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Expanding the Liability of Managing Underwriters Under the Securities Act of 1933

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EXPANDING THE LIABILITY OF MANAGING UNDERWRITERS UNDER THE SECURITIES ACT OF 1933

INTRODUCTION

The Securities Act of 1933[1] (Securities Act or Act) provides express civil remedies to investors for material misrepresentations or omissions that occur during the offering process.[2] Underwriters,[3] as key participants in this process,[4] are often sued under the Act,[5] but their liability has been limited to the price of the securities they underwrite.[6] Specifically, managing underwriters[7] have not been held liable to those who purchased securities from other underwriters in a syndicate.[8]

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1. Securities Act of 1933 (Securities Act or Act), ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-aa (1982)).

2. *See* §§ 11, 12 and 15 of the Securities Act, 15 U.S.C. §§ 77k, *l*, o (1982).

3. The term "underwriter" is defined in § 2(11) of the Securities Act, 15 U.S.C. § 77b(11) (1982), as

> any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.

Section 2(11) excludes persons "whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission." *Id.*

One noted authority has commented that § 2(11) "makes an 'underwriter' out of anyone" who has purchased a security from the issuer or one in control of the issuer with a view toward the security's distribution "whether or not he owns a pair of striped trousers." L. Loss, Fundamentals of Securities Regulation 93 (1983).

4. *See* Greene, *Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System*, 56 Notre Dame Law. 755, 760, 761-62 (1981) (underwriters conduct investigation of the issuer, control preparation of registration statement, determine timing of public offering, and underwrite offering) [hereinafter cited as Greene, *Responsibilities of Underwriters*]; Wolfson, *Investment Banking*, in Abuse on Wall Street: Conflicts of Interest in the Securities Markets 365, 365 (1980) ("A critical element in the capital-raising process is the role of the investment banker—or underwriter . . . ."). For a discussion of the duties of a managing underwriter, see *infra* notes 31, 32 and accompanying text.

5. *See, e.g.*, Sanders v. John Nuveen & Co., 619 F.2d 1222, 1224 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981); *In re* Itel Sec. Litig., 89 F.R.D. 104, 107 (N.D. Cal. 1981); *In re* Gap Stores Sec. Litig., 79 F.R.D. 283, 288 (N.D. Cal. 1978); DiJulio v. Digicon, Inc., 339 F. Supp. 1284, 1285 (D. Md. 1972); Benzoni v. Greve, 54 F.R.D. 450, 452 (S.D.N.Y. 1972); *see also* E. Folk, Developments in Securities Regulation 1975 18 ("In recent years underwriters have joined the ranks of those sued by dissatisfied investors in public offerings.") [hereinafter cited as Folk I].

6. See *infra* notes 62-65, 124, 125 and accompanying text.

7. Managing underwriters are also referred to as "lead underwriters," "syndicate managers," "originating bankers," and "syndicate representatives." These terms will be used interchangeably in this Note.

8. *See* Klein v. Computer Devices, Inc., 602 F. Supp. 837, 840 (S.D.N.Y. 1985); *In re* Itel Sec. Litig., 89 F.R.D. 104, 121 (N.D. Cal. 1981). Two reasons for the limit on underwriters' liability are the limit on damages imposed by § 11(e) of the Act, see *infra* Pt. II.A.1., and the privity requirement of § 12(2) of the Act, *see infra* Pt. II.A.2, yet

This Note argues that managing underwriters' liability should extend to all securities sold in an offering. Part I provides a brief overview of the underwriting process. Part II discusses how the Act's express civil penalties may be applied to managing underwriters and concludes that they should be subject to expanded liability under section 12(2). It also looks briefly at methods by which lead underwriters can spread this risk among other underwriters in the syndicate.

I. BACKGROUND

A securities offering may be underwritten[9] on either a "best efforts" or "firm commitment" basis.[10] In a best efforts underwriting,[11] the underwriter or underwriting group does not actually purchase the securities but acts as broker or agent for the issuer.[12] The underwriters assume no risk: They agree only to use best efforts to offer and sell the securities,[13] and they receive a commission on these sales.[14] The firm commitment is a far more common method of underwriting.[15] In this arrangement un-

managing underwriters have also escaped liability due to the statute of limitations, *see* Turner v. First Wisconsin Mortgage Trust, 454 F. Supp. 899, 906-07 (E.D. Wis. 1978), findings that the communication in question was not defective, *see* DiJulio v. Digicon, Inc., 339 F. Supp. 1284, 1290 (D. Md. 1972), and settlement, *see* Munsey Trust v. Sycor, Inc., 457 F. Supp. 924, 926 (S.D.N.Y. 1978).

9. Securities may also be offered and sold in a direct offering by the issuer. R. Jennings & H. Marsh, Securities Regulation 15-16 (5th ed. 1982). Obviously the liability of underwriters is not a question in such cases.

10. R. Jennings & H. Marsh, *supra* note 9, at 17; L. Loss, *supra* note 3, at 83-90; Greene, *Responsibilities of Underwriters, supra* note 4, at 762; Wolfson, *supra* note 4, at 418 n.1.

Strict or "old-fashioned" underwriting is a third method in which underwriters agree to act as agents for the issuer in reselling securities but underwrite only those securities not bought by the public. This arrangement is rarely used except in "rights offerings," which are offerings to existing security owners by means of warrants or rights. *See* R. Jennings & H. Marsh, *supra* note 9, at 17; L. Loss, *supra* note 3, at 82-83.

11. A best efforts "underwriting" is technically not an underwriting at all because the investment banking firm does not buy the securities from the issuer. R. Jennings & H. Marsh, *supra* note 9, at 17; L. Loss, *supra* note 3, at 90; Greene, *Responsibilities of Underwriters, supra* note 4, at 762 n.35. This arrangement, however, is subsumed within the definition of "underwriter" provided by § 2(11) of the Act, which includes one who "offers or sells for an issuer." 15 U.S.C. § 77b(11) (1982); *see* Greene, *Responsibilities of Underwriters, supra* note 4, at 762 n.35.

12. See *supra* note 11. The term "issuer" is defined, with certain qualifications and exceptions, as "every person who issues or proposes to issue any security." Securities Act of 1933, § 2(4), 15 U.S.C. § 77b(4) (1982).

13. *See* R. Jennings & H. Marsh, *supra* note 9, at 17; L. Loss, *supra* note 3, at 90; Greene, *Responsibilities of Underwriters, supra* note 4, at 762; Wolfson, *supra* note 4, at 418 n.1. Best efforts arrangements are used primarily when an issuer is not well known and no underwriter wants to make a stronger commitment, or when an established issuer attempts to save money on distribution costs. L. Loss, *supra* note 3, at 90.

14. *See* L. Loss, *supra* note 3, at 90; Wolfson, *supra* note 4, at 418 n.1.

15. R. Jennings & H. Marsh, *supra* note 9, at 17; L. Loss, *supra* note 3, at 83-84; Halleran & Calderwood, *Effect of Federal Regulation on Distribution of and Trading in Securities*, 28 Geo. Wash. L. Rev. 86, 88 n.4b (1959); Wolfson, *supra* note 4, at 418 n.1. In 1980, approximately $47.8 billion in securities were underwritten on a firm commit-

derwriters purchase securities outright from the issuer,[16] thereby assuming the risk that the securities might not sell.[17]

There are also several ways for an issuer to select an underwriter.[18] In a competitive bidding, two or more underwriting groups submit sealed bids and the highest bidding group gets the deal.[19] More frequently,[20] an issuer negotiates an underwriting agreement by approaching one or more investment bankers with whom it has had previous dealings[21] or whose reputations are respected.[22]

Most offerings are handled by syndicates, rather than by single underwriters.[23] This arrangement allows underwriters to spread the risks involved.[24] Traditionally one[25] investment banking house acts as the syndicate's "lead" or "managing" underwriter.[26] In a competitively bid underwriting, each group chooses its leader prior to the bidding.[27] When

ment basis, compared with $4.6 billion sold on a best efforts basis and $6.5 billion sold directly by the issuer. Greene, *Responsibilities of Underwriters*, *supra* note 4, at 762 (citing 40 SEC Monthly Statistical Review 28 (Feb. 1981)).

16. R. Jennings & H. Marsh, *supra* note 9, at 17; *see* Greene, *Responsibilities of Underwriters*, *supra* note 4, at 762; Wolfson, *supra* note 4, at 418 n.1.

17. *See* Wolfson, *supra* note 4, at 418 n.1. A more likely risk is that the securities will sell at a price lower than the public offering price. *See* Greene, *Responsibilities of Underwriters*, *supra* note 4, at 762 & n.34. The underwriter's commitment is generally subject to a "market out" provision, allowing the underwriter to back out if market conditions change radically prior to the effective date of the registration statement. R. Jennings & H. Marsh, *supra* note 9, at 17; Tyler, *More About Blue Sky*, 39 Wash. & Lee L. Rev. 899, 918 & n.18 (1982).

18. One method of selecting an underwriter that will not be discussed in detail is the "Dutch auction," in which each underwriter submits a bid only for the amount of securities it intends to purchase. This arrangement is rarely used. *See generally* R. Jennings & H. Marsh, *supra* note 9, at 15-16 (Dutch auction and its use by Exxon Corp.); L. Loss, *supra* note 3, at 89 n.6 (same); Greene, *Responsibilities of Underwriters*, *supra* note 4, at 792-93 (same).

19. L. Loss, *supra* note 3, at 89-90. Competitive bidding is used for the sale of municipal and state securities and is required in many regulated industries. Wolfson, *supra* note 4, at 370; *see* L. Loss, *supra* note 3, at 89 & n.6; Greene, *Responsibilities of Underwriters*, *supra* note 4, at 763 & n.44, 791; Halleran & Calderwood, *supra* note 15, at 103.

20. *See* Greene, *Responsibilities of Underwriters*, *supra* note 4, at 792 & n.231 ("competitive bidding is not a widespread practice"); *see also* Halleran & Calderwood, *supra* note 15, at 103, 104 (there has been "enormous growth" in amount of securities sold by competitive bidding, but few issuers choose this method unless required to).

21. L. Loss, *supra* note 3, at 84; *see* Greene, *Responsibilities of Underwriters*, *supra* note 4, at 762-63; Wolfson, *supra* note 4, at 367, 418 n.1.

22. L. Loss, *supra* note 3, at 84. In the case of a first public offering, an issuer might seek a firm that specializes in new issues. Wolfson, *supra* note 4, at 418 n.1.

23. This is especially true with larger issues. *See* R. Jennings & H. Marsh, *supra* note 9, at 17; *see also* L. Loss, *supra* note 3, at 84-85 (history and development of syndicates). For the structure of underwriting syndicates, see R. Jennings & H. Marsh, *supra* note 9, at 18-19.

24. L. Loss, *supra* note 3, at 84, 85; Greene, *Responsibilities of Underwriters*, *supra* note 4, at 762; Wolfson, *supra* note 4, at 418 n.1. See *infra* notes 160, 161 and accompanying text.

25. In many offerings there is more than one managing underwriter. R. Jennings & H. Marsh, *supra* note 9, at 19; L. Loss, *supra* note 3, at 86.

