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SECTION 11 OF THE SECURITIES ACT: THE UNRESOLVED DILEMMA OF PARTICIPATING UNDERWRITERS

I. INTRODUCTION

In the few short years since Escott v. BarChris Construction Corp.¹ and Globus v. Law Research Service, Inc.² there has been a flood of commentary on section 11 of the Securities Act of 1933,³ but surprisingly little judicial guidance. Aside from procedural questions, there has been only one adjudicated case in the area: Felt v. Leasco Data Processing Equipment Corp.⁴ There have been some recent developments in the area which indicate that the Securities and Exchange Commission intends to be more active in the field of registration statements, especially with regard to investment bankers and their counsel.⁵ This comment will attempt to explore the effects of section 11 liability on one of the host of potential defendants, the participating underwriter.⁶

⁴ 332 F. Supp. 544 (E.D.N.Y. 1971). This does not mean that plaintiffs are not availing themselves of section 11 remedies. There has been a spate of cases since 1968 dealing with the procedural problems involved in bringing such a suit. See, e.g., Miller v. Mackey Int'l, Inc., 452 F.2d 424 (5th Cir. 1971) (remanding district court's denial of class action); Hohmann v. Packard Instr. Co., 399 F.2d 711 (7th Cir. 1968) (allowing plaintiffs to maintain a class action); Dijulio v. Digicon, Inc., 325 F. Supp. 963 (D. Md. 1971) (upholding service of process on a participating underwriter); Rosenfield v. Integrated Container Serv. Indus. Corp., 50 F.R.D. 237 (S.D.N.Y. 1970) (allowing plaintiffs to maintain a class action); Weiss v. Tenney Corp., 47 F.R.D. 283 (S.D.N.Y. 1969) (amended complaint required to determine propriety of continuing as a class action).
⁵ See Wall Street J., Feb. 15, 1972, at 1, col. 1. The article noted that the Securities and Exchange Commission has recently filed a series of actions "designed to bring lawyers, accountants and bankers within the framework of securities regulations traditionally aimed at stock traders, brokers and publicly held companies. In the past two years, the commission has brought probably a dozen cases aimed at least partly at forcing these professions, in representing their individual clients in securities matters, to consider the interests of public investors." Id.
⁶ See text accompanying notes 16-20 infra for a listing of potential defendants under section 11.

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The 1933 Act was enacted to correct abuses existing in the securities industry by requiring participants in a public offering of securities to disclose all relevant facts, thereby putting the investing public on an equal footing with the seller in the purchase of its securities.\textsuperscript{7} Thus, one must explore the role of the participating underwriter in fulfilling this obligation in order to evaluate his potential liability under section 11. It is inadequate and unrealistic to be satisfied with the proposition that both lead and participating underwriters have identical obligations under this section.\textsuperscript{8} Furthermore, such a view would seem to be contrary to the purposes of the Act.\textsuperscript{9} One commentator has noted that if lead and participating underwriters had similar investigatory duties "chaos would prevail . . . . The underwriters would spend all of their time writing inquiries, posing questions, holding diligence meetings and generally doing everything but trying to market securities. . . . [I]t would be a costly and usually pointless duplication of the efforts which the lead underwriter should undertake.\textsuperscript{10} As the law stands, however, the participating underwriter must either duplicate the efforts of the lead underwriter or rely on the lead underwriter’s investigation and risk being held liable on his account, regardless of the participating underwriter’s fault or connection with the source of the liability.

One factor which has softened much of the impact of section 11 liability for the underwriter is indemnity by the issuer. While there has been a decision voiding an indemnity agreement,\textsuperscript{11} it was limited in scope.\textsuperscript{12} Nonetheless, it may have sounded the death knell for this type of protection.\textsuperscript{13} With regard to this issue, as with the basic issue of liability, the question arises whether the courts should distinguish between lead and participating underwriters.

\textbf{II. Section 11}

One of the primary concerns of investment bankers is the liability imposed by section 11\textsuperscript{14} for the faulty preparation of a registration statement. This


\textsuperscript{8} This is apparently where the law stands today as a result of Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

\textsuperscript{9} H.R. Rep. No. 85, 73d Cong., 1st Sess. 9, See text accompanying note 134 infra.

\textsuperscript{10} Folk (pt. 1) 57.


\textsuperscript{12} Id. at 1288; see note 186 infra and accompanying text.


\textsuperscript{14} Securities Act of 1933 § 11, 15 U.S.C. § 77k (1970). It is important to note at the outset that proof of fraud or deceit is not necessary under section 11. Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d Cir. 1951). There is also potential liability for the underwriter in section 12, which prohibits the use of false or misleading statements in the pros-
section provides that if a registration statement containing an untrue material fact or omitting a material fact which would make it misleading becomes effective, any person acquiring a security marketed under such registration statement may bring an action based on such misrepresentation unless it is shown that he had knowledge of the untruth or omission. The person acquiring the security can bring the action against every signer of the registration statement, every director, every person named as a director in the registration statement, every expert (including accountants, engineers or appraisers), and "every underwriter with respect to such security."

The use of this section is somewhat limited because of its privity requirements. In most cases the prospectus will be filed as part of a registration statement; therefore, a misrepresentation in the former will create section liability, which does not contain privity requirements. Folk (pt. 2) 201-16.

15. "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 . . . ." Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1970). The Securities and Exchange Commission has defined the term "material" within the context of section 11 as follows: "The term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered." 17 C.F.R. § 230.405(1) (1971). One court, in interpreting materiality within the confines of section 11, has held "that a fact is proved to be material when it is more probable than not that a significant number of traders would have wanted to know it before deciding to deal in the security at the time and price in question." Felt v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 571 (E.D.N.Y. 1971).

17. Id. § 11(a)(2), 15 U.S.C. § 77(a)(2) (1970). This section covers every person who was a director at the time of the filing of the registration statement.
20. Id. § 11(a)(5), 15 U.S.C. § 77k(a)(5) (1970). The Act defines "underwriter" to mean "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; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly
Section 11 also enumerates the defenses to such an action. The first, which is available to all defendants, applies where the purchaser has acquired the security after the issuer has produced an earnings statement for a twelve month period after the offending registration statement has become effective. In such a case the claim for relief "shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission . . . ."21 It is somewhat anomalous, however, that the aggrieved security holder need not prove that he actually read the registration statement.22

Subsection (b) of section 11 establishes three defenses available to persons other than the issuer. The first of these applies to persons who withdraw from the registration process and so inform the Securities and Exchange Commission.23 The second protects persons who are not aware that the registration statement has become effective and who, being informed of this, notify the Commission of their withdrawal and give reasonable public notice of this lack of knowledge.24

