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Chris-Craft and Section 14(e): The Expansion of Lead Underwriters' Liability

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CHRIS-CRAFT AND SECTION 14(e): THE EXPANSION OF LEAD UNDERWRITERS' LIABILITY

I. Introduction

In 1968 Congress amended[1] the Securities Exchange Act of 1934 to include section 14(e), an antifraud provision closely patterned after rule 10b-5.[2] However, section 14(e) expressly applies to tender offers, requests or invitations for tenders, and solicitations in favor of or opposed to such offers, requests or invitations.[3] Five years later, in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,[4] the Second Circuit Court of Appeals handed down a comprehensive statement of principles controlling the application of the new provision. In the course of its opinion, the court held a lead underwriter liable on an exchange offer because the registration statement of the offeror grossly overvalued one of its major assets and concealed the fact of the impending sale of that asset at a substantial loss.[5] This Comment will analyze the route employed by the court in predicating lead underwriters' liability on section 14(e). After the facts of the case are developed briefly, the decision of the court will be analyzed in terms of its use of rule 10b-5 precedent in developing section 14(e), and its disregard of the express liability parameters of section 11 of the Securities Act of 1933.[6]

II. The *Chris-Craft* Case

A. *The Facts*

The Second Circuit's opinion climaxed protracted litigation arising out of a takeover battle between Chris-Craft Industries, Inc. ("CCI") and Bangor-

1. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454, amending 15 U.S.C. § 78l, m, n (1964) (codified at 15 U.S.C. § 78l(i), m(d) & (e), n(d), (e) & (f) (1970)).

2. Rule 10b-5 provides in part:

"It shall be unlawful for any person . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of 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 (1973).

3. § 14(e) provides in part:

"It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. . . ." 15 U.S.C. § 78n(e) (1970).

4. 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910, 924 (1973).

5. Id. at 369-73. For further discussion see text accompanying notes 12-22 infra.

6. 15 U.S.C. § 77k (1970).

Punta Corp. ("BPC") for control of Piper Aircraft Corp. ("Piper").[7] The contest involved an intricate pattern of offensive and counteroffensive tactics of which only those relevant to underwriters' liability will be developed here.[8]

From the outset Piper opposed CCI's takeover efforts, and early in the contest opened negotiations with BPC aimed at preventing the CCI takeover. Finally, on May 8, 1969, BPC announced its intention to make an exchange offer for outstanding shares of Piper. Neither the Schedule 13D nor the S-1 filed with the SEC mentioned that BPC was negotiating a sale of one of its major assets—Bangor and Aroostook Railroad ("BAR")—carried on the books and in the SEC filings at $18.4 million, for the substantially smaller consideration of $5 million which resulted in a 12 percent loss of BPC shareholders' aggregate book equity.[9]

First Boston Corp. acted as the lead underwriter and dealer manager on the exchange offer. After examining the books and records of BAR, they questioned BPC about a possible divestiture of BAR, but were informed that no action was contemplated at that time.[10] First Boston made no effort to verify this re-

7. On May 22, 1969, at the height of the takeover battle, CCI brought an action against, inter alia, First Boston, Piper, and three members of the Piper family alleging violations of § 5(c) of the Securities Act, 15 U.S.C. § 77e(c) (1970) (sale of securities without a filed registration statement), rule 135, 17 C.F.R. § 230.135 (1973) (constituting certain notices of offer as § 5 offers to sell), §§ 9, 10(b), and 14(e) of the 1934 Act, 15 U.S.C. §§ 78i, j(b), n(e) (1970) (§ 9 prohibits market manipulation of securities prices; § 10(b) prohibits manipulative and deceptive practices in the purchase or sale of securities; § 14(e) prohibits manipulative and deceptive practices in connection with tender offers), and rules 10b-5 and 10b-6, 17 C.F.R. § 240.10b-5, -6 (1973) (rule 10b-5 prohibits manipulative and deceptive practices in connection with the purchase or sale of securities; rule 10b-6 prohibits securities trading by persons interested in a distribution of securities). 480 F.2d at 355. The court denied a motion for a preliminary injunction to prevent BPC from obtaining and exercising control of Piper. 303 F. Supp. 191, 200 (S.D.N.Y. 1969). On expedited appeal, the Second Circuit affirmed and remanded for further proceedings. 426 F.2d 569, 577 (2d Cir. 1970) (en banc). BPC commenced an action charging CCI with violations of, inter alia, §§ 9(a)(2), 10(b) of the Exchange Act and rules 10b-5 and 10b-6. This action was tried together with that initiated by CCI, and dismissed. 337 F. Supp. 1147 (S.D.N.Y. 1971). On appeal, the judgment was affirmed. 480 F.2d at 380-83. An action was brought by the SEC against BPC on a complaint essentially similar to that of CCI. The district court found certain violations by BPC but denied injunctive relief. 331 F. Supp. 1154, 1163 (S.D.N.Y. 1971). On cross appeals the judgment was modified. 480 F.2d at 383-92.

8. Factual treatment of the takeover battle is found at 480 F.2d at 349-55; see 337 F. Supp. at 1130-32. Detailed discussion of the circumstances surrounding the BPC registration statement, the pivotal event for present purposes, is found at 480 F.2d at 366-73; 331 F. Supp. at 1156-60.

9. 480 F.2d at 353, 366-69; 331 F. Supp. at 1159-62.

10. 480 F.2d at 369. The minutes of the April 1 BPC board meeting reflected that a committee, including two directors of BAR and two of BPC, was established to study divestiture. This group was still deliberating when, on May 12, Amoskeag, Inc., offered to purchase BAR for $5 million cash. The committee reported at the May 21 board meeting that sale to Amoskeag appeared the best alternative, and continued negotiations. On May 27 the parties

sponse, either through further examination of BPC records or by questioning of the projected buyer mentioned in board minutes, Amoskeag, Inc.[11]

B. *The Opinion of the Court*

Since prior cases had not construed section 14(e) extensively, the court chose to analyze the section in terms of rule 10b-5 precedents.[12] Accordingly, the court held that the omission of the intended BAR divestiture was a material misrepresentation in light of the rule 10b-5 test of "whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action . . . .' "[13] The element of scienter was established since the defendants knew or failed to ascertain by a reasonable investigation that material facts had been omitted.[14] The court framed the reliance element in terms of whether Piper shareholders relied on the false registration statement in deciding between the competing tender offerors,[15] and held that the finding of materiality raised a presumption of reliance on the misrepresentation.[16] Similarly, the court held that materiality raised a presumption of causation.[17]

The court then sought to determine whether First Boston, as underwriter, was within the parameters of section 14(e). It reasoned that the securities laws place upon private parties the primary responsibility for verifying the accuracy and completeness of disclosure to investors, and sanction civil liabilities for their failure to do so. These civil liabilities, the court noted, are expressly developed in section 11 of the Securities Act, which empowers purchasers of registered securities to hold underwriters liable for material misrepresentations in the regis-

entered into a letter of understanding which the board tabled on June 3. 480 F.2d at 367, 371-72 & n.25; 331 F. Supp. at 1157-58.

