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The Underwriter's Duty of "Due Diligence" Under Section 11 of the Securities Act: Reflections on *BarChris*

The Securities Act of 1933[1] seeks to protect the investing public by putting into the hands of the potential securities purchaser information upon which he can base an enlightened investing choice.[2] The participants in a public distribution of securities—including the underwriters—are required to collect, accurately and completely in a registration statement and an accompanying prospectus, the relevant facts about the company issuing the securities. Failure to do so will render the participants liable under section 11 of the Act. The Act then imposes a duty of care on the underwriter and enforces that duty by the threat of civil liability. The liability imposed by section 11, however, is not absolute. It can be avoided if the underwriter can convince a court that he has been "duly diligent" in collecting the facts.

Before 1968 no judicial decision had specifically ruled on the validity of an alleged "due diligence" defense. But in a recent decision—*Escott v. BarChris Construction Corp.*[3]—a federal district court rejected the "due diligence" defenses of all the participants in a securities offering, including the underwriters. The *BarChris* decision has had a dramatic effect on the financial community. It has forced

1. 15 U.S.C. §§ 77a-77aa (1964) [hereinafter cited as Securities Act employing section numbers as in the original public act rather than as in the United States Code].

2. In broad outline, the Securities Act prohibits a prospective issuer from using the mails or interstate commerce to sell or offer to sell securities unless a "registration statement" has been filed with the Securities and Exchange Commission containing certain required information. Securities Act § 5(a). Some of the information must be incorporated into a "prospectus" which must be delivered to each prospective investor either before or at the time he receives the securities certificate. Securities Act §§ 5(b), 10. The information required in the registration statement is set forth in Securities Act § 7.

During the "waiting period" after filing the registration statement, the issuer may make offers to sell the securities (provided they are accompanied by a "prospectus"), but may not sell any of the securities. Securities Act § 5(b). During the "waiting period" the SEC examines the information and may require additions or clarifications. Securities Act §§ 8, 19. Once the Commission feels that the information presented is not inaccurate, it allows the registration statement to become "effective," after which the issuer may make sales to the public. Securities Act § 5(a).

While the SEC carefully examines the material contained in the registration statement, it does not guarantee the accuracy of the material. Consequently, should it later develop that a registration statement became effective while containing material misrepresentations or omissions, the Commission will issue a "stop order," which prohibits further sales until the information is corrected. Securities Act § 8(d). Furthermore, any purchaser may bring an action under the civil liabilities sections of the Act, including section 11.

3. 283 F. Supp. 643 (S.D.N.Y. 1968) (hereinafter cited as *BarChris*).

investment bankers to re-evaluate their procedures for preparing registration statements. At the same time, it has led them to seek to immunize themselves from the economic consequences of liability. In the wake of the *BarChris* opinion, businessmen are looking upon devices such as indemnification agreements and liability insurance policies with increasing favor. Such devices, however, must be critically examined since they may allow underwriters to escape from their statutory duty of care. In light of both the policy behind the Act and modern commercial practices, this note evaluates the duty of care imposed on investment bankers by section 11, ways of complying with it and methods of avoiding it.

I. SECTION 11: PURPOSE AND POLICY

Section 11 of the Securities Act permits "any person acquiring [a] security" to sue the underwriters of an issue, among others, if any part of the registration statement pertaining to the securities contained, at the time it became effective, "an untrue statement of a material fact" or omitted a material fact which made the information presented misleading.[4] Among those who may also be sued are all signers of the registration statement, the directors of the issuing corporation, and "experts" who prepared or certified any part of the registration statement.[5]

While the issuer is held almost strictly liable for misstatements or omissions,[6] the other defendants may escape liability by affirmatively proving "due diligence."[7] The Act provides that no defendant, other than the issuer, may be held liable if he proves that he had, "after

4. Securities Act § 11(a). *See generally* 3 L. Loss, SECURITIES REGULATION 1721-42 (1961) (hereinafter cited as Loss).

5. Securities Act § 11(a) also subjects to suit persons performing functions similar to directors or partners of the issuer, § 11(a)(2): "every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner," § 11(a)(3); and every expert "whose profession gives authority to a statement made by him who has . . . prepared or certified any part of the registration statement," § 11(a)(4). An expert, however, may be subjected to liability only to the extent that the inaccuracy in the registration statement "purports to have been prepared or certified by him." Furthermore, only those who were directors and officers at the time that that part of the registration statement containing the inaccuracy was filed are made liable. § 11(a)(2).

6. The issuer may escape liability if he proves that the purchaser knew of the defect at the time he purchased the security. Securities Act § 11(a). In addition, if the issuer "has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement," then the plaintiff must prove affirmatively that he acquired the security relying on the registration statement. § 11(a), *as amended*. But the issuer is expressly denied the defenses of § 11(b).

7. Securities Act § 11(b).

reasonable investigation, reasonable ground to believe, and did believe," that the registration statement was accurate and complete.[8]

Section 11 does not impose liability only on the defendant who contributed the false or misleading information. Rather, it makes *each* potential defendant liable for any inaccuracies occuring in *any part* of the registration statement.[9] Thus, an underwriter can be held liable for failing to discover a misstatement made by another party.[10]

The threat of such liability attempts to insure that each possible defendant protects the investing public by making an independent investigation into the truthfulness and completeness of the information presented in the registration statement.[11] Section 11 embodies a policy decision that the investor is better protected by an accurate registration statement than by the knowledge that he may sue to recover his loss if the material is false. Thus, it seeks to regulate the conduct of the participants, rather than to compensate the victim.[12] The theory behind section 11 is to insure the truthfulness of the information given to the investor by imposing a duty of care upon each participant in the preparation of the material and by policing this duty with the threat of a civil liability[13] which has been considered penal in nature.[14]

It must be noted, however, that the defendants, other than the

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8. Securities Act § 11(b)(3)(A). Furthermore, no defendant, other than the issuer, may he held liable for false statements or omissions made by an *expert* if, after reasonable investigation, the defendant had "no reasonable ground to believe and did not believe" that the registration statement was untrue or contained omissions. § 11(b)(3)(C). The expert himself must show that he believed that his statements were true. § 11(b)(3)(B).

9. An expert, however, is liable only for untruths or omissions in that part of the registration statement which he prepares. Securities Act § 11(a)(4).

10. *See* Note, *Indemnification of Underwriters and Section 11 of the Securities Act of 1933*, 72 YALE L.J. 406 (1962) [hereinafter cited as *Indemnification of Underwriters*].

