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APPORTIONING CONTRIBUTION SHARES UNDER THE FEDERAL SECURITIES ACTS: A SUGGESTED APPROACH FOR AN UNSETTLED AREA

INTRODUCTION

The federal securities acts were designed to produce and enforce a market system in which there is adequate disclosure of all factual information that is material to a securities transaction. An issuer that desires to raise money through a sale of securities must file a registration statement with the Securities Exchange Commission (SEC), disclosing all pertinent information. To ensure the accuracy

3. A registration statement is a disclosure document which the issuer must prepare and submit to the SEC as a prerequisite to a public offering of securities. The registration statement contains financial and other information about the issuer and is intended to provide investors with a factual background for making informed investment decisions. The information which the issuer must disclose in a registration statement is set forth in the Securities Act of 1933, Schedule A, 15 U.S.C. § 77aa (1976). The 1933 Act makes it illegal to perform certain acts in connection with a public sale of securities without a registration statement. Id. § 5(c), 15 U.S.C. § 77e(c) (1976). Section 5(c) provides that “[i]t shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to sell, or to carry or cause to be carried through the mails or in interstate commerce, any such security for the purpose of sale or for delivery after sale.” Id. Ordinarily, a registration statement automatically becomes effective twenty days after filing unless the SEC finds it to be inadequate. Id. § 8(a), 15 U.S.C. § 77h(a) (1976). The SEC, however, has the power to accelerate the effective date of the registration statement if, in its discretion, it determines that an adequate disclosure has been made. Id.
of such information and to deter fraud, civil liability is imposed for material misrepresentations or omissions of material facts. Section 11(a) of the Securities Act of 1933 (1933 Act) expressly creates a private cause of action specifically for misrepresentations in registration statements. The purchaser may also have an overlapping cause of action under the general anti-fraud provision of the Securities Exchange Act of 1934 (1934 Act), if he can prove that


Under the scheme of liability imposed by § 12, there is no right to contribution; instead, liability is apportioned "by allowing each purchaser in the chain of distribution to pursue an action against his seller." Lawler v. Gilliam, 569 F.2d 1283, 1294 (4th Cir. 1978).


6. Id. Section 11(a) of the 1933 Act provides that "[i]n case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue— (1) every person who signed the registration statement; (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted; (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner; (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him; (5) every underwriter with respect to such security." Id.


9. Id. § 78j(b). Section 10(b) makes it unlawful to employ any manipulative or deceptive device in connection with the purchase or sale of securities in contravention of the rules prescribed by the SEC as necessary for the protection of investors. Id. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1981), promulgated pursuant to the rulemaking authority granted to the SEC under § 10(b), provides that "[i]t 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, (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
the defendants acted with scienter.10

In the typical corporate offering of securities, the broad net of liability fashioned by these two sections falls upon two categories of defendants: (1) insiders—the issuer and those persons who direct the issuer’s operations;11 and (2) outsiders—the underwriters and experts, such as accountants, retained by the issuer to facilitate the sale of the securities to the investing public.12 In the ordinary course of an offering, these two groups work together closely and have a common interest in the offering’s success.13 Liability under sections 11 and

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.” Id. Although § 10(b) and rule 10b-5 do not expressly create a private cause of action, the federal courts have consistently implied such a cause of action since the decision in Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). The Supreme Court expressly recognized the private right of action. Superintendent of Ins. v. Banker’s Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

10. See infra note 105.

11. Section 11 of the 1933 Act expressly provides for liability on the part of everyone who was, or was about to become, a director or partner or person performing similar functions in the issuer. Securities Act of 1933, § 11(a)(2), (3), 15 U.S.C. § 77k(a)(2), (3) (1976). In addition, specific sections in both the 1933 Act and the 1934 Act make persons who directly or indirectly control the issuer jointly and severally liable with the issuer. Id. § 15, 15 U.S.C. § 77o (1976); Securities Exchange Act of 1934, § 20, 15 U.S.C. § 78t (1976).

12. Securities Act of 1933, § 11(a)(4), (5), 15 U.S.C. § 77k(a)(4), (5) (1976). A sale of registered securities to the public involves a number of different parties. The issuer, desiring to raise capital through a sale of securities, contacts an underwriting firm and secures its willingness to participate in the offering. This underwriting firm, known as the “managing underwriter,” conducts a thorough investigation of the issuer and participates in the preparation of the registration statement covering the securities to be offered along with the issuer’s counsel and independent accounting firm. The managing underwriter also contacts other underwriting firms who agree to participate in the underwriting syndicate. Typically, these agreements are embodied in letters of intent, which are not binding on the parties. Once the registration becomes effective, the underwriting agreement is signed between the underwriters and the issuer. This agreement is binding and commits the underwriters to the issue. Several days later the closing takes place and the underwriters actually purchase the securities from the issuer. In the actual offering, an underwriter acts as either a retailer or a wholesaler, depending on the type of underwriting. In a “firm commitment” underwriting the underwriter acts as a wholesaler, actually purchasing the securities from the issuer and assuming the risk of sale to the investing public. In a “best efforts” underwriting the underwriter acts as a retailer, agreeing to use his best efforts to sell the securities for the issuer but not agreeing to purchase any unsold portion of the issue. For a general discussion of the mechanics of a public offering and the various types of underwriting arrangements, see Freund & Hacker, Cutting Up the Humble Pie: A Practical Approach to Apportioning Litigation Risks Among Underwriters, 48 St. John’s L. Rev. 461, 464-68 (1974).

