JUDICIAL CONSTRUCTION OF THE FEDERAL SECURITIES LAWS: LEGISLATIVE INTENT AND PRESENT-DAY APPLICATION OF THE CIVIL LIABILITY PROVISIONS— RANDALL V. LOFTSGAARDEN

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"[L]et the seller . . . beware."[1]

I. Introduction

A. *Legislative Background*

Securities[2] ownership by the American public increased dramatically in the early twentieth century.[3] Between 1920 and

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1 1 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at 937 (1973) [hereinafter ELLENBERGER & MAHAR] (President Franklin D. Roosevelt used this phrase in his message to the Senate to set the tone for the debates on the proposed federal securities laws).

2 In this context, Representative Samuel Rayburn referred only to stocks and bonds during the House debate. *Id.* at 2917. Section 2(1) of the Securities Act of 1933 defines a "security" as:

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1982). The breadth of this definition gives the Securities Exchange Commission an expansive jurisdiction. *See* Ratner, *The SEC: Portrait of the Agency as a Thirty-Seven Year Old*, 45 ST. JOHN'S L. REV. 583, 590 (1971) [hereinafter Ratner].

3 *See* ELLENBERGER & MAHAR, *supra* note 1, at 2917 (statement of Rep. Rayburn). Samuel Rayburn was chairman of the House Subcommittee formed to consider a draft bill which ultimately evolved into the Securities Act of 1933. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 38 (1959) [hereinafter *Legislative History*]. James M. Landis played an integral part in the genesis of

1928, common stock participation rose approximately fifty percent.[4] By 1928, American corporate assets accounted for an estimated seventy-five to eighty percent of the total wealth in the country.[5] Investors had implicit confidence in the management of the companies in which they had invested their life savings.[6] The infamous stock market crash of 1929, however, transformed this quixotic optimism in the economy into a "los[s] [of] faith in government."[7]

Because "[m]illions of citizens [had] been swindled into exchanging their savings for worthless stocks,"[8] legislators concluded it was time for congressional action.[9] After careful consideration of the available options,[10] Congress enacted a stat-

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this legislation. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U. L. REV. 627, 657 n.134 (1963) [hereinafter Ruder].

4 ELLENBERGER & MAHAR, *supra* note 1, at 2917 (statement of Rep. Rayburn).

5 *Id.*

6 *Id.* at 2916.

7 *Id.* at 2919. Representative Rayburn noted that it was the duty of the government, as the sentinel of the public, to ensure that businessmen conducted their entrepreneurial activities openly and equitably. *Id.*

8 *Id.* at 2918.

9 *Id.* Representative Rayburn elaborated on the causes and effects of the problem:

> This bill is not so much a response to the frauds of criminals as it is to the reticence of financiers. Today we are forced to recognize that the hired managers of great corporations are not wise, not as conservative, and sometimes are not as trustworthy as millions of American investors have been persuaded to believe. During the last 12 years, an era falsely designated as one of prosperity, American people lost perhaps a hundred billion dollars through the purchase of stocks and bonds. This catastrophe so colossal as to stagger the imagination did not come upon our people through the machinations of common fraud. This loss of an amount equal to perhaps a third of the total national wealth did not follow from the kind of confidence game against which parents warn their sons. It came through the leadership that the average investor had a right to believe that he could trust.

Id. See also Legislative History, supra note 3, at 30.

10 A former member of the Federal Trade Commission, Huston Thompson, outlined a proposal based largely on state securities laws. The proposal required the government to consider the merits of the issuance. *See Legislative History, supra* note 3, at 30-31. Rather than burden the government with the onerous task of determining the soundness of the security, Congress chose to demand merely that all pertinent information be revealed. *See* Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171 (1933) [hereinafter Douglas & Bates]. The burden falls on the prudent investor to study the balance sheets, past performance, future prospects, and other "imponderable factors" relating to the issuing corporation. *See id.* at 172.

ute[11] to regulate the distribution of securities.[12] On May 27th, the Securities Act of 1933[13] [hereinafter Securities Act or Act] was signed into law by President Roosevelt.

The express purpose of the Securities Act is to furnish complete and accurate disclosure of the character of the securities to be distributed.[14] To fulfill this dictate, an issuer[15] must first file a registration statement[16] concerning the proposed security with

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11 The Securities Act was intended to provide a uniform system of regulation which the states with their blue sky laws can assist and support. ELLENBERGER & MAHAR, *supra* note 1, at 2914 (statement of Rep. Greenwood). At that time, forty-seven of the forty-eight states had enacted statutes, commonly referred to as "blue sky laws," which addressed securities fraud. ELLENBERGER & MAHAR, *supra* note 1, at 2912 (statement of Rep. Mapes). However, these blue sky laws were viewed as ineffective. *See* L. LOSS, SECURITIES REGULATION 105 (Temporary Student Ed. 1961) [hereinafter Student Edition]. For an excellent exposition on a state's reaction to speculative security abuses, see generally, Note, *The Securities Law Reform and Protection Act of 1985: New Jersey's Response to Penny Stock Abuse*, 10 SETON HALL LEGIS. J. 147 (1986).

12 T. HAZEN, THE LAW OF SECURITIES REGULATION § 1.2 at 7 (1985) [hereinafter HAZEN].

13 15 U.S.C. §§ 77a to 77aa (1982).

14 *See generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

15 Section 2(4) of the Securities Act designates an "issuer" as:

> every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term 'issuer' means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity, except that with respect to equipment-trust certificates or like securities, the term 'issuer' means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term 'issuer' means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.

15 U.S.C. § 77b(4) (1982).

16 Sections 6, 7 and 8 of the Act contain the registration prescriptions. 15 U.S.C. §§ 77f-77h (1982); *see also* Regulation C, 17 C.F.R. §§ 230.400-.494 (1987). The registration statement is the basic disclosure device under the Securities Act. Schneider, Manko, and Kant, *Going Public: Practice, Procedure and Consequences*, 27

the Securities Exchange Commission[17] [hereinafter SEC or Commission] unless it qualifies for an exemption.[18] The Act provides civil liability for material[19] misstatements or omissions contained in the registration statement[20] or prospectus.[21] This remedial

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VILL. L. REV. 1, 10 (1981) [hereinafter *Going Public*]. There are essentially two components to the registration statement. *Id.* The first is the prospectus, *see infra* note 21, which is to be provided to all interested investors. The second portion consists of additional information about the issuer and is available for review at the SEC's office in Washington, D.C. *Id.* After a cursory examination of the documents, if the Commission finds the registration statement materially incomplete or inaccurate, it will issue a "stop order" which prevents the distribution of the securities until the issuer remedies the defect. 15 U.S.C. § 77h(b) (1982).

17 15 U.S.C. § 77f(a) (1982). *See Going Public*, *supra* note 16, at 10-14.

18 Section 3 of the Act excepts certain types of securities from the registration requirements. *See* 15 U.S.C. § 77c (1982). Furthermore, section 4 immunizes some specified transactions involving securities. *See* 15 U.S.C. § 77d (1982). However, neither of these exemptions shields an issuer from liability if it is engaged in prohibited conduct. *See, e.g.*, HAZEN, *supra* note 12, at 86.

19 The Supreme Court originally designated a fact as "material" if an average investor *might* consider the fact important. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970) (emphasis supplied). The Court reaffirmed this standard in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972). However, the subsequent decision in T.S.C. Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976) modified the import of the term and stated that a "fact is material if there is a substantial likelihood that a reasonable shareholder *would* consider it important [in making an investment decision]." *Id.* at 449 (emphasis added). This is the test now used in the federal courts, *see, e.g.*, Securities Exch. Comm'n v. Tome, 638 F. Supp. 596, 621 (S.D.N.Y. 1986); *but see In re* Washington Pub. Power Supply Sys. Sec. Litig., 650 F. Supp. 1346 (W.D. Wash. 1986) (standard relaxed for omissions). The concept of materiality possesses the same meaning in the context of all of the securities acts. *See, e.g.*, Alton Box Board Co. v. Goldman Sachs & Co., 560 F.2d 916, 920 (8th Cir. 1977).