11. 480 F.2d at 369.

12. Id. at 362. In a footnote, however, the court quoted language from Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 948 (2d Cir. 1969), comparing the circumstances of a tender offer to those of a proxy fight. 480 F.2d at 362 n.14. Proxy solicitations are governed by Exchange Act regulations which include their own antifraud provision, 17 C.F.R. § 240.14a-9 (1973), which will be discussed in detail in part III infra.

13. 480 F.2d at 363 (quoting List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965)); 480 F.2d at 363 n.15 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)).

14. 480 F.2d at 364.

15. Id. at 373.

16. Id. at 374, citing Kahan v. Rosenstiel, 424 F.2d 161, 173-74 (3d Cir.), cert. denied, 398 U.S. 950 (1970) (class action against controlling shareholder and others alleging fraud in connection with tender offer); Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969) (class action alleging purchases of securities in reliance on misrepresentations of issuer); List v. Fashion Park, Inc., 340 F.2d 457, 462-64 (2d Cir.), cert. denied, 382 U.S. 811 (1965) (action by single plaintiff alleging sale of securities in reliance on defendants' misrepresentations during negotiations with plaintiff's broker).

17. 480 F.2d at 374, quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972). The court stipulated as the measure of CCI's damages "the reduction in the appraisal value of CCI's Piper holdings attributable to BPC's taking a majority position . . . thus being able to compel a merger at any time." 480 F.2d at 380.

tration statement.[18] The court thought it consistent to predicate underwriters' liability to competing tender offerors upon section 14(e).[19] While this latter section is directed at those who "make" untrue statements,[20] the court broadly interpreted it to include underwriters:

> An underwriter by participating in an offering constructively represents that statements made in the registration materials are complete and accurate.... [W]hen the underwriter does not speak out, the investor reasonably assumes that there are no undisclosed material deficiencies. The representations... are those of the underwriter as much as they are those of the issuer.[21]

Thus, First Boston would be liable for the materially false registration statement if it possessed the requisite degree of scienter. Stating that the information in the BPC board minutes was sufficient to enable First Boston to "deduce" the registration statement's falsity, the court held that the underwriter's failure to follow up the answers it received from BPC constituted a "complete abdication" of its duty to verify them, warranting a finding of scienter.[22]

III. SECTION 14(e): RULE 10b-5 vs. RULE 14a-9

Despite the steady expansion of securities fraud liability beyond the common law tort of deceit, the courts continue to analyze "securities fraud" in terms of the elements of that common law tort. Thus, First Boston's liability turned on scienter, materiality, reliance, and causation.[23]

The *Chris-Craft* court observed the textual similarities between section 14(e) and rule 10b-5, and chose to develop the antifraud elements of section 14(e) from rule 10b-5 precedents.[24] Other cases had adopted this approach;[25] indeed,

18. 480 F.2d at 369-70. Section 11 provides in pertinent part:

"(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact . . . any person acquiring such security . . . may, either at law or in equity . . . sue—

. . . .

(5) every underwriter with respect to such security." 15 U.S.C. 77k(a) (1970).

19. 480 F.2d at 370.

20. Id.; see note 3 supra.

21. 480 F.2d at 370.

22. Id. at 371-73; see note 10 supra.

23. For analysis of these common law elements see W. Prosser, Torts 683-736 (4th ed. 1971); Restatement of Torts §§ 526, 537-38, 546 (1938). Securities cases sometimes confuse reliance with causation. E.g., Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970). A case distinguishing these two elements is Emmi v. First-Mfrs. Nat'l Bank, 336 F. Supp. 629, 636-37 (D. Me. 1971) (plaintiff alleged violations of rule 10b-5 and § 14(e) in connection with misleading prospectus; plaintiff relied upon prospectus in taking action resulting in her receiving excess value from an exchange offer; these counts dismissed for failure to allege causation).

24. 480 F.2d at 362; see note 12 supra and accompanying text.

25. See, e.g., Neuman v. Electronic Specialty Co., [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,591, at 98,705 (N.D. Ill. 1969).

in *Electronic Specialty Co. v. International Controls Corp.*,[26] an action against an exchange offeror by the target's management, tendering shareholders and nontendering shareholders, the Second Circuit established rule 10b-5 as the basis of section 14(e)'s development.[27] The district court in *Electronics Specialty*, on the other hand, had concluded on the basis of section 14(e)'s legislative history that section 14(a) of the Exchange Act and its antifraud rule 14a-9[28] were the provisions "most analogous" to section 14(e).[29] In fact, Congress had analogized proxy fights to tender offers and used the proxy rules as the model for regulation of tender offers.[30] Thus, in *Chris-Craft* the Second Circuit confronted a split in authority when it sought to develop the principles governing section 14(e). Congress apparently had employed rule 14a-9, while the courts had relied on rule 10b-5. Ostensibly *Chris-Craft* adopted the latter approach. However, analysis reveals that the *Chris-Craft* formulations of scienter, materiality, reliance and causation embody precedents developed under rule 14a-9.

Purportedly drawing on Second Circuit rule 10b-5 cases, the court in *Chris-Craft* held that scienter meant knowledge or reckless disregard of the truth, where "reckless" was defined as failure or refusal to ascertain available or reasonably discoverable facts.[31] It is difficult to isolate specific precedent for this formulation. In fact, until recently there were four different scienter tests in the

26. 409 F.2d 937 (2d Cir. 1969).

27. Id. at 940-41. The court stated that § 14(e) "applies Rule 10b-5 both to the offeror and to the opposition—very likely, except perhaps for any bearing it may have on the issue of standing, only a codification of existing case law." Id.

28. § 14(a) provides that no proxy solicitation shall be made in contravention of such rules as the SEC may prescribe for the protection of investors. 15 U.S.C. § 78n(a) (1970). The Commission promulgated an antifraud provision, rule 14a-9, 17 C.F.R. § 240.14a-9 (1973), which provides in part:

"(a) No solicitation . . . shall be made by means of any proxy statement . . . or other communication . . . containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading . . . ." Id.

29. Electronic Specialty Co. v. International Controls Corp., 295 F. Supp. 1063, 1069-72 & n.5 (S.D.N.Y. 1968), aff'd in part, rev'd in part & remanded, 409 F.2d 937 (2d Cir. 1969).