13. Underwriters make their profit from the “gross spread,” which is the difference between the price they pay to the issuer for the securities and the price at which they sell the securities to the public. The more successful the offering, the more
10(b) is joint and several, however, and once the possibility of civil liability under these sections is raised, the groups' interests become sharply antithetical. Damages awarded in federal securities cases can be substantial, and even crushing. Frequently, therefore, outside assured the profit. See Freund & Hacker, supra note 12, at 466; Comment, Section 11 of the Securities Act: The Unresolved Dilemma of Participating Underwriters, 40 Fordham L. Rev. 869, 874-78 (1972).


15. A plaintiff's damages for misrepresentation are measured according to the "out-of-pocket rule." Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 168 & n.24 (2d Cir. 1980) (action under § 10(b)) (citing Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972)); Fershtman v. Schectman, 450 F.2d 1357, 1361 (2d Cir. 1971) (actions under §§ 12 and 17(a) of the 1933 Act), cert. denied, 405 U.S. 1066 (1972); Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971) (action under § 10(b)); In re Gap Stores Sec. Litig., 79 F.R.D. 283, 298 (N.D. Cal. 1978) (action under § 11 of the 1933 Act); Tucker v. Arthur Andersen & Co., 67 F.R.D. 468, 482 (S.D.N.Y. 1975) (action under § 10(b)); Mullaney, Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability, 46 Fordham L. Rev. 277, 281 (1977); Note, The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities, 26 Stan. L. Rev. 371, 383-84 & n.65 (1974) [hereinafter cited as Measure of Damages]. Out-of-pocket damages are measured as the difference between the price paid for the securities and the actual value of the securities at the time of the suit, or the resale price of the securities if they have been resold by the plaintiff prior to his suit. Reyos v. United States, 431 F.2d 1337, 1348 (10th Cir. 1970); Sarlie v. E.L. Bruce Co., 265 F. Supp. 371, 376 (S.D.N.Y. 1967); Securities Act of 1933, § 11(e), 15 U.S.C. § 77k(e) (1976). Punitive damages are not recoverable under either the 1933 Act or the 1934 Act. Section 28(a) of the 1934 Act provides that “no person permitted to maintain a suit for damages under the provisions of this chapter shall recover . . . a total amount in excess of his actual damages.” 15 U.S.C. § 78bb(a) (1976). This section has been interpreted as barring punitive damages under both acts. Byrnes v. Faulkner, Dawkins & Sullivan, 550 F.2d 1303, 1313 (2d Cir. 1977); Globus v. Law Research Serv., 418 F.2d 1276, 1283-87 (2d Cir. 1969) (1933 Act), cert. denied, 397 U.S. 913 (1970). Consequential damages, however, are available. Foster v. Financial Technology Inc., 517 F.2d 1068, 1071 (9th Cir. 1975) (a plaintiff seeking consequential damages in an action under § 10(b) of the 1934 Act can recover them if he establishes a causal nexus between the amounts claimed as consequential damages and the defendant's wrongdoing with reasonable certainty); Madigan, Inc. v. Goodman, 498 F.2d 233, 238-40 (7th Cir. 1974) (“good deal” of certainty); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 803 (2d Cir.) (same), cert. denied, 414 U.S. 908 (1973). The concept of consequential damages has been used to recover outlays of capital which are directly attributable to the defendant's fraudulent conduct. Madigan, Inc. v. Goodman, 498 F.2d at 238-39.

16. Mullaney, supra note 15, at 290-94; Measure of Damages, supra note 15, at 376-77. The problem of potentially crushing liability is obviated somewhat in suits brought under § 11 of the 1933 Act. Section 11(e) provides, inter alia, that “[i]n no event shall any underwriter . . . be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price.
defendants who are held liable in securities cases seek to shift their liability for the plaintiff’s damages to the inside defendants through claims for contribution.\(^{17}\)

Although a right to contribution clearly exists under sections 11\(^{18}\) and 10(b),\(^{19}\) the method of apportioning the contribution shares among defendants is unsettled.\(^{20}\) Traditionally, contribution shares

at which the securities underwritten by him and distributed to the public were offered to the public.” 15 U.S.C. § 77k(e) (1976).


19. The courts permit contribution in suits brought under § 10(b) of the 1934 Act, although such a right is not expressly provided in the section. E.g., Huddleston v. Herman & MacLean, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,919, at 90,677 (5th Cir. Mar. 9, 1981); Heizer Corp. v. Ross, 601 F.2d 330, 334 (7th Cir. 1979); Madigan, Inc. v. Goodman, 498 F.2d 233, 238 (7th Cir. 1974); Marrero v. Abraham, 473 F. Supp. 1271, 1277-78 (E.D. La. 1979); Note, Globus: A Prolific Generator of Nice Questions, 33 Ohio St. L.J. 898, 912-13 (1972).