20 15 U.S.C. § 77k (1982). For an analysis of § 11 liability, see Student Edition, *supra* note 11, at 1721-42. *See also* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATIONS, at 1029-46 (1983) [hereinafter FUNDAMENTALS].

21 15 U.S.C. § 77*l* (1982). A prospectus normally is the offering document given to interested investors. Section 2(10) defines a "prospectus" as:

> any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that (a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of [section 10]) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of [section 10] at the time of such communication was sent or given to the person to whom the communication was made, and (b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of

measure helps ensure the enforcement of the disclosure demands to prevent fraudulent sales of securities.[22] The Securities Act also sets forth a general antifraud provision.[23]

Congress augmented its control over the securities industry by enacting the Securities Exchange Act of 1934[24] [hereinafter Securities Exchange Act or Exchange Act] designed to combat the fraudulent trading of securities.[25] The Exchange Act permits private causes of action against manipulators of securities prices,[26] "insiders" who trade on material nonpublic information,[27] and issuers who knowingly file documents with the Commission containing false or misleading information.[28] Moreover, pursuant to the Exchange Act, the Supreme Court has implied civil liability[29] for proxy disclosure rules violations,[30] and fraudu-

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> [section 10] may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

15 U.S.C. § 77b(10) (1982).

22 *See* HAZEN, *supra* note 12, at 7.

23 15 U.S.C. § 77q(a) (1982). This provision of the Act has been construed to cover the trading as well as the initial distribution of securities. United States v. Naftalin, 441 U.S. 768, 777-78 (1978). The Supreme Court thus far has expressly declined to decide whether § 17(a) provides a private right of action. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 n.6 (1975). The lower courts are split on its existence. *Compare* Mauersberg v. E.F. Hutton & Co., Inc., [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶92,726, at 93,524 (May 1, 1986) (private right not conferred) *with* Rhoades v. Powell, 644 F. Supp. 645, 658-59 (E.D. Cal. 1986) (in which a private right was conferred).

24 15 U.S.C. §§ 78a to 78kk (1982).

25 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1975).

26 15 U.S.C. § 78i(e) (1982).

27 15 U.S.C. § 78p(b) (1982). Generally, an "insider" is an executive or director, an agent, a stockholder owning more than 10% of the outstanding shares, or a fiduciary of a corporation. *Cf.* Chiarella v. United States, 445 U.S. 222 (1979) (a "stranger" who traded on material nonpublic information regarding a corporation held not to be an insider).

28 15 U.S.C. § 78r(a) (1982). The injured party must not be aware of the falsity of the statements. *Id.*

29 The four-factor test of Cort v. Ash, 422 U.S. 66, 78 (1975) had been the standard for determining whether an action may be implied from a statute which does not expressly confer one. The Burger Court modified the approach in Touche Ross & Co. v. Redington, 442 U.S. 560 (1978). The examination is now acutely focused on congressional intent. *Id.* at 575.

30 *See generally* J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (referring to § 14(a) of the Exchange Act, 15 U.S.C. § 78n(a) (1982)).

lent conduct in connection with purchase or sale of a security.[31] The latter implied right of action, the general antifraud provision of section 10(b), stands as the most formidable securities litigation weapon in the federal arsenal aimed at deceptive practices.[32]

While the statutory framework is not unduly complicated, interpreting the securities laws can become troublesome within the context of specific cases.[33] Decisions frequently pivot on subtle distinctions in the wording of a clause,[34] or the policy considerations which provided the impetus for the legislation when the intent of Congress cannot be discovered.[35] The Supreme Court has developed a set of statutory interpretation guidelines to assist the lower federal courts in their struggle with determining difficult securities law issues.

B. *Interpreting the Securities Acts*

Ascertaining the intent of Congress is the paramount objective when exploring the implications of a provision in the Act or Exchange Act.[36] While the overall purpose of the federal securities laws is remedial,[37] specific clauses require careful scrutiny to discern the intendment of that section.[38] Jurists are occasionally confronted with this tension between the Congressional intent and the specific language embodied in a section.[39] To prevent a

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31 *See* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971) (referring to § 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1982)).

32 *See, e.g.*, Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 350 n.2 (1984) [hereinafter Thompson].

33 *See generally* FUNDAMENTALS, *supra* note 20, at 42.

34 *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (wording of § 10(b) requires fraud to be committed with scienter).

35 *Cf.* Batemen Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (recognition of common law *in pari delicto* defense as inappropriate for securities laws because it would thwart the purposes of the acts).

36 *See generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); *see also* 3A SUTHERLAND, STATUTORY CONSTRUCTION § 70.04 (4th ed. 1986).

37 *See, e.g.*, United Housing Found., Inc. v. Forman, 421 U.S. 837, 849 (1975).

38 *Cf.* Ernst & Ernst, 425 U.S. at 200 ("Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section.").

39 *Cf.* AFL-CIO v. Donovan, 757 F.2d 330, 344 (D.C. Cir. 1985) ("Since '[a]bsent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive,'. . . arguments as to the general intent or mind set of Congress cannot overturn the clear language of a specific provision.") (citation omitted).

court from construing a specific clause more broadly or narrowly than was contemplated, a three-stage approach to construction must be *consistently* employed when interpreting the acts.[40]

The first step in identifying congressional intent is to analyze the words of the statute.[41] The most reliable source of intendment is to be found in the deliberate expressions of the lawmakers. Significantly, unless the context indicates to the contrary,[42] the "commonly accepted meaning" of the language is presumed.[43] If the meaning of a provision is unambiguous and not at odds with the legislative history, the words of the statute control, and it is unnecessary to consider the policies which precipitated the Act and Exchange Act.[44] The salutary incantation of "remedial legislation" should never be used to distort the express language of a statute.[45]

If an examination of the plain language is unavailing, the next step is to read the section with the assistance of ordinary principles of statutory interpretation,[46] as well as to inspect any

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40 Perhaps the most fundamental principle of statutory interpretation is the duty of judicial restraint. *See* Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COL. L. REV. 527, 529 (1947) [hereinafter Frankfurter]. The role of a jurist is limited to "translat[ing]" the meaning of a statute. *Id.* at 534. *Cf.* Symons v. Chrysler Corp. Loan Guar. Bd., 670 F.2d 238, 241 (D.C. Cir. 1981) (The broad remedial purposes underlying federal legislation "does not give the judiciary license, interpreting a provision, to disregard entirely the plain meaning of the words used by Congress.").

41 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring).

42 Securities Exch. Comm'n v. National Sec., Inc., 393 U.S. 453, 459 (1969).

43 *See* Ernst & Ernst, 425 U.S. at 199 & n.19 (citing Addison v. Holly Hill Fruit Prods., Inc., 322 U.S. 607, 617-18 (1944)). This basic tenet of interpretation is essential to the orderly compliance of any untechnical statutory scheme. Easy understanding is vital because it is the populace who must conform their conduct to the legislation's dictates. *See id.*

44 *Id.* at 214 & n.33, *quoted in* Aaron v. Securities Exch. Comm'n, 446 U.S. 680, 695 (1980).

45 Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979), *quoted in* Aaron, 446 U.S. at 695. *Cf.* Pillsbury v. United Eng'g Co., 342 U.S. 197, 200 (1952) (The Supreme Court does not possess the authority to disregard the expressed intentions of Congress to avoid a harsh result which will inure to a litigant). *But cf.* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) ("remedial legislation should be construed broadly to effectuate its purposes").