26. *See* R. Jennings & H. Marsh, *supra* note 9, at 17; L. Loss, *supra* note 3, at 85, 86.

27. *See* L. Loss, *supra* note 3, at 89-90.

the negotiated method is used, the investment banking firm that is first approached by the issuer usually gets this position.[28]

The managing underwriter title brings added responsibility and an extra fee,[29] both of which are described in an "Agreement Among Underwriters."[30] The most significant duty[31] for purposes of this Note is the lead underwriter's investigation of the issuer's financial strength and future earnings potential.[32] This study is used to determine both the price of the securities[33] and whether the prospectus is complete and not materially misleading under the Securities Act.[34] Of course, nothing in the

28. *See* R. Jennings & H. Marsh, *supra* note 9, at 17; L. Loss, *supra* note 3, at 83; Greene, *Responsibilities of Underwriters, supra* note 4, at 763.

29. *See* R. Jennings & H. Marsh, *supra* note 9, at 17, 20-21; L. Loss, *supra* note 3, at 88; Greene, *Responsibilities of Underwriters, supra* note 4, at 763; Halleran & Calderwood, *supra* note 15, at 101. The fee of each participant in the offering process is determined by the "gross spread"—the difference between the price paid to the issuer and the public offering price. For example, if the gross spread is one dollar per share, the lead underwriter might receive 20 cents per share on every share sold. R. Jennings & H. Marsh, *supra* note 9, at 20-21. In other words, the lead underwriter receives a fee on the shares sold by other underwriters. As for the rest of the dollar, 30 cents might represent the "gross underwriting fee," which is compensation to the syndicate for expenses, use of capital and assumption of the underwriting risk, and 50 cents would go to the firm that actually sold the share. *Id.* at 21.

30. The "Agreement Among Underwriters" should be distinguished from what is generally called the "Underwriting Agreement." The former contract involves only the syndicate and usually contains, inter alia, the following provisions: payment and security delivery terms; designation of the managing underwriters and the scope of their authority; indemnification arrangements among syndicate members; trading restrictions; and termination date of the offering. Greene, *Responsibilities of Underwriters, supra* note 4, at 763 & n.39; *see* R. Jennings & H. Marsh, *supra* note 9, at 18; L. Loss, *supra* note 3, at 86. The "Underwriting Agreement," on the other hand, is signed by the issuer and the lead underwriter acting on behalf of the participating underwriters, who thereby become parties to the contract. R. Jennings & H. Marsh, *supra* note 9, at 18. For the terms of this agreement, see Greene, *Responsibilities of Underwriters, supra* note 4, at 763.

31. Other duties of the lead underwriter include organizing the syndicate and notifying each underwriter of how much of the security it can retain for sale and how much goes into a "pot" to be distributed to retailers. *See* R. Jennings & H. Marsh, *supra* note 9, at 17, 18, 20. The lead underwriter will also manage or settle any litigation that arises from the offering. *See In re* Gap Stores Sec. Litig., 79 F.R.D. 283, 289, 290 n.4 (N.D. Cal. 1978).

32. *See* Greene, *Responsibilities of Underwriters, supra* note 4, at 764 (detailed investigation is expected and is usually performed by the managing underwriter, issuer and counsel). In practice, the "bulk of the investigation" may be conducted by the underwriter's law firm. Wolfson, *supra* note 4, at 375. Yet the lead underwriter is ultimately responsible for assuring the scope and accuracy of this investigation and its correct summary in the prospectus. *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696, 697 (S.D.N.Y. 1968) (underwriters are as responsible for the truth of the prospectus as are issuers).

33. *See* Folk, *Civil Liabilities Under the Federal Securities Acts: The* BarChris *Case (Part I)*, 55 Va. L. Rev. 1, 55 (1969) (underwriter who investigates plays an often decisive role in pricing the offering) [hereinafter cited as Folk II]. Price is also determined by other factors, such as market conditions, price earnings multiples of companies comparable to the issuer, and a fair amount of intuition on the part of the investment banker. Wolfson, *supra* note 4, at 382-85.

34. Schedules A and B of the Securities Act, 15 U.S.C. § 77aa (1982), provide a detailed list of information required in the registration statement, which includes and ex-

agreement among underwriters prevents other underwriters in the syndicate from conducting their own investigations of the issuer.[35] A syndicate may include more than 100 underwriters,[36] however, and it is unlikely that each will conduct its own thorough investigation.[37] In fact, it is "standard operating procedure in the investment banking industry"[38] for all the underwriters in a syndicate to rely on the lead underwriter's investigation.[39]

This reliance calls into question the way in which the courts have apportioned liability. If an issue turns sour,[40] the managing underwriter

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pands upon the information required in a prospectus, *see* 15 U.S.C. § 77j (1982). Section 11 of the Act, 15 U.S.C. § 77k(a) (1982), adds the requirement that no false or misleading statements appear in the registration statement, and § 12(2) of the Act, 15 U.S.C. § 77*l*(2) (1982), makes the same true for prospectuses. *See* Folk II, *supra* note 33, at 55, 56-57 (investigation used to ensure accuracy of registration statement and satisfy requirements of Securities Act).

The investigation may also be a means for the underwriter to determine whether a public offering is appropriate for the firm in question. Greene, *Responsibilities of Underwriters*, *supra* note 4, at 764; *see, e.g.* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 693 (S.D.N.Y. 1968) (purpose of preliminary investigation was to determine whether underwriter should undertake financing).

35. For the terms of the agreement, see *supra* note 30.

36. *See, e.g.*, *In re* Itel Sec. Litig., 89 F.R.D. 104, 111 (N.D. Cal. 1981) (one offering involved 104 underwriters; another included 114); McFarland v. Memorex Corp., 493 F. Supp. 631, 634 n.4 (N.D. Cal. 1980) (offering made by 103 underwriters); Benzoni v. Greve, 54 F.R.D. 450, 451 (S.D.N.Y. 1972) (syndicate included 133 underwriters); *see also* R. Jennings & H. Marsh, *supra* note 9, at 19 (approximately 10 to 100 firms participate in any given offering); L. Loss, *supra* note 3, at 83 (trend is toward larger syndicates, sometimes well over 100 firms); Wolfson, *supra* note 4, at 418 n.1 (syndicates range from a handful to over 100 firms).

37. *See* Folk II, *supra* note 33, at 56-57. The author states that "chaos would prevail if each underwriter participated in the investigation and tried to verify the accuracy of the registration statement" because the underwriters would spend all their time on these activities instead of marketing the securities. *Id.* at 57. Another commentator also believes that an independent investigation by each underwriter would be impractical. *See* Wolfson, *supra* note 4, at 374. However, that author implies that participating underwriters should at least take steps to determine whether the lead underwriter has done a responsible job in its investigation. *See id.* at 375. The Securities and Exchange Commission (SEC) has suggested that a participating underwriter need not actually verify the information in a registration statement but must " 'satisfy himself that the managing underwriter makes the kind of investigation the participant would have performed if he were the manager.' " *In re* Gap Stores Sec. Litig., 79 F.R.D. 283, 301 (N.D. Cal. 1978) (quoting SEC Act of 1933 Rel. No. 5275, at 11-12 (July 26, 1972)); *see also Gap Stores*, 79 F.R.D. at 300-02 (discussing relative responsibilities of participating and managing underwriters for purposes of section 11 class action); L. Loss, *supra* note 3, at 1037 (it is unclear how much participants may rely on lead underwriter). See *infra* text accompanying note 51.

38. Wolfson, *supra* note 4, at 374.

39. *Id.*; *see* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 692 (S.D.N.Y. 1968) (participating underwriters made no investigation of the accuracy of the prospectus); Folk I, *supra* note 5, at 19 (participating underwriters take a relatively passive, background position); Greene, *Responsibilities of Underwriters*, *supra* note 4, at 778 (participating underwriter merely ascertains that reliance on manager is reasonable); Wolfson, *supra* note 4, at 374-75 (participating underwriters do not even check on lead underwriter's investigation).

40. This does not necessarily mean that the issuer has filed for bankruptcy, although

has traditionally been under no potential liability to those who were not its direct customers[41]—in other words, most of the investors.[42] There is not even a chance of indirect liability, as the agreement among underwriters usually precludes indemnification by the lead underwriter.[43]

Consider this problem in practice:[44] Corporation C makes its initial public offering of securities. Forty underwriters handle the offering on a firm commitment basis, but lead underwriter U is the only one to check C's finances and future prospects.[45] U concludes that C is a high risk business but still a good investment gamble for the syndicate. However, U does not object when C's attorneys prepare a prospectus that is more optimistic than C's finances warrant. A number of investors purchase C's securities, relying in part on the good name of underwriter U,[46] and are shocked when C files for bankruptcy within a year. Because suing C will probably not produce a sufficient recovery,[47] investors will look to the underwriters as potential "deep pockets."[48] Yet if an investor prevails in a suit against the underwriter from whom he bought, the recovery will come from a firm whose involvement in preparing the prospectus was minimal.[49] Lead underwriter U, which could have corrected

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this is often the case. *See, e.g.*, Klein v. Computer Devices, Inc., 591 F. Supp. 270, 272 n.3 (S.D.N.Y. 1984), *modified on rehearing*, 602 F. Supp. 837 (S.D.N.Y. 1985); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 654 n.5 (S.D.N.Y. 1968). A stock issue may also turn sour, at least from the points of view of shareholders, if the market price drops substantially. *See, e.g.*, *In re* Gap Stores Sec. Litig., 79 F.R.D. 283, 288-89 (N.D. Cal. 1978) (price dropped from $18 to $8 per share over a three month period).

41. See *infra* notes 62-65, 124, 125 and accompanying text.

42. If a syndicate consists of a large number of underwriters, see *supra* note 36 and accompanying text, it is likely that a high percentage of sales will be made by members other than the lead underwriter. *See* Brodsky, *Corporate and Securities Litigation: Underwriters' Liability Under Section 12(2)*, N.Y.L.J., Sept. 5, 1984, at 1, col. 1 (lead underwriter "may only have sold a small proportion of the securities" in an offering).

43. The agreement usually provides for several, but not joint, liability. See *infra* note 161 and accompanying text. This provision is included in order to limit liability under § 11(e) of the Act, 15 U.S.C. § 77k(e) (1982). See *infra* notes 60-65 and accompanying text.

44. The scenario described is similar to the facts in Klein v. Computer Devices, Inc., 591 F. Supp. 270 (S.D.N.Y. 1984), *modified on rehearing*, 602 F. Supp. 837 (S.D.N.Y. 1985).

45. See *supra* notes 38, 39 and accompanying text.

46. See *infra* notes 133-35 and accompanying text.

47. Recovery from the issuer is likely to be limited because it is in bankruptcy proceedings and its assets, which may be insubstantial to begin with, must be divided among a number of creditors. *See* 11 U.S.C. § 507 (1982) (priority of creditors). Moreover, any action against the issuer will be stayed under a provision of the Bankruptcy Act, *id.* § 362(c), until bankruptcy proceedings are completed. *See* Klein v. Computer Devices, Inc., 591 F. Supp. 270, 272 n.3 (S.D.N.Y. 1984), *modified on rehearing*, 602 F. Supp. 837 (S.D.N.Y. 1985). As for the officers and directors of the issuer, their fortunes may be tied to the fate of the issuer, and their funds might be depleted quickly if a large number of investors were to recover.