11. The Securities and Exchange Commission has recognized "the duty of thorough investigation and analysis imposed by the Act on the underwriter proper." SEC Securities Act Release No. 1862 (Dec. 14, 1938), 1 CCH FED. SEC. L. REP. ¶ 1531.

12. For discussions of the policies behind the Act, written contemporaneously with the Act's passage, see Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933); Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933). Both commentators emphasize that the Act's purpose was regulatory, rather than compensatory.

13. Securities Act § 11(f) reinforces this regulatory policy by allowing every person held liable to recover "contribution" from any other person "who, if sued separately, would have been liable to make the same payment. . . ." The draftsmen of the Act were not satisfied by a distant threat of liability, but rather sought to insure that those who owned a duty of care suffered some economic sanction whenever a registration statement contained a misstatement or an omission, unless due diligence was proved. Note, *Indemnification of Directors: The Problems Posed By Federal Securities and Antitrust Legislation*, 76 HARV. L REV. 1403, 1419 (1963) [hereinafter cited as *Indemnification of Directors*].

14. See note 105 *infra*.

issuer, are not required to insure the accuracy of the registration statement. The liability of section 11 is not absolute. Since the Act provides the due diligence defenses, it is possible for a registration statement to contain inaccuracies which a "reasonable investigation" would not have uncovered. But section 11 does require the underwriter to examine the entire registration statement to avoid incurring an economic penalty. The question, then, is what constitutes a "reasonable investigation."

Section 11(c) defines "reasonable investigation" as "the standard of reasonableness . . . required of a prudent man in the management of his own property."[15] Professor Loss has noted that the adoption of this standard was not intended to impose the same burden of investigation upon all the potential defendants.[16] But it is not clear just what burden it was intended to impose. A Congressional report declared only that the "duty of care to discover varies in its demands 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 a right to expect. . . ."[17]

The boundaries of the underwriter's due diligence defense are still cloudy in view of the lack of cases decided under section 11.[18] Before 1968 no case had expressly ruled on the reasonableness of the underwriter's investigation, although in two previous Securities and

15. Securities Act § 11(c). As originally enacted, however, the standard of reasonableness was that "of a person occupying a fiduciary relationship." 3 Loss 1726. The 1934 amendment adopted the standard of RESTATEMENT (SECOND) OF TRUSTS § 174 (1959). "The amendment to section 11(c) removes possible uncertainties as to the standard of reasonableness by substituting for the present language the accepted common law definition of the duty of a fiduciary." H.R. REP. No. 1838, 73d Cong., 2d Sess. 41 (1934).

16. 3 Loss 1730.

17. H.R. REP. No. 85, 73d Cong., 1st Sess. 9 (1933).

18. Professor Loss noted that between 1933 and 1961 only eleven actions were initiated under § 11. 3 Loss 1687, 1688 n.11. Of these, only two resulted in liability for the defendants. Martin v. Hull, 92 F.2d 208 (D.C. Cir.), *cert. denied*, 302 U.S. 726 (1937) (no evidence that underwriters were defendants; all defendants who appealed were exonerated); Thorne v. Austin Silver Mining Co., 171 Misc. 400, 12 N.Y.S.2d 675 (Sup. Ct. 1939) (underwriters failed to disclose commitments and options on previously issued stock; no claim of due diligence). Professor Loss's figures ignore the fact that many cases are settled out of court. *See, e.g.*, Barnes v. Osofsky, 254 F. Supp. 721 (S.D.N.Y. 1966) (court approved settlement of $775,000); Fox v. Glickman Corp., 253 F. Supp. 1005 (S.D.N.Y. 1966) (court approved settlement of $1,825,000); Cherner v. Transitron Electronic Corp., 221 F. Supp. 48 (D. Mass. 1963) (court approved settlement of $5,300,000); Derdiarian v. Futterman Corp., 38 F.R.D. 178 (S.D.N.Y. 1965) (court approved settlement of approximately $2,200,000). *See also* Wall St. J. (Sw. ed.), Nov. 11, 1968, at 4, col. 3 (investment bankers' settlement payment of $350,000 announced to court). Even Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968), has been settled. Comment, 44 NOTRE DAME LAWYER 122, 127 n.36 (1938).

Exchange Commission proceedings, the SEC has commented on the investigation made by the underwriters. In *Charles E. Bailey & Co.*,[19] a proceeding to revoke a broker-dealer registration under section 15(b) of the Securities Exchange Act of 1934,[20] the Commission rejected the defendant's contention that his preliminary investigation was sufficient and that the underwriter was not responsible for the prospectus because it was based upon material provided by the issuer. The Commission found that the underwriter had a duty "to exercise a degree of care reasonable under the circumstances of this offering to assure the substantial accuracy of the representations made in the prospectus and other sales literature."[21] The Commission then noted that the investigation was clearly inadequate, since the investment banker knew of the issuer's financial difficulties, paid little attention to back orders, and failed to insist on test results of the performance of the issuer's risky new product line.

The Richmond Corp.[22] was a proceeding under Securities Act section 8(d) to determine whether a stop order should issue. The managing underwriter in this case visited two of the company's three tracts of land, examined the shareholder list and obtained a credit report. For all other information, however, the underwriter relied on the issuer. Despite the fact that the underwriter was not before the Commission, the SEC remarked that "such a limited investigation by an underwriter does not measure up to the degree of care, reasonable under the circumstances, necessary for and required of an underwriter to satisfy himself as to the accuracy and adequacy of the representations in the prospectus."[23] The SEC pointed out that the investing public judges the worth of a securities offering partly on the reputation[24] of the investment banker. By allowing his name to be used on the prospectus, an underwriter "impliedly represents" that he has investigated the accuracy of the material and is satisfied with its truthfulness. "The underwriter who does not make a reasonable investigation is derelict in his responsibilities to deal fairly with the investing public."[25] This was the unsettled state of prior authority before the decision in *BarChris* was handed down. With that decision,

19. 35 S.E.C. 33 (1953).
20. 15 U.S.C. § 78(o)(b)(5) (1964).
21. Charles E. Bailey & Co., 35 S.E.C. 33, 41 (1953).
22. 41 S.E.C. 398 (1963).
23. *Id.* at 405.
24. PRACTICING LAW INSTITUTE, WHEN CORPORATIONS GO PUBLIC 43 (Israels & Duff eds., 1962).
25. The Richmond Corp., 41 S.E.C. 398, 406 (1963).

the financial community was forced to evaluate carefully the "reasonableness" of its practices.[26]