46 National Sec., 393 U.S. at 466 (contextual setting is a relevant factor). An important aid to construction of the securities acts is to research the state of the law at the time of their promulgation. *See* Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 378 (1982). Courts should also consult the Proposed Fed-

legislative history.[47] The purpose of investigating legislative history and using canons of statutory construction is to clarify congressional intent, not create it.

A court should only retreat to the remedial guidelines of the Act and Exchange Act when the legislative history and common principles of statutory interpretation fail to clarify the meaning of vague phraseology used by Congress. Resorting to the broad reparative aims of the statutes to resolve securities law issues necessarily leads to judicial speculation of specific intendment.

While these precepts of statutory interpretation are well-established, reasonable minds may differ as to their application.[48] *Randall v. Loftsgaarden*[49] is indicative of this potential for disagreement.[50]

II. Randall v. Loftsgaarden

A. *Factual Circumstances*

B. J. Loftsgaarden created the limited partnership[51] of Alotel

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eral Securities Code for guidance when interpreting the Act and Exchange Act because it is viewed as a restatement of the securities laws. R. JENNINGS & H. MARSH, SECURITIES REGULATION, at xvii (5th ed. 1982) [hereinafter JENNINGS & MARSH].

47 *Cf.* Blum v. Stenson, 465 U.S. 886, 896 (1984) (The Supreme Court relies on a federal act's legislative history only when the wording of a statute is obscure).

48 *See, e.g.*, Randall v. Loftsgaarden, 106 S. Ct. 3143, 3157 (1986) (Brennan, J., dissenting).

49 106 S. Ct. 3143 (1986).

50 Authoritative commentators sagaciously observed that "reasonable men will continue to interpret the section [§ 11 of the Securities Act] differently, and the resulting uncertainty will force into prominence the *in terrorem* aspects of the section." Douglas & Bates, *supra* note 10, at 176. It may be effectively argued today that the quote now equally applies to § 12(2).

51 A limited partnership interest is a security within the meaning of § 2(1) of the Act as a "certificate of interest or participation in any profit-sharing agreement." *See supra* note 2 (statutory definition of a security). *Compare* Securities Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (the indicia for an investment contract security are that investors supply the capital to fuel the common enterprise and receive a portion of the profits derived "solely" from the efforts of others) *with* H. HENN & J. ALEXANDER, LAW OF CORPORATIONS § 28 (2d ed. 1970) ("the limited partner may contribute money or other property, but not services.") [hereinafter HENN 2D]. (However, the Revised Uniform Limited Partnership Act permits the contribution of services by the limited partner. H. HENN & J. ALEXANDER, LAW OF CORPORATIONS § 28 (3d Ed. 1983)) [hereinafter HENN 3D]. *See also* Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 650 F. Supp. 1378 (W.D. Va. 1986); Stewart v. Germany, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶92,723, at 93,507 (May 28, 1986).

Associates in 1973 to finance the construction and management of a hotel.[52] The general partners in Alotel Associates were Loftsgaarden and Alotel Inc., a corporation owned and operated by Loftsgaarden.[53] The promoter intended to raise three and one-half million dollars through the offering.[54]

Loftsgaarden advertised the limited partnership interests specifically as tax shelters for relatively wealthy individuals in need of deductions.[55] The prospectus stated that the partnership would secure a nonrecourse loan to meet most of the construction costs.[56] In addition, rapid depreciation techniques would be implemented to create substantial losses in the early years of the venture.[57] Because of the nature of this entity, the deductible losses would flow through the partnership to the limited part-

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[52] *Loftsgaarden*, 106 S.Ct. at 3146. B.J. Loftsgaarden was an attorney and the president and sole shareholder of several corporations at the time the petitioners invested in Alotel Associates. Austin v. Loftsgaarden, 675 F.2d 168, 173 (8th Cir. 1982) [hereinafter *Austin I*]. The petitioners sued Loftsgaarden and his companies involved with the security. For convenience, all of the respondents will be referred to collectively as Loftsgaarden or respondent.

[53] *Loftsgaarden*, 106 S.Ct. at 3146. In contradistinction to limited partners, general partners are those who actively manage the business and are subjected to "unlimited personal liability" for harms arising out of the company's activities. HENN 3D, *supra* note 51.

[54] *Loftsgaarden*, 106 S.Ct. at 3146. Although it is not clear from the opinions of the Supreme Court or the Eighth Circuit, Loftsgaarden possibly sold the securities under the private offering exemption of § 4(2) of the Act and Rule 505 or 506 of Regulation D. 15 U.S.C. § 77d(2); 17 C.F.R. §§ 230.505 -.506 (1986). While the exemption excuses the issuer from the registration requirements of the Securities Act, the civil liabilities provisions still apply. *See supra* note 16. For extensive discussion of real estate partnerships and the federal securities acts, see generally Dahlk, *Real Estate Partnerships and the Securities Laws: A Primer*, 12 CREIGHTON L. REV. 781 (1979); Hrusoff, *Securities Aspects of Real Estate Partnerships*, 11 CAL. W.L. REV. 425 (1975). It must be noted that the Tax Reform Act of 1986 limits the advantages of the tax losses in partnership ventures. *See* 26 U.S.C. § 704(d) (1982).

[55] *Loftsgaarden*, 106 S.Ct. at 3146-47. The offering memorandum stated that investors must have either a net worth of $200,000 or a portion of their income taxed at the 50% rate. *Austin I*, 675 F.2d at 173.

A tax shelter is an investment "which allow[s] the investor to offset certain 'artificial losses' (that is non-economic losses but losses which are available as deductions under the present tax laws) not only against the income from those investments but also against the [investor's] other income, usually from his regular business or professional activity." *Id.* at 183 (citing STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94 CONG., 1ST SESS., *Overview of Tax Shelters* 1 (Comm. Print 1975)).

[56] *Loftsgaarden*, 106 S.Ct. at 3147.

[57] *Id.*

ners.[58] This offering failed to attract a sufficient number of investors.[59]

Undaunted by the apprehension of potential investors, Loftsgaarden modified the plan by incorporating an additional deductible loss.[60] Specifically, instead of purchasing the land on which the hotel was to be built, Loftsgaarden proposed renting it.[61] This rental strategy created an additional deductible expense.[62] The extra tax incentive proved successful.[63] Relying on the revised prospectus, Randall and other individuals purchased limited partnership interests in Alotel Associates.[64]

The hotel was plagued with financial problems from the outset.[65] To avoid insolvency, the promoter implored the limited partners to execute an advancement to Alotel Associates.[66] The limited partners' suspicions were aroused, and they retained an attorney and an accountant to examine the financial affairs of the partnership.[67] Despite their concern, the investors acquiesced to

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[58] *Id.* at 3146-47; *see* 26 U.S.C. § 702(a) (1982) (subject to the limitations of § 704). The economic realities of such an investment are that a limited partner can reap immediate and considerable tax benefits which in effect would eventually pay for the original investment. *See Austin I*, 675 F.2d at 173-74. Thus, the investor receives a "free" participation in future profits. *See* Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments—Offsetting Plaintiffs' Relief to the Extent of Tax Benefits Received*, 16 CREIGHTON L. REV. 1140, 1140 n.4 (1983).

The petitioners' investments and realized tax savings are as follows:

Petitioner	Investment	Tax Benefit [Income Offset]
1. Randall	$35,000.00	$36,404.00
2. Anderson	$35,000.00	$29,657.00
3. Neumann	$52,500.00	$57,014.00
4. Austin	$35,000.00	$33,333.00

Austin v. Loftsgaarden, 768 F.2d 949, 960 (8th Cir. 1985) [hereinafter *Austin II*].