CONTRIBUTION IN SECURITIES CASES

were apportioned on a pro rata basis—that is, equally among the defendants without regard to individual fault. Recently, however, some courts have moved away from the traditional rule toward apportionment based upon the relative fault of the various defendants. This Note proposes a method for the apportionment of contribution shares in federal securities cases which synthesizes the pro rata and relative fault approaches. After briefly reviewing the mechanics of a securities offering, Part I examines the judicial treatment of contribution and indemnification under the federal securities acts. Part II concludes that section 10(b) of the 1934 Act and section 11 of the 1933 Act require different methods for the apportionment of contribution shares in order to effectuate the deterrent policies that are central to the two Acts.

I. SHIFTING THE BURDEN UNDER THE FEDERAL SECURITIES LAWS

With respect to the preparation of a registration statement for an offering, the 1933 Act requires the underwriter and experts to conduct a thorough investigation of the issuer's business affairs and makes the underwriter or expert liable for any misrepresentations in the registration statement. Even though the threat of civil liability encourages the outsider to make a thorough investigation, the issuer is in a position to conceal information from the underwriter or expert if it has something to hide. The outsider may thus be actively prevented by the issuer's duplicity from ensuring sufficiently accurate disclosure.


23. Commentators in this field have assumed that one general rule on the apportionment of contribution shares under the federal securities acts is appropriate in all circumstances and have not attempted to draw distinctions in apportioning contribution shares under the various provisions of the federal securities acts which impose civil liability. 3 L. Loss, Securities Regulation 1738 (2d ed. 1961); Adamski, Contribution and Settlement in Multiparty Actions Under Rule 10b-5, 66 Iowa L. Rev. 533, 557-58 (1981); Ruder, supra note 18, at 650.

24. See supra note 6. Outside defendants can avoid this liability by proving their "due diligence." See infra notes 121-23 and accompanying text.

25. See supra note 2 and accompanying text.

An outside defendant who is found liable for such misrepresentation will, quite naturally, seek to shift the burden onto the inside defendants. Indeed, securities defendants in a variety of contexts have consistently sought to shift their liability to other parties in the litigation through claims for indemnification or contribution.

The availability of either contribution or indemnification in a federal securities case is a matter to be determined under federal rather than state law. These doctrines are equitable devices developed to mitigate the harshness of joint and several liability. Indemnification permits a jointly liable defendant to shift all his liability to another joint tortfeasor. It is available in situations involving vicarious liability or an express agreement of indemnification between the parties. Contribution, on the other hand, permits a jointly liable defendant to shift a portion, but not all, of his liability to another. The right to contribution is not founded upon contract but is based on principles of fundamental justice that require all jointly

27. Id. at 1265.


29. Heizer Corp. v. Ross, 601 F.2d 330, 331 (7th Cir. 1979). The common-law rules on contribution are therefore inapposite. See supra note 18.

30. Restatement (Second) of Torts § 886A comment c, at 338-39 (1979); see id. § 886B comment c, at 345-46. See generally W. Prosser, supra note 18, § 50 (contribution); id. § 51 (indemnification). Joint tortfeasors are jointly and severally liable for the plaintiff's loss. Each individual tortfeasor is therefore liable for the entire amount of the plaintiff's damages. See W. Prosser, supra note 18, § 47, at 297. Contribution and indemnification are remedies which joint and severally liable defendants have inter se. They do not affect the plaintiff's substantive right to sue any tortfeasor he chooses and to seek execution from any tortfeasor against whom he obtains a judgment. Contribution, supra note 18, at 203-04.


32. W. Prosser, supra note 18, § 51, at 311.

33. Id. at 310.

34. Restatement (Second) of Torts § 886A comment l, at 342 (1979); W. Prosser, supra note 18, § 50, at 310; 2 S. Williston, Treatise on the Law of Contracts § 345, at 767 (3d ed. 1959). The defendant seeking contribution must establish that the party from whom he seeks it is liable in tort to the same person for the same harm. Wassel v. Eglowsky, 399 F. Supp. 1330, 1367 (D. Md. 1975), aff'd per curiam, 542 F.2d 1235 (4th Cir. 1976); W. Prosser, supra note 18, § 50, at 309.
liable parties to bear a portion of the common liability.35 The defendant who has been forced to discharge more than his share of the liability may bring a claim for contribution against any other jointly liable parties to compel reimbursement.36 The losses arising out of the joint liability are thus more evenly distributed among the responsible defendants.37

A. Indemnification

An outside defendant could at one time completely escape liability for a violation of the federal securities acts through an indemnification agreement.38 In the typical agreement, the inside and outside parties agreed to indemnify each other for any acts or omissions giving rise to liability.39 Despite scholarly criticism,40 this practice was the rule in


36. 2 S. Williston, supra note 34, § 345, at 772, 775. Contribution is an inchoate right which ripens into a cause of action when one party pays more than his share of the common liability. Id. at 775; accord Prisbrey v. Noble, 505 F.2d 170, 176 (10th Cir. 1974); Southern Ry. v. State Farm Mut. Auto Ins. Co., 357 F. Supp. 810, 812 (N.D. Ga. 1972), aff'd, 477 F.2d 49 (5th Cir. 1973); Kantlehner v. United States, 279 F. Supp. 122, 128 (E.D.N.Y. 1967). The federal rules of civil procedure, however, permit contribution claims to be brought before one party has been proven liable to another for contribution. Fed. R. Civ. P. 13(g), 14(a); see infra note 52 and accompanying text.

