Inc. v. Echocath, Inc.,* 30 F.Supp.2d 726, 740 (D.N.J. 1998).

3. The complaint must allege that the statements were false or misleading **at the time of the offering.**

   a. Plaintiffs must allege that "the omitted information in fact existed at the time that the allegedly misleading statement was made." *Zucker*, 891 F.Supp. at 1017; *See also In re Ultimate Corp. Sec. Litig.*, No. 86 CIV 5944 (CSH) 1989 WL 86961, at *3 (S.D.N.Y. July 11,

1989) (dismissing section 11 claim because defendants did not have knowledge of the alleged omission at the time of the offering).

b. The complaint is deficient if the facts that allegedly made the statement false were not known, and could not have been known by defendants, at the time of the offering/sale. An allegation of "fraud by hindsight" is insufficient. *See Zucker v. Quasha*, 891 F.Supp. 1010, 1016-1018) (dismissing §§11 and 12 claims "based entirely on hindsight"); *In re Quarterdeck Office Systems, Inc. Sec. Litig.*, No. CV-92-3970 DWW (GHK) 1992 WL 515347, at *3 (C.D. Cal. Nov 4., 1992) ("hindsight is clearly not actionable, absent factors indicating the falsity of the representations when made").

c. A statement that is only misleading in hindsight is not actionable. "[O]missions that create a misleading impression — particularly one that is misleading in hindsight — are not sufficient to constitute the basis of a securities action under section 11 or section 12(2)." *Castlerock Mgmt., Ltd. v. Ultralife Batteries, Inc.*, 68 F.Supp.2d 480, 488 (D.N.J. 1999); *See also Zucker v. Quasha*, 891 F.Supp.1010, 1016-17 (D.N.J.) (liability cannot be imposed on the basis of subsequent events), *aff'd* 82 F.3d 408 (3d Cir. 1996); *Scibelli v. Roth*, No. 98 Civ. 7228, 2000 WL 122193 at *3 (S.D.N.Y. Jan. 31, 2000) (dismissing §11 "misleading omission" claim because "[s]ince it cannot be reasonably inferred that the defendants had the allegedly omitted data at the time the prospectus was issued, it is not even necessary to determine whether the defendants were even required to disclose such information.").

4. Defendants may assert that the allegedly omitted facts/risks were actually disclosed.

a. Plaintiffs may cite an isolated piece of the prospectus in the complaint and argue that it is misleading because it failed to disclose a particular risk. *See, e.g., In re Burlington*, 114 F.3d at 1426. Defendants may move to dismiss on the grounds that the truth or risk is in fact disclosed elsewhere in the offering document. *See, e.g., Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 5 (2d Cir. 1996); *In re Trump Casino*, 7 F.3d at 370-71; *In re N2K Inc. Sec. Litig.*, 82 F.Supp.2d 204 (S.D.N.Y. 2000) *aff'd* 202 F.3d 81 (2d Cir. 2001). An allegedly misleading statement must be examined in the context in which the author makes the statement. *In re Trump*, 7 F.3d. at 369.

b. If the allegations of the complaint are contradicted by any part of the prospectus, a motion to dismiss the complaint may succeed. *See DeMaria v. Andersen,* 2001 WL 303725, *11 (S.D.N.Y. March 29, 2001) (dismissing section 11 claim where the alleged omission was disclosed in the prospectus); *Steinberg v. PRT Group, Inc.*, 88 F.Supp.2d 294, 299 (S.D.N.Y. 2000) (noting that "[i]f a plaintiff's claims of misstatement or omission conflicts with the plain language of the prospectus, the prospectus controls and the court need not accept as true the allegations of the complaint"). The issue is not whether any particular statement is misleading, but whether the entire prospectus, taken as a whole, would have misled a reasonable investor. *See Olkey,* 98 F.3d at 5.