48. Greene, *Why Underwriters Are Nervous*, Forbes, Sept. 12, 1983, at 164 [hereinafter cited as Greene, *Underwriters Nervous*].

49. *See* Wolfson, *supra* note 4, at 374. See *supra* notes 38, 39 and accompanying text.

the prospectus, has escaped liability except to its immediate customers.[50]

Although it would be imprudent to allow the other underwriters to escape liability altogether,[51] some expansion of lead underwriters' liability is required. The current state of the law is somewhat unfair to the other underwriters because they are less responsible for the prospectus than the manager is;[52] on the other hand, they have entered into the arrangement voluntarily. More important, the present law works to the disadvantage of investors. A change in the apportionment of liability will encourage managing underwriters to take the utmost care in their investigation of issuers.[53] In the scenario described above, U might have hesitated before giving its endorsement of C if U's potential liability were greater. A change here will also ease procedural burdens on purchasers of securities, as a plaintiff class will be able to sue one defendant rather than dozens.[54] The Securities Act provides several possible avenues for such a change in liability.

II. Expanding the Liability of Underwriters

A. *Express Civil Liabilities Under the Securities Act*

The Securities Act is primarily a disclosure statute,[55] focusing on the

50. See *supra* note 8, *infra* notes 62-65, 124, 125 and accompanying text.

51. See *supra* note 37.

52. See *supra* notes 38, 39 and accompanying text and *supra* note 49.

53. The premise of the Securities Act as a whole was that increasing the potential liability of actors in the offering process would make them more careful in their representations to the public. See *infra* notes 99-105 and accompanying text.

54. Plaintiff investors often get class certification for themselves, *see, e.g.*, Collins v. Signetics Corp., 605 F.2d 110, 112 (3d Cir. 1979); *In re* Itel Sec. Litig., 89 F.R.D. 104, 107 (N.D. Cal. 1981), but may have trouble getting the defendant underwriters certified as a class, *see, e.g.*, *In re* Gap Stores Sec. Litig., 79 F.R.D 283, 307 (N.D. Cal. 1978) (class certification for defendant underwriters denied with respect to § 12(2) claims). If the managing underwriter could be sued alone, plaintiffs would have to prepare a case against only one defendant. This would reduce litigation expenses considerably.

55. See *infra* notes 99-105 and accompanying text. Some state Blue Sky laws are "merit" statutes—that is, a state agency has the power to disapprove issues which, in the agency's opinion, lack merit. *See, e.g.*, Cal. Corp. Code § 25140 (West 1977); Mo. Ann. Stat. § 409.306 (Vernon 1979); *see also* Tyler, *supra* note 17, at 901-04 (evaluating merit provisions of Uniform Securities Act). The Securities Act does not serve this function, and most of those involved in its enactment did not intend it to do so. One of Franklin D. Roosevelt's first actions in office was to send a message to Congress calling for federal securities legislation. In this message he stated: "Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit." 77 Cong. Rec. 937 (1933) [hereinafter cited as *President's Message*], *reprinted in* 1 J. Ellenberger & E. Mahar, Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934, at Item 3 (1973). One member of the House of Representatives stated that the bill would not "prevent anybody from putting his money into rat holes or into highly speculative ventures if he sees fit to do so." 77 Cong. Rec. 2912 (1933) (remarks of Rep. Mapes), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra*, at Item 7. There was, however, some debate on the issue. *See* L. Loss, *supra* note 3, at 32-38.

need for potential investors to acquire information about issuers.[56] In accordance with this goal, the Act contains several sections that provide for express[57] civil liabilities when disclosure standards are not met.[58] When the lead underwriter is responsible for failing to disclose fully or properly, investors may look to sections 11 and 12(2) of the Act.[59]

1. Section 11

Section 11 explicitly makes underwriters[60] liable for material misstatements or omissions in a registration statement.[61] At first glance this section seems the logical one to use in a suit against an underwriter. However, a 1934 amendment—section 11(e)—contains a provision that limits an underwriter's liability to the total price of the securities it underwrites.[62] A qualifier to the section provides that an underwriter's lia-

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56. *See* 77 Cong. Rec. 2912, 2914, 2919 (1933) (remarks of Reps. Mapes, Greenwood, Rayburn), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7; *see also* Greene, *Responsibilities of Underwriters, supra* note 4, at 756 (basic requirement of Act is disclosure of issuers' financial affairs); Halleran & Calderwood, *supra* note 15, at 94 (purpose of Act was disclosure of all pertinent information; prior to Act even reputable firms issued securities on basis of "rather sketchy information"). See *infra* notes 99-105 and accompanying text. Professor Loss notes that "there is the recurrent theme throughout [federal securities laws] of disclosure, again disclosure, and still more disclosure." L. Loss, *supra* note 3, at 7.

57. The Securities Act and the Securities Exchange Act of 1934 (Exchange Act), ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§78a-kk (1982)), have been interpreted as implying civil liabilities as well as providing express remedies. See, for example, § 10(b) of the Exchange Act, 15 U.S.C § 78j(b) (1982). *See* Harmsen v. Smith, 693 F.2d 932, 938 (9th Cir. 1982), *cert. denied*, 104 S. Ct. 89 (1983); *see also* Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 Geo. L.J. 891, 892-900 (1977) (implied rights of action under § 10(b) of the Exchange Act); Steinberg, *The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws*, 67 Cornell L. Rev. 557, 560-71 (1982) (Supreme Court's approach to implied remedies).

58. *See* Securities Act of 1933, §§ 11, 12, 15, 15 U.S.C. §§ 77k, *l*, o (1982).

59. 15 U.S.C. §§ 77k, *l*(2) (1982).

60. Underwriters are not the only potential defendants under § 11. It also subjects to liability every person who signed the registration statement, directors of or partners in the issuer, those named in the registration statement as being or about to be named directors or partners, and certain experts whose reports are used in the registration statement. *See* 15 U.S.C. § 77k(a) (1982).

61. Section 11(a) provides in pertinent part:

> 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 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— . . . (5) every underwriter with respect to such security.

Id.; *see* H. Bloomenthal, 1982 Securities Law Handbook §11.03[2], at 174-75; Greene, *Responsibilities of Underwriters, supra* note 4, at 765-67.

62. "In no event shall any underwriter . . . be liable in any suit . . . authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public." 15 U.S.C. § 77k(e) (1982). Managing underwriters have avoided unlimited liability under

bility is not limited if it has received an extra fee from the issuer.[63] Managing underwriters do receive an extra fee,[64] but they have "routinely evaded" unlimited liability by arranging for the syndicate rather than the issuer to pay this fee.[65]

Although not entirely clear from the legislative history, it is likely that Congress intended section 11(e) to increase the potential liability of managing underwriters.[66] A memorandum to the Senate explaining the amendment stated: "[I]t provides that an underwriter who does *not* receive any preferential treatment is permitted to limit his total liability."[67] Whom could Congress have had in mind as receiving preferential treatment if not the lead underwriter? Not only does it take in an extra fee from securities sold by the other underwriters,[68] it benefits from the prestige associated with the managing underwriter title.[69] Yet managing underwriters have thus far been successful in evading liability under section 11,[70] and expansion of their liability in this area is unlikely without a mandate from Congress.

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this provision by arranging for the whole syndicate to purchase securities from the issuer in a firm commitment underwriting. *See* Halleran & Calderwood, *supra* note 15, at 98-99. Before the Securities Act was passed, the managing underwriter often made the entire purchase and resold to syndicate members. *See id.* at 98.

63. An underwriter's liability is limited "unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting." 15 U.S.C. § 77k(e) (1982).

64. See *supra* note 29 and accompanying text.

65. L. Loss, *supra* note 3, at 1039 n.67; *see* Greene, *Responsibilities of Underwriters*, *supra* note 4, at 763 n.43.

66. The fact that a number of other amendments to the Securities Act were passed as part of the same bill may explain the lack of legislative history on this point. *See, e.g.*, 15 U.S.C. § 77b(1) (1982) (definition of security); *id.* § 77b(4) (definition of issuer); *id.* § 77b(10) (definition of prospectus); *id.* § 77c(a)(2) (exemption for government issued securities). There is little indication of legislative intent for the phrase concerning limits on underwriters' liability. Yet the language itself points clearly to managing underwriters. *See id.* § 77k(e). See *supra* note 63 and accompanying text. If managing underwriters fall under an exception to a limit on liability, then Congress must have intended their liability to be greater than other underwriters. But see Brodsky, *supra* note 42, at 2, cols. 1-2, who makes the opposite argument in a discussion of Klein v. Computer Devices, Inc., 591 F. Supp. 270 (S.D.N.Y. 1984), *modified on rehearing*, 602 F. Supp. 837 (S.D.N.Y. 1985). See *infra* notes 116-29 and accompanying text. He finds that the earlier *Klein* decision, which suggested that a managing underwriter could be liable to other underwriters' customers, was contrary to the intent of § 11(e). *See* Brodsky, *supra* note 42, at 2, col. 2. Brodsky notes the exception for extra compensation by the issuer but does not suggest what Congress' intent might have been in adding this provision. *See id.* The *Klein* court appears to have agreed with Brodsky's interpretation in its second opinion. *See Klein*, 602 F. Supp. at 840.

67. 78 Cong. Rec. 8669 (1934) (statement of Sen. Fletcher) (emphasis added), *reprinted in* 4 J. Ellenberger & E. Mahar, *supra* note 55, at Item 10.

68. See *supra* note 29 and accompanying text.

69. *See* R. Jennings & H. Marsh, *supra* note 9, at 19.

70. *See, e.g.*, *In re* Gap Stores Sec. Litig., 79 F.R.D. 283, 303 (N.D. Cal. 1978) (managing underwriters' liability in section 11 case was limited to securities they underwrote).

2. Section 12(2)

Section 12(2)[71] has no limit on liability and has a broader reach[72] than section 11. This section provides a civil remedy when a security is offered or sold by means of a prospectus or oral communication[73] that contains a material misstatement or omission.[74] However, the language

71. Section 12 of the Securities Act contains another private remedy provision in § 12(1), 15 U.S.C. § 77*l*(1) (1982), which provides a civil remedy to investors for violations of § 5 of the Act, *id.* § 77e. Section 5 makes it unlawful to use instruments of interstate commerce to sell or transport unregistered securities. This section does not relate to managing underwriters' liability because an unregistered offering usually does not involve underwriters, but §§ 12(1) and 12(2) share an apparent requirement of privity. *See id.* § 77*l*(1). See *infra* note 77 and accompanying text. The tests for privity are generally the same, *see* Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 692-93, 695 (5th Cir. 1971), but if there is any difference, it is that an even broader construction—a looser privity standard—has sometimes been applied to § 12(2), *id.* at 692; *see also* Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057, 1064 n.2 (6th Cir. 1984) (suggesting but not expressing an opinion on this difference), *cert. denied*, 105 S. Ct. 1359 (1985).