II. ESCOTT V. BARCHRIS CONSTRUCTION CORPORATION

A. Background

BarChris Construction Corporation was primarily engaged in constructing bowling centers.[27] During the period of increased public interest in bowling which followed the introduction of automatic pin-setting machines, BarChris's sales rose "dramatically."[28] When a sale was made, BarChris would generally execute a contract with a customer and, after receiving a small down payment, construct the center. The customer would then finance the remainder of the purchase price in one of two ways. Usually he executed notes for the balance which BarChris discounted with a factor (Talcott). However under the so-called "alternative method," BarChris sold the center's interior shell (alley and restaurant facilities) to the factor who would lease it either to the customer directly (Type A) or to a BarChris subsidiary which would in turn sublease it to the customer (Type B). Since either method required BarChris to finance the construction before it was paid, BarChris was constantly in need of cash. In 1961, to satisfy this need, BarChris sought to issue to the public 3.5 million dollars worth of convertible subordinated debentures.[29] A registration statement and accompanying prospectus, which was filed on March 30, 1961, became effective on May 16, 1961.[30] In October of 1962, the company entered bankruptcy proceedings.

That same month in 1962 nine disappointed debenture purchasers brought a class action,[31] alleging that the registration statement

26. For the effect of *BarChris* on the financial community, see Wall St. J., May 14, 1968, at 1, col. 6 (Sw. ed.); FORBES MAGAZINE, Sept. 1, 1968, at 23.

27. The centers were rather elaborate. "They contained not only a number of alleys or 'lanes,' but also, in most cases, bar and restaurant facilities." *BarChris*, at 653.

28. According to the prospectus, net sales amounted to $800,000 in 1957, $1,700,000 in 1958, and $3,300,000 in 1959. The 1960 net sales figure—$9,165,000—was found to be misleading. *BarChris*, at 653.

29. BarChris had sold 560,000 shares of common stock to the public in December of 1959 at a price of $3 per share. *BarChris*, at 654.

30. Before becoming effective, the registration statement was amended twice—on May 11 and May 16. BarChris received the proceeds of the offering on May 24, 1961. *BarChris*, at 654.

31. The nine original plaintiffs sued on behalf of themselves and "all other and present and former holders" of the debentures. Subsequent to the institution of the suit, other plaintiffs were permitted to intervene. At the time of the trial, over sixty plaintiffs had joined in the suit. *BarChris*, at 652. *See* Escott v. BarChris Constr. Corp., 340 F.2d 731 (2d Cir.), *cert. denied sub. nom.* Drexel & Co. v. Hall, 382 U.S. 816 (1965) (commencement of action by some plaintiffs tolled the statute of limitations both as to themselves and others similarly situated).

violated section 11 by containing material false statements and omissions. Joined as defendants were the signers of the registration statement,[32] eight investment banking firms[33] and the independent certified public accountants.[34]

1. *Unaudited Balance Sheet.*—The court found many material[35] defects in the registration statement. Among them were several misrepresentations which appeared in the unaudited balance sheet for the quarter which ended on March 31, 1961. First, BarChris understated certain contingent liabilities. If customers defaulted, BarChris was liable, under the alternative financing method, for 25 per cent of the remaining purchase price if the factor had leased the interior to a customer (Type A), and for 100 per cent if the factor had leased to a BarChris subsidiary (Type B).[36] The company, however, stated its contingent liability under the alternative method at 25 per cent for all transactions.[37] Second, by including intercompany transactions in sales, the company overstated net sales and, consequently, gross profit and net earnings for the period. Third, BarChris overstated the "backlog," the amount of unfilled orders which existed on its books; it did this by including unenforceable contracts for alley construction

32. Among those sued were BarChris's president (Vitolo) and its vice-president (Pugliese). The court noted that they were men of "limited education" who were not "equipped to handle financial matters." *BarChris*, at 653. Also sued were the executive vice-president (Russo), treasurer (Kircher), comptroller (Trilling), and secretary (Birnbaum). In addition, four outside directors were made defendants. One was a banker (Auslander), one a civil enginer (Rose), one a lawyer with the firm representing BarChris (Grant), and one a partner of the managing underwriting firm (Coleman). *BarChris*, at 652.

33. Drexel & Co. was the managing underwriter. Also participating in the offering were: Hemphill, Noyes & Co.; Paine, Weber, Jackson & Curtis; Salomon Brothers & Hutzler; G.H. Walker & Co.; Baird & Co., Inc.; Ira Haupt & Co.; and Peter Morgan & Co.

34. Peat, Marwick, Mitchell & Co. audited BarChris's financial statements as of Dec. 31, 1960. A young accountant (Berardi), not yet a Certified Public Accountant, did most of the audit work. *BarChris*, at 698.

35. The term "material" has been defined by the SEC as "the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered." Rule 405(*l*), 17 C.F.R. § 230.405(*l*). A material fact has been further defined as "a fact which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question." List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

36. Under its normal financing arrangement, BarChris was liable to the factor for 50% of the total unpaid balance if a customer defaulted on its notes. *BarChris*, at 664.

37. The court noted that BarChris correctly computed its contingent liability under its normal financing plan. However, in addition to stating at 25% what should have been stated at 100%, BarChris stated as a *contingent* liability the percentage for a lane which was leased by one BarChris subsidiary to another subsidiary. The court declared that this should have been treated as a *direct* liability. *BarChris*, at 665.

and by including sums "due" under contracts which had been cancelled.

2. *Text of the Prospectus.*—The court also found four material misrepresentations in the text of the prospectus itself. First, a statement that loans from certain officers to the company had been repaid was false, both because the officers failed to deposit payment checks until after BarChris had received the proceeds from the issue and because the prospectus failed to mention that these officers were made new advances shortly prior to the effective date. Second, BarChris failed to use the proceeds from the offering in the manner stated in the prospectus. In fact, the court found, it used the proceeds to pay off many of its concealed debts[38] and to satisfy construction creditors. Third, Judge McLean determined that the company had given the false impression that its "problems with customers' credit and performance were minimal." Actually, Judge McLean declared, "nothing could have been further from the truth."[39] In fact, BarChris was in grave danger of being forced to repurchase over 1,500,000 dollars worth of defaulted notes. Finally, the company misrepresented its operations by failing to disclose that it was operating alleys as well as constructing them.[40]

3. *Audited Balance Sheet—Current Assets.*—Finally the court noted that, for four reasons, the 1960 audited balance sheet overstated the corporation's current assets. First, pursuant to the normal financing plan, Talcott, the factor, held certain reserves as security for the customers' notes. Before the audit was prepared, and at the request of the company's executive vice-president, Talcott released a reserve of 147,466.80 dollars to a BarChris subsidiary. After it was included on the consolidated balance sheet, this sum was then repaid to the factor. Second, the company included as an account receivable the full amount of a down payment owed by a financially troubled customer. The proper accounting treatment of this item, Judge McLean declared, would have been to create a reserve of 50,000

38. The company argued that the application of proceeds section was not misleading because other funds came in which were utilized for the purposes specified in the registration statement. The court rejected this defense, finding BarChris's proof inadequate. *BarChris*, at 675.

