



Vol. 13 No. 7

June 3, 2005

# STRICT STANDING REQUIREMENT FOR SECURITIES FRAUD SUITS UPHeld

by

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Section 11 of the Securities and Exchange Act generally imposes civil liability for false statements made in a prospectus. Unlike 10b-5 claims, a Section 11 claim does not require proof of intent, reliance or causation. The only shareholders who can sue under Section 11, however, are those who “acquir[ed] such security.”

In a prior ruling, the U.S. Court of Appeals for the Fifth Circuit held that aftermarket purchasers may sue under Section 11 if they can demonstrate the ability to “trace” at least one of their shares to the defective prospectus. *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 873 (5<sup>th</sup> Cir. 2003). The *Azurix* decision held that where all available shares originate from a single public offering, aftermarket purchasers necessarily have standing to sue. *Id.* The Fifth Circuit in that opinion, however, left open the question of what would be necessary to “trace” shares to a defective prospectus when shares entered the market by other means.

The Fifth Circuit answered that question in *Krim v. pcOrder*, 402 F.3d 489 (5<sup>th</sup> Cir. 2005). In that case, five aftermarket purchasers filed a Section 11 class action against the company, its directors, officers, majority shareholders, and lead underwriters claiming that they purchased stock pursuant to an initial public offering and a secondary public offering, both of which had defective prospectuses. In addition to those two offerings, however, approximately 800,000 shares had entered the marketplace through insider sales which were not pursuant to a prospectus.

Because none of the plaintiffs purchased their stock directly in one of the public offerings, they presented expert testimony that the statistical probability of at least one of their shares originating from each offering was over 99%. The district court rejected that claim, and the Fifth Circuit affirmed, holding that “statistical tracing would impermissibly expand the statute’s standing requirements.” Recognizing that Section 11 is concerned with the initial distribution of securities and limits claims to the “narrow class of persons” consisting of those who purchase securities that are the direct subject of the defective prospectus, the Fifth Circuit held that allowing any street name shareholder to sue under Section 11 “cannot be squared with the statutory language.”

The Fifth Circuit’s opinion in *pcOrder* was the first appellate ruling on the use of statistical analysis to establish aftermarket purchaser standing under Section 11. It represents an important restriction on the ability of secondary market purchasers to sue under that statute when stock has entered the market through other means. In fact, the Fifth Circuit recognized that its opinion likely

places serious limitation on Section 11 suits, but nonetheless held to a strict tracing requirement, explaining that whether “present market realities, given the fungibility of stock held in street name, may render Section 11 ineffective as a practical matter in some aftermarket scenarios is an issue properly addressed by Congress.”

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