The third defense in subsection (b) is by far the most important for the underwriter and is commonly referred to as the "due diligence" defense. This defense allows a party to show that, in regard to portions of the registration statement that were not included on the authority of an expert,25 it had, after a reasonable investigation, reasonable ground to believe and did believe that the registration statement contained no untrue material fact nor omitted material facts which would make it misleading.26 A similar test controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." Id. § 2(11), 15 U.S.C. § 77b(11) (1970).
22. Id.
26. The following are named as experts under section 11: "[E]very accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report for valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him . . . ." Securities Act of 1933 § 11(a)(4), 15 U.S.C. § 77k(a)(4) (1970). Underwriters are not considered to be experts. Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 683 (S.D.N.Y. 1968); see Folk (pt. 1) 52.
27. Securities Act of 1933 § 11(b)(3)(A), 15 U.S.C. § 77k(b)(3)(A) (1970). The statute provides: "[A]s regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ." Id.
obtains with regard to experts and the material they supply.\footnote{28}{Id. \S 11(b)(3)(B), 15 U.S.C. \S 77k(b)(3)(B) (1970).} Where the allegedly false or misleading material was supplied by an expert to either a non-expert or another expert, the party must demonstrate that he had no reasonable ground to believe and did not believe that the registration statement contained untrue material facts or omitted material facts tending to make it misleading.\footnote{29}{Id. \S 11(b)(3)(C), 15 U.S.C. \S 77k(b)(3)(C) (1970); see Martin v. Hull, 92 F.2d 208, 209-10 (D.C. Cir. 1937).} Expert defendants may also show that the material supplied by them was not accurately presented by the issuer in the registration statement.\footnote{30}{Securities Act of 1933 \S 11(b)(3)(C), 15 U.S.C. \S 77k(b)(3)(C) (1970). Subsection (c) provides that in determining "what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."\footnote{31}{Id. \S 11(c), 15 U.S.C. \S 77k(c) (1970).} Regarding damages, section 11 limits the underwriter's liability to the extent to which he has participated in the issue provided, however, he did not receive any special consideration from the issuer.\footnote{32}{Id. \S 11(e), 15 U.S.C. \S 77k(e) (1970). Subsection (e) also provides that damages shall be, basically, the difference between the price paid for the security by the public and the price of the security at the time the suit was filed. Regarding underwriters, the subsection provides: "In no event shall any underwriter (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) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public." Id.} Subsection (c) provides that in determining "what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."\footnote{31}{Id. \S 11(c), 15 U.S.C. \S 77k(c) (1970).} Regarding damages, section 11 limits the underwriter's liability to the extent to which he has participated in the issue provided, however, he did not receive any special consideration from the issuer.\footnote{32}{Id. \S 11(e), 15 U.S.C. \S 77k(e) (1970). Subsection (e) also provides that damages shall be, basically, the difference between the price paid for the security by the public and the price of the security at the time the suit was filed. Regarding underwriters, the subsection provides: "In no event shall any underwriter (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) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public." Id.}

Thus, section 11 creates civil liability through the enforcement of private rights of action against those persons who have thwarted the overall goal of the Securities Act of 1933 by failing to make such disclosure to investors as to place them on an equal footing with the sellers of securities.\footnote{33}{Id.; see Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967) (limiting benefits of a settlement of a section 11 action to those persons who could establish that they purchased securities issued under the registration statement); Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d Cir. 1951).} Upon its
enactment, section 11, and especially the due diligence requirement, caused much consternation among the investment community and led some to conclude that it signaled the demise of investment banking and commercial financing. These fears proved groundless. Professor Loss has noted that through mid-1969 he could find only thirty reported adjudications under section 11, an average of less than one per year. This lack of cases has been attributed both to the care taken by those concerned with the preparation of registration statements and to the meticulous review given these financial tracts by the Securities and Exchange Commission. “Nothing else,” according to Loss, “can account for the fact that more than 30,000 registration statements have resulted in only two adjudicated recoveries under § 11, none since 1939, together with six reported decisions approving settlements of class actions since 1963.” However, recent developments have complicated this area of the law, and indicate the necessity of a review of this section with particular regard to the liability it imposes on participating underwriters.

III. The Role of the Participating Underwriter in the Registration of Securities Under the Securities Act of 1933

There are four basic forms of underwriting, and the underwriter’s obligation to the issuer varies with each. In “best efforts” underwriting, the underwriter acts as a retailer in that he agrees to use his best efforts to sell the issue, but makes no commitment to buy the unsold portion. In an “all or nothing” underwriting, the underwriter agrees to sell the entire issue or, if he fails, to return any funds received from the sale and cancel the underwriting. Oftentimes both of these types are combined, so that a “best efforts” underwriting will contain an “all or nothing” provision. "Strict" or "stand-by" underwriting is usually "considered the weakest underwriting technique and is generally only acceptable to an issuing corporation which has insufficient bargaining power to obtain any other type of underwriting." G. Robinson & K. Eppler, Going Public § 22, at 95 (2d ed. 1972). [hereinafter cited as Robinson & Eppler]. Professor Loss notes that “[p]aradoxically, this type of distribution is also preferred on occasion by companies which are so well established that they can do without any underwriting commitment, thus saving on cost of distribution.” 1 Loss 171.

40. “This form of underwriting carries the obvious risk of resulting in no public issue and, in recent years, has hardly been used at all.” Robinson & Eppler § 22, at 95.

41. This combination is common today and may be required under blue sky laws in certain states. Id.
underwriting is the type most commonly used today in conjunction with a rights offering where the issue is subject to the pre-emptive rights of the issuing corporation's own shareholders.\textsuperscript{42} In this case the underwriters enter into a "stand-by agreement" to purchase securities not purchased by the corporation's shareholders.\textsuperscript{43} The final method is "firm commitment" underwriting. Here the underwriter simply acts as a wholesaler and agrees to purchase the entire issue. Aside from rights offerings, this is the most prevalent type of underwriting, especially in the case of larger issues.\textsuperscript{44} Therefore, in discussing the role of the participating underwriter, it will be presumed that the transaction involves "firm commitment" underwriting.\textsuperscript{46}

Companies desiring to make a public offering of securities usually contact an underwriter either directly or through a finder.\textsuperscript{46} The choice of underwriter is usually limited by the type of industry in which the issuer is engaged, his reputation in the financial community, and the size of the issue.\textsuperscript{47} The selection is extremely important for both parties, not only because of the potential liability under section 11, but also because the reputation of both will be affected by the quality of the issue. It is obvious that an underwriter must sell securities to stay in business, but his ability to sell depends largely upon his reputation for underwriting issues which bring his customers profits.\textsuperscript{48} Thus the underwriter has strong motivation, completely independent of liability under section 11, to conduct a thorough and accurate investigation of the issuer. This fact also gives added importance to the underwriter's role in the

\textsuperscript{42} 1 Loss 161.

\textsuperscript{43} Id. "Of the $3 billion of common stock issues registered with the SEC . . . in the three years 1951, 1953 and 1955 and offered through investment bankers, 59 percent were 'rights offerings.' Usually stockholders are thus given a prior opportunity to purchase at a price below the market. If the discount is sufficiently large, and especially if the issuer is well established, the services of investment bankers may be dispensed with entirely. But it is common practice for the issuer to enter into a 'stand-by agreement' with an investment banker." Id. (footnotes omitted).

\textsuperscript{44} Id. at 163-64.

\textsuperscript{45} For an excellent history and explanation of the investment banking system see United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953). The case involved an anti-trust action brought against seventeen prominent investment banking houses. Judge Medina traced the history of investment banking and then, after visiting one of the defendant firms, detailed the functions of an investment banker. Id. at 635-55. There are several books which explain the mechanics of underwriting. See, e.g., Going Public: Filing Problems (A. Levenson ed. 1970); Robinson & Eppler, supra note 39; When Corporations Go Public (C. Israels & G. Duff eds. 1962) [hereinafter cited as When Corporations Go Public]. The Practicing Law Institute also publishes material in conjunction with its lectures in this field. See, e.g., Going Public: Recent Registration Statement Developments (A. Levenson ed. 1969); 2d Annual How to Go Public Institute (S. Friedman & D. Schwartz eds. 1971). See also 1 Loss 159-78.

\textsuperscript{46} A finder is an independent intermediary who serves to bring issuers and underwriters together. Robinson & Eppler § 23, at 96-97.

\textsuperscript{47} Going Public: Recent Registration Statement Developments, supra note 45, at 66.

\textsuperscript{48} Robinson & Eppler § 25, at 102.
preparation of the registration statement. It has been noted that "[w]hile investors theoretically are supposed to rely on the prospectus to make their evaluation of the investment merits of an issue, many investors, as a matter of fact, regard the character of the underwriter as indicative of the character of the issue."

The next step in the underwriting involves negotiations between the company and the underwriter. During these negotiations, the underwriter generally conducts an investigation of the company by checking its annual reports and former prospectuses and consulting the banks with which the company has dealt. The underwriter will also analyze the prospects for the particular industry as a whole. The purpose of this preliminary investigation is to decide whether or not the underwriting should proceed. After the parties have agreed on the terms of the underwriting and any steps the company must take to facilitate it, the underwriter prepares a "letter of intent" setting forth the basic terms which the parties intend to incorporate into the final underwriting contract.