c. The issue is especially crucial where the plaintiff alleges that the defendants failed to disclose a risk that eventually occurred and contributed to a decline in the stock price. Defendants may bring a motion to dismiss on the grounds that, considering the prospectus in its entirety, the risk is in fact disclosed. *See I. Meyer Pincus & Assoc. v. Oppenheimer & Co., Inc.*, 936 F.2d 759, 763 (2d Cir. 1991*); In re Ultrafem Inc., Sec. Litig.*, 91 F.Supp.2d 678, 700 (S.D.N.Y. 2000) (finding a statement not misleading because the risk was disclosed elsewhere in the prospectus)*; Saslaw v. Al Askari*, No. 95 CIV. 7641(LAP) 1997 WL 221208 at *8 (S.D.N.Y. April 25, 1997) (same).

D. Claims brought under section 12(a)(2) may be deficient because the defendants are not "sellers" within the meaning of the Securities Act.

1. Liability under section 12(a)(2) is limited to "sellers" of securities. Under certain circumstances, both issuer and underwriter defendants may argue that they are not "sellers" within the meaning of the statute. To sufficiently plead a §12(a)(2) claim, plaintiffs must allege (1) that the defendant directly sold stock to the plaintiff or (2) directly solicited the plaintiff's purchase of stock. *See In re American Bank Note Holographics Inc. Sec. Litig.*, 93 F.Supp.2d 424 (S.D.N.Y. 2000).

2. In most firm commitment underwritings, a defendant issuer may argue that it is not a "seller" within the meaning of section 12. *See e.g., Lone Star Ladies Investment Club v. Schlotsky's Inc.,* 238 F.3d 363, 370 (5th Cir. 2001) ("[I]n a firm commitment underwriting . . . the public ordinarily cannot hold the issuers liable under section 12, because the public does not purchase from the issuers."); *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1215-16 (1st Cir. 1996) ("Because the issuer in a firm commitment

underwriting does not pass title to the securities, [the issuer and its officers] cannot be held liable as "sellers" under section 12(2) unless they actively 'solicited' the plaintiffs' purchase of securities to further their own financial motives."); citing *Pinter v. Dahl*, 486 U.S. 622, 644-47 (1988) and Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation,* 1000-01 (3d ed. 1995) ("[I]t seems quite clear that §12 contemplates only an action by a buyer against his immediate seller. That is to say, in the case of the typical 'firm-commitment underwriting', the ultimate investor can recover only from the dealer who sold to him or her.").

3. Note, however, that the test of whether an issuer is a seller for purposes of section 12(2) is not a bright line test, even in a firm commitment underwriting. *See In re Craftmatic Sec. Litig.*, 890 F.2d 628 (3d Cir. 1990). The plaintiff may demonstrate "direct and active participation in the solicitation of the immediate sale." However, participation in the preparation of the prospectus is not enough. *See id.* at 636; *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126 (2d Cir. 1989); *Moore v. Kayport Package Express, Inc.,* 885 F.2d 531, 536-37 (9th Cir. 1989); *Shaw,* 82 F.3d at 1216.

   a. The Supreme Court has indicated that a party solicits a purchase for purposes of §12(1) if that party is motivated at least in part by a desire to serve his or her financial interests or those of the securities owner. *See Pinter v. Dahl*, 486 U.S. 622, 647 (1988). A party that merely gives gratuitous advice to assist the buyer does not "solicit" the purchase within the meaning of §12(1). *See id.*

   b. Most courts apply a similar standard to cases under §12(a)(2). In the Second Circuit, for example, only the actual seller and anyone actively soliciting the purchase may be held liable. *See Wilson v. Saintine Exploration and Drilling Corp.*, 872 F.2d 1124 (2d Cir. 1989); *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336 (2d Cir. 1987); *See also Credit Suisse First Boston Corp. v. ARM Financial Group, Inc.*, 2001 WL 300733, at *10 (S.D.N.Y. March 28, 2001) (noting that bald allegations of solicitation will not suffice); *Dorchester Investors v. Peak International Ltd.*, 134 F.Supp.2d 569, 580 (S.D.N.Y. 2001) (allegation that individual is named in the prospectus in insufficient).