72. "Section 12(2) is the broadest of the Act's civil liability provisions . . . ." Schneider, *Section 12 of the Securities Act of 1933: The Privity Requirement in the Contemporary Securities Law Perspective*, 51 Tenn. L. Rev. 235, 236 (1984); *see* L. Loss, *supra* note 3, at 1021-22; Schneider, *supra*, at 236 n.7. Section 12(2) reaches securities exempt from registration requirements under §§ 3 and 4 of the Act, 15 U.S.C. §§ 77c, d (1982). *See id.* § 77*l*(2); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 695 (5th Cir. 1971); Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5*, 13 Hous. L. Rev. 231, 236 (1976). It specifically excludes, however, securities exempt under § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1982) (government-sold securities). *See id.* § 77*l*(2); Kaminsky, *supra*, at 236. For another area in which §12 is broader than § 11, see *infra* note 73.

73. 15 U.S.C. § 77*l*(2) (1982). This is also broader than § 11, which only reaches misstatements or omissions in registration statements filed with the SEC pursuant to § 6, *id.* § 77f. *See id.* § 77k. A prospectus may include a circular, advertisement, letter or communication that is written or delivered by radio or television. *Id.* § 77b(10). The inclusion of the term "oral communication" in § 12(2) extends its reach still further. *Id.* § 77*l*(2).

74. Section 12(2) provides in part that any person who

> offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . shall be liable to the person purchasing such security from him . . . .

15 U.S.C. § 77*l*(2) (1982).

The elements of a cause of action under § 12(2) are the purchase of a security, use of the jurisdictional means in connection with the sale of the security, and use of a prospectus or oral communication that contains a false or misleading statement or omission. *See* Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 695 (5th Cir. 1971); *In re* Itel Sec. Litig., 89 F.R.D. 104, 115 (N.D. Cal. 1981); Bloomenthal, *supra* note 61, § 11.05, at 182-83; Kaminsky, *supra* note 72, at 253.

Section 12(2) does not require a plaintiff to prove reliance on the prospectus or communication. *See, e.g.*, Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057, 1068 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 1359 (1985); Junker v. Crory, 650 F.2d 1349, 1359 (5th Cir. 1981); Sanders v. John Nuveen & Co., 619 F.2d 1222, 1225 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981); *Hill York*, 448 F.2d at 695; Gilbert v. Nixon, 429 F.2d 348, 356-57 of section 12(2) appears to demand a showing of privity between plaintiff and defendant.[75] This requirement is the primary impediment to suits against managing underwriters.[76]

Section 12(2) clearly states that a defendant may be liable only to "the person purchasing [a] security *from him*."[77] Many courts have sidestepped this privity requirement, however, by expanding the definition of "seller"[78] or by using secondary liability theories.[79] For instance,

(10th Cir. 1970); Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1129-30 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974); Bloomenthal, *supra* note 61, §11.05, at 183; Kaminsky, *supra* note 72, at 264-66; Schneider, *supra* note 72, at 237 & n.9. Nor need plaintiff show scienter on the part of defendant. *Davis*, 739 F.2d at 1068; *Junker*, 650 F.2d at 1359; *Hill York*, 448 F.2d at 695; Kaminsky, *supra* note 72, at 233 & n.18; Schneider, *supra* note 72, at 237 & n.10; Note, *Seller Liability Under Section 12(2) of the Securities Act of 1933: A Proximate Cause-Substantial Factor Approach Limited by a Duty of Inquiry*, 36 Vand. L. Rev. 361, 363 (1983) [hereinafter cited as *Seller Liability*].

A number of defenses are available, most notably the due care defense: that defendant did not know and in the exercise of reasonable care could not have known of the untruth or omission. *See Davis*, 739 F.2d at 1068; *Itel*, 89 F.R.D. at 115; Lorber v. Beebe, 407 F. Supp. 279, 285 (S.D.N.Y. 1975); Bloomenthal, *supra* note 61, § 11.05, at 183; Kaminsky, *supra* note 72, at 236-37, 275-78; Rapp, *Expanded Liability Under Section 12 of the Securities Act: When Is a Seller Not a Seller?*, 27 Case W. Res. L. Rev. 445, 447 n.11 (1977); Schneider, *supra* note 72, at 237 & n.11. Other possible defenses are the short statute of limitations, under which an action generally must be brought within one year of discovery of the misrepresentation, *see* 15 U.S.C. § 77m (1982); Rapp, *supra*, at 447 n.11; Schneider, *supra* note 72, at 237 n.12, waiver and estoppel, *see* Kaminsky, *supra* note 72, at 278-80, and in pari delicto (unclean hands), *see* Can-Am Petroleum Co. v. Beck, 331 F.2d 371, 373-74 (10th Cir. 1964) (investor did not have degree of culpability to be in pari delicto); Peterson, *Recent Developments in Civil Liability Under Section 12(2) of the Securities Act of 1933*, 5 Hous. L. Rev. 274, 287-88 (1967) (ramifications of *Can-Am* decision); Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597, 659-664 (1972) (use of in pari delicto defense in other areas of securities law).

Section 12(2) is based on common law rescission, but plaintiffs may ask for either rescission or damages. *See* Kaminsky, *supra* note 72, at 233 n.15; Rapp, *supra*, at 446; Schneider, *supra* note 72, at 236 n.4.

75. See *infra* note 77 and accompanying text.

76. *See* Schneider, *supra* note 72, at 237 (the privity requirement is the "most significant limitation" of section 12(2)).

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

78. *See* SEC v. Seaboard Corp. (Seaboard I), 677 F.2d 1289, 1294 (9th Cir. 1982) ("The meaning of 'seller' for purposes of § 12 has been judicially expanded beyond the person who tranfers title . . . ."); Pharo v. Smith, 621 F.2d 656, 665 (5th Cir. 1980) (the "definition of seller has broadened slowly and cautiously"); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 692 (5th Cir. 1971) ("It is clear that a seller is not required to be the person who passes title."); *see also* Schneider, *supra* note 72, at 238 ("[N]umerous courts have held that a statutory seller need not be the actual transferor of title."). The court in *Seaboard Corp.* noted that a broad reading of "seller" may be in doubt due to recent Supreme Court cases. *See* 677 F.2d at 1294 n.4.

"Seller" theories include proximate causation, see *infra* note 85 and accompanying text, significant participation and substantial factor tests, see *infra* notes 86-88 and accompanying text, and solicitation, see *infra* note 89. Section 2(3) of the Securities Act, 15 U.S.C. § 77b(3) (1982), provides definitions of "sale" and "sell" but not "seller."

79. Secondary liability theories include control relationships under § 15 of the Act, see *infra* note 89, and aiding and abetting or conspiracy, see *infra* notes 83, 84 and accompanying text. For a discussion of secondary liability theories, see Rapp, *supra* note 74, at

agents,[80] accountants,[81] and attorneys[82] have all been found liable under section 12(2) even though they may not have actually sold the securities.

Plaintiffs may charge a defendant with "aiding and abetting" or "conspiring with" other defendants in the preparation of an issuer's misleading prospectus. Courts have skirted the privity requirement by finding civil liability for aiding and abetting a section 12(2) violation when defendants knew of and substantially assisted in the violation.[83] The requirement of scienter, however, may make it difficult for a plaintiff to

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481-501; Comment, *Attorneys and Participant Liability Under §12(2) of the Securities Act of 1933*, 1982 Ariz. St. L.J. 529, 531 n.8 [hereinafter cited as *Participant Liability*]; *Seller Liability*, *supra* note 74, at 377-81.

80. *See* SEC v. Seaboard Corp. (Seaboard I), 677 F.2d 1289, 1294-95 (9th Cir. 1982) (agent may be a "seller" under § 12(2) if participation in transaction is extensive); Lennerth v. Mendenhall, 234 F. Supp. 59, 65 (N.D. Ohio 1964) (agent's activity was tantamount to that of a seller).

81. *See* Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F. Supp. 440, 444 (N.D. Ohio 1975) (accounting firm may be liable if aiding and abetting is established); Kaminsky, *supra* note 72, at 248 & n.89 (accountants may be liable if they directly aided and abetted the wrong); Schneider, *supra* note 72, at 238 & n.16 (accountants have been charged with § 12(2) violations despite lack of privity with buyer).

82. *See, e.g.*, Junker v. Crory, 650 F.2d 1349, 1360 (5th Cir. 1981) (attorney's active participation made him a seller); *In re* Home-Stake Prod. Co. Sec. Litig., 76 F.R.D. 337, 349 (N.D. Okla. 1975) (attorneys may be liable if participation is significant); *see* Kaminsky, *supra* note 72, at 248 & n.87 (lawyers liable when they have aided and abetted the wrong); Schneider, *supra* note 72, at 238 & n.15 (attorneys have been charged with § 12(2) violations despite lack of privity with buyer); Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys Under the Federal Securities Statutes*, 34 Ohio St. L.J. 231, 264-65 (1973) (liability of attorneys under *Katz*); *Participant Liability*, *supra* note 79, at 532-50 (various theories under which attorneys may be liable); Note, *Corporate Attorney Who Actively Negotiated Merger Transaction Held a "Seller" Within Scope of Section 12(2) of the Securities Act of 1933*—Junker v. Crory, 55 Temp. L.Q. 528, 530-39, 548-53 (1982) (analyzing *Junker* decision); *see also* Croy v. Campbell, 624 F.2d 709, 714 (5th Cir. 1980) (attorneys may be liable but here proximate causation was lacking); *cf.* Katz v. Amos Treat & Co., 411 F.2d 1046, 1049, 1053 (2d Cir. 1969) (attorney could be a seller for purposes of § 12(1)).

83. *See, e.g.*, Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 800-01 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978); Lorber v. Beebe, 407 F. Supp. 279, 287-88 (S.D.N.Y. 1975); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 378-79 (S.D.N.Y. 1973).

The elements of an aiding and abetting cause of action were set out recently in *Monsen*, 579 F.2d at 799. Plaintiff must show an underlying securities violation, defendant's knowledge of the violation, and defendant's knowing and substantial participation in the act. *See id.*; *cf.* Harmsen v. Smith, 693 F.2d 932 (9th Cir. 1982) (same elements for aiding and abetting a violation of § 10(b) of Securities Exchange Act), *cert. denied*, 104 S. Ct. 89 (1983). *See generally* L. Loss, *supra* note 3, at 1187 (noting the incorporation of these requirements into proposed Federal Securities Code); Rapp, *supra* note 74, at 482-99 (analyzing cases that use aiding and abetting theory); Ruder, *supra* note 74, at 620-28 (general discussion of aiding and abetting test); Schneider, *supra* note 72, at 244-47, 251-59 (analyzing *Caesars Palace* and discussing Supreme Court view on aiding and abetting); *Participant Liability*, *supra* note 79, at 563-65 (elements of aiding and abetting theory).