In the typical "firm commitment" underwriting, the underwriter with whom the company has dealt will generally want to, and in many cases be required to, spread the risk among other underwriters. This risk dispersal creates a second level in the underwriting transaction. The first transaction involves the agreement between the underwriter and the company while the second

50. Robinson & Eppler § 21, at 94.
51. The negotiations initially cover such items as the price of the issue and the underwriter's compensation, which usually takes the form of a "spread." The spread is the difference between the price the underwriter pays for the security and the price at which it is offered to the public. The amount of the spread will depend upon the quality of the issue; speculative stock can have a spread approaching thirty percent. When Corporations Go Public 65.
52. Robinson & Eppler § 13, at 52-53.
53. Id.
54. This investigation, as opposed to those conducted during the preparation of the registration statement, is carried on for business reasons. The latter investigation will usually be concerned with the accuracy of the registration statement. Id.
55. "While such a letter of intent does not constitute a binding obligation on the part of the underwriter to complete the underwriting, it is generally regarded as a satisfactory indication that the expense of preparation of the issue is warranted. Conscious of their reputations, most underwriters would only fail to carry out its terms in extreme cases." Id. § 14, at 55. For a sample "letter of intent" see id. § 15, at 57; When Corporations Go Public 306.
56. SEC Rule 15c3-1(a)(1), promulgated under the Securities Exchange Act of 1934, provides that an underwriter can not allow his indebtedness to exceed 2,000 percent of his capital. 17 C.F.R. § 240.15c3-1(a)(1) (1971). This limitation can affect the quantity of issues that can be underwritten. The underwriter may also desire to spread his risk because of potential liability under Securities Act of 1933 § 11, 15 U.S.C. § 77k (1970), and the limits on it provided by id. § 11(e), 15 U.S.C. § 77k(e) (1970). See United States v. Morgan, 118 F. Supp. 621, 647 (S.D.N.Y. 1953); When Corporations Go Public 84-86.
57. The agreement between the issuer and the lead underwriter is referred to hereinafter as the "underwriting contract." For a sample underwriting contract see When Corporations Go Public 272.
involves the relationship between the underwriter and other investment bankers regarding the formation of the underwriting syndicate. The underwriter dealing with the issuer usually assumes the role of managing or principal underwriter, and he is normally referred to as the representative. Those underwriters invited by the representative to purchase portions of the offering are referred to as participating underwriters. The participating underwriters compensate the representative in the form of a management fee.

Both the managing and participating underwriters may be held to the same standards of liability under section 11. Due to this potential liability the contractual relationship of the issuer to the underwriters is several rather than joint, thereby making each underwriter responsible only for his percentage of the issue. Nonetheless, it is quite common for only the representative to carry on a detailed investigation of the company in preparing the registration statement, while the participating underwriters' contact with the company is usually far less extensive. One commentator has noted that although "[e]ach underwriter makes a separate, severable and unique commitment with the company . . . the company's president may not even know the name of one person in any of these [participating] underwriting houses . . . ." Thus, while the traditional underwriting is in the legal form of a group of investment bankers individually distributing the issue, the only underwriter who participates in the compiling of information required to be disclosed by the securities laws is the representative. The participating underwriters usually consent to having the representative act on behalf of the group and give him authority to sign the registration statement for them.

The participating underwriter, however, is not completely without knowledge of the facts contained in the registration statement. The representative and the company usually draw up a preliminary prospectus which they are allowed to distribute to participating underwriters. The Commission encourages

58. The agreement between the lead and participating underwriters is referred to hereinafter as the "agreement among underwriters." For a sample agreement among underwriters see Robinson & Eppler § 36, at 149.

59. 1 Loss 164. It is also possible that more than one investment banker will manage an offering and therefore the issue could be managed by several representatives. Id. at 169. Hereinafter, the terms representative and lead underwriter are used interchangeably.

60. Robinson & Eppler § 34, at 147. The management fee is usually based on the percentage of the issue purchased and is computed in cents per share. Id.

61. Section 11(a)(5) of the Securities Act of 1933 establishes liability without distinguishing between lead or participating underwriters. 15 U.S.C. § 77k(a)(5) (1970); see note 143 infra and accompanying text.

62. Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (1970). "Witness the fact that underwriters still frequently take title jointly, or jointly and severally, when the security is a municipal issue or some other type which is exempted from registration under the Securities Act." 1 Loss 167 n.15.

63. Going Public: Recent Registration Statement Developments, supra note 45, at 72.

distribution of such a prospectus to underwriters and dealers, and generally will not declare a registration statement effective unless this preliminary prospectus has been made "conveniently available to underwriters and dealers who it is reasonably anticipated will be invited to participate in the distribution of the security to be offered or sold." This preliminary ("red herring") prospectus contains most of the information that will appear in the final prospectus, with the exception of basic underwriting data. The red herring prospectus serves a dual purpose for the participating underwriters. It is used by them to gauge the interest of their customers in the issue before the effective date of the registration statement, thereby helping them to decide how they will price the issue. This preliminary prospectus is also the focal point of the "due diligence" meeting.

A few days before the public sale takes place, the company and the underwriters hold a "due diligence" meeting. The meeting is attended by the company, the principal underwriter, the independent auditor, and the participating underwriters. Its purpose is to allow the participating underwriters to question the company, the representative, and the accountant in order to determine whether any of the information in the registration statement is misleading and whether it is sufficient to satisfy the disclosure requirements of the securities acts. In playing this essentially passive role, the participating underwriter has a very limited impact on the contents of the prospectus and registration statement.

To complete the transaction the representative signs the underwriting contract and thereby binds himself and the participating underwriters to purchase the issue. This is usually done on the date that the registration statement is to become effective. Shortly thereafter, the underwriters, lead and participating, perform their functions as wholesalers or retailers of the public offering.

IV. DUE DILIGENCE

The underwriter's proof that "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time . . . the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . " is, as pre-
viously noted, a defense to an action brought under section 11. The statute further provides that "[i]n determining... what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property." This defense is commonly referred to as the "due diligence" defense, and the person pleading it is required to "sustain the burden of [its] proof...".

To understand this defense and its application to a participating underwriter, it is again necessary to focus on the roles the various participants play in the preparation of the registration statement. As previously indicated, the participating underwriter does not play an active role and usually delegates the responsibility to investigate to the representative in the agreement among underwriters. The first phase of the representative's investigation usually consists of checking the legality and regularity of all corporate proceedings, including a check of the minutes of directors' meetings, the legality of prior stock offerings, the possibility of restrictions on the present issue contained in the charter, by-laws, loan agreements or contracts, the election of directors, and any other corporate act which may affect the legality of the offering under state or federal securities laws. The next phase consists of an extensive and detailed examination of the issuer in regard to its business activities and the data it intends to include in the registration statement. The role the underwriter plays in this investigation, especially the second phase, is extremely critical. A recent decision noted that

"the courts must be particularly scrupulous in examining the conduct of underwriters since they are supposed to assume an opposing posture with respect to management. The average investor probably assumes that some issuers will lie, but he probably has somewhat more confidence in the average level of morality of an underwriter who has established a reputation for fair dealing."

It can be questioned, therefore, whether mere participation in a due diligence meeting would satisfy the requirements of section 11, especially in light of evidence that this meeting is an ineffective deterrent to misrepresentations in the registration statement.