[59] *Loftsgaarden*, 106 S.Ct. at 3147.

[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *Id.* The petitioners were four of the original twenty-two investors. *Austin I*, 675 F.2d at 172.

[65] *Loftsgaarden*, 106 S.Ct. at 3147.

[66] *Id.* The respondent requested $125,000 from the investors. *Austin I*, 675 F.2d at 175-76.

[67] *Austin I*, 675 F.2d at 176.

Loftsgaarden's request for additional capital.[68] The added income proved to be inadequate and Alotel Associates collapsed.[69]

The limited partners brought an action averring, *inter alia*, violations of section 10(b)[70] of the Exchange Act, Rule 10b-5[71] promulgated thereunder by the Commission, and section 12(2)[72]

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[68] *Loftsgaarden*, 106 S.Ct. at 3147. Section 12(2) contains a notice defense. If the defendant can prove that the plaintiffs had actual or constructive notice of the fraud, the claimants cannot recover to the extent of their notice. 15 U.S.C. § 77*l*(2) (1982). Therefore, the petitioners could not seek a rescission recovery for the additional loans. *Austin I*, 675 F.2d at 176.

[69] *Loftsgaarden*, 106 S.Ct. at 3147.

[70] Section 10 provides:

> 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—
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> (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, or any security registered on a national securities exchange, 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.
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> (b) 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, 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.

15 U.S.C. § 78j (1982).

[71] Rule 10b-5 states:

> 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 any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1987).

[72] Section 12(2) pronounces:

> Any person who—
>
> (2) offers or sells a security (whether or not exempted by the provisions of [section 3], other than paragraph (2) of subsection (a) [thereof]), by 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 light of the circumstances under which they were

of the Act.[73] Although the district court awarded damages to the limited partners in the amount of the consideration tendered, it refused to offset the realized tax benefits under section 12(2).[74] The circuit court of appeals, while affirming the findings of fact,[75] reversed and remanded based on the formulation of damages.[76] The court ruled that the considerable tax benefits must be factored into the award.[77] However, the court expressly limited this decision to investments marketed as tax shelters.[78] In a subsequent appeal, the circuit court of appeals, sitting *en banc*, affirmed its prior decision.[79] The Supreme Court granted the limited partners' petition for *certiorari*.[80]

B. *Legal Arguments and Ruling*

The limited partners steadfastly maintained that tax benefits are not a form of "income received" within that meaning of sec-

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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 to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, *less the amount of any income received thereon*, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77*l*(2) (1982) (emphasis added).

It must be noted that section 12(2) applies to section 4 exempted transactions as well as the specifically mentioned section 3 exempted securities. The section 4 exempted transactions clause was inadvertently omitted during the drafting of the statute. Student Edition, *supra* note 11, at 1699 n.45.

73 *Loftsgaarden*, 106 S.Ct. at 3147.

74 *Id.* Significantly, the petitioners tendered their securities to the promoter to comply with § 12(2) immediately prior to trial. *Austin I*, 675 F.2d at 179. This strategy underscores the value of the tax benefits to the investors.

75 The jury had concluded that Loftsgaarden failed to advise the limited partners that he would indirectly receive additional compensation because his various closely held companies would be involved in much of the construction and financing of the hotel. *Austin I*, 675 F.2d at 175. Moreover, "the budgets and forecasts in the offering memorandum were found to be based on unreasonable and misleading assumptions." *Id.*

76 *Id.* at 184.

77 *Id.* at 183-84.

78 *Id.* at 183.

79 Austin v. Loftsgaarden, 768 F.2d 949 (8th Cir. 1985) (Heaney, J., concurring and dissenting; Lay, C.J. and Bright, J., dissenting).

80 106 S.Ct. 379 (1985).

tion 12(2).[81] Writing for the majority, Justice O'Connor agreed.[82] The Court began its analysis with the words of section 12(2).[83] The majority observed that the unambiguous language of the statute made it unnecessary to delve into Congress' intent.[84] Placing substantial reliance on the Internal Revenue Code's definition of income,[85] Justice O'Connor ruled that tax "benefits cannot, under any reasonable definition, be termed 'income.' "[86] The majority concluded that it would require "compelling evidence" to the contrary before inferring from section 12(2) that Congress intended tax deductions to be subsumed in the phrase "income received thereon."[87]

Loftsgaarden contended that the equitable remedy of rescission, which is required under section 12(2), mandates that the aggrieved party remit " 'whatever he may have received . . . in the way of . . . consideration or benefit.' "[88] Only then will the parties be truly restored to their *status quo ante*.[89] Furthermore, Loftsgaarden contended that the tax benefit obtained by the limited partners constituted such a "consideration or benefit."[90]

In response to these contentions, the Court observed that

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81 Randall v. Loftsgaarden, 106 S.Ct. 3143, 3149-50 (1986). *See also* 77 U.S.C. § 77*l*(2) (1982).

82 *Id.* at 3150. Justice Blackmun concurred with the result. *Id.* at 3155 (Blackmun, J., concurring). Justice Brennan dissented from the opinion. *Id.* at 3157 (Brennan, J., dissenting).

83 *Id.* at 3150; *see also supra* note 41 and accompanying text.

84 *Loftsgaarden*, 106 S.Ct. at 3150; *see also supra* note 44 and accompanying text.

85 *See* 26 U.S.C. § 61 (1982).

86 *Loftsgaarden*, 106 S.Ct. at 3150; *see also* 26 U.S.C. § 61 (1982). By analogy, the majority was of the opinion that *United Housing Foundation* lent further support. *Loftsgaarden*, 106 S.Ct. at 3150. In that case, renters of the cooperative housing sought the protection of the federal securities laws arguing, *inter alia*, the presence of a *W.J. Howey*—type investment contract. *See* United Housing Found., Inc. v. Forman, 421 U.S. 837, 845 (1975); *see also* Securities Exch. Comm'n v. W.J. Howey, 328 U.S. 293 (1946). The Court rejected the contention stating that the deductibility of interest payments on a mortgage did not constitute income for purposes of the *W.J. Howey* test. *United Housing Found.*, 421 U.S. at 856. In its conclusion, the Court stated that "we decide only that the type of transactions before us, in which purchasers were interested in acquiring housing rather than making an investment for profit, is not within the scope of the federal securities laws." *Id.* at 860.

87 *Loftsgaarden*, 106 S.Ct. at 3150.

88 *Id.* at 3150-51 (quoting 2 H. BLACK, BLACK ON RESCISSION AND CANCELLATION § 617 (1916)).

89 *Id.* at 3150-51.

90 *Id.* at 3151.

"generalities" unsubstantiated by case law[91] did not rise to the level of compelling evidence.[92] In fact, the majority continued, the common law "direct product" rule[93] would prohibit the type of tax benefit offset asserted by the respondent because tax deductions are a collateral consequence of the security ownership.[94] Moreover, Loftsgaarden's strict interpretation of the rescissionary remedy embodied in section 12(2) fails to consider the central purpose of the Securities Act: to protect the investing public by deterring fraudulent omissions and misrepresentations in the distribution of securities.[95] Thus, Justice O'Connor concluded that tax benefits going to the limited partners, for purposes of section 12(2) of the Securities Act, was not to be considered when applying a rescissionary measure of damages.[96]

Loftsgaarden next insisted that section 28(a)[97] of the Securities Exchange Act limits a defrauded investor's claim to his "ac-

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91 *But cf.* Berg v. Xerxes-Southdale Office Bldg. Co., 290 N.W.2d 612, 615 (Minn. 1980) (The Supreme Court of Minnesota indicated that income tax considerations could influence the valuation of limited partnership interests.). The Court was unable to offer any authority to refute the respondent's argument.