The conspiracy theory, which is closely related to aiding and abetting, is not used as frequently. *See Participant Liability*, *supra* note 79, at 531 n.8; *see also* Ruder, *supra* note 74, at 638-41 (relevant questions for courts in a securities conspiracy charge and relationship of conspiracy to aiding and abetting).

prevail under this theory.[84]

Plaintiffs who are aware of this obstacle may also claim that a defendant's role in the offering was the "proximate cause" of their injury; that is, "but for" the actions of the defendant, plaintiffs would not have purchased the securities.[85] Finally, complaints may allege that a defendant "significantly participated" and was a "substantial factor" in the offering.[86] The participation and factor tests are the theories most favorable to plaintiffs because they are not clearly defined[87] and require

84. *See* Stokes v. Lokken, 644 F.2d 779, 783 (8th Cir. 1981) (scienter requirement not met); deBruin v. Andromeda Broadcasting Sys., 465 F. Supp. 1276, 1280 (D. Nev. 1979) (defendant had no direct knowledge nor could it be imputed to him); *see also* Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799 (3d Cir.) ("Knowledge of the underlying violation is a critical element in proof of aiding-abetting liability" but "the 'requirement of knowledge may be less strict where the alleged aider and abettor derives benefits from the wrongdoing.' ") (quoting Gould v. American-Hawaiian Steamship Co., 535 F.2d 761, 780 (3d Cir. 1976)), *cert. denied*, 439 U.S. 930 (1978). *But see Seller Liability*, *supra* note 74, at 387 (aiding and abetting approach is more liberal in scope than other theories).

85. *See, e.g.*, Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057, 1065 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 1359 (1985); SEC v. Seaboard Corp. (Seaboard I), 677 F.2d 1289, 1294 (9th Cir. 1982); Junker v. Crory, 650 F.2d 1349, 1360 (5th Cir. 1981); SEC v. Murphy, 626 F.2d 633, 650 (9th Cir. 1980); Croy v. Campbell, 624 F.2d 709, 713 & n.5 (5th Cir. 1980); Lewis v. Walston & Co., 487 F.2d 617, 621-22 (5th Cir. 1973); Somerville v. Major Exploration, Inc., [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,570, at 97,250 (S.D.N.Y. Nov. 17, 1983); *cf.* Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 693 (5th Cir. 1971) (in § 12(1) case, plaintiffs would not have bought securities without defendant promoters' actions).

An early case suggesting a proximate cause test was Lennerth v. Mendenhall, 234 F. Supp. 59, 65 (N.D. Ohio 1964) ("The hunter who seduces the prey and leads it to the trap he has set is no less guilty than the hunter whose hand springs the snare."). *See generally* Kaminsky, *supra* note 72, at 248-50 (discussing *Hill York* and proximate causation test); Schneider, *supra* note 72, at 241-44, 259-63 (showing development of proximate cause theory and discussing its legitimacy).

86. *See* Stokes v. Lokken, 644 F.2d 779, 785 (8th Cir. 1981) (section 12 liability limited to one in privity or one whose participation was a substantial factor in transaction); Lawler v. Gilliam, 569 F.2d 1283, 1288 (4th Cir. 1978) (limited partners' activity was substantial factor in transaction); Brick v. Dominion Mortgage & Realty Trust, 442 F. Supp. 283, 306 (W.D.N.Y. 1977) (purchaser may have cause of action against one who significantly participates in transaction); *In re* Home-Stake Prod. Co. Sec. Litig., 76 F.R.D. 337, 349 (N.D. Okla. 1975) (significant participation in sale may be sufficient for § 12(2) liability).

87. These theories do not have strong roots in criminal law, as aiding and abetting does, *see* Schneider, *supra* note 72, at 244-45, or in tort theory, as proximate causation does, *see* Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 693 (5th Cir. 1971) (quoting Lennerth v. Mendenhall, 234 F. Supp. 59, 65 (N.D. Ohio 1964)); *see also* Schneider, *supra* note 72, at 238-39 (proximate cause and aiding and abetting are common law doctrines). *But see* Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057, 1066-67 (6th Cir. 1984) (substantial factor test also springs from tort law), *cert. denied*, 105 S. Ct. 1359 (1985).

There is a good deal of overlap between the theories for avoiding the privity requirement, and apparent confusion among the courts concerning their use. For instance, the participation and factor theories are often mixed with other tests or with each other. *See, e.g.*, SEC v. Murphy, 626 F.2d 633, 650 (9th Cir. 1980) (defendant must be substantial factor in transaction in order to be proximate cause); Lawler v. Gilliam, 569 F.2d 1283, 1287-88 (4th Cir. 1978) (applying both tests as well as a solicitation approach); Lewis v.

less involvement by the defendant.[88]

Most courts will choose one or a combination of these theories in "satisfying" the privity requirement of section 12(2).[89] Because such a result seems contrary to the express language of the statute, the opinions are often supplemented by a discussion of the broad remedial purposes of the Securities Act.[90]

Walston & Co., 487 F.2d 617, 622 (5th Cir. 1973) (broker was a substantial factor so she was proximate cause of transaction); *see also Seller Liability, supra* note 74, at 370-76 (discussing proximate cause and substantial factor tests as single approach).

Some courts feel that making distinctions among the theories discussed *supra* notes 83-86, *infra* notes 88-89 and accompanying text is "nothing more than an exercise in semantic hair-splitting" because all the tests indicate some degree of participation. *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 380 (S.D.N.Y. 1973). *But see Davis*, 739 F.2d at 1065 (theories present more than a semantic exercise; each case must be decided on facts and the degree of participation may change result).

88. While the standard is more than de minimis participation, Katz v. David Katz & Co., [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,669, at 97,687 (S.D.N.Y. Feb. 14, 1984), these tests do not seem to require the high degree of involvement that other theories do. For instance, even if the defendant's participation is found to be active, significant, or meaningful, *see id.*, this does not necessarily mean that the defendant had scienter, as required by the aiding and abetting theory. See *supra* note 84 and accompanying text.

89. *See, e.g.*, Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057, 1065 (6th Cir. 1984) (loan company liable under proximate cause test), *cert. denied*, 105 S. Ct. 1359 (1985); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 802 (3d Cir.) (bank found to be an aider and abettor), *cert. denied*, 439 U.S. 930 (1978); *In re* Home-Stake Prod. Co. Sec. Litig., 76 F.R.D. 337, 349 (N.D. Okla. 1975) (attorneys liable due to their significant participation in sales of securities); *cf.* Lewis v. Walston & Co., 487 F.2d 617, 622 (5th Cir. 1973) (combining substantial factor and proximate cause tests to find broker to be a seller under § 12(1)).

A number of other theories that are less likely to be used against managing underwriters are available to plaintiffs in § 12(2) actions. Perhaps the simplest justification for expanding liability is the "controlling persons" doctrine. Section 15 of the Act, 15 U.S.C. § 77o (1982), makes a person liable under §§ 11 or 12 if he controls another person or entity that is liable under one of these sections. In other words, one may be liable under § 12(2) if the direct seller of securities is liable under this section and there is some kind of control relationship between the seller and defendant. These elements may be difficult to prove. *See, e.g.*, duPont v. Wyly, 61 F.R.D. 615, 626 (D. Del. 1973) (control relationship not properly alleged in complaint); Dorfman v. First Boston Corp., 336 F. Supp. 1089, 1092-93 (E.D. Pa. 1972) (no allegation of control). Even a court that does not approve of the liberal trend regarding privity will accept this theory if the proper elements are present because it is based on a statutory exception rather than on a court-contrived substitute for privity. *See, e.g.*, Collins v. Signetics Corp., 605 F.2d 110, 111-12, 113 (3d Cir. 1979). *See generally* Rapp, *supra* note 74, at 481-82 (discussing the liability of controlling persons).

One of the earlier nonstatutory theories for expansion of liability was solicitation; that is, a defendant should be liable if it solicited the sale even if it did not actually sell securities to the plaintiff. *See* Katz v. Amos Treat & Co., 411 F.2d 1046, 1053 (2d Cir. 1969); Murphy v. Cady, 30 F. Supp. 466, 469-70 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940). *See generally* Rapp, *supra* note 74, at 454-56 (discussion of cases using solicitation approach); Schneider, *supra* note 72, at 240-41, 263-76 (reevaluation of solicitation doctrine in light of Supreme Court views); *Participant Liability, supra* note 79, at 532-36 (solicitation test applied to attorneys).

90. *See, e.g.*, Croy v. Campbell, 624 F.2d 709, 713 (5th Cir. 1980) ("broad construction . . . should be given to the Act in order to effectuate its remedial purpose"); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 382-83 (S.D.N.Y. 1973) ("courts have con-

A small number of courts rejects such an inquiry. Specifically, these courts believe that whether privity is required should be dictated by the plain meaning of the statute without looking to legislative intent.[91] The Third Circuit has stated that it has "no difficulty in concluding" that, in the absence of special circumstances,[92] "Congress intended the unambiguous language of Section 12(2) to mean exactly what it says."[93]

Yet this minority view is an unreasonably restrictive approach to a statute that does not even use the term "privity";[94] the statute merely states that a defendant is liable to one who purchased from him.[95] While

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tinually recognized the broad, remedial nature of the 1933 Act and the need to adopt a liberal interpretation of the statute in order to best effectuate the congressional purpose"); Lennerth v. Mendenhall, 234 F. Supp. 59, 65 (N.D. Ohio 1964) (agent was tantamount to a seller within the "liberal remedial spirit of the securities laws"); *cf.* SEC v. Murphy, 626 F.2d 633, 641 (9th Cir. 1980) (exemptions from registration provisions should be construed narrowly to further the purpose of the Act); Katz v. Amos Treat & Co., 411 F.2d 1046, 1052 (2d Cir. 1969) (limited construction of § 12(1)'s privity requirement, see *supra* note 71, "does not accord with the language and the remedial purpose of the statute").

91. *See, e.g.*, Sanders v. John Nuveen & Co., 619 F. 2d 1222, 1226 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981); Collins v. Signetics Corp., 605 F.2d 110, 113 (3d Cir. 1979); Unicorn Field, Inc. v. Cannon Group, Inc., 60 F.R.D. 217, 221-22 (S.D.N.Y. 1973). In *Collins* the court looked to legislative intent only to the extent that it is evidenced by the language of the statute. *See* 605 F.2d at 113.

The court in Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 1359 (1985), which did not agree with the opinions above, stated: "These courts put great emphasis on the consideration that the securities statutes are indeed *statutes*, and not mere commissions to the federal courts to ride abroad on a great white horse like the Lone Ranger righting all wrongs." *Id.* at 1064 (emphasis in original); *see also Seller Liability*, *supra* note 74, at 382 (courts construe statute according to plain meaning because legislative history does not show contrary intention).

92. An example of special circumstances is a control relationship under § 15. *See* Collins v. Signetics Corp., 605 F.2d 110, 112 (3d Cir. 1979). See also *supra* note 89.

93. Collins v. Signetics Corp., 605 F.2d 110, 113 (3d Cir. 1979). One reason some courts insist on privity is that § 12(2) is based on common law rescission. *See* McFarland v. Memorex Corp., 493 F. Supp. 631, 648 (N.D. Cal. 1980); Schneider, *supra* note 72, at 238 n.19. See *supra* note 74. As one court has stated, "It would seem natural to hold only the actual party to the contract to provide such relief." Lennerth v. Mendenhall, 234 F. Supp. 59, 64 (N.D. Ohio 1964). The same court, however, continued: "On the other hand, the spirit of the Acts would be defeated if such a narrow view would be adopted." *Id.* Another court noted that the word "rescission" appears nowhere in the statute and that there is no evidence that Congress intended such a limitation. *See* Cady v. Murphy, 113 F.2d 988, 991 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940). Finally, even at common law, "[w]hen rescission is based on a contract theory—mistake, or breach of contract—only the party to the contract is liable. But, when it is predicated on fraud [as § 12(2) is], privity is not essential." L. Loss, *supra* note 3, at 1183.