37. Of course, the parties who are potentially liable could agree among themselves in advance of litigation to apportion contribution shares in the event of liability. 2 S. Williston, supra note 34, § 345, at 769; Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 178-79 (1933). This private agreement is enforceable if it is not contrary to public policy. See 2 S. Williston, supra note 34, § 345, at 769-70. Several commentators have suggested this approach to the problem of apportioning contribution shares under the federal securities acts. Freund & Hacker, supra note 12, 480-85; Comment, Section 11 of the Securities Act—A Proposal For Allocating Liability, 45 Wash. L. Rev. 95, 116-28 (1970). This Note is concerned with the apportionment of contribution shares in the absence of such a private agreement on the matter.


40. 3 L. Loss, supra note 23, at 1831 ("Indemnification defeats pro tanto the statutory provision on contribution. And it is hostile to the in terrorem effect intended for § 11; negligence in the preparation of the registration statement was made a basis of civil liability largely in order to promote careful adherence to the statutory requirements." (footnote omitted)).
the securities industry prior to the 1968 decision in *Globus v. Law Research Service*. In *Globus*, the district court refused to enforce an indemnification agreement between two defendants on the ground that an agreement that absolved a defendant guilty of a knowing violation of the federal securities acts was contrary to public policy and therefore unenforceable. The court reasoned that the threat of civil liability that could not be avoided by contract was necessary in order to encourage outside defendants to adhere to the statutory requirements of thorough investigation and disclosure. The Second Circuit affirmed, but it stopped short of propounding a general rule barring indemnification in all circumstances, noting that it was only considering a situation in which the defendant seeking indemnification was himself guilty of more than mere negligence.

The Second Circuit's decision in *Globus* thus left open the possibility that a merely negligent party could obtain indemnification from one significantly more culpable. This possibility proved to be illusory, however, as courts applying the *Globus* rule in subsequent indemnification cases routinely held that the party seeking indemnifica-

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41. *Id.* at 1834-35.
42. 287 F. Supp. 188 (S.D.N.Y. 1968), aff'd in part, rev'd in part on other grounds, 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970). The defendants in *Globus* were the issuer, its president and the underwriter involved in an offering of one hundred thousand shares of Law Research Service, Inc. They were all found liable for having circulated in connection with the stock sale an advertisement that contained a misrepresentation in violation of § 10(b) of the 1934 Act and § 17(a) of the 1933 Act. *Id.* at 191. The underwriter had entered into a standard indemnification agreement with the issuer and sought by way of a cross-claim to enforce this agreement and shift its liability for the plaintiff's losses onto the issuer and its president. *Id.* at 198-99.
43. *Id.* at 199.
44. *Id.* ("The purpose of the federal securities acts is to insure that the public investor, including particularly small investors such as the plaintiffs here, will obtain the benefit of a thorough investigation of the facts set forth in a prospectus or offering circular, not only by the issuer but also by the underwriter, so that prospective investors will have access to the truth. If an underwriter were to be permitted to escape liability for its own misconduct by obtaining indemnity from the issuers, it would have less of an incentive to conduct a thorough investigation and to be truthful in the prospectus distributed under its name, than it would be if the indemnity was unenforceable under such circumstances."); accord State Mut. Life Assurance Co. v. Peat, Marwick, Mitchell & Co., 49 F.R.D. 202, 213 (S.D.N.Y. 1969).
45. 418 F.2d at 1287-88.
tion was guilty of more than ordinary negligence.47 Adopting a stricter approach, another line of cases concluded that indemnification would not be permitted under the federal securities acts as a matter of law, regardless of the culpability of the party seeking it.48 The rule denying indemnification as a matter of law is consistent with the policies underlying the federal securities acts.49 Enforcing an indemnification agreement in favor of a negligent outside defendant would tend to encourage a less thorough investigation of the issuer, and consequently less than satisfactory disclosure, by removing the penalty for a negligent investigation.50 Deprived of indemnification by Globus and its progeny, outside defendants in federal securities lawsuits may nevertheless obtain the benefits of contribution.51

B. Contribution

An express right to contribution52 is granted in section 11 of the


49. The commentators generally agree that indemnification is undesirable in a federal securities lawsuit. 3 L. Loss, supra note 23, at 1831-32; Ruder, supra note 18, at 651-59; Indemnification of Underwriters, supra note 38, at 411-12.