30. The congressional reports state that the similarity between proxy fights and tender offers warrants imposition of comparable disclosure requirements upon the latter. S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967); H.R. Rep. No. 1711, 90th Cong., 2d Sess. 3 (1968). The reports further state that when a majority of directors are to be replaced pursuant to a takeover, shareholders of the target must be given information comparable to that required by the proxy regulations in connection with the election of directors. S. Rep. No. 550, supra, at 5; H.R. Rep. No. 1711, supra, at 5. The reports were explicit that regulation of takeovers must not tip the "balance of regulation" in favor of either incumbent management or the tender offeror. S. Rep. No. 550, supra, at 4; H.R. Rep. No. 1711, supra, at 4. The cases reiterate this. Compare Ronson Corp. v. Liquifin Aktiengesellschaft, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,369, at 95,248-49 (D.N.J. Jan. 11, 1974) with Corenco Corp. v. Schiavone & Sons, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,099, at 94,433 (S.D.N.Y. 1973).

31. 480 F.2d at 356-57, 363-64.

Second Circuit.[32] That court's opinion in *Lanza v. Drexel & Co.*[33] reduced the confusion by stating the formula as willful or reckless disregard for the truth.[34] The opinion, however, defined "reckless" as "the equivalent of knowledge,"[35] a stricter reading of the term than that in *Chris-Craft.*[36] Thus, although the court sought to rely on rule 10b-5 precedent, it in fact adopted a more liberal and unprecedented scienter test which is more analogous to the prevailing rule 14a-9 standard. The district court in *Richland v. Crandall*[37] concluded that under rule 14a-9, if defendants "*knew or should have known,*" that would be sufficient.[38] In *Gould v. American Hawaiian Steamship Co.,*[39] the trial court was at first "unwilling to . . . rule"[40] that scienter was irrelevant under rule 14a-9, but in a later opinion in the same case the court adopted the negligence standard.[41] Other cases have followed this approach.[42] *Chris-Craft* is the first case to consider in depth the appropriate standard of scienter under section 14(e). Its

32. This is the conclusion of Bucklo, Scienter and Rule 10b-5, 67 Nw. U.L. Rev. 562, 576 n.64 (1972), based on an examination of SEC v. Great Am. Indus., Inc., 407 F.2d 453, 463 (2d Cir. 1968) (en banc) (Hays, J., concurring in result), cert. denied, 395 U.S. 920 (1969); id. at 464 (Moore, J., dissenting); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 (2d Cir. 1968) (en banc) (Waterman, J., for the court), cert. denied, 394 U.S. 976 (1969); id. at 867-68 (Friendly, J., concurring); id. at 869-70 (Hays, J., concurring & dissenting); id. at 870 (Moore, J., dissenting).

33. 479 F.2d 1277 (2d Cir. 1973).

34. Id. at 1304-06.

35. Id. at 1305.

36. See text accompanying note 31 supra. Consistent application of rule 10b-5 scienter formulations to § 14(e) will result in as many versions of scienter under the section as exist under the rule. Concerning rule 10b-5, the circuits are not in accord. The Ninth Circuit has adopted a negligence standard. Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961); Bucklo, Scienter and Rule 10b-5, 67 Nw. U.L. Rev. 562, 581-84 (1972); see White v. Abrams, Nos. 71-2068, 71-2069, 71-2076, 71-2077 (9th Cir. March 15, 1974). Seventh Circuit cases contain dicta dispensing with any requirement of scienter. Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123, 126-27 (7th Cir. 1972); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963); Bucklo, supra, at 584-87. The same is true of the Eighth Circuit. Vanderboom v. Sexton, 422 F.2d 1233, 1238-39 (8th Cir.), cert. denied, 400 U.S. 852 (1970); Myzel v. Fields, 386 F.2d 718, 734-35 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Bucklo, supra, at 587-88. Authority in the Tenth Circuit is split regarding the existence of a scienter requirement. See Bucklo, supra, at 588-90. Compare Gilbert v. Nixon, 429 F.2d 348, 357 (10th Cir. 1970) with Stevens v. Vowell, 343 F.2d 374, 379 (10th Cir. 1965).

37. 262 F. Supp. 538 (S.D.N.Y. 1967).

38. Id. at 553 n.12 (emphasis added).

39. 331 F. Supp. 981 (D. Del. 1971) (on cross motions for summary judgment).

40. Id. at 998.

41. 351 F. Supp. 853, 865 (D. Del. 1972) (on motions to modify grant of partial summary judgment). The court examined at length three standards of culpability: strict liability, scienter as previously developed under rule 10b-5, and negligence, reaffirming the last-mentioned after a detailed discussion of prior cases, congressional intent, policy operatives, and possible conflicts with other provisions of the securities laws. Id. at 858-65.

42. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1298-1301 (2d Cir. 1973); Union

departure from rule 10b-5 precedent represents movement towards Professor Bromberg's conclusion that the negligence standard of rule 14a-9 should apply to section 14(e).[43]

Unlike scienter, the element of materiality under rule 10b-5 was considered by the Supreme Court in *Affiliated Ute Citizens v. United States*.[44] There, the Court held that the materiality test in rule 10b-5 damage actions is whether "a reasonable investor might have considered [omitted facts or misrepresentations] important in the making of this decision [to sell shares]."[45] Recent lower court cases are in accord.[46] It is not clear whether the materiality test under rule 14a-9 differs. The Supreme Court in *Mills v. Electric Auto-Lite Co.*[47] apparently held the materiality tests under rule 14a-9 and rule 10b-5 to be identical.[48] Two subsequent lower court cases, however, have indicated in dicta that the rule 14a-9 materiality test is more stringent than that of rule 10b-5.[49] Similar confusion exists concerning the proper materiality test under section 14(e). Professor Bromberg equates it with the test under rule 10b-5, reading *Electronic Specialty Co. v. International Controls Corp.*[50] to that effect.[51] Another commentator reads the same case as adopting the "different" rule 14a-9 test.[52] *Chris-Craft* expressly adopted the rule 10b-5 "reasonable investor" test[53] but simultaneously reaffirmed in a footnote the substantially different and apparently

Pac. R.R. v. Chicago & N.W. Ry., 226 F. Supp. 400, 408-09 (N.D. Ill. 1964); Central Foundry Co. v. Gondelman, 166 F. Supp. 429, 440 (S.D.N.Y. 1958).

43. 2 A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5, § 8.4, at 204.79 (1973) [hereinafter cited by volume as Bromberg]; see id. at 204.71-72.

44. 406 U.S. 128 (1972).

45. Id. at 153-54; accord, List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965); see SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

46. Sonesta Int'l Hotels Corp. v. Wellington Associates, 483 F.2d 247, 251 (2d Cir. 1973); SEC v. First Am. Bank & Trust Co., 481 F.2d 673, 679 (8th Cir. 1973); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970).

47. 396 U.S. 375 (1970).