94. At least ten statutes within the United States Code contain the word "privity." *See, e.g.*, 30 U.S.C. § 229a(c) (1982) (government may develop wells drilled by persons not in privity with one who holds lease for them); 35 U.S.C. § 182 (1982) (patent application may be abandoned if inventor or one in privity with him published or disclosed invention); 39 U.S.C. § 3012(a) (1983) (a person in privity with one who commits certain mail fraud may be liable). The term is even used in the Securities Act. *See* 15 U.S.C. § 77b(3) (1982) (an offer to buy does not include negotiations "among underwriters who are or are to be in privity of contract with an issuer"). One can argue that if Congress had really meant to require privity, it would have used the specific term instead of language that may be considered to be more ambiguous.

95. *See* 15 U.S.C. § 77*l*(2) (1982).

it is not desirable for courts to assume the role of legislators, neither should judges put on "blinders . . . obscuring from view everything but the text of the statute."[96] Generally, the plain meaning rule should be used when statutory language is unambiguous,[97] but courts are "increasingly willing to consider other indicia of intent and meaning from the start rather than beginning their inquiry by considering only the language of the act."[98]

Congress intended the Securities Act to encourage a free flow of information about distributed securities[99] and to set high standards of conduct for those involved in securities offerings.[100] These goals reflected two causes of the 1929 stock market crash: investor ignorance[101] and abuses

96. 2A N. Singer, Sutherland Statutory Construction § 46.02, at 81 (C. Sands rev. 4th ed. 1984).

97. *Id.* § 46.01, at 74.

98. *Id.* § 46.07, at 110. "The literal interpretation of the words of an act should not prevail if it creates a result contrary to the apparent intention of the legislature and if the words are sufficiently flexible to allow a construction which will effectuate the legislative intention." *Id.* See *supra* note 90. The words used in § 12(2) may be considered flexible because they do not include the word "privity." See *supra* note 94 and accompanying text.

99. In President Roosevelt's message to Congress regarding federal securities legislation, he asked Congress to assure that "every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public." *President's Message, supra* note 55, *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 3. Congress agreed. Said Representative Mapes: "[T]he chief and primary accomplishment of the legislation [will be to] make available to the public the information upon which the public is asked to invest its money." 77 Cong. Rec. 2912 (1933), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7. For further discussion of this issue, see remarks of Representatives Rayburn, 77 Cong. Rec. 2918, 2919 (1933), and Wolverton, 77 Cong. Rec. 2931 (1933), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7.

A number of cases have reiterated this congressional intent. *See, e.g.*, Croy v. Campbell, 624 F.2d 709, 712 (5th Cir. 1980) (quoting Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341, 357 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973)); Wasson v. SEC, 558 F.2d 879, 886 (8th Cir. 1977); *see also* R. Jennings & H. Marsh, *supra* note 9, at 23 (one objective of the Act was to provide investors with information about securities).

100. The President's message suggested that securities legislation "should give impetus to honest dealing in securities and thereby bring back public confidence." *President's Message, supra* note 55, *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 3. Debate in Congress echoed this sentiment. For example, Representative Greenwood commented that

> many of the leading bankers of the country no longer have the old-time sense of ethics or [pay] attention to the strict detail of honest business like the bankers of a former day. . . . The sale of . . . securities has reached a point where it is a scandal and a gigantic racket in America, and the Federal Government is the agency to stop it.

77 Cong. Rec. 2914 (1933), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7; *see also* R. Jennings & H. Marsh, *supra* note 9, at 23 (one objective of the Act was to prohibit misrepresentation, deceit and other fraudulent practices in sales of securities); Greene, *Responsibilities of Underwriters, supra* note 4, at 756 (Act's broad objective was to protect investors by preserving honesty and fair dealing in investment banking industry; disclosure was expected to improve corporate conduct and business practices).

101. *See* 77 Cong. Rec. 2918 (1933) (remarks of Rep. Rayburn) ("[T]he American

of the system by securities professionals.[102] Because of the Act's broad legislative intent,[103] many courts have construed provisions such as section 12(2) liberally when such construction is necessary to protect investors[104] or chastise those responsible for fraudulent securities offerings.[105]

Courts refusing to read the statute broadly often base their reasoning on what they perceive to be the Supreme Court's nonexpansive approach to securities law.[106] One observer noted in 1977 that the Court has repeatedly found for defendants and "enunciated principles that may circumscribe the rights of plaintiffs under the federal securities laws for many years to come."[107] Indeed, the Court has limited implied causes of action,[108] the definitions of "security"[109] and "materiality,"[110] and at

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people pay to be gulled.") (quoting P.T. Barnum), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7. See *supra* note 99 and accompanying text.

102. The President stated: "[T]he public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities." *President's Message*, *supra* note 55, *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 3. Members of Congress agreed. "[H]onest and legitimate industry . . . has been . . . made the victim of greedy and ruthless investment bankers." 77 Cong. Rec. 2925 (1933) (remarks of Rep. Kelly), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7; *see also* Greene, *Responsibilities of Underwriters*, *supra* note 4, at 757 ("the untoward conduct of some investment bankers during the rampant speculation of the 1920's brought discredit upon the entire banking industry"). See *supra* note 100 and accompanying text.

103. Not only was the intent of this Act broad and remedial; it was also clear and for the most part unanimous. Debate in Congress centered on the specifics of the Act rather than on the need for legislation, which seems to have been taken for granted. According to Rep. Shannon, there was "not a member of [the] House on either side whose heart [was] not in sympathy with remedial legislation along the lines proposed in this measure." 77 Cong. Rec. 2914 (1933), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7.

104. Kaminsky, *supra* note 72, at 239 & n.38. See *supra* note 90.

105. *See, e.g.*, Wasson v. SEC, 558 F.2d 879, 886 (8th Cir. 1977); Lennerth v. Mendenhall, 234 F. Supp. 59, 65 (N.D. Ohio 1964); *cf.* Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341, 357 (2d Cir.) (issuer, investment banker and others were liable under § 14(e) of the Exchange Act), *cert. denied*, 414 U.S. 910 (1973). See *supra* note 90.

106. *See* Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057, 1069 (6th Cir. 1984) (Lively, J., dissenting), *cert. denied*, 105 S. Ct. 1359 (1985); SEC v. Seaboard Corp. (Seaboard II), 677 F.2d 1301, 1311 n.12 (9th Cir. 1982); Collins v. Signetics Corp., 605 F.2d 110, 113 (3d Cir. 1979); McFarland v. Memorex Corp., 493 F. Supp. 631, 647-48 (N.D. Cal. 1980).

107. Lowenfels, *supra* note 57, at 892; *see also* Schneider, *supra* note 72, at 239 (Supreme Court has dramatically restricted scope of securities laws); Steinberg, *supra* note 57, at 557 (Court has strictly construed some provisions and limited implied rights). Yet even Lowenfels notes that the Supreme Court does not rely solely on statutory construction:

> [T]he Supreme Court's reputation for classical strict construction is a myth. The Court is pragmatic. It desires to reach a particular result, and it will utilize whatever processes of reasoning it finds helpful to achieve that result [such as] word-by-word statutory analysis[,] . . . legislative history[,] . . . policy considerations and common sense.

Lowenfels, *supra* note 57, at 921.

108. *See* Lowenfels, *supra* note 57, at 914-19; Schneider, *supra* note 72, at 236; Steinberg, *supra* note 57, at 557; *see, e.g.*, Piper v. Chris-Craft Indus., 430 U.S. 1, 34, 35 (1977) (no implied right of action under antifraud provision of Williams Act); Securities Inves-

least one section of the Securities Exchange Act of 1934.[111] Yet the Supreme Court has not ruled on the section 12(2) privity issue,[112] and it does not seem wise to rely solely upon a general trend that is not binding on the Court or lower courts.[113] The Supreme Court has never abandoned Congress' goal of investor protection; in fact, it has stressed this goal in several recent decisions.[114]

Although the Supreme Court has not addressed the issue, at least one lower court has considered the application of section 12(2)'s privity requirement to managing underwriters. *Klein v. Computer Devices, Inc.*[115] demonstrates the dilemma courts may have with this issue. In *Klein* several shareholders claimed to have suffered losses from their investment in Computer Devices, Inc. (CDI), which went bankrupt several months after its initial public offering.[116] The investors sued CDI, various officers and directors of the company, and A.G. Becker Paribas, Inc. (Becker), the lead underwriter of the offering.[117] Most of the plaintiff shareholders had purchased their shares from underwriters other than Becker.[118]

In a motion for summary judgment, the United States District Court for the Southern District of New York ruled that a managing under-

tor Protection Corp. v. Barbour, 421 U.S. 412, 423 (1975) (no implied right of action under Securities Investor Protection Act). *But see* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 18-19 (1979) (implying a right to relief under § 215 of the Investment Advisers Act of 1940); Hazen, *The Supreme Court and the Securities Laws: Has the Pendulum Slowed?*, 30 Emory L.J. 5, 15 (1981) ("Court has been careful to avoid denying implied remedies to all private litigants"). *See supra* note 57.

109. *See* Hazen, *supra* note 108, at 7-11; Lowenfels, *supra* note 57, at 906-11; *see, e.g.*, United Hous. Found., Inc. v. Forman, 421 U.S. 837, 848-51 (1975) (shares in a state financed apartment project were not securities).

110. *See* Lowenfels, *supra* note 57, at 911-14; *see, e.g.*, TSC Indus. v. Northway, Inc., 426 U.S. 438, 445, 449 (1976) (omitted fact in proxy statement is material if there is substantial likelihood a shareholder would consider it important in deciding how to vote; lower court's standard was "might" not "would").

111. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976) (requiring scienter in § 10(b) actions); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975) (limiting classes of potential plaintiffs in § 10(b) actions); Steinberg, *supra* note 57, at 561-62 (Supreme Court has limited scope of §10(b)). See *supra* note 57.

112. Most recently the Court denied a petition for certiorari in Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057 (6th Cir. 1984), *cert. denied*, 105 S. Ct. 1359 (1985). In *Davis* the Sixth Circuit noted that the Supreme Court has never passed on the § 12(2) privity issue. *See id.* at 1060; *Seller Liability, supra* note 74, at 365.

113. In any case, this trend may be changing. *See* Hazen, *supra* note 108, *passim*; Steinberg, *supra* note 57, at 560-71.

114. "[T]he Court's recent decisions . . . reflect a concern with investor protection and the integrity of the marketplace." Steinberg, *supra* note 57, at 562; *see id.* at 558 & n.5, 562-64. For Supreme Court cases reflecting this concern, see Rubin v. United States, 449 U.S. 424, 431 (1981) (scope of §17(a) of Securities Act); Chiarella v. United States, 445 U.S. 222, 227-29 (1980) (insider trading).

115. 591 F. Supp. 270 (S.D.N.Y. 1984), *modified on rehearing*, 602 F. Supp. 837 (S.D.N.Y. 1985).