92 *Loftsgaarden*, 106 S.Ct. at 3151.

93 Under the direct product rule, the party demanding rescission must remit " 'that which is derived from the ownership or possession of the property without the intervention of an independent transaction by the possessor.' " *Loftsgaarden*, 106 S.Ct. at 3151 (quoting RESTATEMENT OF RESTITUTION § 157 comment b (1937)).

94 *Loftsgaarden*, 106 S.Ct. at 3151. Restating his argument in slightly different terms, Loftsgaarden argued alternatively that the tax benefits received by the limited partners should be subtracted from the original purchase price of the security, before the transactions were rescinded. *Id.* at 3151. The Court found that there was no indication that the Congress intended such a reduction, especially in light of the "income received" offset. *Id.* at 3151-52.

95 *Id.* at 3151. *See also United Housing Found.*, 421 U.S. at 849.

96 *Loftsgaarden*, 106 S.Ct. at 3152.

97 Section 28(a) provides:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.

15 U.S.C. § 78bb(a) (1982).

tual damages" under section 12(2) as well as section 10(b).[98] Relying on *Globus v. Law Research Service, Inc.*[99] for support, Loftsgaarden maintained that because the *Globus* court read section 17(a) of the Act *in pari materia* with section 28(a) and denied a claim for punitive damages, the same rule of construction should be applied in the instant action.[100] Therefore, recovery of the full purchase price of the security in addition to retaining the tax deductions should be proscribed.[101]

The majority found that reliance on *Globus* was misplaced. The Court in that case denied punitive damages under a statute that does not indicate specifically that some remedy is available.[102] The remedy set forth in section 12(2) however is manifested clearly.[103] To rule that section 28(a) limits the partners' damages in section 12(2), the Court reasoned that such an interpretation would implement a partial repeal of the Act's provision.[104]

Next, in addressing whether rescission was a proper cure for a section 10(b) injury,[105] Justice O'Connor evaluated the effect of section 28(a) on the investors' section 10(b) count.[106] Loftsgaarden, while acknowledging that rescission was a possible measure of damages under section 10(b), argued that section 28(a) man-

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98 *Loftsgaarden*, 106 S.Ct. at 3152.

99 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

100 *Loftsgaarden*, 106 S. Ct. at 3152 (citing Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970)). (*In pari materia* is defined as: on the same subject or matter; in a similar case. WEBSTER'S THIRD INTERNATIONAL DICTIONARY 1167 (15th ed. 1963).

101 *Loftsgaarden*, 106 S.Ct. at 3152.

102 *Id.*

103 *Id.*

104 *Id.* A rule of statutory construction cautions courts against even implying a partial repeal. *See, e.g.*, Radzanower v. Touche Ross & Co., 426 U.S. 148, 154 (1976) (quoting United States v. United Continental Tuna Corp., 425 U.S. 164, 168 (1976)).

105 It is generally acknowledged by commentators that a plaintiff may demand rescission or damages pursuant to § 10(b) and rule 10b-5 actions. *See* HAZEN, *supra* note 12, at 471-73. If damages are averred, the most often used standard of calculation is the "out-of-pocket" measure in which the plaintiff is awarded the difference between the value of what he gave up and the value of what he obtained in the transaction. JENNINGS & MARSH, *supra* note 46, at 1119. This standard is the normal remedy. *See, e.g.*, Rowe v. Maremont Corp., 650 F. Supp. 1091 (N.D. Ill. 1986). The A.L.I. Proposed Federal Securities Code § 1708 comment 1(a) [hereinafter Securities Code] designates the "out-of-pocket" formula as the most acceptable mode.

106 *Loftsgaarden*, 106 S.Ct. at 3153.

dated a tax benefit offset if the recission remedy was utilized.[107] She urged that section 28(a) prohibits a claim from exceeding the "actual damages" sustained.[108] Therefore, the investors' rescissionary restoration should be limited to their "net economic harm."[109]

Noting that Congress did not define "actual damages," the Court determined that an examination of the legal milieu surrounding the enactment of section 28(a) would be instructive.[110] Justice O'Connor observed that section 12(2) was in existence prior to the enactment of section 28(a).[111] Thus, according to the majority, because it had already found that tax benefits were not to be considered in a section 12(2) rescission action, a correlative 10(b) claim should be given similar treatment.[112]

The Court remarked further that section 28(a) was not to be construed as strictly limiting the recovery of a claimant to the net economic harm sustained.[113] In *Affiliated Ute Citizens v. United States*,[114] the Supreme Court noted that in order to prevent the unjust enrichment of the wrongdoer, when the seller's loss is exceeded by the defendant's gain "damages are the amount of the defendant's profit."[115] Using the rationale of *Affiliated Ute* as being consonant with the purposes of the securities laws, Justice O'Connor decided that the parameters of section 28(a) were not breached simply because the defrauded party would be placed in

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107 *Id.*

108 *Id.* (quoting Blue Chip Stamps v. Manor Drug Stores, 451 U.S. 723, 739 (1975)).

109 *Id.*

110 *Id. See also supra* note 46 and accompanying text.

111 *Loftsgaarden*, 106 S.Ct. at 3153.

112 *Id. See also* accompanying text *supra* note 95-96.

113 *Id.*

114 406 U.S. 128 (1972) (concerning a § 10(b) and rule 10b-5 action).

115 Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972) *cited in Loftsgaarden*, 106 S.Ct. at 3153. Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965) was marshalled for further support. The court in *Janigan* reasoned that as between the victim and the malefactor, it was more appropriate to bestow the technically undeserved benefits upon the injured party. *Id.* at 786. *See also* D. DOBBS, REMEDIES § 4.1, at 224 (1973) [hereinafter DOBBS]. The relevance of *Janigan* and *Affiliated Ute* to *Loftsgaarden* is questionable. In those cases the tortfeasors' net gains were in excess of the defrauded parties' losses. There is no unjust enrichment in *Loftsgaarden*. The respondent did not profit from the petitioners' tax write-offs. Thus, there is nothing for Loftsgaarden to disgorge.

a better position than his *status quo ante*.[116]

Returning to the broad remedial principles which precipitated the securities acts,[117] the Court noted that deterrence of wrongdoing was another goal of the securities legislation.[118] The majority explained that a strict adherence to compensating claimants for their net economic loss would thwart the Act's and Exchange Act's prophylactic design.[119] Disallowing a subtraction of tax benefits from the damages[120] serves the time-honored policy of encouraging private enforcement of the securities law.[121]

Loftsgaarden contended that the "economic realities"[122] of tax shelters demand that tax benefits be considered in the calculation of damages.[123] He argued that one of the major incentives for investing in limited partnership real estate securities is to exploit the deductible losses which neutralize comparatively substantial taxable incomes.[124] The promoter urged that it would be manifestly unjust to ignore the receipt of tax credits when formulating damages pursuant to section 28(a).[125] The Court remained unimpressed, and reiterated that it had previously determined that neither section 12(2) nor section 28(a) could be interpreted to include a tax benefit offset.[126] In terms of the economic realities of tax benefits, the Supreme Court observed that

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116 *Loftsgaarden*, 106 S.Ct. at 3153. The Court repudiated the analogous argument that the limited partnership would obtain a "windfall" by an award of damages in addition to the tax benefits received since the recovery will be taxed as ordinary income. *Id.* at 3154-55.

117 *See supra* note 37 and accompanying text.

118 *Loftsgaarden*, 106 S. Ct. at 3154.