48. Id. at 384 & n.6. The Court cites for its formulation of the rule 14a-9 materiality test List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965) (rule 10b-5 action) and General Time Corp. v. Talley Indus., Inc., 403 F.2d 159, 162 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969) (rule 14a-9 action).

49. Republic Tech. Fund Inc. v. Lionel Corp., 483 F.2d 540, 551 n.11 (2d Cir. 1973); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1301-02 (2d Cir. 1973). But see Rosenblatt v. Northwest Airlines, Inc., 435 F.2d 1121, 1126 (2d Cir. 1970).

50. 409 F.2d 937 (2d Cir. 1969).

51. Bromberg, The Securities Law of Tender Offers, 15 N.Y.L.F. 459, 557 (1969); see Elco Corp. v. Microdot Inc., 360 F. Supp. 741, 752 (D. Del. 1973).

52. Hamilton, Some Reflections on Cash Tender Offer Legislation, 15 N.Y.L.F. 269, 290-91 (1969). Professor Hamilton does not attempt a reconciliation of this interpretation of Electronic Specialty with the case's manifest adoption of rule 10b-5 as the basis of § 14(e) principles. 409 F.2d at 940, 944-46.

53. 480 F.2d at 362-63.

more stringent wording found in *Electronic Specialty*,[54] thus perpetuating the confusion.

Chris-Craft was equally unclear regarding the element of reliance. The court observed that, to serve the policy of vigorous private enforcement of the securities laws, reliance under some circumstances was subsumed into a presumption arising from a finding of materiality.[55] The rule 10b-5 cases often reiterated the necessity of independent proof of reliance.[56] However, other courts adopted a variety of techniques to evade reliance as an independent element of rule 10b-5 liability, recognizing that large plaintiff groups find proof of reliance almost impossible.[57] In *Affiliated Ute Citizens v. United States*[58] the Supreme Court held that in rule 10b-5 nondisclosure cases a finding of materiality is a finding of reliance.[59] Cases and commentators reached the same conclusion relative to rule 14a-9.[60] However, the Supreme Court in *Mills v. Electric Auto-Lite Co.*,[61] a rule 14a-9 nondisclosure case, held that a finding of materiality establishes a presumption of reliance *if* plaintiff proves the false proxy solicitation to be "an essential link in the accomplishment of the transaction,"[62] a proviso not explicit in the rule 10b-5 cases. *Chris-Craft*, relying on both *Mills* and *Affiliated Ute Citizens*, thus introduced the question whether the "essential link" proviso of *Mills* is the law under section 14(e).[63]

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54. Id. at 362-63 n.14; accord, Gulf & W. Indus., Inc. v. Great Atl. & Pac. Tea Co., 476 F.2d 687, 696 (2d Cir. 1973).

55. 480 F.2d at 357 (citing Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (rule 10b-5 violation); Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970) (rule 14a-9 violation)).

56. List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir.), cert. denied, 382 U.S. 811 (1965); Reed v. Riddle Airlines, 266 F.2d 314, 319 (5th Cir. 1959); Kohler v. Kohler Co., 208 F. Supp. 808, 823 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963).

57. Mader v. Armel, 402 F.2d 158, 160-62 (6th Cir. 1968), cert. denied, 394 U.S. 930 (1969) (stockholders' class action; held plaintiffs need not prove individual reliance); see Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970) (reliance "plays little role in nondisclosure cases"); Vine v. Beneficial Fin. Co., 374 F.2d 627, 635 (2d Cir.), cert. denied, 389 U.S. 970 (1967) (reliance not required when defendants intended a forced sale to result and success of the scheme required no volitional act); H.K. Porter Co. v. Nicholson File Co., 353 F. Supp. 153, 165 (D.R.I.), aff'd, 482 F.2d 421 (1st Cir. 1973) (following Vine, supra). Contra, Neuman v. Electronic Specialty Co., [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,591, at 98,703-04 (N.D. Ill. 1969) (action by nontendering cash tender offerees against target).

58. 406 U.S. 128 (1972).

59. Id. at 153-54.

60. Gould v. American Hawaiian S.S. Co., 319 F. Supp. 795, 801 (D. Del. 1970); Note, False and Misleading Proxy Statements, 3 Ga. L. Rev. 162, 188 (1968); see Union Pac. R.R. v. Chicago & N.W. Ry., 226 F. Supp. 400, 411 (N.D. Ill. 1964). But cf. Barnett v. Anaconda Co., 238 F. Supp. 766, 771 (S.D.N.Y. 1965).

61. 396 U.S. 375 (1970).

62. Id. at 385.

63. See note 55 supra and accompanying text.

Mills also altered the then prevailing causation test under rule 14a-9 by holding that materiality plus the "essential link" requirement established a presumption of causation.[64] The cases generally had concluded that causation was an independent element of proof under rule 14a-9.[65] Some of the cases so holding considered rule 14a-9's causation requirement to be more onerous to a plaintiff than that of rule 10b-5.[66]

The rule 10b-5 cases themselves complicated the causation issue by holding that causation is an element in damage actions only.[67] Further complication of the issue arose in cases where plaintiff claimed that its damages resulted from the reliance of parties other than itself. For example, in *Crane Co. v. Westinghouse Air Brake Co.*,[68] Standard purchased large blocks of Air Brake's shares on the market and disposed of them off the market, driving the market price of Air Brake above that of Crane's exchange offer and allegedly inducing Air Brake shareholders to withhold tender. The court held that these facts established causation as a matter of law, saying:

> "What must be shown is that there was deception which misled [other] stockholders and that this was in fact the cause of plaintiff's claimed injury." Standard's deception caused injury to Crane. Crane's tender offer could only be successful if its value... was attractive in comparison with [the market price of Air Brake stock]. The extent of the damage will have to be determined by the District Court.... [T]he causation requirement is satisfied here to the extent of imposing liability upon Standard....[69]

Crane apparently was precedent under section 14(e), for cases prior to *Chris-Craft* equated the causation tests of rule 10b-5 and section 14(e).[70]

64. 396 U.S. at 385.

65. Penn Cent. Sec. Litigation, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,318, at 95,089-90 (E.D. Pa. Nov. 19, 1973); Cohen v. Colvin, 266 F. Supp. 677, 685 (S.D.N.Y. 1967); Barnett v. Anaconda Co., 238 F. Supp. 766, 773-74 (S.D.N.Y. 1965).

66. Globus, Inc. v. Jaroff, 266 F. Supp. 524, 530-31 (S.D.N.Y. 1967); see Barnett v. Anaconda Co., 238 F. Supp. 766, 772, 775 (S.D.N.Y. 1965); Lockwood, Corporate Acquisitions and Actions Under Sections 10(b) and 14 of the Securities Exchange Act of 1934, 23 Bus. Law. 365, 369 (1968). Contra, Seeburg-Commonwealth Litigation, [1972-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,802, at 93,450 (S.D.N.Y. 1972) (semble).