39. *BarChris*, at 677-78.

40. Not only did the company fail to disclose this fact, it also neglected to mention that it soon would be operating other alleys which had been repurchased due to customer defaults. *BarChris*, at 678.

dollars.[41] Third, the balance sheet included a 150,000 dollar account receivable for a lane which had never been sold to an outside buyer. Such sales to its own subsidiaries were intercompany transactions and should not have been included on the consolidated balance sheet. Fourth, the court objected to the company's including, as a *current* asset, the entire reserve held by Talcott. While he agreed that the amount was an asset, Judge McLean classified it as *non-current* because the sums were released to BarChris only as the customers paid their notes.

B. Due Diligence Defense

All the defendants, including the managing underwriter, Drexel & Co., contended that after they had made a "reasonable investigation," they reasonably believed the registration statement to be correct.[42]

In testing the standard of "due diligence" against the actions of the underwriters,[43] Judge McLean emphasized that since section 11 was intended to protect the investing public, each potential defendant owed an independent duty to the public. He reasoned that since company officers tend to make "unduly enthusiastic" statements to underwriters to induce them to handle the offering, the underwriters must protect the public by investigating rather than accepting these statements.[44] He noted that this was especially true of the underwriters

41. The plaintiffs argued that the reserve should have been the full amount due ($125,000). Judge McLean, although noting that "this question of adequate reserves must be determined in the light of the facts as they existed at the time, not as they later developed," ruled that a reserve of $50,000 was sufficient, without elaborating his reasons. *BarChris*, at 662.

42. There is a lesser burden of due diligence with regard to the "expert" portions of the registration statement. There was some confusion in the answers to the complaint as to just which portions had been prepared by experts. Some of the defendants contended that only the accountant was the expert. Others claimed that the lawyers were also experts. Judge McLean held that only the accountant was an expert within the meaning of § 11 and that only the 1960 certified financial statement was "expertised." *BarChris*, at 683-84. *See* note 8 *supra*. Judge McLean did find that the underwriters satisfied the due diligence defense with regard to the "expertised" financial statement. *BarChris*, at 697.

43. Judge McLean did not require each defendant to make the same investigation. He declared that "in considering Grant's [BarChris's lawyer] due diligence defenses, the unique position which he occupied cannot be disregarded." Since Grant, as company counsel, drafted the registration statement, "more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work." *BarChris*, at 690. The court's discussion of the underwriter's due diligence defense appears at *BarChris*, at 692-97.

44. "An underwriter has not put the company's officers 'into a position of trust for the express purpose of attending to details of management.' The underwriters did not select them. In a sense, the positions of the underwriter and the company's officers are adverse." *BarChris*, at

because of their role in the distribution process.[45] Judge McLean found it "impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go," but concluded that the underwriters in *BarChris* were not duly diligent when they made "almost no attempt to verify management's representations."[46]

To reach this conclusion, Judge McLean examined the investigation which the underwriters had actually made. The managing underwriter had delegated most of the duties of investigation to its counsel "as its agent" and was then bound by the failure of its counsel to make an adequate investigation.[47]

Coleman, a partner of Drexel & Co., was first introduced to BarChris Construction Corporation on September 15, 1960. Prior to Drexel's agreement to underwrite the issue, Coleman made a preliminary investigation of the company. He read the prospectus of BarChris's 1959 stock offering, its annual reports and unaudited financial statements, as well as recent prospectuses of the company's principal competitors. In addition, Coleman received favorable assessments of the company's financial situation from Dun & Bradstreet and Talcott. Also, he conducted his own interviews with BarChris officers.

In mid-March of 1961, Coleman and Ballard, his attorney, attended three meetings at which a first draft of the prospectus was

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696. One commentator has noted that only the underwriter and the accountant can easily assume such an adverse role since they can resist the pressures to be blindly optimistic and possess the facilities and competence to perform adequately an independent investigation. Furthermore, the SEC does not have the manpower to investigate the truthfulness of the statements in the registration statement. *See* Note, *BarChris: Due Diligence Refined,* 68 COLUM. L. REV. 1411, 1421 (1968). Recently the SEC has attempted to streamline its procedures for processing registration statements. Wall St. J., Nov. 22, 1968, at 2, col. 3-4 (Sw. ed.). The Commission attributed its inability to process effectively all of the statements to the increased number of public offerings and a reduced personnel due to federal budget cuts. Consequently, the SEC is seeking to shift the responsibility for adequate disclosure to the issuer. " 'It's the issuer, not the SEC, that investors should turn to for verification of prospectuses,' Charles E. Shreve, director of the agency's corporate finance division said. 'We only clear these things as a service to the companies.' " *Id.* This view reflects an increased emphasis on the underwriter's responsibilities and the increased influence of the *in terrorem* policy.

45. "The underwriters say that the prospectus is the company's prospectus, not theirs. Doubtless this is the way they customarily regard it. But the Securities Act makes no such distinction. The underwriters are just as responsible as the company if the prospectus is false. And prospective investors rely upon the reputation of the underwriters in deciding whether to purchase the securities." *BarChris,* at 696.

46. *BarChris,* at 697.

47. For a discussion of the duty of reasonable investigation of sub-underwriters, see notes 76-81 *infra* and accompanying text.

discussed.[48] Apparently all the relevant questions were asked and settled during these meetings. Coleman and Ballard received answers which satisfied them as to the adequacy of the 1960 reserve figures, the "use of proceeds" information, the contract "backlog" figure, the down payment figures, the proper treatment of customer delinquencies, the company's possible operation of bowling alleys, and officers' loans.

On April 17, 1961, Coleman became a director of the company. Assuming that Ballard was attending to the accuracy of the prospectus, Coleman made no further investigation of this matter.