   c. In contrast, some courts apply a broad interpretation of "seller" under §12(a)(2). *See, e.g., Kennsington Capital Management v. Oakley, Inc.*, No. SACV97-808GLTEEX, 1999 WL 816964 (C.D. Cal. Jan., 14 1999) (holding issuer and issuer's officers liable as sellers

under §12(a)(2) because they signed the registration statement); *Degulis v. LXR Biotechnology, Inc.*, Nos. 95 CIV. 4204, 4299, 4298, 6422, 7215 ((RWS) 1997 WL 20832 (S.D.N.Y. Jan. 21., 1997) (finding that because plaintiffs alleged that issuer signed the registration statement, plaintiff has adequately plead "seller" status under §12(a)(2); *In re Proxima Corp. Sec. Litig*, No. 93-1139-IEG (LSP) 1994 WL 374306 ((S.D. Cal. May 3, 1994) (same).

4. Underwriter defendants may make a similar argument. *See, e.g. DeMaria v. Andersen,* 2001 WL 303725, *5 (S.D.N.Y. March 29, 2001); *Dartley v. Ergobuilt Inc.*, 2001 WL 313964, *2 (N.D. Tex. 2001). They may, if possible, argue that plaintiffs have failed to allege that plaintiffs purchased shares directly from the defendant underwriter, or that the defendant underwriter specifically solicited plaintiffs' purchase. *See In re Craftmatic Sec. Litig.*, 890 F.2d 628 (3d. Cir. 1989).

E. Claims brought under sections 11 and 12 may be deficient because the plaintiffs' shares are not traceable to the allegedly defective offering.

1. Pursuant to §11, when any part of the registration statement for the sale of a security contains an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading, "any person acquiring such security" may make a claim. Section 12(a)(2), on the other hand, provides a cause of action only to "the person purchasing such security from him."

   Notwithstanding that sections 11 and 12 share the same legislative history indicating that these provisions were intended to "affect[] only new offerings of securities, *see* H.R. Rep. No. 73-85, at 5, a split has arisen among the courts concerning the availability of section 11 to aftermarket purchasers.

2. **Gustafson v. Alloyd Co.**. The Supreme Court has held that only those persons who purchased their shares in the allegedly defective offering have standing to maintain an action pursuant to section 12(a)(2). *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995). Since *Gustafson*, courts have uniformly held that aftermarket purchasers, i.e., those that did not purchase in the public offering, lack standing to bring a section 12 claim. *See, e.g.*, *Maldonado v. Dominguez*, 137 F.3d 1, 8 (1st Cir. 1998); *Saslaw v. Al Askari*, No. 95 Civ. 7641, 1997 WL 221208, at *5 (S.D.N.Y. Apr. 25, 1997); *In re WRT Securities Litig.*, Nos. 96 CIV. 3610 (JFK), 96 CIV. 3611 (JFK), 1997 WL 576023, at *5 (S.D.N.Y. Sept. 15, 1997); *Weinstein v. Jain*, No. C-94-1015-EFL, 1995 WL 787549 at *2 (N.D. Cal. Oct. 23, 1995).

In dicta, the *Gustafson* Court acknowledged that section 11 claims are similarly limited to those who purchased in the offering itself. *Id.* at 571, 572. Moreover, even Justice Ginsburg in dissent agreed with the limitation on section 11 standing: "[t]here is no dispute that [both §§11 and 12] apply only to public offerings — or, to be precise, to transactions subject to registration." *Id.* at 600 n.4 (Ginsburg, J., dissenting).