67. The leading case so holding is Mutual Shares Corp. v. Genesco, 384 F.2d 540, 546-47 (2d Cir. 1967). Authorities supporting the requirement of causation in damage actions include List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 771 (D. Colo. 1964); 2 Bromberg § 8.7, at 213; cf. Wittner v. Ghen, [1964-66 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,623, at 91,324 (S.D.N.Y. 1966). Authorities supporting no requirement of causation in private actions for equitable relief include Kahan v. Rosenstiel, 424 F.2d 161, 173 (3d Cir.), cert. denied, 389 U.S. 950 (1970); Britt v. Cyril Bath Co., 417 F.2d 433, 436 (6th Cir. 1969); Neuman v. Electronic Specialty Co., [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,591, at 98,703-04 (N.D. Ill. 1969).

68. 419 F.2d 787 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970).

69. Id. at 797 (citation omitted).

70. Emmi v. First-Mfrs. Nat'l Bank, 336 F. Supp 629, 636-37 (D. Me. 1971); Neuman v. Electronic Specialty Co., [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,591, at 98,703 (N.D. Ill. 1969).

Urged to do so, the *Chris-Craft* district court refused to follow *Crane* and *Mills*. The district court distinguished *Crane* on the ground that the facts there clearly disclosed causation in fact.[71] Furthermore, it distinguished *Mills* as a proxy case where the plaintiffs claimed their own deception, not that of third parties.[72] Thus insisting on proof of causation in fact, the district court held that CCI failed to establish that the BAR nondisclosure induced Piper shareholders to reject the CCI tender offer *and likewise* to tender to BPC.[73]

On appeal the Second Circuit reversed the district court, claiming that the *Mills* presumption had been imported into rule 10b-5 by *Affiliated Ute Citizens*.[74] This conclusion presents difficulties. *Affiliated Ute Citizens* was concerned with the reliance element and seems not to have extended the *Mills* causation presumption to rule 10b-5.[75] Thus, the *Chris-Craft* court hurdled two obstacles

71. 337 F. Supp. at 1140.

72. Id. at 1139-41. In footnotes the court emphasized its interpretation of Mills as applicable only to fact patterns wherein plaintiff seeks recovery for his own detrimental reliance, rather than that of a third party, by quoting language from Mills which in part reads: "a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation . . . was an essential link in . . . the transaction." Id. at 1139 n.15 (quoting 396 U.S. at 385). Apparently, the court believed that the corporate shareholder, as opposed to the corporation itself, is entitled to a privileged remedial position under the securities laws, for immediately preceding its distinction of Mills the court resorted to language in J.I. Case Co. v. Borak, 377 U.S. 426, 428 (1964), suggestive of such a conclusion. 337 F. Supp. at 1139 n.14.

73. Id. at 1139. Conceding arguendo that Piper shareholders were induced to withhold tender from CCI by the false registration statement, there remains the fact that over half of the then remaining shareholders, apparently influenced by a bear market, chose not to tender to BPC, but rather to hold their shares. Brief for First Boston Corp. at 17-18, Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973). This remains the missing link in the factual chain of causation from the BAR nondisclosure to the reduction in the appraisal value of CCI's interest in Piper occasioned by BPC's "unfairly obtaining control" which the court stipulates as CCI's injury. 480 F.2d at 375-76, 380.

74. 480 F.2d at 373-76 (citing 406 U.S. 128, 153-54 (1972)).

75. The Chris-Craft court relied on the following language in Affiliated Ute Citizens: "Under the circumstances of this case . . . positive proof of reliance is not [necessary]. All that is necessary is that the facts withheld be material . . . . See Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 . . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." 406 U.S. at 153-54 (citations omitted). It is noteworthy that the Court was here supporting its conclusion that the Affiliated Ute lower court had erred in holding that proof of actual reliance was necessary. Id. at 152. Moreover, Affiliated Ute Citizens involved plaintiffs' sale of stock to defendants at well under the prevailing market price, to plaintiffs' detriment. The proofs further disclosed that defendants had knowingly and falsely represented their purchase price to be the going market price. Id. at 145-48. The only remaining issue was whether plaintiffs could prove (or benefit from a presumption) that their sales had been in reliance on the misrepresentations. Causation in fact as an ultimate legal conclusion, then, depended only upon resolution favorable to plaintiffs of the one remaining issue, reliance. Since reliance was presumed from materiality, the facts themselves established causation without the aid of further presumption. Thus, interpretation of the language quoted supra as constructing a presumption of causation ignores the factual context giving rise to the language.

in silence. First, it failed to come to grips with the apparently valid distinction of *Mills* made in the district court. Second, in *Mills* plaintiffs sought to set aside a merger in a court of equity.[76] In this light *Chris-Craft* failed to employ rule 10b-5 precedents distinguishing, for causation purposes, damage actions and actions for equitable relief.[77] The *Chris-Craft* district court had expressly drawn this distinction.[78]

Purporting to borrow the elements required by rule 10b-5—scienter, materiality, reliance, and causation—*Chris-Craft* instead substituted the causation doctrine applicable to rule 14a-9. In thus adopting the presumption of causation developed in *Mills*, the court lightened the plaintiff's burden of proof under section 14(e). The question remaining is whether this indirect expansion of implied underwriters' liability can be justified in view of the narrower boundaries of express civil liability imposed by Congress in section 11 of the Securities Act.

IV. Implied Underwriters' Liability vs. Section 11

The district court in *Chris-Craft* observed that CCI had chosen to pursue its action under "the broad provisions of Section 10 . . . and Rule 10b-5 . . . and of Section 14(e),"[79] rather than under sections 11 or 12 of the Securities Act which were formulated expressly for such complaints.[80] In fact, neither section 11 nor 12 was available to CCI. Section 11 affords a remedy only to purchasers under the registration statement in question[81]—which CCI was not. Nor would section 12 have embraced CCI as a possible plaintiff.[82] That this plaintiff brought suit under the broader provisions of rule 10b-5 and section 14(e), however, neither necessitates nor justifies the imposition of implied civil liability in excess of that required by section 11 which was drafted to deal with the realities of under-

76. 396 U.S. at 377-81.

77. See note 67 supra and accompanying text.

78. 337 F. Supp. at 1139.

79. Id. at 1138-39.

80. Id. at 1138.

81. 15 U.S.C. § 77k(a) (1970); see note 18 supra. In addition, § 11(a) establishes reliance as an element of plaintiff's case when plaintiff purchases the security after the release of an earnings statement covering a period of at least a year from the effective date of the registration statement.

Section 11(b) provides, inter alia, a defense of due diligence to all parties except the issuer who can show, generally speaking, that after reasonable investigation they had reasonable grounds to believe, and did believe, the statements in the registration statment to be true.