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73. See note 27 supra and accompanying text.
76. See notes 56-64 supra and accompanying text.
77. Oftentimes the delegation of responsibility is so complete that the lead underwriter has authority to sign the underwriting contract for the syndicate and thereby legally bind its members to purchase the issue. Robinson & Eppler § 36, at 150-51.
78. Going Public: Recent Registration Statement Developments, supra note 45, at 70-71.
79. Id.
A. Judicial Development of Due Diligence

Due to the relative paucity of cases on section 11 liability, the courts have had little chance to lay down guidelines for the defense of due diligence. There have been a few decisions, however, and they provide the only indication we have of how the courts will view the due diligence question. In re Charles E. Bailey & Co. involved the revocation of a broker-dealer registration before the Securities and Exchange Commission. The underwriter knew that the issuer was "in bad shape" and that the issuer "was embarking on a new and untried business" which, if not successful, would cause the proceeds of the issue to be "quickly consumed by overhead expenses." The Commission held that since the new enterprise was already experiencing difficulty, the underwriter could not simply rely on information furnished to him by the issuer. This reliance did not constitute the exercise of reasonable investigation required as a defense to this action. The Commission noted that in a case such as this one "the underwriter must be particularly careful in verifying the issuer's obviously self-serving statements as to its operations and prospects.

In re Richmond Corp. involved the issuance of a stop order suspending the effectiveness of a registration statement. One of the reasons cited for the order was the registration statement's failure to disclose the limited experience of the underwriter. The issuer was in the real estate business and was going to develop certain unimproved lands into residential lots and shopping centers. The deal was replete with speculation, undisclosed competition and conflicts of interest. The Commission found that the underwriter's visiting two of the three tracts of land owned by the issuer, examining stockholder lists, and obtaining credit reports on the registrant, and thereafter relying on representations of the registrant regarding the rest of the material in the registration statement, did not amount to a reasonable investigation within the

82. 35 S.E.C. 33 (1953).
83. Id. at 41-42.
84. Id. The transaction involved a "best efforts" underwriting. The corporation was seeking funds to develop the automatic production of bicycle chains. The management was of the opinion that it could produce 1,000 chains per day but it had never been able to produce more than 400 chains per day. Id. at 36. The management also overstated orders and was misleading in its description of the market potential for chains. Id. at 36-37. The Commission stated that the underwriter owed a duty to the investing public "to assure the substantial accuracy of representations made in the prospectus..." Id. at 41.
85. Id at 42.
86. Id. The underwriter had seen the machine used for production break down. He had also seen the dated orders referred to in the prospectus and knew that those orders still effective were only a fraction of the amount stated in the prospectus. Id.
88. The managing underwriter's only previous experience was the fact that he had become a broker-dealer earlier in the year. The firm's only experience was in connection with two prior offerings. "One of these offerings was deregistered... In the other offering, made pursuant to a claimed exemption from registration under Regulation A under the Act, the firm acted together with co-underwriters and sold 30,000 shares at $2 per share." Id. at 403.
meaning of section 11.89 Reflecting on the inadequacies of the underwriter's investigation, the Commission felt that it was "appropriate to comment on the importance which [the Commissioners] attach to the duties of the underwriter in this respect,"90 and reaffirmed its holding in an earlier case "that an underwriter willfully violates [section 11 and 12] if a prospectus used in the sale of securities contains fraudulent representations and he failed to exercise reasonable care to satisfy himself as to the accuracy of the prospectus."91

Two recent decisions which dealt with underwriters' liability under section 11 also involved the due diligence defense. In one, Feit v. Leasco Data Processing Equipment Corp.,92 the court upheld the defense while in the other, Escott v. BarChris Construction Corp.,93 it was rejected. Leasco was a class action brought by a shareholder of Reliance Insurance Company seeking damages resulting from misrepresentations and omissions in a registration statement used in an offering of Leasco Data Processing Corporation stock. The Leasco stock was used in conjunction with a tender offer to exchange plaintiff's Reliance stock for that of defendant Leasco.94

The plaintiff named as defendants Leasco, as issuer under the registration statement, its principal officers and two dealer-managers.95 The chief allegation was that the registration statement failed to clearly reveal that Reliance had a surplus of approximately one hundred million dollars over and above that required of insurance companies by state law (surplus surplus) which Leasco, as a parent holding company, intended to use for its own purposes after the takeover.96 The dealer-managers played a somewhat limited role in the preparation of the registration statement.97 They relied primarily on the issuer to "produce relevant material from its files rather than [personally inquiring] into corporate developments such as negotiations between target and acquiring

89. Id. at 405.
90. Id.
91. Id. at 405-06 (footnote omitted). The Commission referred to its holding in In re Charles E. Bailey & Co., 35 S.E.C. 33 (1953). Id. at 405.
94. 332 F. Supp. at 549-50. The plaintiff was a former shareholder of Reliance who exchanged his shares for those of Leasco. Id. at 550.
95. Id.
96. Id. at 549. Surplus surplus is the liquid assets held by an insurance company over and above the surplus which the company is required by state law to maintain. The required surplus can only be used within the insurance business of the company, while the company is free to use the surplus surplus in any manner it chooses. The problem is that insurance companies are generally not allowed to engage in noninsurance business. However, this restriction may be circumvented if the insurance company can siphon off the surplus surplus to a parent holding company. In this case, Leasco sought to be that holding company and thereby gain the use of the surplus surplus. Id. at 550-51.
97. Id. at 561. In this transaction the investment banker's function was simply to manage the exchange of stock between Reliance and Leasco, as opposed to purchasing the Leasco shares and then marketing them to the investing public. Id. at 561-62.
companies. The dealer-managers were aware of the surplus but felt it should not be included in the registration statement because of Reliance's refusal to cooperate in the registration process. The dealer-managers reasoned that, absent the cooperation of Reliance, the surplus "should not be estimated" and therefore should not be included in the registration statement.

The investigation carried on by the dealer-managers consisted of a thorough review of all available financial data, an independent audit of Leasco, the study of an actuarial report on Reliance, and detailed inquiries directed to Leasco's major bank. The dealer-managers were also particularly careful in their inquiries of Leasco concerning surplus, and had a justified belief that the lack of cooperation by Reliance would prevent them from getting the information required to accurately estimate it. In this investigation, counsel for the dealer-managers studied the corporate minutes, records and major agreements of Leasco.

The court felt that the dealer-managers were aware of a contract between the Reliance management and Leasco whereby the former were guaranteed tenure in their positions for five years and large bonuses in return for their support of Leasco's tender offer. In discussing the liability of Leasco's directors, the court stated that they could only reach one conclusion—that Reliance's management would have cooperated in the estimation of surplus if it had been asked. The failure of the directors to inquire as to surplus was grounds for their liability. This could have been a source of liability for the dealer-managers as well, but they were "in continuous contact with Leasco... and [were] apparently never disabused of the notion that [Reliance's management] remained recalcitrant. This view was conclusively buttressed... by receipt of a letter six days before the effective date of the registration statement which reaffirmed the dealer-managers' belief that no cooperation would be forthcoming." Based on this, the court concluded that the dealer-managers had exercised due diligence, noting that "[t]hough the finding might have gone

98. Id. at 562.
99. Id. at 561-62. In speaking of the dealer-managers, the court stated that they were "at no time disabused of the notion that Reliance would not provide data to assist in an approximation of surplus. Since, based on [the dealer-managers'] own experience, [they] had high regard for the competence of both Leasco's representatives and its law firm, there was no reason for him to suspect they would be withholding relevant information." Id. at 561.
100. Id. at 582.
101. Id. at 582-83. The dealer-managers were aware of the importance of surplus in the transaction but felt that it "could not be computed accurately because there was no factual basis for such a computation in the absence of access to Reliance's management..." Id. at 561.
102. Id. at 583.
103. Id. at 556-57.
104. Id. at 579.
105. Id. at 580.
106. Id. at 583.
107. Id.
the other way, on balance we conclude that the dealer-managers conducted a reasonable investigation . . .."\textsuperscript{108}