In April, Ballard sent Stanton, a young lawyer who had never before worked on a securities offering, to examine the company's minutes and its "major contracts."[49] Stanton spent one day in the company's offices where he read the Board minutes, the available executive committee minutes and the minutes of "a few" subsidiaries. He learned that there were other un-typed executive committee minutes, but did not ask to see them. The only major contract which he examined was an insurance policy. In his reading of the executive committee minutes, Stanton noted that an officer had stated that "because of customers' defaults, BarChris might find itself in the business of operating alleys."[50]

Stanton reported his findings to Ballard who, in turn, asked a company officer about the missing executive committee minutes, the incomplete minutes of one subsidiary, and the statement about operating alleys. The officer replied that the missing minutes were insignificant and that the chance that the company would operate alleys was "merely hypothetical." Without further investigation, an amendment to the registration statement was prepared; this became effective five days later.

Judge McLean found this to be an inadequate investigation. Stanton's investigation was deficient because he failed to read all the relevant minutes. Had he done so, he would have discovered that BarChris was already operating one alley and was contemplating operating others. Furthermore, Stanton had failed to examine all the important contracts. Consequently, he failed to appreciate the true

48. Present were Grant (except on two days when another lawyer took his place), the company's treasurer, Coleman and Ballard. A representative of Peat, Marwiek, Mitchell & Co. was present at one of the meetings. *BarChris*, at 693.

49. Stanton was performing what has been termed a "hallowed tradition" of sending young lawyers to check the dusty corporate records. *See* notes 67-68 *infra* and accompanying text.

50. *BarChris*, at 694.

contingent liability to Talcott under Type B financing or the inaccuracy of the "backlog" figure. Finally, he had not examined any accounting records.

Coleman and Ballard also failed to establish their due diligence defense. Ballard had failed to insist that the missing minutes be produced, he had failed to examine the factor's agreement and customer contracts, and he had not asked to see the company's schedule of delinquencies. He had also neglected to examine BarChris's correspondence with the factor, and had made no new inquiry about officer loans (despite the insistence of one officer that the Trust Indenture give loans from individuals priority over the debentures). Had these steps been taken, the court concluded, the omissions and misrepresentations contained in the propsectus would have been discovered. Furthermore, since Coleman had delegated Ballard as his agent, Coleman's own defense rested with the reasonableness of Ballard's investigation.

III. Section 11: Standard of Conduct

A. The Need For More Specific Standards

The *BarChris* decision has produced a howl of protest in the business community.[51] "Honest Abe Lincoln could lose a shareholder suit today," grumbled one lawyer.[52] What has most distressed businessmen is the possibility of being held liable when they had no intent to deceive, as well as the lack of clear standards by which to guide themselves against negligent conduct. Said one: "You have to be candid, careful, lucky, and have an attorney watch your every move. Even then you can't be sure that you might not lose a shareholder suit."[53] The real problem, then, is to determine when an underwriter's investigation is reasonable.[54] In view of the severity of section 11 liability, the standards should be clearly defined.

Although Judge McLean did not articulate specific requirements of a "reasonable investigation" for underwriters, such guidelines are clearly necessary.[55] Without them, uncertainty in the business community may hinder commercial practice. Furthermore, investment

51. *See* note 26 *supra.*

52. FORBES MAGAZINE, Sept. 1, 1968, at 25.

53. *Id.*

54. Judge McLean himself admitted that the application of the requirement of due diligence to the facts of each case was "a question of degree, a matter of judgment." *BarChris,* at 697.

55. *See* note 44 *supra.*

bankers may react with an "overabundance of caution" and incur unnecessary expenses which will be passed on to the issuer, thus making access to the capital market more difficult.[56]

Because the *in terrorem* effect of the *BarChris* decision will increase the likelihood that section 11 suits will be settled, it is unlikely that such guidelines will come from the courts.[57] One commentator suggests that authoritative guidelines be devised, either by the SEC pursuant to its rule-making power, or by the investment banking industry through the establishment of standards for its profession. If not superseded by further legislation, such guidelines would probably be respected by the courts.[58]

B. *Standards of Due Diligence in* BarChris

The basis of Judge McLean's determination of liability was that an underwriter who accepts the representations of the issuer without attempting to verify them has not made a "reasonable investigation." "The way to prevent mistakes," he elaborated, "is to test oral information by examining the original written record."[59] Had this been done, the court held, the misrepresentations would have been discovered.

There is very little which is surprising in the holding in the case. As applied to the facts in *BarChris*, Judge McLean's decision is correct. Upon examination, the underwriters' investigation is difficult to justify as reasonable. Had all the minutes been carefully read, Ballard should have learned of the "backlog" miscalculation, because the matter of unenforceable contracts was discussed. At this point he should have become suspicious and asked to see the contracts which comprised the backlog. He should also have questioned the default situation in view of the comment about operating alleys. A check of the schedule of deficiencies would have confirmed his suspicions. The unread minutes would also have informed him of the fact that

56. Note, *supra* note 44. *See also* note 83 *infra* and accompanying text.

57. Note, *supra* note 44, at 1421.

58. *Id.* at 1427. The SEC's rule-making power is conferred by Securities Act § 19. Underwriters could follow the example of the American Institute of Certified Public Accountants which has developed standards for accepted accounting praetice. For a discussion of the use of such accounting standards, see Note, *Accountants Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1435, 1464-68 (1967).

59. *BarChris*, at 690. This statement was made in connection with the defense of Grant, the company's counsel. But the test is appropriate to all the defendants, including the underwriters.

BarChris actually was operating one alley. Furthermore, a study of the minutes or the financial statements would have revealed the intercompany sales. A careful reading of all major contracts, especially the factor's agreement, would have exposed the contingent liability misrepresentation. When an officer demanded that loans from individuals be given priority over the debentures, Ballard should have asked to see the cancelled checks to confirm whether the officers' loans had in fact been repaid.[60]

It would have been more difficult to find specific written information indicating the company's intent not to use the proceeds in the way specified in the prospectus. But the opinion must be read cumulatively. Had the other material misrepresentations been discovered, it is inconceivable that the use of proceeds section would have gone unchallenged. BarChris's serious financial difficulty would have been exposed; this would immediately have raised the use of proceeds question.

The seriousness of the misrepresentations and the almost total absence of investigation make the value of the *BarChris* decision to the investment banker and his counsel difficult to discover. What light does the opinion shed on the underwriter's duty to make a "reasonable investigation?" Hopefully, *BarChris* will support the proposition that proof by an underwriter that he carefully and critically assessed all oral representations and made a serious effort to examine all relevant written information will satisfy the "due diligence" defense.

C. *Investigation Guidelines*

"The decision is likely to mean that everyone connected with a registration will be much more meticulous than in the past," reported the Wall Street Journal. It noted that "Law firms and underwriters . . . already are revising their standards in light of Judge McLean's tougher standard of what constitutes a 'reasonable' measure of care."[61] What procedures for exercising care can be devised which meet the rationale of the *BarChris* decision?[62]

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60. For a discussion of the difficulties in obtaining the "written record" from company officials, see notes 73-75 *infra* and accompanying text.