50. See supra note 44.


52. There are three situations in which a claim for contribution may be asserted in the context of a federal securities lawsuit. A defendant may bring a cross-claim for contribution against another defendant in the action when the plaintiff has sued both. E.g., Sherlee Land v. Commonwealth United Corp., [1972-1973 Transfer
In addition, the courts have implied a right to contribution in actions brought under section 10(b) of the 1934 Act. Unlike indemnification, which drastically reduced the incentives to investigate, contribution enhances the deterrent effect of civil liability under the federal securities acts. Because every party involved in an offering may be liable for contribution claims, each has an incentive to investigate and perform due diligence.  


53. Securities Act of 1933, § 11(f), 15 U.S.C. § 77k(f) (1976). Section 11(f) provides in pertinent part: "All or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment . . . ." Id. Express contribution provisions containing language similar to that of § 11(f) are also found in § 9(e) and § 18(b) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78i(e), r(b) (1976).


55. See supra note 44.
to comply with the requirements of investigation and accurate disclosure.\footnote{56}

Once a right to contribution has been established, the problem of apportioning the total liability among the defendants must be addressed.\footnote{57} Contribution shares may be apportioned among the defendants either equally, on a pro rata basis,\footnote{56} or unequally, on the basis of relative fault.\footnote{59} Under the pro rata method of apportionment, the total liability to the plaintiff is divided by the number of defendants, and equal shares are apportioned to each defendant.\footnote{60} Under relative fault apportionment, each defendant's share of the


58. Restatement (Second) of Torts \textsection 886A comment h, at 340 (1979); \textit{see supra} note 18.


60. Wassel v. Eglowsky, 399 F. Supp. 1330, 1370 (D. Md. 1975), \textit{aff'd per curiam}, 542 F.2d 1235 (4th Cir. 1976); W. Prosser, \textit{supra} note 18, \textsection 50, at 310.}
total liability is dependent upon its respective responsibility for bringing about the plaintiff's injury.\textsuperscript{61}

1. Pro Rata Apportionment

The pro rata method is the traditional approach for apportioning contribution shares among defendants under the federal securities acts.\textsuperscript{62} When the issue of contribution was first addressed in federal securities cases, comparative fault was considered in tort law to be an unworkable mechanism for apportioning liability among defendants.\textsuperscript{63} Pro rata apportionment, on the other hand, had the advantages of predictability of results and ease of application.\textsuperscript{64} As a result, the earliest federal securities contribution case\textsuperscript{65} applied the pro rata rule as a matter of course, without an extended discussion.\textsuperscript{66}

Moreover, the language in the express contribution provision of section 11 of the 1933 Act could be read to indicate that Congress had intended contribution in federal securities cases to be apportioned on a pro rata basis. Section 11 provides that “every person who becomes liable to make any payment under this section may recover contribution as in cases of contract.”\textsuperscript{67} Commentators advocating pro rata apportionment have argued that this language was intended to engraft the common-law rule of pro rata contribution in contract cases onto federal securities law.\textsuperscript{68}


\textsuperscript{66}Id. at 957-58.

\textsuperscript{67}Securities Act of 1933, § 11(f), 15 U.S.C. § 77k(f) (1976); see supra note 53.

\textsuperscript{68}3 L. Loss, supra note 23, at 1737-38; Douglas & Bates, supra note 37, at 178-80; Ruder, supra note 18, at 650. In contrast to joint tortfeasors, see supra note 18, at common law a co-obligor who paid more than his proportionate share of the joint liability was entitled to contribution. J. Calamari & J. Perillo, The Law of Contracts § 20-6, at 750 (2d ed. 1977). The general rule for apportionment in such
Pro rata contribution, however, did not always yield equitable results. Although it mitigated the common-law "no contribution" rule, it required all liable defendants to bear an equal share of the burden. In situations involving a significant disparity in the relative culpability of the defendants, a more equitable distribution of the liability can be achieved by apportioning contribution shares on the basis of culpability.

The first assault on the equal apportionment rule was indirect, combining the pro rata rule with the so-called "entity" theory of liability. In *Feit v. Leasco Data Processing Equipment Corp.* and *Wassel v. Eglowsky,* the courts recognized that certain defendants were significantly less culpable than the others. One reading of the 1971 decision in *Feit* suggests that it may have been the first federal securities case to employ the entity approach. Four defendants, the issuer and three directors, were found liable for violating section 11 of the 1933 Act. Instead of holding each defendant jointly and severally liable to the plaintiff, it appeared that the court split the defen-
dants into two separate entities—one comprised only of the issuer and the other, the three directors. Each entity, as opposed to each individual, was then held jointly and severally liable for the plaintiff's losses.77

Wassel, decided four years later, was the first federal securities case to expressly adopt and explain the entity theory.78 The defendants in Wassel were the two sellers and the former corporate counsel for the issuer.79 The Wassel court, pursuant to an explicit recognition that one seller was less culpable than the other,80 classified the sellers as one entity and the corporate counsel as another, and held each entity responsible for half the plaintiff's damages.81

The entity approach led to more equitable results in these two cases, but it was a half measure at best. Groping toward a rule of equitable apportionment, these courts adopted an expedient but did not elaborate on the rationale behind it. It was unlikely that courts which at least in theory were still following the pro rata rule of apportionment could have devised another way to prevent the inequity.