116. *See* Smith, *Revenge of the Nerds*, Forbes, Oct. 22, 1984, at 102.

117. *Klein*, 591 F. Supp. at 272.

118. *See id.* at 274.

writer may indeed be liable to those who were not its direct customers.[119] Judge Goettel's opinion recognized the split among the circuits on the privity issue[120] and found that controlling law in the Second Circuit favors a more liberal interpretation of the statute.[121] The *Klein* court appeared to prefer a test that combined several theories[122] but it did not rule out any of them.[123]

On a motion for reargument of the section 12(2) issue, however, the *Klein* court retreated from its original stance, holding that an underwriter that performs only the typical duties of the syndicate manager may not be liable to other underwriters' customers.[124] The court did not reject the various theories it had espoused earlier but found that normal managing underwriter duties do not constitute the participation envisioned by these theories.[125] This position is untenable. It is difficult to imagine a case in which the normal role of a managing underwriter does not dwarf that of any other actor besides the issuer. Yet the *Klein* court advocated making attorneys and agents liable when their involvement in an offering is substantial enough.[126] If a court accepts the weakening of the section 12(2) privity requirement in these circumstances, there is no reason not to do so for managing underwriters.

The second *Klein* opinion relies heavily on a suggestion by defendant

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119. *See id.* at 276.

120. *See id.* at 274-75.

121. The court relied heavily on Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969), in determining Second Circuit law. *See Klein*, 591 F. Supp. at 275. In *Katz*, an investor sued a number of defendants, including a stock brokerage firm and its president, directors of the issuer, and a lawyer. *See* 411 F.2d at 1049. Plaintiff claimed both a lack of registration of the securities in question and misrepresentation in their offer and sale. *Id.* The court used a "solicitation" approach in finding that certain defendants had been involved enough in the transaction to warrant liability. *Id.* at 1053. *Katz* has been interpreted as adopting "an extremely liberal standard of privity in §12(2) situations" and "requiring only some indicia of participation or solicitation" by the defendant, *see In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 380 (S.D.N.Y. 1973), even though the *Katz* court limited its discussion of privity to claims under § 12(1), *see* 411 F.2d at 1052-53.

122. "[T]he plaintiffs' section 12(2) claims must be allowed to stand since they include allegations that the defendants substantially participated in the sale of CDI stock to the plaintiffs." *Klein*, 591 F. Supp. at 276 (footnote omitted). "Substantial participation" is a hybrid of the phrases "significant participation" and "substantial factor," which are used more frequently. The *Klein* court's phrase is indicative of the overlap between theories and, perhaps, of the confusion of many opinions with regard to these theories. See *supra* note 87.

123. Indeed, the court noted plaintiffs' allegations that "defendants *participated* and/or *aided and abetted* or *conspired* with each other in the preparation of the prospectus [and that they] played an *active and substantial role* in promoting and providing assistance in the sale of the CDI stock to the plaintiffs and that these acts *proximately caused* or were a *substantial factor* in causing the sale of the stock to the plaintiffs." *Klein*, 591 F. Supp. at 276 (emphases added).

124. *See Klein*, 602 F. Supp. at 840.

125. *See id.* at 840-41.

126. For example, the *Klein* court cited with approval Junker v. Crory, 650 F.2d 1349 (5th Cir. 1981) (holding attorney liable under § 12(2)), *see* 591 F. Supp at 274 & n.13, and SEC v. Seaboard Corp., 677 F.2d 1289 (9th Cir. 1982) (holding agent liable under § 12(2)), *see* 591 F. Supp. at 274 & n.11.

Becker that section 12(2) must be read in conjunction with section 11(e),[127] which, as noted earlier, limits an underwriter's liability to the price of securities it underwrites.[128] Naturally, plaintiffs responded that the exception to this limit was meant specifically to reach managing underwriters.[129] In rejecting this argument the *Klein* court regrettably did not give its view on whom this exception was intended to reach if not the manager. The *Klein* opinion also declined to address any general reasons for or against treating managing underwriters differently from participants. Yet sound policy dictates that section 12(2) not be read so literally as to preclude the liability of one who is as intimately involved in a securities offering as is a managing underwriter.

B. *Policy Arguments for Expansion of Managing Underwriters' Liability*

A number of policy considerations unique to lead underwriters support an expansion of their liability. Perhaps most important is the responsibility of a managing underwriter for assuring the accuracy of a prospectus.[130] It has already been noted that the lead underwriter's investigation of an issuer is usually the final word on the subject.[131] If the lead underwriter is the sole representative of the syndicate to become involved in prospectus preparation,[132] any investor should be able to seek compensation from this underwriter for material misrepresentations.

Furthermore, an investor may reasonably rely on the reputation of the managing underwriter in deciding to buy securities.[133] The inclusion of a highly respected investment banking firm's name at the top of a tombstone advertisement's list of underwriters[134] increases the credibility of

127. *See id.* at 840. The court did not explain why the two sections must be read together. Such a conclusion is unwarranted because § 11(e) limits an underwriter's liability "in any suit . . . authorized *under subsection (a) of this section.*" 15 U.S.C. §77k(e) (1982) (emphasis added). Thus, the statute expressly confines its liability limit to § 11.

128. *See id.* § 77k(e); *Klein*, 602 F. Supp. at 840. See *supra* note 62 and accompanying text.

129. *See id.* at 840. See *supra* notes 63-69 and accompanying text.

130. See *supra* note 32 and accompanying text.

131. See *supra* notes 38, 39 and accompanying text.

132. See *supra* notes 38, 39 and accompanying text.

133. *See In re* Gap Stores Sec. Litig., 79 F.R.D. 283, 299 (N.D. Cal. 1978) (citing Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696 (S.D.N.Y. 1968)); L. Loss, *supra* note 3, at 1041 ("prospective investors rely on the reputation of the underwriters"); Folk II, *supra* note 33, at 54 (investors assume that "a house of outstanding reputation will not take on a 'cat-and-dog' issue"); Tyler, *supra* note 17, at 920 (even SEC administrators "draw comfort from the fact that a reputable underwriter stands behind" an issue). This reliance was probably a factor in the enactment of the Act itself. *See* 77 Cong. Rec. 2929 (1933) (remarks of Rep. Pettengill) ("The small investor relies almost exclusively upon the [investment] banker for his knowledge and judgment as to the quality of the security, and it is this which makes his relation to the banker one of confidence.") (quoting L. Brandeis, Other People's Money and How the Bankers Use It), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7.

134. *See* R. Jennings & H. Marsh, *supra* note 9, at 19 ("On the 'tombstone ad' the managing underwriter or underwriters will receive top billing.").

an issuer previously unknown to the public.[135]

Yet an underwriter may have motives that are not always beneficial to investors. One commentator has noted that an underwriter has three major interests which sometimes overlap and often conflict: its own profit, success for its client (the issuer) and protection of investors.[136] The structure of the underwriting process itself produces forces that work against total disclosure. In a firm commitment arrangement each underwriter has taken on the risk that the securities will not sell.[137] In a best efforts underwriting the underwriter's profit depends on commissions, so sales are important here too.[138] Moreover, in either arrangement profits depend on the price of the securities as well as the number of sales.[139] A more optimistic—if not entirely accurate—prospectus may increase both the market price and sales;[140] this puts a strain on an investment banker's integrity and investigative efforts.[141] Such economic factors affect every underwriter in the syndicate, but only the lead under-

135. *See* Halleran & Calderwood, *supra* note 15, at 89 (lead underwriter impliedly endorses issuer's financial integrity and security's merits). In debate over the Act, Representative McFadden stated: "[T]he public is being exploited by banking houses of that reputation [referring to J.P. Morgan & Co.], whose very names lend confidence to the public [about securities that] are not worth the paper they are written on." 77 Cong. Rec. 2930 (1933), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7.

136. *See* Wolfson, *supra* note 4, at 365, 373. The underwriter's interest in profit is especially strong because securities are sold and not bought, *see id.*, *passim*; that is, hard-sell techniques may be necessary to get a new issue off the ground. The high profits involved in an underwriting—as opposed to trading—increase this incentive. *See* Tyler, *supra* note 17, at 919. As for the client's interests, underwriters should be suspicious of the issuer's statements because they may be self-serving, unduly enthusiastic or deliberately false. *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968).

Wolfson notes a fourth area of conflict that results when an investment banking firm is involved in both underwriting and retail brokerage distribution. The major problems with such arrangements are that the investment banker, because of its relationship with the issuer, may oversell an issue to retail clients, and that it may violate the issuer's confidence by alerting retail customers to buy or sell opportunities in the issuer. Wolfson, *supra* note 4, at 366-67. This conflict, while undoubtedly a serious one, is less relevant to the question of managing underwriters' liability because the problem may occur with any underwriter.

137. *See* Wolfson, *supra* note 4, at 374. See *supra* note 17 and accompanying text.

138. See *supra* notes 13, 14 and accompanying text. "Even when the investment banker acts as agent, rather than as principal for his own account, the temptation to puff the securities is enormous, because the investment banker receives three or four times or more the commissions normally applicable to ordinary transactions." Wolfson, *supra* note 4, at 374.

139. See *supra* note 29.

140. This premise is not entirely unimpeachable. Some commentators have noted that many or most individual investors do not read or understand the prospectus. *See* Halleran & Calderwood, *supra* note 15, at 96; Wolfson, *supra* note 4, at 381. However, if a broker who reads and is convinced by an optimistic prospectus pushes a certain security, the sales as well as the price of that security may rise. It should be noted that there is a serious potential conflict in this area when a firm acts as both investment banker and retail broker. See *supra* note 136.

141. *See* Wolfson, *supra* note 4, at 373-74.

writer is in a position to assert some control over their abuse by ensuring the accuracy of the prospectus.

The manner in which an underwriter is chosen may also have subtle implications for disclosure. In a negotiated underwriting, the investment banking firm that gets the deal may not want to offend its client by appearing too eager either to investigate the issue or to word the prospectus negatively.[142] The issuer and underwriter may have a longstanding and amicable affiliation that the underwriter does not wish to disturb,[143] or the issuer may be a new client, in which case their relationship may be even more fragile.[144] To make matters worse, in economically troubled times the pressure to maintain clients increases.[145] In a competitively bid deal the underwriting groups submitting bids have little incentive to begin a thorough investigation of the issuer because there is no guarantee of getting the deal.[146] Once a bid is accepted, time constraints may affect the accuracy of the prospectus.[147]

Because in each of these cases the interests of an investment banking firm in itself and its client are likely to overwhelm its desire to protect

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142. Wolfson quotes several investment bankers who testified at the SEC Hot Issue Hearings of 1972. One stated: "In view of the good reputation and demonstrated record of success, at least in the stock market, of the . . . promoters, we were indeed flattered to be selected as the underwriter. It would have been regarded as poor taste if we had made any further investigations of the company . . . ." Wolfson, *supra* note 4, at 373 (quoting SEC Hot Issue Hearings of 1972). Another admitted: "In any event, we made no further investigation of the company, the industry or the management except that both my partner and I visited the company's restaurant where we each ate a hamburger with no ill effects." *Id.* at 373 (same).