61. Wall St. J., May 14, 1968, at 1, col. 6 (Sw. ed.).

62. In the preparation of the following discussion, the writer has utilized several memoranda of law from law firms with large securities practices. These firms remain anonymous at their own request. The writer, however, wishes to acknowledge his indebtedness to these firms. *See also* Israels, *Checklist For Underwriters' Investigation: Addendum—1968 Escott*

The initial protection for the investment banker is the careful screening of securities offerings before making the decision to underwrite. Initially, the underwriter should make a preliminary investigation of the issuer and its industry. Reading earlier prospectuses and trade publications, inquiring of financial institutions, and interviewing company officials are minimum requirements.[63] It should be noted that Judge McLean did not criticize the preliminary investigation made by Coleman in any way. Before making the survey, underwriters should review and formalize the methods they use in deciding whether to manage an issue; considerations include the standards employed, the extent of the investigation and the persons authorized to make the decision. Before committing itself, an underwriting firm should detail its operating procedures to the prospective issuer, making clear exactly what the underwriter demands of the issuer. The firm should require and obtain assurances of the issuer's total cooperation in satisfying the due diligence defense. Such cooperation should include access to company minutes, contracts and other relevant files.[64]

Once the underwriter decides to manage the issue, it is important to prepare time schedules which allow sufficient latitude for conducting the investigation. The preparation of the initial registration statement and subsequent amendments for the SEC is generally done under pressure. As described in *BarChris*, lengthy conferences occur during which drafts are reviewed, discussed, and revised.[65] The time schedule should provide sufficient time for the underwriter to review the final proof of each document before it is filed.

During these drafting sessions, many questions are asked of company officials and accountants. The oral answers become the

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v. BarChris Construction Corp., in AMERICAN BAR ASSOCIATION, SELECTED ARTICLES ON FEDERAL SECURITIES LAW 65 (1968); Riordan & Wragg, *Examination of Corporate Books in Connection With Stock Offerings and Acquisitions*, 18 BUS. LAW. 677 (1963).

63. At least one investment banking firm investigates prospective issuing corporations and their officials through a private detective agency.

64. One commentator sees BarChris's lack of candor as the most disturbing element of the case. "From the underwriters' standpoint *BarChris* emphasizes the necessity for confidence in the management of the issuer above and beyond its willingness fairly (and satisfactorily) to answer all inquiries made. It calls for a relationship which gives fullest assurance that the smallest cloud on the horizon will be immediately reported, tracked and its potential destructive effects assessed as best they may be. Managements which, like that of BarChris do not merit that degree of trust cannot, unfortunately be classified as extinct. Nor can underwriters who despite their best endeavors, nevertheless can be misled by such a management. There will be more litigation under Section 11 of the 1933 Act. We have not heard the last of *BarChris*." Israels, *supra* note 62, at 73.

65. See note 48 *supra* and accompanying text.

basis for a substantial part of the registration statement. While the court in *BarChris* made it clear that this oral information must be tested against the written documents, to interrupt these already lengthy conferences is obviously impractical. Therefore, a better procedure would be to take careful notes of the questions raised and the answers given during the meetings. Then, during the interim between the filing of the statement and the receipt of the letter of comments from the SEC, the investment banker should independently verify the information contained in the registration statement. Thus, any inaccuracies discovered can be corrected by amendment before the statement becomes effective.

The work to be done during the investigation should be divided between the underwriter and the lawyer.[66] But however it is divided, all involved should re-read the registration statement and review the notes of the conferences. A list should be prepared of all items in both the registration statement and the notes, which the underwriter may then verify either from a review of corporate records or from outside sources.

At this point either the underwriter or his attorney should visit the offices of the issuer to examine company records.[67] The quality of the men making this search is important. Judge McLean indicated that Stanton was inadequately prepared since he had never worked on a securities offering before and had been a member of the bar for only six months. "The decision could well end what one lawyer wryly calls the 'hallowed tradition' of sending junior lawyers to check the records of a company offering securities."[68] The general purpose of the search has usually been to determine whether the shares are duly authorized, validly issued, and fully paid. Is the corporation duly incorporated? Are there any unusual or burdensome commitments not previously disclosed? In addition the lawyer should read the minutes of the Board of Directors, Executive Committee, any other committees and

66. The lawyer's particular province traditionally includes such areas as the validity of the securities, material contracts, litigation, patents, property rights, and governmental regulation. The underwriter's province includes fact-finding functions, such as the accuracy of the description of the property, the salaries for management, and the description of the business. But in *BarChris*, Judge McLean noted that the lawyer performed both functions, and this is often the case.

67. *See* Riordan & Wragg, *supra* note 62.

68. Wall St. J., May 14, 1968, at 1, col. 6 (Sw. ed.). In light of the manpower demands on large legal firms, it is questionable whether this "hallowed tradition" has in fact ended. At the least, however, the preparation of the younger attorney is now more extensive and his findings more carefully checked than in the past.

shareholders meetings from the last five years. If any such minutes are missing, the lawyer should demand that they be produced. Evidence of the compliance made by the company should be reported.

Specifically, the lawyer should look for any references to the following:

(1) Any difficulties of a financial nature such as unfavorable cash flow, decline in sales, slow receivables, and customer defaults;
(2) Anything which indicates that the proceeds of the offering will not be used as provided in the registration statement, or that there are pressing demands which must be met;
(3) Anything which suggests that the company is engaging, or is about to engage in any business not described in the registration statement;
(4) Difficulties created or contemplated by increased or new competition;
(5) Earnings reports which are at variance with any of the earnings statements in the statement;
(6) Transactions with officers, directors, or controlling stockholders which have not been disclosed or have been inadequately disclosed;
(7) Material contracts which have not been filed as exhibits to the registration statement; and
(8) In general, anything which suggests a material misstatement or omission from the registration statement.

During the course of the investigation, the person making the search should review all debt instruments and loan agreements, with special emphasis on default provisions. The terms of such documents should be checked against their description as found in the registration statement. All contracts mentioned in the statement should be carefully read and checked against the description of them. Furthermore, the searcher should make a general review of the company's correspondence files with key outsiders, such as its counsel, principal creditors and principal customers. These files should be examined for references to the problems outlined above. Finally a check should be made to insure that all buildings and equipment comply with their description in the registration statement. As with corporate minutes, evidence of the cooperation which the underwriter receives from the company should be noted and should bear on the reasonableness of the verification.