Section 11(c) defines "reasonableness" for purposes of the due diligence defenses as "that required of a prudent man in the management of his own property."

Section 11(e) limits underwriters' liability to the total price at which the securities the underwriter himself underwrote were offered to the public, and § 11(g) limits plaintiff's total recovery to the price at which the security was offered to the public. 15 U.S.C. §§ 77k(a)-(g) (1970).

82. Section 12, 15 U.S.C. § 77 (1970), is an antifraud provision covering misrepresentations in the course of sales, or offers to sell, of securities. Standing, however, is limited in terms to the immediate purchaser from the defendant seller, and this strict privity requirement sharply limits the section's utility. See 1 CCH Fed. Sec. L. Rep. ¶ 4765 (noting one narrow exception to the privity requirement).

writers' functions.[83] There was nothing to prevent the *Chris-Craft* court from construing the new and undeveloped section 14(e) in accordance with the boundaries established by section 11 for the purpose of defining underwriters' liability under section 14(e). While this would place underwriters in a separate category under section 14(e), it is submitted that neither the legislative history nor the legal rationale underlying underwriters' civil liability prevents such preferential treatment.

Congress enacted section 11 in the belief that the public's loss of confidence in the integrity of the securities marketplace accounted for the failure of the private sector to raise industrial financing.[84] Faced with the problem of insuring the integrity of the new offerings market without exterminating it as a source of new capital, Congress defined underwriters' liability in terms of fiduciary duty.[85] This was not settled, however, without considerable debate over the appropriate standard and its ramifications on the market economy.[86] As originally enacted,[87] section 11 embodied features which imposed prohibitive business risks on underwriters,[88] with a resulting diminution in the underwriting of new offerings.[89] Accordingly, in the Securities Exchange Act of 1934 Congress amended

83. For a description of the functions of underwriting and the underwriter, see Dooley, The Effects of Civil Liability on Investment Banking and the New Issues Market, 58 Va. L. Rev. 776, 784-92 (1972) [hereinafter cited as Dooley]. A succinct history of American investment banking is found in United States v. Morgan, 118 F. Supp. 621, 635-50 (S.D.N.Y. 1953).

84. Dooley 794-95; 77 Cong. Rec. 2982-83 (1933) (remarks of Senator Fletcher); id. at 2918-19 (remarks of Rep. Rayburn); see Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev. 29, 30 (1959).

85. Securities Act of 1933, ch. 38, § 11(c), 48 Stat. 82, as amended 15 U.S.C. § 77k(c) (1970).

86. The Senate was unwilling to make concessions to the industry at the expense of its conception of the public interest, and spoke of the duty of participants in the distribution process in terms of strict liability. S. Rep. No. 47, 73d Cong., 1st Sess. 4-6 (1933). The House sought to insure the public's right to an honest marketplace without deterring any significant number of public offerings, and accordingly selected the less rigorous standard of fiduciary duty. H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933). The latter standard prevailed in the conference committee. Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev. 29, 48-49 (1959).

87. Securities Act of 1933, ch. 38, § 11, 48 Stat. 82, as amended 15 U.S.C. § 77k (1970).

88. Plaintiff's sole burden was to prove a material misrepresentation in the registration statement; reliance and causation were eliminated, even by way of affirmative defense. Actions could be commenced within two years after discovery of the fraud, to a maximum of ten years after the offering. Standing extended to all holders of registered securities without regard to privity. In effect, underwriters and others stood accountable for all trading losses incurred by holders of registered securities at any time within ten years of the offering. Dooley 803-05. See also Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 174-77 (1933); James, The Securities Act of 1933, 32 Mich. L. Rev. 624, 648-55 (1934).

89. Some members of Congress blamed the decrease in underwriting activity on § 11. 78 Cong. Rec. 4984, 8709-10 (1934) (remarks of Senator Thomas); id. at 6877 (remarks of Rep. Bacon). Industry spokesmen and financial leaders also urged limitation of the civil liabilities to stimulate the new issues market. Id. at 6203-08 (Washington Post surveys inserted into record on motion of Senator Hastings).

section 11,[90] decreasing underwriters' potential civil liability.[91] It is clear, therefore, that Congress recognized the necessity for protecting underwriters from exposure to excessive liability, and acted both to safeguard the integrity of the marketplace and to allow underwriters a standard of liability reasonably related to the risks of their role in the market structure.

The ability of lead underwriters[92] to avoid section 11 liability hinges on their ability to meet the standards of "due diligence" developed in section 11(b)(3). Due diligence imposes a duty of reasonable investigation intended to secure independent verification of the accuracy and completeness of the disclosure in the registration statement.[93] Courts have examined the requirements of due diligence imposed on underwriters in *Escott v. BarChris Construction Corp.*[94] and *Feit v. Leasco Data Processing Equipment Corp.*[95]

In *BarChris* a construction firm filed a registration statement which included a substantial understatement of its contingent liabilities, marked overstatement of quarterly earnings, gross profits and backlog, and nondisclosure of significant officers' loans and customer delinquencies.[96] The lead underwriters' investigation, conducted through counsel, included intensive questioning of BarChris

90. Securities Exchange Act of 1934, ch. 404, § 206, 48 Stat. 907 (codified at 15 U.S.C. § 77k (1970)).

91. The maximum period of limitations was reduced from ten to three years. 15 U.S.C. § 77m (1970). An underwriter's liability was limited to the aggregate public offering price of the securities which he himself underwrote. Id. § 77k(e). This enabled the underwriter to determine, in advance of the underwriting, the extent of the business risk imposed by civil liability. Lack of causation was made a defense. Id. In addition, a reliance requirement aimed at purchasers acquiring registered securities a significant interval after the offering was introduced. Id. § 77k(a). For discussion of these amendments, see 3 L. Loss, Securities Regulation 1725-28 (1961); Dooley 806-08. The amendments also altered the standard of due diligence from a fiduciary duty to that of "a prudent man in the management of his own property." 15 U.S.C. § 77k(c) (1970). Professor Dooley considers this change "cosmetic." Dooley 806 n.41. See 3 Loss, supra, at 1726.

92. It is common practice for an issue to be underwritten by several investment bankers who together form the underwriting group. However, the group usually relies on one of its number to perform the investigatory and advisory functions preceding the actual marketing of the issue. This underwriter usually will act as the lead underwriter on the distribution of the issue as well. Dooley 784-92.

93. 15 U.S.C. § 77k(b)(3) (1970). This section reduces an underwriter's duty to uncover misrepresentations in portions of registration statements prepared by "experts" or public officials by allowing the underwriter to rely upon their representations (in the absence of actual or constructive knowledge of misrepresentations). Id § 77k(b)(3)(C), (D). An "expert" is defined as "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him." Id. § 77k(a)(4). When the underwriter is himself the expert, or when he is dealing with a part of the registration statement not prepared by an expert, the duty of the underwriter remains unchanged from that of a prudent man in the management of his own property. Id. § 77k(b)(3)(A), (B). See 3 L. Loss, Securities Regulation 1726-27 (1961); Dooley 795.