\textit{Escott v. BarChris Construction Corp.}\textsuperscript{109} was a class action brought by buyers of debentures in which the plaintiffs alleged that the registration statement filed in connection with the debentures "contained material false statements and material omissions."\textsuperscript{110} BarChris, as issuer and signer of the registration statement, eight investment banking firms which had acted as underwriters, and the accounting firm that had audited BarChris were named as defendants. The misstatements and omissions were numerous and concerned, inter alia, earnings, current assets, contingent liabilities, backlog of orders, officers' loans, customer delinquencies, use of the proceeds of the offering and corporate operations.\textsuperscript{111} "The underwriters other than Drexel made no investigation of the accuracy of the prospectus . . . . They all relied upon Drexel as the (lead) underwriter."\textsuperscript{112} Drexel conducted a preliminary investigation to decide whether or not it would undertake the financing. This consisted of familiarizing itself with the general industry and gathering information about BarChris by reading a former stock prospectus and inquiring about BarChris in certain banks with whom BarChris had dealt.\textsuperscript{113} After the "letter of intent" was delivered, Drexel obtained a Dun & Bradstreet report on BarChris, read BarChris' annual report and participated in extensive discussions with BarChris' management, in which pertinent questions were asked as to the truth of statements made in the prospectus.\textsuperscript{114}

Up to this point, the investigation was conducted by a partner of the underwriter and a partner in the law firm representing the underwriter. Thereafter, the bulk of the investigation, which consisted of searching the corporate minutes for the five preceding years and examining the major contracts of the issuer, was carried on by what the court characterized as "a very junior associ-
ate" of the underwriter's counsel. Some of the principal omissions and misstatements in the registration statement arose out of areas concerning major contracts and corporate minutes. Although certain corporate minutes were known to be missing, the underwriter simply relied on information supplied by BarChris. The court stressed that if the underwriters had read certain major contracts they would have been better able to appreciate the serious effects thereof on BarChris' financing. In holding the underwriters liable, the court stated that "[i]n order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempts to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them." 

B. Comparison of Feit v. Leasco and BarChris

The investigations conducted by the underwriters in Leasco and BarChris were somewhat similar. In both cases the misrepresentations and omissions arose out of material in the registration statements which was supplied by the issuer. What distinguishes BarChris from Leasco is the court's treatment of the justification proffered by the respective underwriters for their reliance upon the information supplied by the issuer without further independent verification. The Leasco court stressed the fact that the broker-managers were aware of the agreement between Leasco and Reliance's officers reached nineteen days before the registration statement was to become effective. The court also noted, however, that they had received information to the effect that Reliance had still refused to cooperate in supplying information necessary for an accurate estimate of surplus surplus as late as six days before the effective date. Although it would seem reasonable to attempt to clarify this apparent contradiction, the court did find some justification for the broker-managers' reliance. On the other hand, the lead underwriter in BarChris was aware of the fact that corporate minutes were missing and that some of the issuer's opera-

115. Id. at 694 n.23.
116. Id. at 695.
117. Id. at 594-95.
118. Id. at 697.
119. 332 F. Supp. at 583.
120. See note 108 supra and accompanying text.
121. The court noted that the underwriter was completely familiar with the surplus surplus concept and had been very concerned over the problem of estimating it. 332 F. Supp. at 561-62, 582-83. It was also noted that the dealer-managers' counsel, a former member of the Securities and Exchange Commission, conducted a thorough investigation of the issuer. Id. at 562, 582-83. A reading of the court's view of the investigation conducted by the dealer-managers would lead one to conclude that it was, overall, a conscientious and professional one, conducted with sufficient vigor. Therefore, while the court felt that the dealer-managers were aware of an agreement between Leasco and Reliance, it still felt that they could not obtain Reliance's cooperation in estimating surplus surplus. Id.
A further distinction in the justification of this reliance was found in the experience of the parties who exercised their judgment by relying on the issuer. In *Leasco* the court stressed the knowledge and experience of the individuals assigned to carry out the investigation by the broker-managers and their counsel; whereas in *BarChris* the court stressed the relative inexperience of certain of the individuals who conducted the investigation.

Perhaps the two most important factors the courts relied on in determining whether or not due diligence had been exercised were first, the role the underwriter played in terms of leadership and control of the registration process, and second, in view of the issuer's financial status, the degree of reliance which would be placed on his statements by a reasonable man in the management of his own property. In *BarChris*, due to the inexperience of the issuer's management, the underwriter assumed a role of leadership in the transaction, at various points directing the management to take certain steps regarding the registration statement. The financial position of the issuer was also an important factor. *BarChris* was, prior to the registration process, riding the crest of a wave in a new and flourishing industry—the construction of bowling centers after the introduction of the automatic pin setting machine. During the registration process, however, there were indications that the tide had begun to change for the industry and facts subsequent to the filing of the registration statement revealed that *BarChris* defaulted on the debentures and filed a petition under Chapter XI of the Bankruptcy Act.

In *Leasco*, on the other hand, the underwriters played no role in preparing the registration statement, having simply acted as dealer-managers of an issue.
which was to be used in conjunction with a takeover by exchange of stock.128 Moreover, the participants, Leasco and Reliance, were at the time well respected members of the financial community. This was not an attempt to paint a rosy picture of a speculative industry to help sell the issue, but rather an attempt by the respective managements of Leasco and Reliance to benefit themselves at the expense of Reliance shareholders by not disclosing the true value of Reliance.129

C. Due Diligence and Participating Underwriters

The problem of determining the meaning of due diligence with regard to the participating underwriter is even more complex. In BarChris, the court held that since the participating underwriters did nothing and relied on the representative, they would be bound by his failure to exercise due diligence.130 The court, however, declined to decide whether they would have been protected had a reasonable investigation on the part of the representative been established.131

The question arises, then, as to what type of investigation is required by the participating underwriter to satisfy the due diligence test. May he simply rely on the information given to him in the "red herring" prospectus or must he, like the lead underwriter, make some reasonable attempt at verification? The latter alternative would create serious problems from a business point of view. One commentator has postulated the following problem:

Think of the plight of the non-managing underwriters of COMSAT, where a public offering of 1,000,000 shares in 1964 was participated in by nearly 400 underwriters, scattered throughout the country. As you know, that was a new enterprise, with little financial history. However, if each of the underwriters had deemed it essential to make an independent investigation of all aspects of the registration statement, COMSAT'S activities would have been seriously disrupted.132

In addition, the cost of an investigation by each individual underwriter would be prohibitive.133

However, BarChris did not hold that participating underwriters can no longer effectively delegate their duties of reasonable investigation to the representative and be protected if he makes such an investigation. The question re-

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128. 332 F. Supp. at 561. "The dealer-managers . . . played a somewhat limited role in the exchange offer. Leasco's attorneys accepted primary responsibility for preparation of the registration statement with the brokerage houses performing only the 'due diligence' function." Id.
129. Id. at 554-61.
130. 283 F. Supp. at 697.
131. Id. n.26. There is near unanimity among commentators that satisfaction of the due diligence requirement by the lead underwriter ought to protect the participating underwriters. See, e.g., Folk (pt. 1) 139; Comment, BarChris: Easing the Burden of "Due Diligence" Under Section 11, 117 U. Pa. L. Rev. 735, 745 (1969).
133. See text accompanying note 192 infra.
mains, therefore, what does section 11 require of the participating underwriter in order for him to satisfy the due diligence standard? Congress recognized that "[t]he duty of care to discover varies in its demand upon participants in security distribution with the importance of their place in the scheme of distribution and with the degree of protection that the public has the right to expect." In 1933 the Chairman of the F.T.C., originally responsible for the enforcement of the Securities Act of 1933 and one of the principal draftsmen of that Act, specifically recognized the differing position between lead and participating underwriters and felt that participating underwriters should be subject to a less stringent standard of due diligence.