3. **Post-Gustafson case law.** Many courts have applied *Gustafson*'s reasoning to limit aftermarket purchaser claims under section 11. *See Brosious v. Children's Place Retail Stores*, 189 F.R.D. 138, 144 (D.N.J. 1999); *In re Paracelsus Corp. Sec. Litig.*, 6 F.Supp.2d 626, 631 (S.D. Tex. 1998); *In re Summit Med. Sys. Inc., Sec. Litig.*, 10 F.Supp.2d 1068, 1070 (D. Minn. 1998); *Warden v. Crown Amer. Realty Trust*, No. Civ. A. 96-25J, 1998 WL 725946, at *2 (W.D. Pa. Oct. 15, 1998); *Flecker v. Hollywood Entertainment Corp.*, 1997 WL 269488, at *2 (D. Or. Feb. 12, 1997); *Gould v. Harris*, 929 F.Supp.353, 358 (C.D. Cal. 1996); *Gannon v. Continental Ins. Co.*, 920 F.Supp.566, 575 (D.N.J. 1996); *Murphy v. Hollywood Entertainment Corp.*, Civ. A. No. 95-1926, 1996 WL 393662, at * 4 (D. Or. May 9, 1996); *Stack v. Lobo*, 903 F.Supp.1361 (N.D. Cal. 1995).

Recently, however, a number of courts have held that section 11 standing is not so limited, and have resurrected the doctrine of "traceability," extending standing to those purchasers in the aftermarket that can "trace" their shares to the offensive registration statement. *See Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1046 (9th Cir. 1999); *In re Complete Management Inc. Sec. Litig.*, 2001 WL 314631 (March 30, 2001); *DeMaria v. Andersen,* 2001 WL 303725, *5 (S.D.N.Y. March 29, 2001); *Salomon Smith Barney v. Asset Securitization Corp.*, No. 98 Civ. 4186, 1999 WL 1095605, at *3 (S.D.N.Y. Dec. 3, 1999); *Milman v. Box Hill Sys. Corp.*, 192 F.R.D. 105, 109 (S.D.N.Y. 2000) ; *In re Ultrafem Inc. Sec. Litig.*, 91 F.Supp.2d 678, 694 (S.D.N.Y. 2000); *Feiner v. SS&C Tech., Inc.*, 47 F.Supp.250 (D. Conn. 1999); *Adair v. Bristol Tech. Sys., Inc.*, 179 F.R.D. 126, 130-33 (S.D.N.Y. 1998); *Schwartz v. Celestial Seasonings, Inc.*, 178 F.R.D. 545, 556 (D. Colo. 1998); *In re Fine Host Corp. Sec. Litig.*, 25 F.Supp.2d 61, 67 (D. Conn. 1998); *Cooperman v. Individual, Inc.*, No. Civ. A. 96-12272, 1998 WL 953726, at *4 (D. Mass. May 27, 1998), *aff'd*, 171 F.3d 43 (1st Cir. 1999); *In re Stratosphere Corp. Sec. Litig.*, 1 F.Supp.2d. 1096, 1119 (D. Nev. 1998).

4. **Traceability and Secondary Offerings**. *Wiles* and *Hertzberg* are the only recent Circuit Court decisions addressing section 11 aftermarket purchasers' standing. Both cases hold that anyone purchasing a security that was issued pursuant and/or traceable to a false or misleading registration statement has standing to bring a section 11 claim,

"regardless of whether he bought in the initial offering, a week later, or a month after that." *Hertzberg*, 191 F.3d at 1080. Although the *Wiles* Court did not discuss the issue of how a plaintiff could prove that a given security was traceable to a given registration statement, the *Hertzberg* Court acknowledged that its interpretation of section 11 standing could present a significant burden of proof in the context of a secondary public offering, stating that "[w]hile it might present a problem of proof in a case in which stock was issued under more than one registration statement, the only stock [defendant] ever sold to the public was pursuant to the allegedly misleading registration statement at issue in this case." *Id.*