2. Relative Fault Apportionment

Apportionment on a relative fault basis has been accepted by many jurisdictions as a more equitable method of allocating liability among joint tortfeasors.82 Although some courts predicted it would be too difficult to administer,83 the states that have adopted relative fault have found it well worth the slight additional difficulty of taking the facts of each case into account.84

The growing acceptance of relative fault apportionment in general tort law by the mid-1970's sparked a concomitant trend away from strict pro rata contribution in federal securities law.85 The first ex-

77. Id. In apportioning liability, the Feit court wrote, "[t]he issuer, Leasco, and these three directors are jointly and severally liable to the class." Id. To indicate that the four defendants had been made jointly and severally liable for all the damages, the sentence would arguably have had to read: "The issuer, Leasco, and these three directors are each jointly and severally liable to the class." But see McLean v. Alexander, 449 F. Supp. 1251, 1275 & n.82 (D. Del. 1978) (the court asserted that the less culpable defendants in Feit paid substantially less than an equal share of the liability, but there is no indication of this in the Feit decision), rev'd on other grounds, 599 F.2d 1190 (3d Cir. 1979).
78. 399 F. Supp. at 1368-70.
79. Id. at 1336-37.
80. Id. at 1370 (one seller's fault was derivative of the other's).
81. Id.; see id. at 1366 (counsel's conduct may have posed greater danger).
82. See supra note 59.
84. See supra note 71.
85. See supra note 22 and accompanying text.
press recognition of relative fault apportionment in a securities case appeared in dictum in Gould v. American-Hawaiian Steamship Co. The Gould court determined that the phrase "as in cases of contract" in the express contribution sections of the federal securities acts did not mandate pro rata apportionment. As mentioned above, the phrase had been interpreted as requiring apportionment according to the pro rata rule, which was generally applied in contract cases at the time the federal securities acts were enacted. The court in Gould noted, however, that the phrase was not defined in the legislative history, and concluded that the contribution sections were intended to avoid the tort rule barring contribution among joint tortfeasors rather than to preclude equitable considerations in awarding contribution in securities cases.

The movement toward an equitable distribution of liability among securities defendants came of age with the express adoption of relative fault apportionment in McLean v. Alexander. In McLean, an ac-

86. 387 F. Supp. 163 (D. Del. 1974), vacated on other grounds, 535 F.2d 761 (3d Cir. 1976). The plaintiff class in Gould alleged and proved a violation of § 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1976), arising out of a false and misleading proxy solicitation issued in connection with a merger. 387 F. Supp. at 165. Each of three sets of defendants urged the court to adopt a different method for the apportionment of contribution shares. Id. at 169-70. Many of the defendants had settled with the plaintiffs prior to the trial. These defendants argued that contribution shares should be apportioned on the basis of relative fault. Id. The corporate defendants argued for contribution based on the benefits received by the individual defendants in the transaction. Id. The non-settling defendants were found liable and cross-claimed against the settling defendants for indemnity or in the alternative for contribution, id. at 165-66, to be apportioned by the pro rata method. Id. at 169-70. They argued that the phrase "as in cases of contract" found in the contribution sections of the 1933 Act and the 1934 Act was intended to codify the pro rata method of apportionment that was the rule for contract cases at common law. Id. at 170. The court denied the cross-claim for indemnity as contrary to the deterrent policy of the federal securities acts. Id. at 168; see supra note 4 and accompanying text. It held, however, that contribution was available under § 14(a) of the 1934 Act, citing the compatibility of a system of contribution and the policies behind § 14(a), 387 F. Supp. at 169, and the "recent trend in the law favoring contribution." Id. (citing Kohr v. Allegheny Airlines, 504 F.2d 400 (7th Cir. 1974), cert. denied, 421 U.S. 978 (1975), and Globus, Inc. v. Law Research Serv., 318 F. Supp. 955 (S.D.N.Y. 1970), aff'd per curiam, 442 F.2d 1346 (2d Cir.), cert. denied, 404 U.S. 941 (1971)).

87. 387 F. Supp. at 170.
88. See supra notes 67-68 and accompanying text.
90. See supra note 18.
91. 387 F. Supp. at 170.
92. 449 F. Supp. 1251 (D. Del. 1978), rev'd on other grounds, 599 F.2d 1190 (3d Cir. 1979). The plaintiff in McLean brought an action under § 10(b) of the 1934 Act
counting firm, having been held liable for violation of section 10(b), moved for an apportionment of contribution shares on the basis of relative fault. The firm argued that the issuer's fraudulent activities were chiefly responsible for the plaintiff's losses, and therefore the issuer should bear the greater burden of liability. The court concluded that the liability of the outside defendant was in a sense derivative because the inside sellers had supplied the outside defendant with false information and had then actively concealed the true nature of the transactions in question. Determining that application of either the entity theory or pro rata apportionment would, under the circumstances, result in substantial inequity, the court observed that "[i]n this case there was a vast difference between defendants in the degrees of their wrongdoing and the damages ought to reflect that fact."