Before the registration statement becomes effective, a further investigation must be made to make certain that material changes occurring between the first filing of documents with the SEC and the effective date are reflected. There are many ways to accomplish such an "updating." One method is continuous communication with company officials, counsel and accountants, including, where appropriate, intensive cross-examination of them. Whenever possible, the results should be confirmed by reference to any

authoritative written materials. In addition, many of the techniques used in the original investigation may be re-employed.

Two final methods of verification have been cast in doubt by *BarChris*. The first method, officers' and directors' questionnaires, has been considered fairly reliable in the past. But Judge McLean indicated that dependence on the answers of the issuer is not satisfactory. Therefore, it would seem that such questionnaires can be used only to gather information which must then be verified. If they are used for this purpose, however, it is suggested that these questionnaires be as detailed as possible; the language, however, should not be too intricate to be easily understood.

Neither does the due diligence meeting, the second method, seem to meet Judge McLean's criterion for study of original, written documents. Professor Loss has admitted that such meetings may not be a valuable safeguard.[69] Such gatherings are generally attended by the issuer's officials, its counsel, underwriters and their counsel, accountants and other experts. "Everybody is thus afforded an opportunity to exercise 'due diligence' by asking questions."[70] According to Judge McLean, merely to ask questions is clearly not due diligence. Often the due diligence meeting is simply a perfunctory meeting over cocktails. But one commentator suggested that the meeting can still be useful in keeping open the "channels of communication between the lead underwriter and the members of the group. . . ."[71]

While an underwriter will not be held liable for inaccuracies in a certified financial statement if he had reasonable belief that the financial statement was correct, both the audited and unaudited financial statements should be reviewed for possible misrepresentations. The most practical way to verify the unaudited financial statements is to delegate the duty to the accountants and then to rely on their "cold comfort" letter. Nevertheless, if the underwriter's own examination raises suspicions, the matter should be pursued despite this "comfort" letter.

At every stage in the process of investigation and verification, the

69. 3 Loss 1731.

70. *Id.*; PRACTICING LAW INSTITUTE, *supra* note 24, at 155-56 describes the "due diligence meeting" as "an attempt to meet a statutory test." The meeting "provides a means for the proposed underwriter and others to ask questions which they feel they should ask and which go beyond the prospectus, at times which go beyond the written material which may have been made available to them." *Id.*

71. Israels, *supra* note 62, at 73. For a discussion of the sub-underwriters' due diligence, see notes 76-81 *infra* and accompanying text.

underwriter personnel and the attorneys should carefully document the procedures followed and the results obtained.[72] They should collect evidence of the cooperation which the underwriter received from other parties. If requested documents are not produced, such information should bear on the reasonableness of the investigation.

An effective due diligence investigation can be accomplished only with the total cooperation of the issuer, because of the issuer's access to and control over many of the documents which must be examined. While the investment banker should obtain assurances of cooperation from the issuer, practical difficulties can be anticipated. Certain material may be confidential for legitimate business reasons, and the company executives may balk at producing it. "'We'd get fired if we asked to see the backlog contracts,' said one Wall Street lawyer.'"[73] Furthermore, material may simply be unavailable.[74] If such information either cannot or will not be produced, there is little an underwriter can do to compel its availability. The availability of the documents should bear on the reasonableness of the investigation required by section 11. But if the underwriter seeks to examine relevant records and is unnecessarily denied access to them, he should be prepared to refuse to continue with the offering. While the underwriter should not be held strictly liable for the contents of unproduced material, this should not encourage issuers to foil a diligent investigation by refusing to produce damaging information. At some point, the underwriter should be put on notice that all is not being disclosed.

Normally, however, the issuing corporation and the investment banker will desire to cooperate with each other to prepare an accurate registration statement. It is in the best interests of the issuer and its officers to cooperate fully with the underwriter. Not only are they still subject to liability, but they will also lose the benefit of the underwriter's contribution if he subsequently establishes his defense and they do not. But managements which, like that of BarChris, are

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72. One New York firm recommends that "proofs with notations thereon . . . be retained permanently. Accurate and complete diaries or entries reflecting conferenees and telephone calls are most important."

73. Wall St. J. (Sw. ed.), May 14, 1968, at 1, col. 6.

74. One Wall Street lawyer has interpreted "[J]udge McLean's strictures as to backlog [as] directed to the specific facts of *BarChris*. Tbey cannot seriously be construed to require that underwriters attempt an independent check of the backlog of a manufacturing company which might well consist of bundreds, even thousands of purchase orders." Israels, *supra* note 62, at 71. It is also possible that older minute books of old corporations may be lost. Conversation with James H. Cheek, III, Assistant Dean, Vanderbilt University School of Law, Nov. 6, 1968.

either disinterested in full disclosure of relevant facts or are consciously seeking to hide adverse information still exist,[75] and underwriters must be aware of them.

The lesson of *BarChris*, then, is that while an underwriter must make a reasonable investigation, this should not mean that he must detect all misrepresentations and omissions. On the other hand, the underwriter should not be allowed to accept the word of others at face value. Rather, *BarChris* should stand for the proposition that, in so far as possible, suspicious facts must be checked against the original written record. Consequently, if the procedures just outlined are conscientiously followed, a court should determine that "due diligence" has been established.

D. *Problems of the Sub-Underwriters*

The preceding discussion has concerned itself with problems the managing underwriter encounters in the public offering of securities. In practice, however, it is common commercial procedure for the sub-underwriters, each of whom buys a portion of the total number of securities, to rely on the activities of the managing underwriter.[76] The sub-underwriter does not prepare the registration statement, and he is not involved in the distribution process until after the closing. That is, he makes no due diligence investigation, but rather relies on the investigation of the head underwriter.

In *BarChris*, since the head underwriter failed to establish his due diligence defense, the sub-underwriters also failed to establish their defenses.[77] But section 11 declares that "every underwriter" can be sued, and it says nothing about the right of one underwriter to rely on the statements of another. In fact, *BarChris* supports the proposition that every defendant must independently verify the truthfulness of the registration statement. Does this then mean that each underwriter, regardless of his position in the underwriting group and regardless of the fact that he did nothing to prepare the registration statement, must make a separate "due diligence" investigation?