119 *Id.*; *see also* Salcer v. Envicon Equities Corp., 744 F.2d 935, 940 (2d Cir. 1984), *cert. granted and judgment vacated*, 106 S. Ct. 3354 (1986).

120 *Loftsgaarden*, 106 S.Ct. at 3154 (the Court noted further that calculating offsetting tax benefits would be a weighty imposition on the trial courts).

121 *Id.* The SEC is an administrative agency charged with rule-making, adjudicatory, and investigatory duties with respect to the six federal securities acts. HAZEN, *supra* note 12, at 12. Of the Commission's three chief functions, the most burdensome is its investigatory—enforcement role. *See* Ratner, *supra* note 2, at 589. Hence, the Supreme Court has expressly adopted a policy which assists the SEC in its enforcement function. *See, e.g.*, Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S.Ct. 2622, 2628 (1985).

122 *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

123 *Loftsgaarden*, 106 S.Ct. at 3154.

124 *Id.* (quoting *Salcer*, 744 F.2d at 940). *See also supra* note 58.

125 *Loftsgaarden*, 106 S. Ct. at 3154.

126 *Id.* at 3154-55. *See supra* notes 95-96 and accompanying text.

unlike securities, tax benefits are intangible assets.[127] Tax benefits "are not . . . freely transferable from one person to another if wholly severed from the property or activity to which they relate."[128] Justice O'Connor found that Loftsgaarden's impression of the economic realities was fantasy, and ruled that tax benefits could not be treated as property interests for the purposes of the securities laws.[129]

With the disposition of Loftsgaarden's array of contentions, the Court concluded the *Austin II* decision was improperly decided.[130] The Supreme Court held that sections 12(2) and 10(b) could not be interpreted to require the investor's rescissionary award to be offset by tax benefits received from the deductible losses incurred by the limited partnership.[131]

Justice Blackmun concurred with the majority's decision, but wrote separately to express his view that a tax benefit offset may be appropriate in some actions brought exclusively under section 10(b) and rule 10b-5.[132] If a court elects to use the out-of-pocket measure of damages instead of rescission, the analysis diverges.[133] According to Justice Blackmun, the application of tax

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127 *Id.* at 3155.

128 *Id.* However, the Third Circuit Court of Appeals has ruled that an investor may file an action based upon fraud when a tax shelter security has failed to deliver tax benefits warranted in an opinion letter. Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982). It certainly appears inequitable to permit an investor to sue for the failure to produce tax benefits while denying a defendant the right to offset his damages based on tax benefits received.

129 *Loftsgaarden*, 106 S.Ct. at 3155.

130 *Id.* The Supreme Court declined to express its opinion on two issues. It did not judge whether intentionally delaying the tender of the security under § 10(b) to capitalize on the tax credits would bar a rescissionary recovery. *Id.* The general rule is that postponing the tender is permissible. *See, e.g.*, Wigand v. Flo-Tek, 609 F.2d 1028, 1034-35 (2d Cir. 1979); *but see* Feldman v. Pioneer Petroleum, Inc., [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,170, at 95,759-60 (March 5, 1987). Such dilatory tactics may be tantamount to ratification. *See* Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 232 & n.16 (1933) [hereinafter Shulman]. The majority observed that the trial courts possess the discretion to address this abuse. *Loftsgaarden*, 106 S.Ct. at 3155. The Court further refused to resolve whether a § 10(b) claimant has the right to select either an out-of-pocket or rescissionary measure of damages. *Loftsgaarden*, 106 S.Ct. at 3155; *see also supra* note 105.

131 *Loftsgaarden*, 106 S.Ct. at 3155.

132 *Id.* at 3155-56 (Blackmun, J., concurring).

133 *Id.* at 3156 (Blackmun, J., concurring). Justice Blackmun explained that "an investor's out-of-pocket loss . . . is, 'the difference between the fair value of all that [the plaintiff] received and the fair value of what he would have received had there

shelter investments to the out-of-pocket loss formula requires an examination of the tax deductions realized, as well as the value of the security, because additional consideration was paid for the ability to offset taxable income.[134] In cases where the tax shelter fails and fraudulent conduct is present, the investors still have received the benefit of their bargain insofar as the tax write-offs are concerned in situations where the participants enjoy deductible losses.[135] Justice Blackmun concluded that under the section 10(b) out-of-pocket standard, the receipt of tax credits must be considered.[136]

In a rather persuasive dissent, Justice Brennan inferred from section 12(2) of the Securities Act that "income received" could indeed be reasonably interpreted to include the acquisition of tax benefits.[137] Commencing his inquiry with the language of the provision,[138] the Justice observed that Congress indisputably dictated that when the defrauded party is in possession of the security rescission is the proper remedy under section 12(2).[139] Justice Brennan reasoned: "Given this intent, I would look for guidance in interpreting the word 'income' in the theory and goals of common-law and equitable restitution, rather than in the Internal Revenue Code, as the Court does."[140]

Justice Brennan's review of the common law of rescission evinced that the objective was to place the parties in the positions they had occupied before the formation of the contract.[141] This

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been no fraudulent conduct.' " *Id.* (Blackmun, J., concurring) (quoting *Affiliated Ute*, 406 U.S. at 155 (1972). *See also supra* note 105.

134 *Loftsgaarden*, 106 S.Ct. at 3156 (Blackmun, J., concurring).

135 *Id.* at 3156-57 (Blackmun, J., concurring).

136 *Id.* at 3157 (Blackmun, J., concurring).

137 *Id.* (Brennan, J., dissenting). Justice Brennan's dissent in *Loftsgaarden* is similar to his dissent in United Housing Found., Inc. v. Forman, 421 U.S. 837, 860 (1975) (Brennan, J., dissenting).

138 *Id.* (Brennan, J., dissenting). *See also supra* note 41 and accompanying text.

139 *Loftsgaarden*, 106 S.Ct. at 3157 (Brennan, J., dissenting).

140 *Id.* (Brennan, J., dissenting) (citing FUNDAMENTALS, *supra* note 20, at 1022). Justice Brennan alludes to the flaw in the reasoning of the majority which may be attributed to its inconsistent use of established canons of construction. While the Court properly uses the state-of-the-law to aid interpretation when searching for the meaning of "actual damages," *see supra* note 46, it ignores this precept and decides that it is more appropriate to explore the technical and specialized field of tax law in ascertaining the intent of the Congress' use of the term "income."

141 *Loftsgaarden*, 106 S.Ct. at 3157-58 (Brennan, J., dissenting) (citing 3 H. BLACK, RESCISSION OF CONTRACTS AND CANCELLATION OF WRITTEN INSTRUMENTS § 616, at

return to the *status quo ante* involved the plaintiff remitting all that he had bargained for and received, including the transitional property, in exchange for the original consideration and anything which flowed directly from it.[142] If a party is permitted to retain anything received in the bargain, deduced the Justice, the design of rescission is frustrated.[143]

Justice Brennan then applied the common law principles of rescission to real estate tax shelters.[144] He noted that this type of investment is marketed as a tax shelter, and participants are willing to pay additional consideration for the capacity to deduct the losses sustained in their venture.[145] He concluded that tax benefits must be included in the rescission formula because the plaintiff has bargained for and received the capability to write-off tax losses.[146]

Brennan continued that the mere use of the word "income" by Congress does not alter the realities of the investment.[147] The commonly accepted meaning of "income" is " 'a gain or recurrent benefit usually measured in money that derives from capital or labor.' "[148] He reflected that perhaps tax benefits cannot be described as income pursuant to the Internal Revenue Code, but can constitute income in the ordinary sense of the word.[149] Justice Brennan reasoned that since there is no indication in the Se-

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1482 (2d ed. 1929); DOBBS, *supra* note 115, at 224; C. MCCORMICK, LAW OF DAMAGES § 121, at 448 (1935)).