The trend toward the apportionment of contribution shares based upon relative fault has been generally well received by the commentators. The exact state of the law, however, is difficult to assess. The

against the inside sellers of a corporation that he had purchased and the accounting firm that had handled the transaction, claiming that the defendants had duped him into purchasing the corporation by supplying him with misleading information. Id. at 1255-56.

93. Id. at 1265. The inside sellers had settled with the plaintiff, id. at 1255, but the accounting firm was found liable at trial by reason of its failure to perform a thorough audit. Id. at 1276. They performed what amounted to a cursory audit and as a result certified the accounts receivable covering these purported sales as "considered fully collectible." Id. at 1256.

94. Id. at 1256-60. These inside sellers had induced both the plaintiff and the accounting firm to believe that certain purchase orders represented firm sales, when in fact the underlying transactions were merely consignments. Id. The inside sellers perpetuated their fraud during the audit by causing to be sent to the accountants telegrams which appeared to confirm purchases of the corporation's product, when in fact no such purchases existed. Id. 1259-60. In one instance a salesman forged a telegram purporting to confirm a sale. Id. at 1260.

95. Id. at 1256-60. The inside defendants in McLean argued for pro rata apportionment. Id. at 1271.

96. Id. at 1272, 1276-77; see supra note 94. The court held the accounting firm responsible for 10% of the plaintiff's losses and the inside sellers liable for the remainder. Id. at 1276-77.

97. Id. at 1272-74.

98. Id. at 1272.

Gould court endorsed the relative fault concept but did not actually apply it. The "entity" theory of Feit and Wassel has not been followed in subsequent cases, and the McLean decision, apportioning contribution shares on the basis of relative fault, was reversed on other grounds by the Third Circuit. The case law is thus in a state of transition; the strict pro rata rule is being abandoned, but the exact contours of the emerging alternative methods of apportionment have yet to be explored fully.

II. A Suggested Approach to Apportionment

Apportionment of contribution shares according to the relative fault of defendants is a desirable practice in many instances. It ensures that a less culpable outside defendant will not be saddled with a disproportionate share of the total liability. There are, however, certain situations in which the apportionment of contribution shares on an unequal basis would be inappropriate and ill-suited to the implementation of the deterrent policies of the 1933 Act and the 1934 Act.

A. Section 10(b) of the 1934 Act

An apportionment of contribution shares on the basis of proportionate fault presupposes the possibility of an appreciable disparity in the relative culpability of the defendants. This method of apportionment is thus unsuited for actions brought under section 10(b) of the 1934 Act.


101. McLean v. Alexander, 599 F.2d 1190 (3d Cir. 1979). The circuit court held that the accounting firm had not acted recklessly in preparing the audit because the invoices pertaining to the transactions at issue appeared to be regular on their face and, in any event, they were not so irregular as to put the firm on further inquiry into the true nature of the underlying transactions. Id. at 1199-1201. The court acknowledged that the firm had been negligent in the preparation of the audit but added "negligence—whether gross, grave or inexcusable—cannot serve as substitute for scienter." Id. at 1198. Because it ruled that the accounting firm was not a joint tortfeasor under § 10(b) of the 1934 Act, the circuit court did not have occasion to pass upon the apportionment formula that the district court applied in the case. Id. at 1202.

102. See supra notes 59, 71.

103. See supra notes 84-86 and accompanying text.

A section 11 plaintiff will have an overlapping section 10(b) cause of action if he can establish that each defendant acted with scienter.¹⁰⁵ This standard is satisfied upon a showing of intentional or reckless misrepresentation,¹⁰⁷ but is not met by proof of mere negligence.¹⁰⁸ In the context of section 10(b), reckless conduct has been characterized by the courts as substantially equivalent to intentional conduct.¹⁰⁹ Reckless performance by an outside expert of the statutory duties of investigation constitutes an extreme departure from the standards of ordinary care.¹¹⁰ The danger of misleading the public in such a situation is so obvious that the reckless outside defendant must either have intended to mislead the public or have known of the misrepresentation and chosen to ignore the consequences of its actions.¹¹¹ Any theoretical disparity in culpability that exists under section 10(b) between an inside defendant whose liability is predicated on intentional conduct and the outside defendant who acted


¹⁰⁹. E.g., Wertheim & Co. v. Codding Embryological Sciences, Inc., 620 F.2d 764, 766-67 (10th Cir. 1980) (recklessness in the context of a 10(b) action is tantamount to scienter and is defined as a frame of mind closer to a lesser form of intent than to a greater degree of ordinary negligence); Broad v. Rockwell Int’l Corp., 614 F.2d 418, 440 (5th Cir. 1980) (same), aff’d on rehearing, 642 F.2d 929 (5th Cir.), petition for cert. filed, 50 U.S.L.W. 3046 (U.S. Jul. 16, 1981) (No. 81-239); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir.) (same), cert. denied, 439 U.S. 1039 (1978); Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977) (same); Marbury Management v. Kohn, 470 F. Supp. 509, 516 n.12 (S.D.N.Y. 1979) (same), aff’d in part, rev’d in part on other grounds, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980).