Whenever shares are offered to the public, therefore, if there are any pre-existing publicly traded shares at the time of that offering, plaintiffs must prove that his or her shares came from the allegedly defective offering. The burden in such a case may be impossible to satisfy, however, because today virtually all shares publicly traded are held in fungible brokerage "house accounts," in which shares issued pursuant to the allegedly defective registration statement are commingled with shares from previous offerings. As acknowledged by the Second Circuit more than twenty years ago: "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 since many brokerage houses do not identify specific shares with particular accounts but instead treat the account as having an unallocated interest in the house's position." *Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967) (placing the burden on plaintiff to show traceability). *See also Warden v. Crown Am. Realty Trust*, No. Civ. A. 96-25J, 1998 WL 725946 at*3 n.2 (W.D. Pa. Oct. 15, 1998); *Lilley v. Charren*, 936 F.Supp.715-16 (N.D. Cal. 1996); *In re Quarterdeck Office Sys., Inc. Sec. Litig.*, No. CV 92-3970-DWW(GHK), 1993 WL 623310 (C.D. Cal. Sept. 30, 1993); *Abbey v. Computer Memories, Inc.*, 634 F.Supp.870, 873 (N.D. Cal. 1986); *Kirkwood v. Taylor*, 590 F.Supp.1375, 1383 (D. Minn. 1984); *McFarland v. Memorex Corp.*, 493 F.Supp.631, 642 (N.D. Cal. 1980); *Lorber v. Beebe*, 407 F.Supp.279, 286 (S.D.N.Y. 1975).

F. Claims brought under sections 11 and 12 may be deficient because the allegations are not pled with particularity as required by Rule 9.

1. Federal Rule of Civil Procedure 9(b) states that, "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Fed. R. Civ. Pro. 9(b). It is well established that claims brought under Rule 10b-5 and Section 10(b) must meet the

particularity requirements of Rule 9(b). *See In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1404 (9th Cir. 1996).

2. Defendants may test the sufficiency of certain section 11 and 12 claims on the ground that the plaintiff is actually pleading fraud and has failed to satisfy the requirements of Rule 9(b). The majority of courts that have addressed this issue hold that the particularity requirements of Rule 9(b) apply to claims brought under §§11 and 12 that are "grounded in fraud." *Id.*; *See also In re Westinghouse Sec. Litig.*, 90 F.3d 696, 717 (3d Cir. 1996) (holding that section 12(2) claims that "sound in fraud" must be pled with particularity); *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1223 (1st Cir. 1996) (holding that the threshold question in determining whether Rule 9(b) applies to §11 and §12(2) claims is whether the complaint contains any "averments of fraud"); *Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994) (holding that Rule 9(b) applies to 1933 Securities Act claims when they are grounded in fraud rather than negligence); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 288 (3d Cir. 1992) (holding that Rule 9(b) applies when §11 and §12(2) claims are grounded in fraud rather than negligence); *Sears v. Likens*, 912 F.2d 889, 892-93 (7th Cir. 1990) (applying Rule 9(b) to 1933 Securities Act claims sounding in fraud); *In re CBT Group PLC Sec. Litig.*, 2000 WL 33339615 (N.D. Cal. Dec. 29, 2000).

3. The Eighth Circuit, on the other hand, holds that the particularity requirement of Rule 9(b) does not apply to claims under sections 11 and 12 of the Securities Act because proof of fraud and scienter are not a prerequisite to establishing liability under these sections. *See In re NationsMart Corp. Sec. Litig. v. Thaman*, 130 F.3d 309, 319 (8th Cir. 1997). The court reasoned that any allegation of fraud in a section 11 or 12 claim is surplusage and that a plaintiff's claim should not be dismissed for alleging more than is necessary. *Id.* at 315.