142 *Id.* at 3158 (Brennan, J., dissenting) (citing 2 H. BLACK, RESCISSION OF CONTRACT AND CANCELLATION OF WRITTEN INSTRUMENTS § 617 (2d ed. 1929) [hereinafter 2 BLACK]; 5 A. CORBIN, CORBIN ON CONTRACTS § 1114, at 607 (1964) [hereinafter CORBIN]; 1 G. PALMER, LAW OF RESTITUTION § 3.9, § 3.11, § 3.12 (1978); Thompson, *supra* note 32, at 366, 369.

143 *Id.* (Brennan, J., dissenting) (citing CORBIN, *supra* note 142, at 607; 2 BLACK, *supra* note 142, at 1488) (Brennan, J., dissenting).

144 *Id.* (Brennan, J., dissenting).

145 *Id.* (Brennan, J., dissenting). *See also Salcer*, 744 F.2d at 940. Justice Brennan remarked that there is no appreciable difference between dividends which must be calculated in rescission and tax savings: "To a rational investor, a security that yields $101.00 of tax benefits differs from a security that yields $100.00 in dividends in only one way—by one dollar." *Id.* (Brennan, J., dissenting). *See also* United Housing Found., Inc. v. Forman, 421 U.S. 837, 863-64 (1975) (Brennan, J., dissenting).

146 *Id.* at 3158-59 (Brennan, J., dissenting).

147 *Id.* (Brennan, J., dissenting).

148 *Id.* (quoting WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 610 (1983)) (Brennan, J., dissenting).

149 *Id.* at 3159 (Brennan, J., dissenting).

curities Act that the word "income" was to be given any other interpretation, it should be defined by its common meaning.[150] Justice Brennan determined that the irresistible inference is that the rescissionary language in section 12(2) requires tax benefits to be considered in the calculation of damages.[151]

III. Analysis

A. *Defining Income*

The Internal Revenue Code defines income as "all income from whatever source derived."[152] This version of income is used by the Supreme Court to interpret section 12(2) of the Securities Act.[153] While the legislative history of section 12(2) provides little assistance in determining whether income can be construed to include tax benefits,[154] the Internal Revenue Code's characterization proves even less useful.[155]

> To let general words draw nourishment from their purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another. . . . After all, legislation when not expressed in technical terms is addressed to the common run of men and is therefore to be understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him.[156]

The common usage of the term should prevail. As noted by Justice Brennan, tax benefits fall within the ordinary meaning of income since they are " 'a . . . recurrent benefit . . . that derives from

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150 *Id.* (Brennan, J., dissenting). The Justice relies on the maxim of statutory interpretation which instructs judges to presume the plain implication of a provision unless the context indicates to the contrary. *See supra* note 43 and accompanying text.

151 Randall v. Loftsgaarden, 106 S.Ct. 3143, 3159 (1986) (Brennan, J., dissenting). Justice Brennan stated that his opinion is the same for § 10(b) and rule 10b-5.

152 26 U.S.C. § 61 (1982).

153 *See Loftsgaarden*, 106 S. Ct. at 3150.

154 *See id.*

155 *Id.* at 3157 (Brennan, J., dissenting). Justice Holmes was applauded for "hug[ging] the shores of the statute itself, without much re-enforcement from without." Frankfurter, *supra* note 40, at 532.

156 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.19 (1975) (quoting Addison v. Holly Hill Fruit Prods., Inc., 322 U.S. 607, 617-18 (1944)). Hence the Court deviated from traditional principles of statutory interpretation.

capital. . . .' "[157] Not only does the Court err in failing to interpret income by its common meaning, it also seeks substantiation from a source entirely foreign to the securities laws.

If the Court was dissatisfied with this plain language interpretation of income, it would have been more appropriate to consult a source relevant to securities regulation for further clarification. The SEC and the commentators have urged the courts to look to the Proposed Federal Securities Code[158] [hereinafter Securities Code] for assistance when attempting to resolve difficult securities law questions.[159] In this regard, it is probative to observe that section 12(2)'s counterpart in the Securities Code selected a phrase which is more akin to the plain import of "income."[160] The Securities Code declares that a plaintiff must remit the security to the defendant "less *any return* (with interest) that he received on the security. . . ."[161]

While this distinction between "income" and "return" seems subtle, in fact it is extremely important. If the Supreme Court heeded the Commission and scholars by availing itself of the direction of the Securities Code, it is doubtful that the Court would have used the tax law's characterization of "income." Furthermore, the Fourth Circuit, in a post-*Loftsgaarden* decision, mused that the income-return distinction would have been crucial.[162] In *dicta*, the court stated that had Congress used more general terms such as "value" or "economic benefit" in the place of "income," tax benefits could be fairly read into section 12(2).[163] "Return," "value,"

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157 *Loftsgaarden*, 106 S. Ct. at 3159 (quoting WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 610 (1983)) (Brennan, J., dissenting). *Cf.* WEBSTER'S NEW INTERNATIONAL DICTIONARY 1258 (2d ed. 1944) (defining income as "[t]hat gain or recurrent benefit (usually measured in money) which proceeds from labor, business or property; commercial revenue or *receipts of any kind.*") (emphasis added).

158 *See supra* note 105. Louis Loss, the preeminent authority in the securities regulation field, was the principal drafter of the code. HAZEN, *supra* note 12, at 8. *See also* JENNINGS & MARSH, *supra* note 46, at xvii; Ruder, *supra* note 3, at 627 n.2. Although never enacted, the Code is viewed as momentous. JENNINGS & MARSH, *supra* note 46, at xvii.

159 The SEC has routinely supported the official adoption of the Code. HAZEN, *supra* note 12, at 9 & n.20; *see also id.* at 9 (courts often seek assistance of the Code for interpretation); JENNINGS & MARSH, *supra* note 46, at xvii (courts citing the Code as a restatement of the securities laws).

160 *See* Securities Code, § 1702 (d), at 694-95.

161 *Id.* (emphasis supplied).

162 *See* Adalman v. Baker, Watts & Co., 807 F.2d 359, 372 (4th Cir. 1986).

163 *Id.*

and "economic benefit" are equally general. Therefore, it is highly probable that the Securities Code would necessitate that tax benefits be calculated in a rescissionary recovery.

Instead of invoking the complex area of tax law, a more judicious method would have been to interpret income using the Securities Code.[164] If the Court had applied the commonly accepted meaning of income, which is analogous to the one in the Securities Code, tax benefits would have been included. Presently viewed as a restatement of the law of securities regulation, the Securities Code would have compelled the majority to recognize that the term "income," as used in section 12(2), is to be understood by its conventional meaning.

B. *Rescission in Section 12(2)*

Examining the state of the law at the time of the legislation's enactment serves only to buttress the plain reading conclusion that tax benefits must be deemed income for purposes of section 12(2). The language of the statute indisputably provides for rescission when the purchaser in possession of a security sues an issuer pursuant to section 12(2). The rescissionary language of section 12(2) must be viewed in the context of the common law from which it was derived.[165] Common law required dismantling the transaction,[166] restoring the parties to their *status quo ante*,[167] and crediting the defendant with any partial performance.[168] Permitting the claimant to retain any portion of his bargain essentially negates the doctrine of rescission.[169]

In some respects, this common law theory of recovery within the confines of section 12(2) is no different.[170]

> The object of the rescission [remedy of section 12(2)] being to restore the status quo ante the sale, it does not seem that a liability for loss is imposed upon the seller, or that money is

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164 *See supra* note 159 and accompanying text.