94. 283 F. Supp. 643 (S.D.N.Y. 1968).

95. 332 F. Supp. 544 (E.D.N.Y. 1971).

96. 283 F. Supp. at 654-80.

management and study of a Dun & Bradstreet report on BarChris. The underwriters then delegated to a "very junior associate" of counsel, working on his first registration, the task of examining the board minutes and major contracts of BarChris. The associate spent one day on these tasks and failed to uncover several major discrepancies.[97]

The court rejected the lead underwriters' claim of due diligence, emphasizing two aspects of the investigation which it felt to be inadequate. First, the underwriters (through counsel) failed to make a reasonable attempt to verify independently management's representations concerning certain details of BarChris' financial posture. Secondly, the court found unreasonable the lack of independent verification—indeed, lack of even sufficient examination—of the key contracts and board minutes.[98]

In *Leasco,* which involved an exchange offer for control of an insurance company, the question of due diligence centered on representations concerning the target company's cash reserves. The insurance company possessed a reserve of approximately $100 million above that required by state regulations (a "surplus surplus"). Leasco's registration statement disclosed neither the existence of the surplus surplus nor Leasco's desire to obtain it for its own expansionary goals.[99]

The lead underwriters acted only as dealer managers on the distribution and left preparation of the registration statement entirely to Leasco's counsel. On the basis of an intensive investigation and several meetings with the Leasco management, both counsel and the underwriters concluded that it would be impossible to make a sufficiently reliable estimate of the surplus surplus to justify its inclusion in the registration statement.[100] The underwriters believed that the insurance company's hostility to the takeover was the reason for Leasco's inability to aid in such estimation. Actually, Leasco failed to apprise the underwriters that the insurance company's refusal to aid in estimating surplus surplus had begun to dissipate fully three weeks prior to the effective date of the registration statement.[101]

Upon suit brought by shareholders of the insurance company, the court upheld the underwriters' due diligence defense. The opinion noted that the underwriters observed many expressions of the target's refusal to cooperate, justifying their conclusion that the surplus surplus could not be estimated reliably. The underwriters knew that Leasco and the target had executed a contract effectively ending the latter's resistance to the takeover, but they also received a letter from Leasco's counsel stating that the target would not assist in an estimate of surplus surplus despite the contract. The court deemed the letter conclusive in establishing the underwriters' due diligence defense insofar as it showed that even an exhaustive examination could not uncover that which was unknown.[102]

97. Id. at 692-95.

98. Id. at 697.

99. 332 F. Supp. at 549-52.

100. Id. at 561-62.

101. Id. at 556-59, 562.

102. Id. at 581-83. The letter in question, a copy of which went to the dealer managers, read in part: "Certified financial statements of Reliance . . . are not included . . . since that

Certain important similarities and dissimilarities between *Leasco* and *BarChris* and between these two cases and *Chris-Craft* invite examination. The relative inexperience of BarChris in public offerings and the speculative nature of its industry demanded intense involvement of the underwriter in the registration process; neither factor was present in *Leasco* or *Chris-Craft*. Consequently the underwriters in these cases assumed, with justification, less prominent roles.[103]

In addition, there was a vast difference in the degree of independent investigation needed to cure defects in the respective registration statements—if investigation could cure the defect at all. *BarChris* involved numerous misrepresentations covering diverse areas of its financial involvements: many of these, however, could have been discovered with relatively little additional effort. In contrast, the underwriters in *Leasco* faced the easily concealed fact of the target's willingness to help estimate surplus surplus. *Chris-Craft* more nearly resembles *Leasco* in these respects than it resembles *BarChris*.

In *Chris-Craft*, inspection of corporate minutes disclosed the formation on April 1 of a committee to consider disposal of BAR and that committee's May 21 report that a sale to Amoskeag appeared the best solution. Presumably, First Boston also knew that the BPC board had disapproved Amoskeag's first offer on June 3. Even if receipt of this contradictory information imposed a duty upon First Boston to make further investigation,[104] the fact is that there was no resource to which First Boston could turn with any substantial chance of successfully uncovering the deception. The court suggested further inspection of BPC records or conference with Amoskeag officials.[105] In reality, the only existing business record mentioned by the court which contradicted the representations of BPC officials was the May 27 letter of understanding between BPC and Amoskeag. Assuming that BPC officers did leave this sensitive docu-

company has continued to refuse to cooperate in the making of the Exchange Offer." Id. at 562 (emphasis of the court deleted).

The Leasco court, having disposed of the case under § 11, expressly refused to decide claims under four of the antifraud provisions (§§ 12(2), 17 of the 1933 Securities Act, 15 U.S.C. §§ 77l, 77q (1970) and rule 10b-5 and § 14(e) (of the 1934 Exchange Act, 17 C.F.R. § 240.10b-5 (1973), 15 U.S.C. § 78n(e) (1970)), on the grounds that "Congress specially tailored Section 11 . . . . It wrestled with the delicate problem of what degree of liability to impose . . . .

"In light of our finding of liability under this carefully wrought provision, we need not now decide [the case under the above-named antifraud provisions]." 332 F. Supp. 583-84 (citation omitted). The court further noted the "[s]erious, unresolved ambiguities surrounding the scienter requirement in Rule 10b-5 and . . . Section 14(e)." Id. at 584. See text accompanying notes 31-43 supra.

103. Comment, Section 11 of the Securities Act: The Unresolved Dilemma of Participating Underwriters, 40 Fordham L. Rev. 869, 885-86 (1972). In this connection the Chris-Craft court noted the district court's finding "on substantial evidence, that in its capacity as investment banker First Boston merely provided professional services [to Piper and BPC]. The business decisions that led to violations of the securities laws were initiated by these companies, not by First Boston . . . ." 480 F.2d at 373 n.27.

104. The court so held. 480 F.2d at 371.

105. Id. at 373.

ment among its records subject to the underwriter's inspection, the likelihood of its discovery by feasible search procedures through the voluminous records of a large corporation is small.[106] Furthermore, the court pointed to nothing indicating that Amoskeag officials would prove more amenable. Finally, First Boston had no business dealings with Amoskeag which would give it any opportunity as a matter of right or business courtesy to investigate Amoskeag's records to verify its answer. Thus, the suggested further reasonable investigation probably would have availed First Boston nothing.