143. *See* Halleran & Calderwood, *supra* note 15, at 88-89 (lead underwriter has close contacts with issuer, sometimes extending over a long period of time). The affiliation between issuer and underwriter may be so close that key employees of the investment banking firm serve on the issuer's board. Greene, *Responsibilities of Underwriters*, *supra* note 4, at 791 & n.224; Wolfson, *supra* note 4, at 367, 374; *see, e.g.*, Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 692 (S.D.N.Y. 1968). Interlocking directorates were so widespread in the days before the Securities Act was passed that many believed that the Act should prevent them outright. *See* 77 Cong. Rec. 2932 (1933) (remarks of Rep. Marland), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7. This view did not prevail, but it was hoped that the Act would have some effect on this practice. *See id.* at 2929 (remarks of Rep. Pettengill) ("This bill does not directly strike at interlocking directorates, but one of its great benefits should be that it indirectly does so by making the responsibility of corporate directors such that few men can afford to sit on more than one or two corporate boards," making it difficult for one person to be on both sides of a trade.), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7.

144. *See* Wolfson, *supra* note 4, at 369 (some investment banking firms engage in aggressive competition for new clients).

145. *See* Greene, *Responsibilities of Underwriters*, *supra* note 4, at 761 ("increasingly competitive climate" of industry may be causing some underwriters to skimp on investigations when trying to keep clients); *see also* Wolfson, *supra* note 4, at 369-70 (economy has forced many investment banking firms out of business).

146. Greene, *Responsibilities of Underwriters*, *supra* note 4, at 764, 792 & n.229; Halleran & Calderwood, *supra* note 15, at 104; Wolfson, *supra* note 4, at 371, 419 n.1. The group that wins relies on the issuer's bidding prospectus and registration statement, both of which were prepared by the issuer and its lawyers. *Id.* at 371, 372, 425 n.32.

147. Wolfson, *supra* note 4, at 419 n.1 (competitive bidding has led to insufficient disclosure in utility issues due to time factor).

investors, courts may need to fill this role. In fact, this situation—in which an underwriter's avarice or its legitimate business goals interfere with full disclosure—is exactly what Congress intended the Act to remedy.[148] To deter such behavior, additional liability should be placed on those whose responsibility for the information is greatest.[149] After all, many other actors in the process have been held liable, including brokers who were not involved in prospectus preparation.[150]

The counterargument is that such potentially enormous liability will "chill" underwriting.[151] This will be particularly true, it has been suggested, in high risk and high technology industries.[152] In the former, chances are greater that an issuer will fold, leaving disappointed purchasers eager to find a scapegoat.[153] In the latter, the complex and scientific nature of the industry may make errors in a prospectus more difficult to discern.[154]

Yet these are precisely the cases in which investor protection is most needed. An error that is difficult for a securities professional to spot will be virtually impossible for the average investor to discover,[155] and information about risky issuers is crucial.[156] Underwriters of these securities

148. See *supra* notes 99-103 and accompanying text.

149. See *supra* notes 32-34, 100, 102, and accompanying text.

150. *See, e.g.*, Lewis v. Walston & Co., 487 F.2d 617, 621 (5th Cir. 1973); Murphy v. Cady, 30 F. Supp. 466, 469 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); Peterson, *supra* note 74, at 278; Schneider, *supra* note 72, at 238 & n.17, 241 & n.35; *Participant Liability*, *supra* note 79, at 533.

151. *See* Brodsky, *supra* note 42, at 2, col. 2; Smith, *supra* note 116, at 102.

152. *See* Greene, *Underwriters Nervous*, *supra* note 48, at 164 (increased liability may chill underwriting of high tech issues); Smith, *supra* note 116, at 102 (offerings of corporations in emerging or high risk industries will be particularly chilled); *see also* Greene, *Responsibilities of Underwriters*, *supra* note 4, at 802-03 (if these issues are "hot"—that is, their price is expected to rise quickly—negligence by underwriters is even more likely).

153. While the problem is certainly not as great as it was before the Securities Act was passed, securities with extremely questionable prospects are still issued. By one estimate, at least $100 million in worthless new securities are sold each year. Tyler, *supra* note 17, at 899.

154. Greene, *Underwriters Nervous*, *supra* note 48, at 164. For example, in Klein v. Computer Devices, Inc., 591 F. Supp. 270 (S.D.N.Y. 1984), *modified on rehearing*, 602 F. Supp. 837 (S.D.N.Y. 1985), plaintiffs' complaint alleged that the issuer's prospectus failed to disclose the fact that its primary product, a portable computer, was substantially unmarketable because it used a 3.5 inch disk drive rather than a 5.25 inch disk drive. *See id.* at 279 n.27; Plaintiff Davella's Amended Complaint ¶ 11, at 6-7, Klein v. Computer Devices, Inc., 591 F. Supp. 270 (S.D.N.Y. 1984), *modified on rehearing*, 602 F. Supp. 837 (S.D.N.Y. 1985).

155. A prospectus is difficult enough for the average investor to understand, *see* Wolfson, *supra* note 4, at 378-81, and technical language about an issuer's industry may intensify this problem. An underwriter, on the other hand, may retain experts to appraise highly technical issues. *See* Greene, *Underwriters Nervous*, *supra* note 48, at 164.

156. A huge number of the securities issued in the 1920's turned out to be worthless. Representative Bulwinkle remarked in debate over the Act:

> [F]or the past ten years the United States has been flooded with not only worthless stock but fraudulent stock as well. The amount in value that the people of the United States paid for the securities is purely a conjecture, but it is safe to say that it runs well into the billions.

should be forced to take greater care. If the risk is so great that no underwriter wishes to disclose fully the bad news, the public is probably better off if the securities are never offered. Furthermore, a "chill" today in the underwriting field is better than allowing investors to become so disenchanted with the securities markets that they invest elsewhere.[157]

Finally, it should be noted that when the Securities Act was passed in the early 1930's, many securities professionals and others believed that certain provisions, such as section 11, would spell the end of the industry.[158] Instead the Act has led to higher standards of integrity and a generally well run and self-policed investment banking profession.[159] In the same manner, expanded liability for managing underwriters will not bring ruin upon the industry but will produce a more honest and meticulous system.

C. *Indemnification and Contribution*

If managing underwriters' liability is expanded, questions remain about their ability to spread this risk among other underwriters. Underwriting syndicates are formed to limit liability as well as distribute business risks,[160] and the underwriting agreement usually provides for several, but not joint, liability.[161]

As a result of this arrangement, a managing underwriter liable to other underwriters' customers may not be able to obtain contribution from fel-

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77 Cong. Rec. 2924 (1933), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7. Those who passed the Act evidently believed that full disclosure about risky businesses would reduce the fraud perpetrated on investors. See *supra* notes 99-103 and accompanying text. *See also* 77 Cong. Rec. 2929 (1933) (remarks of Rep. Pettengill) ("In practice the banker gets the higher commission for underwriting the weaker security, on the ground that his own risk is greater. And the weaker the security the greater is the banker's incentive to induce his customers to relieve him.") (quoting L. Brandeis, Other People's Money and How the Bankers Use It), *reprinted in* 1 J. Ellenberger & E. Mahar, *supra* note 55, at Item 7; Wolfson, *supra* note 4, at 366 ("A risky venture may . . . boost underwriters' compensation to six or seven times the secondary market rate," providing a marketing incentive that may not be in the public's best interest).

157. *See* Smith, *supra* note 116, at 102.

158. *See* L. Loss, *supra* note 3, at 1017, 1029. This fear continued even after the Act had passed. Senator Walcott warned in 1934: "[T]he Securities Act is going to appear in glaring fashion as a restrictive and almost a paralyzing measure. It will so restrict business that business will not be able to finance its requirements properly." 78 Cong. Rec. 8700 (1934).

159. *See* Greene, *Responsibilities of Underwriters*, *supra* note 4, at 757 & n.9 (federal securities laws have become "a basic part of the mores of business" and have made the financial community largely self-policing); Halleran & Calderwood, *supra* note 15, at 96, 118 (Act has "undoubtedly contributed greatly to improving standards of corporate morality and the practices of the financial community"; this community is generally self-policing).

160. See *supra* note 24 and accompanying text.

161. L. Loss, *supra* note 3, at 86; Halleran & Calderwood, *supra* note 15, at 99; *see In re* Gap Stores Sec. Litig., 79 F.R.D 283, 289 (N.D. Cal. 1978). "The main attribute of a joint liability, as distinguished from a several or a joint and several liability, is the right of one joint obligor to insist that his co-obligor be joined as a co-defendant with him, i.e.: that they be sued jointly." Schram v. Perkins, 38 F. Supp. 404, 407 (E.D. Mich. 1941).

low syndicate members.[162] Moreover, an investment banking firm may be hesitant to ask others for contribution as "this is not likely to win [it] any popularity contests on Wall Street,"[163] but perhaps firms should take this into account when accepting the lead underwriting position and when investigating an issuer. Indemnification is still more unlikely as it involves shifting the entire loss to another based on the other's complete fault.[164]

As for other underwriters in the syndicate, the possibility of contribution may provide an incentive for them to change their practice of blindly relying on the assurances of the lead underwriter.[165] Even so, because their agreement calls for several liability, if participating underwriters are impleaded they will still not be liable for more than their pro rata share of the offering.[166] As their liability will always be limited, these underwriters will probably tend not to exercise maximum care in the underwriting process. This further supports an increase in the liability of managing underwriters.

CONCLUSION

The responsibilities of managing underwriters in the public offering process exceed those of any other underwriter. The potential liability of managers should be commensurate with this role. An expansion in this area is most likely to occur through use of section 12(2) of the Securities Act. Courts should allow this section to be used to reach managing underwriters because expanded liability will force them to be especially conscientious in their public offering participation.

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162. *See* Brodsky, *supra* note 42, at 2. Brodsky states that "[w]hether contribution is available is an open question because the acts of the managing underwriter . . . are different from the more passive participation of the other dealers in the underwriting." *Id.*; *see* Kaminsky, *supra* note 72, at 288 ("It may be argued that . . . court[s] should adopt a comparative fault test and apportion liability accordingly.").

163. Smith, *supra* note 116, at 102; *see* Brodsky, *supra* note 42, at 2.

164. For a discussion of the distinction between contribution and indemnification, see D. Dobbs, R. Keeton, D. Owen, W. Prosser & W. Keeton on The Law of Torts 341 (5th ed. 1984). The "Underwriting Agreement," see *supra* note 30, usually provides for indemnification of the underwriters by the issuer, but only if the latter is at fault. *See* Halleran & Calderwood, *supra* note 15, at 99; Weiss, *The Underwriting Agreement—Form and Commentary*, 26 Bus. Law. 647, 660-63 (1971). *But see* Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288 (2d Cir. 1969) (underwriter with actual knowledge of misstatement may not enforce indemnification agreement), *cert. denied*, 387 U.S. 813 (1970); Koch, *Attorneys' Liability: The Securities Bar and the Impact of* National Student Marketing, 14 Wm. & Mary L. Rev. 883, 897 (1973) (ramifications of *Globus* decision).

165. See *supra* notes 37-39 and accompanying text.

166. The agreement limits a participating underwriter's liability, see *supra* note 161, and there is no theory under which a participating underwriter would be liable for more than its pro rata share of the offering.