165 FUNDAMENTALS, *supra* note 20, at 1022; Shulman, *supra* note 130, at 243.

166 *See* 3 S. WILLISTON, THE LAW OF CONTRACTS § 1525 (1920).

167 DOBBS, *supra* note 115, at 222.

168 CORBIN, *supra* note 142.

169 *Id.* However, it is generally accepted that if the defendant profits from his wrongdoing and is thereby unjustly enriched even after the plaintiff has recovered his property, the rescission remedy will "forc[e] the defendant to disgorge benefits that it would be unjust for him to keep." DOBBS, *supra* note 115, at 224.

170 Shulman, *supra* note 130, at 231.

> being taken from his pocket to compensate the buyer. His position is not deemed to be unduly prejudiced if bets are declared off and each party returns to the other what he received in the sale.[171]

Hence, the remedy in section 12(2) has been regarded as compensatory rather than punitive.[172]

In *Loftsgaarden*, the investors were lured by[173] and paid for the tax advantages the respondent advertised as being a major component of the limited partnership interests.[174] These advantages included the deductible losses which the petitioners wrote-off on their tax returns.[175] Therefore, "the investor[s] received the benefit of [their] bargain with respect to the part of the purchase price which went toward buying the tax benefits."[176] Rescission requires that Loftsgaarden be credited with this partial performance.[177] Permitting retention prevents a restoration of the parties' pre-contract status, thus frustrating the rescissionary remedy embodied in section 12(2) and the common law.[178] It can scarcely be said that all bets are off when a party retains in excess of thirty-thousand dollars in the tax savings in addition to the return of the original purchase money.

The Court's response to the common law theory of rescission and restitution is two-fold.[179] First, the majority notes that under the "direct product" rule, only gains attributable to the ownership of property, free from intervention, are credited to the defendant.[180] Since tax deductions cannot exist without the intervention of taxable income, the Court concluded that the deductions are not a

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171 *Id.*

172 Douglas & Bates, *supra* note 10, at 177.

173 Indeed, sufficient subscribers to the security were obtained only when Loftsgaarden created another deduction. *See supra* notes 55-63 and accompanying text. *Loftsgaarden*, 106 S. Ct. at 3158-59 (Brennan, J., dissenting).

174 *Loftsgaarden*, 106 S. Ct. at 3146-47.

175 *See supra* note 58.

176 *Loftsgaarden*, 106 S. Ct. at 3157 (Blackmun, J., concurring).

177 *See* CORBIN, *supra* note 142.

178 *See generally id.* The court describes these concepts as "generalities," and then underscores the inability of the respondent to recite a case at common law directly on point. *Loftsgaarden*, 106 S. Ct. at 3150-51. The majority's lack of authority to the contrary indicates that this is either a case of first impression or there are very few decisions involving rescission and tax deductions.

179 *See Loftsgaarden*, 106 S. Ct. at 3151.

180 *Id.* (quoting RESTATEMENT OF RESTITUTION § 157 comment b (1937)).

direct product of the investment.[181]

This reasoning fails to recognize the realities of tax shelter investments.[182] Each party to the transaction presumes a highly profitable indirect product.[183] It would be anomalous to state that tax benefits are an indirect product when they are specifically sought precisely because the petitioners intended the intervention of their substantial taxable incomes.

The majority further states that the language of section 12(2) indicates that Congress intended the rescissionary clause to act as a deterrent.[184] However, the Court reads the statute too expansively. Section 12(2) is compensatory in nature and was not intended to be applied for *in terrorem* purposes.[185] The Supreme Court therefore disregards its warnings to the lower courts not to summon the "remedial purposes" of the securities laws to "justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.' "[186]

IV. Conclusion

The unstructured[187] statutory analysis adopted by the majority in *Loftsgaarden* undermines the legislative purpose of the remedy embodied in section 12(2). Since discerning congressional intent is the polestar in construing the Act and Exchange Act;[188] the duty of the Court was to ascertain the meaning of "income" as expressed by the Congress in section 12(2).

The first step is to scrutinize the language of section

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181 *See id.*

182 *Id.* at 3159 n.* (Brennan, J., dissenting). Justice Brennan reflected that:

> the seller assumes that a buyer has need for the tax deductions the investment will generate, just as the seller of a rebuilt automobile engine assumes that the buyer has a car in which to put the engine. We do not—at least I would not—describe the value that an engine has when placed in a car as 'indirect' simply because the buyer had to acquire a car in order to exploit the value.

Id.

183 *See generally id.*

184 *Id.* at 3154.

185 *See supra* note 172 and accompanying text.

186 Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1978) (quoting Securities Exch. Comm'n v. Sloan, 436 U.S. 103, 116 (1978)).

187 *See supra* notes 36-47 and accompanying text for a consistent method designed to discover true legislative intent in the securities statutes.

188 *See supra* note 36 and accompanying text.

12(2).[189] The operative phrase is "any income received thereon." Since the context of the provision does not suggest to the contrary, the generally accepted import of income is to be implied.[190] The prevailing definition of income is recognized as "a . . . recurrent benefit . . . that derives from capital. . . ."[191] This characterization of income encompasses purchased tax benefits. Therefore, because this definition of income does not conflict with the Act's legislative history, the tax deductions secured by the petitioners should have been calculated in their rescissionary recovery under section 12(2).

While proceeding beyond this plain language interpretation is unwarranted,[192] employing the second stage of statutory construction serves only to substantiate its conclusion. Researching the legislative history of the Securities Act to clarify Congress' intendment of the meaning of income proves dissatisfying. However, an acknowledged canon of construction in the securities laws does indeed explain the meaning of the rescissionary clause of section 12(2).

An examination of the state of the law at the time of the promulgation of the Securities Act[193] demonstrates that Congress deemed the common law of rescission to be the proper remedy when a purchaser in possession of a security sues an issuer pursuant to section 12(2).[194] To rescind a contract at common law, all parties must return that which was purchased and received in a transaction.[195] The design of the common law of rescission is simply to place the parties in their respective pre-contract positions.[196] The only means by which the parties could be restored to their *status quo ante* is to credit the respondent with the tax benefits they obtained.[197]

Further support to the conclusion that tax deductions are to

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189 *See, e.g., Ernst & Ernst*, 425 U.S. at 197 (discussing § 10(b)).

190 *See Ernst & Ernst*, 425 U.S. at 198-99 & n.19.

191 WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 610 (1983).

192 *Ernst & Ernst*, 425 U.S. at 214 & n.33.

193 *See* Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 378 (1982).

194 *See* FUNDAMENTALS, *supra* note 20, at 1022; Shulman, *supra* note 130, at 243-44.

195 *See supra* notes 141-43, 166-69 and accompanying text.

196 *Id.*

197 The Supreme Court, however, allows the petitioners to retain a large part of what they bargained for and received in the form of tax deductions.

be included in section 12(2) is found in the "restatement"[198] of the securities laws. The correlate to section 12(2) in the Securities Code replaces "income received" with the more general phrase "*any return*." Tax benefits are a "return" from an income sheltering security. Hence, the Securities Code would require that tax credits acquired by the petitioners in *Loftsgaarden* be formulated in their rescissionary recovery.

Instead of applying an orderly approach to ascertaining the congressional intent expressed in section 12(2) of the Securities Act, the Supreme Court refers to the Internal Revenue Code to resolve *Randall v. Loftsgaarden*. While this method of construction does effectuate the broad remedial purposes of the legislation, it does not accommodate the specific intent of Congress enunciated in section 12(2). If the learned Justices of the Supreme Court fail to honor settled canons of construction and their duties of judicial restraint by interpreting the federal securities laws with the dubious support of incomparable statutes, the ordinary seller will know to beware, but not of what.

198 *See* JENNINGS & MARSH, *supra* note 46, at xvii.