Because of the close factual parallels between *Chris-Craft* and *Leasco* and the particular care with which Congress defined the duties of underwriters,[107] it is suggested that the court in *Chris-Craft* should have adopted the standards of due diligence set forth in section 11, rather than those developed for rule 10b-5, in defining underwriters' liability under section 14(e). *Chris-Craft* presented the issue as a matter of first impression and thus gave the court an unqualified opportunity to incorporate into the new section 14(e) the carefully developed and intentionally limited parameters of section 11.

An explanation for *Chris-Craft*'s failure to take advantage of this situation may lie in the progressive expansion of implied civil liability under rule 10b-5 (and now section 14(e)) to the point that the express civil liability provided in section 11 almost has been supplanted. In contrast to the careful drafting and amending of section 11, rule 10b-5 began almost casually.[108] At the time neither its drafters nor the SEC contemplated a private right of action under the rule,[109] but the courts soon established implied civil liability.[110] At an early date the courts limited use of rule 10b-5 to defrauded purchasers or sellers of securities.[111] But later cases extended standing to parties not purchasers or sellers in the conventional sense.[112] Moreover, it appears settled that action under rule 10b-5 is

106. See note 10 supra and accompanying text. The conflict between the concept of reasonable investigation as interpreted to require complete, independent verification on the one hand, and the limitations inherent in specific feasible search procedures on the other, has received scant attention in the courts. The commentators have considered the problem at some length. See, e.g., Comment, Escott v. BarChris: "Reasonable Investigation" and Prospectus Liability Under Section 11 of the Securities Act of 1933, 82 Harv. L. Rev. 908, 910-16 (1969); Comment, BarChris: Easing the Burden of "Due Diligence" Under Section 11, 117 U. Pa. L. Rev. 735 (1969).

107. See notes 84-91 supra and accompanying text.

108. See Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967) (account of the drafting of rule 10b-5).

109. "[The Rule] was intended to give the Commission power.... It had no relation in the Commission's contemplation to private proceedings." Id. The release accompanying rule 10b-5 stated: "The new rule closes a loophole in the protections against fraud administered by the Commission ...." SEC Securities Exchange Act Release No. 3230 (May 21, 1942).

110. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946); see Janigan v. Taylor, 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965).

111. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

112. The various extensions of the Birnbaum Doctrine are developed in Comment, 10b-5

not barred by the availability of the express liability provisions of section 11.[113] The net effect is to create a plaintiff class far in excess of that contemplated by section 11,[114] and thereby increase indirectly the liability of potential defendants by subjecting them to suits by an enormous class of plaintiffs.

In addition, rule 10b-5 extends the scope of underwriters' liability beyond two limits set by the 1934 amendments to section 11.[115] First, the statute of limitations governing rule 10b-5 actions is that of the forum,[116] almost invariably longer than the three-year maximum applicable to section 11.[117] Second, damages recoverable under rule 10b-5 are limited neither to the underwriter's actual participation in the offering nor to a maximum representing a business risk ascertainable at the time of the offering.[118] The aggregate result of supplanting section 11 with rule 10b-5 is destruction of the balance section 11 sought to strike between investor protection and market survival.

> Thus, the realistic choices of investment bankers are to accept increased... liability risks or to avoid such risks by foregoing the activity of underwriting. There are reasons to expect that they will choose the latter course.... The "boycott" of 1933-34 demonstrates that investment bankers are sufficiently risk averse to forego underwriting activity when the attendant liability risks exceed... acceptable levels.[119]

Application of section 14(e) to underwriters and other defendants without discrimination will exacerbate this danger. The section 14(e) plaintiff class exceeds that of rule 10b-5 in the exchange offer context, for by its terms section 14(e) discards the purchaser-seller limitation.[120] The application to section 14(e) of the more liberal causation doctrines of rule 14a-9 will produce more frequent recoveries for this enlarged plaintiff class.[121] By adoption as the measure of damages the decline in the appraisal value of CCI's minority interest caused by the fraud of its competitor, *Chris-Craft* produces a standard which

Standing Under Birnbaum: The Case of the Missing Remedy, 24 Hastings L.J. 1007 (1973). Recently, the Seventh Circuit abandoned Birnbaum's purchaser-seller rule entirely. Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973), cert. denied, 42 U.S.L.W. 3595 (U.S. April 23, 1974), noted in 42 Fordham L. Rev. 688 (1974).

113. This is the preponderant view. See Stewart v. Bennett, 359 F. Supp. 878, 880-86 (D. Mass. 1973) (collecting cases). The only limitation on rule 10b-5's availability would be its own scienter requirement. Id. at 884-85; see notes 31-43 supra and accompanying text.

114. E.g., Colonial Realty Corp. v. Brunswick Corp., 257 F. Supp. 875 (S.D.N.Y. 1966) (plaintiff purchaser of securities not issued pursuant to the registration statement in question denied § 11 standing but granted rule 10b-5 standing); see Dooley 816.

115. See note 91 supra.

116. Charney v. Thomas, 372 F.2d 97, 99-100 (6th Cir. 1967); Errion v. Connell, 236 F.2d 447, 455 (9th Cir. 1956); see Dack v. Shanman, 227 F. Supp. 26 (S.D.N.Y. 1964); Dooley 823-24.

117. 15 U.S.C. § 77m (1970).

118. Dooley 824-27; see Herbst v. Able, 47 F.R.D. 11, 18 (S.D.N.Y. 1969); note 91 supra.

119. Dooley 841.

120. See Bromberg, The Securities Law of Tender Offers, 15 N.Y.L.F. 459, 548-55 (1969).

121. See text accompanying notes 64-78 supra.

is alien to section 11's limitation of liability to sums ascertainable in advance of the underwriting.[122]

Chris-Craft's failure to examine the policies and market realities underlying section 11 stands in marked contrast to the Second Circuit's recent admonition:

> To argue that a section of the 1934 Act, which neither by its terms nor its history manifests a similar attention to the careful balance struck in Section 11...is to thwart, not serve, the purpose of Congress and the dictates of sound policy: "To impose a greater responsibility [than that imposed by Sections 11 and 12]...would unnecessarily restrain the conscientious administration of honest business with no compensating advantage to the public."[123]

Future cases face the choice of accepting *Chris-Craft's* expansion of underwriters' liability or reconsideration of the issue in light of the parameters of section 11. These cases must effectuate the congressional judgment that underwriters' liability in excess of the well defined limits of section 11 eventually may drive underwriters out of existence and thus eliminate large parts of the securities market place. In the context of section 14(e), effectuation of that judgment will involve restriction of underwriters' liability to the parameters of section 11. This special status for underwriters will not contravene the policy of investor protection, for the clear alternative will be the loss to investors of the business of underwriting.

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122. See note 17 supra.

123. Lanza v. Drexel & Co., 479 F.2d 1277, 1309 (2d Cir. 1973) (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 10 (1933) in a discussion of directors' duty to disclose under rule 10b-5).