In view of the foregoing, it would seem unreasonable to hold participating underwriters to the same standards as those required of the representative. Yet the nature of the underwriting agreement is such that the underwriters must maintain the fiction that they participate individually, rather than jointly as a group. This is dictated by regulation and by the financial judgment of the investment banking community that participants in public offerings of securities cannot be individually exposed to liability for the entire offering. While the concept of severalty is not applicable to the actual investigation carried on by the parties, it is questionable whether the aims of the statute would be furthered by the needless duplication of such investigations. Mr. Justice Douglas, when still a professor at the Yale Law School, stated that "[e]conomy is achieved by delegating to the originating house the function of investigation, not of the exercise of judgment upon the facts investigated. If it was the design of Congress to assure accuracy and completeness in the registration statement by multiplying the number of investigations, it lost sight not only of this but of other costs entailed." In its interpretation of the due diligence required of outside as opposed to inside directors, the Leasco court recognized that one's duties to reasonably investigate varies with one's relation to the underwriting. Although it would be in accordance with the legislative intent behind the Securities Act of 1933 to do the same with underwriters, this has not been done.

Despite the fact that the purpose of the Act is not served by imposing similar investigatory burdens on both lead and participating underwriters, this result may be mandated by a section originally designed to give relief to the underwriter, section 11(e). This section limits an underwriter's liability to

138. Id. at 202 (footnote omitted).
139. "What constitutes 'reasonable investigation' and a 'reasonable ground to believe' will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data. What is reasonable for one director may not be reasonable for another by virtue of their differing positions." Felt v. Leasco Data Processing Equip. Corp. 332 F. Supp. 544, 577-78 (E.D.N.Y. 1971); see Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 690 (S.D.N.Y. 1968).
the total price of securities underwritten by him. Thus, in a situation where the participating underwriters had been found to have exercised due diligence and the lead underwriter had not, a finding of liability against the lead underwriter would cover only a portion of the potential damages. Since the statute was designed to be preventative rather than remedial,\textsuperscript{141} it could thus allow a situation where defrauded investors could not recover lost funds.\textsuperscript{142} Furthermore, it is clear from reading section 11 that Congress made no attempt to distinguish between lead and participating underwriters and imposed equal standards of liability on both.\textsuperscript{143}

One of the most common answers to the problem has been to allow the participating underwriter to delegate his duty to investigate to the lead, thereby fulfilling the former's obligation if the delegate carries out a reasonable investigation.\textsuperscript{144} The delegation of authority by the participating underwriter is a reflection of the actual business practices in effect today. The only question is whether or not the delegation of the duty to investigate satisfies the due diligence requirements of section 11 for participating underwriters. It is clear under \textit{BarChris} that the participating underwriter will not be protected when he delegates his duties to a lead underwriter who in turn fails to exercise due diligence.\textsuperscript{145}

The court in \textit{BarChris} noted that in view of its decision to hold the lead underwriter liable, it became "unnecessary to decide whether the underwriters other than [the lead] would have been protected if [the lead] had established that as lead underwriter, it made a reasonable investigation."\textsuperscript{146} The court in \textit{Leasco} did not specifically treat this problem, but the investigation was conducted by only one of the two dealer-managers, and the court upheld the due


\textsuperscript{142} One commentator has stated that the section 11(e) limitation on liability "implies that the underwriters of a public offering should stand or fall together in their attempts to satisfy due diligence." Comment, The Expanding Liability of Securities Underwriters: From \textit{BarChris} to Globus, 1969 Duke L.J. 1191, 1208 (footnote omitted); see Douglas & Bates, Some Effects of the Securities Act Upon Investment Banking, 1 U. Chi. L. Rev. 283, 289-92 (1933).

\textsuperscript{143} Section 11(b)(3) only distinguishes between experts and non-experts. The section does not allow non-experts to rely on facts provided by fellow non-experts. Securities Act of 1933 § 11(b)(3), 15 U.S.C. § 77k(b)(3) (1970).


\textsuperscript{145} 283 F. Supp. at 697; Comment, The Expanding Liability of Securities Underwriters: From \textit{BarChris} to Globus, 1969 Duke L.J. 1191, 1214-15. The same reasons that would mitigate against adopting a separate standard of due diligence for participating underwriters also work against delegation as a defense when the lead underwriter has not exercised due diligence.

diligence defense as to both.\textsuperscript{147} Therefore, one can presume that participating underwriters will be protected if the lead underwriter conducts a reasonable investigation.

V. INDEMNIFICATION OF UNDERWRITERS

One aspect of the traditional underwriting transaction which in the past tended to mitigate the underwriters' liability is an indemnification agreement with the issuer. It is standard procedure to include an indemnity clause in an underwriting contract.\textsuperscript{148} Such a clause provides that the issuer will indemnify the underwriter against liability for false or misleading information provided by the issuer in the registration statement. In cases where such information is supplied by the underwriters, they likewise agree to indemnify the issuer.\textsuperscript{149} The agreement among underwriters may also contain a provision in which the underwriters agree to indemnify each other in terms similar to those contained in the underwriting contract.\textsuperscript{150}

In addition to these indemnification agreements, the underwriters may also attempt to secure insurance with the issuer paying the premium in many cases. The problem with insurance is that it is not easy to get and, even if available, is very expensive.\textsuperscript{151} Although individual policies vary, there are two general types: blanket policies, usually covering a period of a year, and specific issue policies. Blanket policies are extremely difficult to obtain\textsuperscript{152} and can present the same problems as indemnification agreements\textsuperscript{153} because insurers insist that the underwriting contract contain an indemnification provision between the insurer and the underwriter, and that in case of liability, the rights of the underwriter will be subject to subrogation by the insurer.\textsuperscript{154}

\textsuperscript{147} 332 F. Supp. at 583. The court noted that the broker-managers were not in the same position regarding the transaction. Id. at 561.

\textsuperscript{148} When Corporations Go Public 83-84.


\textsuperscript{150} For a sample clause in an agreement among underwriters see Robinson & Eppler, § 36, at 156.


\textsuperscript{152} Id. at 685. This type of policy is usually purchased by the underwriter and therefore is not an attempt to shift the burden of a securities act violation as would be a policy where the premiums were paid for by the issuer. "There are only 20 or 25 of these blanket policies in existence... and it is almost impossible to get new ones today. Nevertheless some of the leading underwriting houses have them." Applebaum & McDowell, Indemnification Against Securities Acts Liabilities, Symposium—Officers' and Directors' Responsibilities and Liabilities, 27 Bus. Law. 131, 137 (Special Issue 1972).

\textsuperscript{153} See notes 159-66 infra and accompanying text.

\textsuperscript{154} Id. In light of the questionable validity of indemnification agreements the protection thus afforded to the issuer could be meaningless. This fact would obviously affect the cost and availability of such policies, making it even more difficult for the underwriter to protect himself. See Applebaum & McDowell, supra note 152, at 137.
The second type of policy is designed to cover a specific issue; in larger transactions the coverage is generally limited to one half of the offering. Based on figures stated in January, 1969, "the premiums for a $5 million policy apparently would fall in the $25,000-$35,000 range. It is believed that the largest specific-issue policy ever written was $107 million for the General Aniline offering a few years ago at a premium cost of about $355,000. Today, the cost of premiums has nearly doubled. While it was not difficult to obtain a policy in the late sixties, today insurance "is simply no longer obtainable in many cases when the underwriters would like to have it. You can still get the insurance on a 'blue chip' issue where probably you do not need it. But it is very difficult to get on a new 'over the counter' stock that has not gone public before." 

The protection afforded by indemnification agreements and issuer paid insurance coverage has been cast into doubt by recent developments. Criticism of these practices has been twofold. The first basis for such criticism is that holding an underwriter harmless for his violations of section 11 defeats one of the basic purposes of the Act—to insure that all parties make a thorough investigation of the contents of the registration statement. This makes the underwriter's role as devil's advocate a mere fiction. Professor Loss has stated that indemnification could be interpreted as a waiver of compliance in violation of section 14 and also contrary to "the in terrorem effect intended for §11 ... to promote careful adherence to the statutory requirements."

The second argument against indemnification and issuer paid insurance is that the purpose of section 11(f) is defeated when the underwriters force the issuer to shoulder the entire burden of damages. Section 11(f) provides that where "one or more of the persons ... shall be jointly and severally liable ... every person who becomes liable to make any payment under this section may recover contribution as in cases of contract ... ."