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recklessly will not be of sufficient magnitude to warrant an unequal distribution of the liability through relative fault apportionment.112 The overriding deterrent policy of section 10(b) demands invoking the pro rata rule in these cases.

The function of an outside expert in a corporate offering is to investigate and thereby insure the accuracy of the information in the registration statement.113 When the expert intentionally or recklessly fails to make an adequate investigation, it commits an egregious breach of its statutory duties, jeopardizing the interests of the investing public. The threat of civil liability encourages outside experts to make a thorough investigation of the issuer.114 Contribution among defendants enhances the deterrent effect of this policy by exposing every defendant to liability.115 A rule of pro rata apportionment maximizes this deterrent effect by ensuring that an outside defendant found liable in a section 10(b) action will bear an equal share of the total, potentially onerous116 liability with the other defendants.

B. Section 11 of the 1933 Act

In contrast to the scienter requirement of liability under section 10(b) of the 1934 Act, the range of conduct that is actionable under section 11 of the 1933 Act encompasses negligence, recklessness and intentional misrepresentation.117 For example, if an inside defendant knowingly inserted a misrepresentation in the registration statement, the outside defendants would be jointly and severally liable to the purchasers if they negligently failed to uncover and expose the misrepresentation.118 To be sure, the outside defendants have breached their statutory duty of investigation in such a situation and are properly accountable for a portion of the plaintiff's losses.119 Because their...
breach was the result of negligence, however, rather than an intentiona
tional design, it would not merit the severe sanctions that will poten
tially flow from pro rata apportionment of liability. Assignment of
contribution shares on the basis of relative fault ensures that every
defendant will bear the liability in proportion to the degree to which
it was responsible for the misrepresentation.

The deterrent effect of civil liability under section 11 is not weak
ened by relative fault apportionment. Section 11 expressly provides all
defendants other than the issuer with the defense of due diligence. To estab
lish this defense, the defendant must affirmatively demon
strate that it undertook a thorough investigation of the issuer. A due diligence defense totally absolves a defendant of liability. The availability of this complete defense serves the deterrent policy of civil liability by encouraging outside defendants to comply with the statu
tory requirement of a thorough independent investigation. Any fur
ther incentive to comply, such as the threat of an equal apportion
ment of the liability for a misrepresentation, is therefore unnecessary.

Moreover, it is submitted that relative fault apportionment imple
ments the deterrent policy of section 11 better than pro rata apportion
ment could. A knowing wrongdoer under section 11 would be

120. See 3 A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud § 8.5(585), at 208.52 (1981).
121. Securities Act of 1933, § 11(b), 15 U.S.C. § 77k(b) (1976). The elements of a due diligence defense vary according to which part of the registration statement contains the misrepresentation or omission. As to any part of the registration statement not purporting to be made on the authority of any expert, the outside defendant must show that “after [a] reasonable investigation, [he had] reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.” Id. § 11(b)(3)(A), 15 U.S.C. § 77k(b)(3)(A) (1976). With respect to any portion of the registration statement purporting to be made on the authority of an expert, such as the certified financial statements, a due diligence defense is somewhat easier to establish. The outside defendant need not establish a reasonable investigation. Instead, he need only show that “he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading ...” Id. § 11(b)(3)(C), 15 U.S.C. § 77k(b)(3)(C) (1976). The requirements of the due diligence defense to § 11 liability are exhaustively detailed in the leading case of Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 682-84 (S.D.N.Y. 1968), and thoroughly discussed and explained in Folk, supra note 2, at 19-82. The standard of reasonable investigation and reasonable ground for belief under § 11(c) is that of a “prudent man in the management of his own property.” 15 U.S.C. § 77k(c) (1976).
123. Securities Act of 1933, § 11(b), 15 U.S.C. § 77k(b) (1976). The issuer can only avoid § 11 liability by establishing that the plaintiff was aware of the misrepresentation or omission at the time of his purchase. Id. § 11(a), 15 U.S.C. § 77k(a) (1976).
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more deterred by a rule that required him to bear most of the liability than by a rule of apportionment that permitted him to share the liability equally with another. At the same time, negligent defendants will be neither over-burdened nor absolved by such a rule.

CONCLUSION

The contraction of the strict pro rata rule for the apportionment of contribution shares in federal securities actions is a favorable development. As the McLean court stated, the rule was often "characterized by more mathematical than judicial integrity."

Apportionment based on proportionate fault offers the attractive possibility of more fairly distributing the plaintiff's losses among the responsible defendants. In the context of section 10(b) of the 1934 Act, however, the pro rata method of apportionment continues to serve an important deterrent function and should be retained. Apportionment of contribution shares based on the relative fault of the parties should be reserved for actions brought under section 11 of the 1933 Act.

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