4. The Fifth Circuit has recently held that it was an abuse of discretion for a district court to dismiss §§11 and 12 claims with prejudice for failure to satisfy the Rule 9 pleading standards. *See Lone Star Ladies Investment Club v. Schlotsky's Inc.*, 238 F.3d 363 (5th Cir. 2001). The *Lone Star* Court observed that while Rule 9 does apply to Securities Act claims that are grounded in fraud, a plaintiff's failure to comply with Rule 9 does not warrant dismissal with prejudice. *See id.* at 368. Instead, the district court should disregard averments of fraud that do not satisfy Rule 9 and ascertain whether, absent the defective allegations, a claim has been stated. *See id.* In such situations, the district court should usually permit amended pleadings. *Id.*

5. The Second Circuit has not addressed whether the pleading standards of Rule 9(b) apply to §11 and §12(2) claims, and the courts in this circuit disagree on the application of Rule 9(b). *See In re Ultrafem Inc. Sec. Litig.*, 91 F.Supp.2d 678, 690 (S.D.N.Y. 2000). A majority of the most recent district court decisions in the Second Circuit hold that Rule 9(b) is applicable to §11 and §12 claims if the complaint is grounded in fraud. *See id.; See also Griffin v. PaineWebber Inc.*, No. 99 Civ. 2292, 2000 WL 178180, at *4 (S.D.N.Y. 2000); *Ellison v. American Image Motor Co.*, 36 F.Supp.2d 628, 639 (S.D.N.Y. 1999); *Schoenhaut v. American Sensors, Inc.*, 986 F.Supp.785, 795 (S.D.N.Y. 1997). Other districts courts, however, hold that Rule 9(b) does not apply to §11 and §12 claims. *See In re In-Store Advertising Sec. Litig.*, 878 F.Supp.645 (S.D.N.Y. 1995); *Nelson v. Paramount Communications, Inc.*, 872 F.Supp.1242 (S.D.N.Y. 1994).

G. A section 11 or 12 claim may be deficient because the plaintiff has failed to plead compliance with the applicable limitations period or because publicly available information demonstrates that the limitations period has expired.

1. Section 13 of the Securities Act provides that a section 11 or 12 claim must be brought "within one year after the discovery of the untrue statement or omission, or after such discovery should have been made in the exercise of reasonable diligence . . . [and] in no event shall any such action be brought . . . more than three years after such security was bona fide offered to the public."

2. Plaintiffs must affirmatively plead compliance with section 13 by alleging: (i) the time and circumstance of the discovery of the misstatement or omission; (ii) the reasons why it was not discovered earlier; and (iii) the efforts taken by the plaintiffs in making or seeking such discovery. *See Dorchester Investors v. Peak International Ltd.*, 134 F.Supp.2d 569, 578 (S.D.N.Y. 2001).

3. The Second Circuit has held that the date that a plaintiff should have discovered a misstatement or omission may be determined as a matter of law. *See Dodds v. Cigna Sec. Inc.*, 12 F.3d 346, 350 (2d Cir. 1993).

4. Establishing the reasonable discovery date of a securities fraud is a two-step process. First, a court must determine when a reasonable investor could learn of facts sufficient to indicate the probability that he had been defrauded, a circumstance known as inquiry notice. Once the duty of inquiry notice is triggered, a court mist then determine when, in the exercise of reasonable diligence, the plaintiff should have discovered the facts underlying the alleged fraud. *See In re Complete Management Inc. Sec. Litig.*, 2001 WL 314631 (March 30, 2001).

III. Loss Causation

A. Loss causation. Unlike 10b-5 claims, loss causation is not an element that plaintiffs must plead in a section 11 or 12 claim. *See Fisk v. Superannuities, Inc.*, 927 F.Supp 718, 729 (S.D.N.Y. 1996)

1. However, for section 12(2) claims, defendants may plead and prove lack of loss causation as an affirmative defense. *See* 15 U.S.C. 77l(b) "[I]f the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) represents other than the depreciation in value of the subject security resulting form 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.").

2. Similarly, for claims brought under section 11, a defendant may reduce its liability under section 11 by establishing that any depreciation in value of a stock's price is attributable to factors other than the misleading or omitted statement. *See* 15 U.S.C. 77k(e); *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 340 (2d. Cir. 1987). The defendants' efforts in this regard have been characterized as the burden of 'negative causation'. *Id.*