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155. Kroll, supra note 151, at 687.
156. Id.
157. Applebaum & McDowell, supra note 152, at 137. "[W]hile two years ago you could buy $1,000,000 worth of coverage for a premium which ranged roughly from $24,000 to $34,000, today you are talking about something in excess of a $50,000 premium for this much insurance." Id.
158. Id.
160. 3 Loss 1831; Comment, Indemnification of Underwriters and Section 11 of the Securities Act of 1933, 72 Yale L.J. 406, 408 (1962).
161. 3 Loss 1831.
162. Securities Act of 1933 § 11(f), 15 U.S.C. § 77k(f) (1970); see Globus v. Law Research Serv., Inc., 318 F. Supp. 955 (S.D.N.Y. 1970), aff'd, 442 F.2d 1346 (2d Cir. 1971). This suit was brought by an underwriter to require contribution from other defendants after it had satisfied a judgment. While the judgment was not based on section 11, the court still felt that the underwriter had the right of contribution. Id. at 958.
The Securities and Exchange Commission had expressed its views on the indemnification by the issuer of directors, officers and controlling persons. Rule 460 states that such an agreement "is against public policy as expressed in the act and is, therefore, unenforceable." If the issue is subject to an indemnification agreement, the Commission requires a clause in the registration statement or prospectus expressing its views on this subject. The Commission further requires that where a director, officer or controlling person brings a claim to enforce the indemnification agreement, the issuer will "submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the act . . . ."

The Commission has not attempted to regulate the indemnification of underwriters, even though underwriters' statutory duties under section 11 are the same as those of officers, directors and controlling persons. Professor Loss feels that this is because the Commission feared underwriters would be unwilling to assume the risk of liability under section 11, and would thereby hurt an essential part of the economy—corporate financing.

The first major litigation involving an indemnification agreement between an issuer and an underwriter was *Globus v. Law Research Service, Inc.* Plaintiffs, purchasers of Law Research Service stock, brought an action based on section 17(a) of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934. The Securities and Exchange Commission intervened in *Lesco* and filed a brief stating that it felt it was against public policy to indemnify inside directors when they failed to exercise due diligence. 167 N.Y.L.J. 28, 1972, at 4, col. 2.

164. Id. Rule 460 only requires the issuer to include in a registration statement the fact that there is an indemnification agreement with the underwriter. Id. at n.(b). This rule expresses what is commonly referred to as the "Johnson & Johnson Formula" because it was first applied on an informal basis to a registration filed by that company in 1944. Kroll, supra note 151, at 689.
165. 17 C.F.R. § 230.460 n.(a) (1971); SEC Securities Act Release No. 4936 (Dec. 9, 1968), 1 CCH Fed. Sec. L. Rep. § 3805, at 3227-6. In speaking of indemnification of directors, officers, or controlling persons, the Release provides that if the registration statement does not contain a statement of the SEC's policy on indemnification of those parties for liabilities arising under the 1933 Act, its views should be included in the prospectus. Regarding underwriters, the Release provides that "[i]f the underwriting agreement provides for indemnification by the registrant of the underwriters or their controlling persons against liabilities arising under the Act, a brief description of such indemnification provisions may be furnished in the body of the prospectus . . . ." Id. The Commission does not require any statement about insurance against liability arising under the Act, regardless of who pays the premiums. Id.
166. 17 C.F.R. § 230.460 n.(a) (1970). Absent such a commitment, the Commission will not grant acceleration. Id. The Securities and Exchange Commission intervened in *Lesco* and filed a brief stating that it felt it was against public policy to indemnify inside directors when they failed to exercise due diligence. 167 N.Y.L.J. Mar. 28, 1972, at 4, col. 2.
167. 3 Loss 1835; see Comment, Indemnification of Underwriters and Section 11 of the Securities Act of 1933, 72 Yale L.J. 406, 407 (1962).
169. Section 17(a) is the general anti-fraud provision in the Securities Act of 1933. 15 U.S.C. § 77q(a) (1970). The Act provides: "(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—(1)
Securities Exchange Act of 1934. They alleged that the offering circular prepared in connection with a Regulation A offering was misleading. Plaintiffs named the issuer, its officers and the underwriters as defendants. Law Research’s plan was to computerize court opinions and sell this service to lawyers. The corporation could not afford to purchase the hardware necessary for this function so it entered into a contract with the Univac division of Sperry Rand Corporation which provided that Law Research would supply the legal data and Sperry Rand would furnish computer services. Shortly after the system became operative, large debts to Sperry began to build up. At the same time, Law Research’s president began to explore the possibilities of a public offering with Blair & Co., Granbery Marache, Inc., the defendant underwriter. It was decided by Law Research and Blair that funds should be raised by the sale of equity securities, the proceeds of which would be used to pay off the debt and to finance the indexing of federal court opinions.

Prior to the effective date of the offering, a dispute arose with Sperry Rand which resulted in the termination of computer services and the initiation of a lawsuit by Law Research against Sperry Rand based on fraud and breach of contract. Plaintiff alleged that the circular was misleading in that it prominently featured the relationship with Sperry Rand, yet failed to disclose Sperry Rand’s termination of computer services and Law Research’s subsequent filing of the lawsuit. The trial by jury resulted in verdicts against all three defendants and plaintiffs were awarded compensatory and punitive damages. On a cross-claim by Blair against the issuer and its officers based upon an indemnification provision the jury found in favor of Blair. However, the trial judge granted Law Research’s motion to set aside the jury verdict for indemnification, stating that

[i]f an underwriter were to be permitted to escape liability for its own misconduct by obtaining indemnity from the issuers, it would have less of an incentive to conduct a

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to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.\]

170. Id. § 78j(b) (1970).
171. Regulation A permits issuers of small public offerings (less than $500,000) to dispense with the filing of detailed and lengthy full registration statements. The offerer simply submits an offering circular to the Commission instead. [current vol.] CCH Fed. Sec. L. Rep. § 78,485 (Jan. 7, 1972).
172. 418 F.2d at 1278.
173. Id. at 1280-81.
174. Id. at 1281. Law Research’s president did not think it was detrimental to be deprived of the use of Sperry Rand’s computers because the tapes containing the judicial decisions could be used on any Univac computer. Id. n.5. Law Research let the suit lapse by not filing a complaint. Id. at 1281.
175. Id. at 1279.
176. Id.
thorough investigation and to be truthful in the prospectus distributed under its name, than it would be if the indemnity was enforceable under such circumstances.177

The United States Court of Appeals for the Second Circuit reversed the award of punitive damages but otherwise affirmed the district court.178 The court noted that awarding punitive and compensatory damages tended to show, in the light of the trial judge's charge, that the jury found that Blair had actual knowledge of the material misstatements. In light of this, it felt that to enforce the indemnification clause would be against the purposes and policies of the Securities Act of 1933. The decision in Globus was limited, however: "[I]t is important to emphasize at the outset that at this time we consider only the case where the underwriter has committed a sin graver than ordinary negligence."179 In support of its conclusion, the court cited Rule 460, which announced the Commission's opinion that indemnification of directors, officers and controlling persons for liabilities arising under the 1933 Act was contrary to the purpose of the Act. The court felt that to make this a consistent policy "underwriters should be treated equally with controlling persons and hence be prohibited from obtaining indemnity from the issuer."180 The court also noted that although the underwriter receives indemnity from the issuer, the money actually comes from the shareholders who, in many cases, are the people to whom the underwriter will be found liable.181 It was indicated that indemnity may violate section 14 of the 1933 Act182 which prohibits agreements in which the buyers of securities exempt their sellers from liability under the Act.183 The court distinguished cases upholding indemnity in other fields noting that "the Securities Act is more concerned with prevention than cure."184

Although the Globus holding was limited to cases where underwriters have actual knowledge of misstatements and exhibit a wanton indifference towards their obligations,185 some commentators have stated that this is merely the

178. 418 F.2d at 1292.
179. Id. at 1288.
180. Id. (citations omitted). One article has noted two differences between directors and underwriters: "One is that, while the underwriter purchases the securities in a typical underwriting and resells them, he really is providing a service to an issuer, and therefore perhaps is more justified in his attempts to minimize his exposure. Secondly, he has an advantage that the director does not have, namely, he does not have to go forward with this game if it is not being played by rules that are comfortable for him." Applebaum & McDowell, supra note 152, at 132.
181. 418 F.2d at 1289.
183. Section 14 provides: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." Id.
184. 418 F.2d at 1289.
185. "Thus it is important to emphasize at the outset that at this time we consider only the case where the underwriter has committed a sin graver than ordinary negligence." Id. at 1288.
first step toward voiding indemnity in cases of ordinary negligence.\textsuperscript{186} The reasoning of \textit{Globus} would apply equally to both because section 11 does not distinguish between intentional and negligent misrepresentations or omissions, and an underwriter's negligent investigation could not be considered reasonable action for a prudent man in the management of his own property. Although the application of the reasoning in \textit{Globus} has been criticized,\textsuperscript{187} the reasoning itself is valid. It is clear that the policies of the 1933 Act requiring full disclosure and the development of an adversary relationship between the underwriter and the issuer would be defeated by upholding an indemnification agreement in cases where the indemnitee has willfully violated the Act.

Due to his lack of personal contact with the issuer, it would be difficult to envision a situation where a participating underwriter had actual knowledge of misrepresentation or omissions, but if such were the case, one would presume that he would not be allowed to enforce his indemnification agreement.\textsuperscript{188} A far more likely situation is one where the lead underwriter would not be able to enforce his indemnity provisions under \textit{Globus} and yet, under the same test, the participating underwriter would be able to do so. This would be a reasonable solution in the sense that the participating underwriter would be afforded some protection from liability caused by the willful violations of section 11 by those participants he is not in a position to control.\textsuperscript{189} The real problem here lies in the fact that the \textit{Globus} reasoning supports the position that mere negligence should also void an indemnity agreement. Rule 460 does not differentiate between indemnity for intentional or negligent acts, nor does the agreement forbidden by section 14. Furthermore, whether the failure to


\textsuperscript{187} "On its facts, Globus is a black case. It is hard to swallow the notion that, for the price of the underwriting compensation available in an offering of $300,000 or less, an underwriter would engage in the conduct which Judge Mansfield and the jury found should be characterized as "involving actual knowledge of false and misleading statements or omissions and wanton indifference to its obligations and the rights of others..." But swallow it we must, and on that record the denial of indemnification rights can be agreed to. So, Globus is not 'impossible to live with.' It should not frighten our underwriter clients although it may well turn their stomachs." Whitney, Underwriters' Counsel—Advice to My Client: "That Which is Impossible Must Go Away!", Symposium—"The BarChris Case: Prospectus Liability," 24 Bus. Law. 585, 590 (1969).

\textsuperscript{188} In Globus, the court stressed that there was actual knowledge of misrepresentations. Recalling that the participating underwriter's investigation is limited to an examination of the "red herring" prospectus and attendance at a due diligence meeting, it is unlikely that he would discover any misrepresentations or omissions. It should be noted that the Commission regularly reviews "red herring" prospectuses—therefore, if one could detect misrepresentations or omissions from reading it, it is very likely that the Commission would reject the registration statement.

\textsuperscript{189} Yet allowing lead underwriters to escape liability for violations of section 11 caused by their own negligence would be contrary to the purpose of that section. See notes 190-96 supra and accompanying text.
disclose results from negligence or intentional conduct, there is equal harm to the investing public.190

Globus held that indemnity agreements should be questioned when they "would have a tendency [to encourage underwriters] to be lax in their independent investigations."191 This again raises the issue of distinguishing between lead and participating underwriters for purposes of due diligence. It is submitted that the courts should judge each underwriter individually, keeping in mind the fact that Congress seeks to view each participant in terms of the role he plays in the transaction192 and then determine, in view of his actions, whether or not he should receive indemnity from the issuer. Thus, while it is difficult to distinguish between underwriters for purposes of liability under section 11, even though the traditional practices of the financial community indicate that there is not equal culpability, the courts could rectify this injustice by selective voiding of indemnity agreements. This would accomplish the purpose of the Act by encouraging the lead underwriter to verify the contents of the registration statement, while protecting the participating underwriters from vicarious liability. It would also give protection to the participating underwriter without requiring an enormous increase in the cost of underwriting, in all likelihood to be borne by the issuer and in turn the shareholder because of the increase in the spread. Underwriters do not have the freedom to increase the spread to the level they choose.193 Therefore, it is quite possible that because of the increased costs of investigation by a participating underwriter, sound financial houses will be driven out of the underwriting community.194

VI. CONCLUSION

The present day realities of underwriting, taken in conjunction with the limitations on underwriter liability found in section 11(e),195 makes distinguishing between lead and participating underwriters difficult, if not impossible. Assuming that the 1933 Act requires so many unnecessary and duplicative investigations so as to effectively prohibit profitable underwriting, the courts must seek some way to soften the harshness of the potential liability imposed on participating underwriters. As the system stands now, the public investor will be the one who eventually pays. The cost of duplicative investigation will

190. No one can seriously dispute that the negligence in BarChris was just as damaging to the investing public as the willful violations found in Globus.
191. 418 F.2d at 1288.
193. There are certain limits to underwriters' compensation. See Merrifield, Underwriting Compensation, 26 Bus. Law. 1235 (1971). If it becomes impossible to underwrite issues profitably because of the cost of the required investigation, this will drive responsible bankers out of the area and leave it open to underwriters who will not investigate or will make sham investigations and so be able to render the transaction profitable.
194. In light of the present state of it's availability to underwriters, insurance is at best a questionable solution to section 11 liability. See generally notes 151-58 supra and accompanying text.
be passed on in the form of an increased spread on stocks, and the investor will therefore get less actual value for his dollar. Alternatively, if no investigations are conducted individually by participating underwriters, the risk involved will drive responsible investment bankers out of underwriting, thus opening the industry to the type of participants that federal securities legislation sought to ban.

Section 11(f) provides that one can not require contribution if he is guilty of fraudulent misrepresentation. This prohibition should be expanded to prevent the issuer or the lead underwriter from obtaining contribution from participating underwriters where the former parties have not exercised due diligence. The same result would be achieved without amending section 11(f) if the courts would adopt requirements for participating underwriters with due consideration for "their place in the scheme of distribution" and employ them in their decisions on the enforceability of indemnity provisions. In cases where there is no contractual right of indemnification benefiting the participating underwriter, the courts should allow the participating underwriter to seek common law indemnification against both the issuer and lead underwriter if they were responsible for the section 11 violations. While these solutions could make underwriters less desirous of managing the syndicate and assuming a position of leadership, this could be rectified by demanding higher management fees from participating underwriters or by billing each underwriter for the expense of the investigation in proportion to his share of the issue.

196. Id. § 11(f), 15 U.S.C. § 77k(f) (1970). That section provides that there shall be no contribution where "the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation."

197. Professor Loss recently stated, in connection with his position as Reporter for the American Law Institute project attempting to codify federal securities legislation into an integrated Federal Securities Code, that he hoped "we shall say that the court, in considering the defense of reasonable care and reasonable investigation, shall appropriately distinguish between inside and outside directors, and among different kinds of officers, and between orthodox, professional underwriters and purely technical underwriters." Ruder, Wheat & Loss, Standards of Conduct under the Federal Securities Acts, Symposium—Officers' and Directors' Responsibilities and Liabilities, 27 Bus. Law. 75, 88 (Special Issue 1972). It should be noted that when the Securities and Exchange Commission filed a brief opposing indemnification of Leasco directors by the corporation, it argued that indemnification was against public policy only in the case of inside directors. 167 N.Y.L.J. Mar. 28, 1972, at 4, col. 2.