But would the lack of any investigation by the sub-underwriters render them liable even if the lead underwriter successfully established his defense? Judge McLean expressly declined to answer this question.[78] There is, in fact, nothing in the Act which expressly deals

75. See note 64 *supra* and accompanying text.
76. 1 Loss 547, 553-55; Practicing Law Institute, *supra* note 24, at 153-54.
77. *BarChris*, at 697.
78. *BarChris*, at 697 n.26.

with this problem. But to demand that the sub-underwriters make their own investigations seems unreasonable.[79] While sub-underwriters are "participants" in the distribution process, they are not independent participants. Rather, they are members of an underwriting "group" directed by the managing underwriter. A more reasonable approach, it would seem, would be to treat the entire underwriting group as a single entity. To do so would not lessen the chances for an accurate registration statement, since sub-underwriters do not help to prepare the statement anyway. In addition, requiring each underwriter independently to verify the registration statement's accuracy would be so expensive as to make the cost of public distribution prohibitive for small companies.

It would be a simple matter to eliminate the necessity for sub-underwriters to make separate investigations by delegating the head underwriter's attorney as agent for all the underwriters. A successful investigation on behalf of one underwriter, then, would protect them all. In *BarChris*, Drexel, the lead underwriter, delegated its attorney, as its agent, to make most of the due diligence investigation.[80] The court allowed this delegation of authority and held Drexel liable for the failures of its agent. As a matter of common practice, the agreement among the underwriters grants to the managing underwriter broad powers to approve the registration statement, to postpone the effective date, and to manage the issue generally.[81] In effect the agreement among the underwriters is a delegation of authority to the managing underwriter, and it would be merely a matter of legal draftsmanship to delegate the due diligence investigation of all the underwriters to the head underwriter's lawyers.

IV. THE ESCAPE FROM LIABILITY

A. Indemnification

The threat of great liability[82] has led investment bankers to seek to protect themselves in several ways. To the extent that they have

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79. "This holding, more than any other in the decision, upsets Wall Streeters. It's 'downright silly' to expect participating underwriters to make an independent investigation, says a lawyer who otherwise praises the decision. 'That's what the lead underwriter is for.' " Wall St. J., May 14, 1968, at 1, col. 6 (Sw. ed.).

80. *BarChris*, at 697.

81. PRACTICING LAW INSTITUTE, *supra* note 24, at 86.

82. Securities Act § 11(e) limits the underwriter's liability to the "total price at which the securities underwritten by him and distributed to the public were offered to the public." But the amounts involved are still great. *See, e.g.*, Fox v. Glickman Corp., 253 F. Supp. 1005 (S.D.N.Y.

protected themselves by adhering more carefully to the statutory duty of examining the entire registration statement, the purpose of the Act has been accomplished.[83] But underwriters have also sought to protect themselves in other, arguably less responsible, ways—by immunizing themselves from the economic consequences of liability through use of indemnification agreements and liability insurance policies.[84]

It is customary that the underwriting contract contain provisions between the issuer and the underwriter whereby each promises to indemnify the other against any liabilities growing out of any misstatement or omission on his part. That is, the underwriter warrants the truthfulness only of that information which he provides.[85] Consequently the underwriter takes no risk for statements which he does not supply. In view of the fact that the registration statement text is normally prepared by the issuer's counsel, with the underwriter adding only such facts as the offering price, discounts, and modes of distribution, under an indemnification agreement the underwriter takes very little risk indeed.[86]

These mutual indemnification contracts, however, conflict with the policy behind the Act, which is to force several independent verifications of the accuracy of the entire registration statement. Since the indemnification agreement limits the underwriter's economic risk to only a part of the registration statement, such provisions appear

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1966) (settlement of $1,825,000); Cherner v. Transitron Electronic Corp., 221 F. Supp. 48 (D. Mass. 1963) (settlement of $5,300,000); Derdiarian v. Futterman Corp., 38 F.R.D. 178 (S.D.N.Y. 1965) (settlement of approximately $2,200,000).

83. It is not completely clear that the threat of liability will inevitably benefit the investing public. "The result could be higher legal fees in underwritings, higher cost for liability insurance in such offerings and, perhaps greater selectivity by underwriters in bringing out new issues." Wall St. J., May 14, 1968, at 1, col. 6 (Sw. ed.). The result, then, could be a denial of the capital markets to smaller ventures—clearly not an end sought by the federal securities acts. Even if smaller companies can find an investment banker who will handle the offering, the cost—through a greater underwriting "spread"—may be prohibitive.

84. The Wall Street Journal reported that liability insurance policies are increasingly sought and increasingly harder to obtain. One insurance official noted that "The percentage of turndowns for this type of insurance is unusually high." Wall St. J., Aug. 29, 1968, at 1, col. 1 and p. 7, col. 3 (Sw. ed.). The cost of these policies is often prohibitive. *See* note 98 *infra*.

85. *See* Note, *supra* note 10; PRACTICING LAW INSTITUTE, *supra* note 24; at 84. Such provisions have become so common in underwriting contracts that they have been inserted almost automatically. For a representative provision, see Lockwood & Anderson, *Underwriting Contracts. Within Purview of Securities Act of 1933; with Certain Suggested Provisions*, 8 GEO. WASH. L. REV. 33, 55-58 (1939).

86. Note, *supra* note 10, at 406. It should be noted that Drexel & Co. could not obtain indemnity from BarChris, because BarChris went into bankruptcy. *BarChris*, at 654. In this situation, the underwriter's liability increases, since the issuer is unable to contribute pursuant to Securities Act § 11(f).

clearly contrary to public policy.[87] Regulation of conduct is the primary purpose of section 11, and to allow the underwriter indemnification would be to relieve him of the economic consequences of his breach of statutory duty; this, consequently, would defeat the regulatory purpose of the Act. "[S]ince the effect of indemnification is to shift all the liability for any given statement to the indemnitor, the likelihood of multiple verification is decreased."[88]

Until 1968, no court had ever voided an indemnification provision on the grounds that it violated public policy. But in *Globus v. Law Research Service, Inc.*,[89] a federal district court did void such

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87. "Thus, it becomes clear that section 11 is a vital part of the congressional regulatory scheme with which indemnification, if permitted, would interfere." Note, *supra* note 13, at 1419. Curiously neither the securities statutes nor the SEC regulations expressly prohibits the indemnification of underwriters. Section 14 of the Securities Act voids: "any condition, stipulation, or provision binding any person acquiring any security to waive compliance" with the Act. Securities Act § 14. Section 14, then, applies only where potential *plaintiffs* agree not to sue. While the underwriter "purchases" the securities from the issuer for distribution to the public, he is best seen as a participant in the distribution process—he is a potential defendant, not a plaintiff.
process—he is a potential defendant, not a plaintiff.

The SEC expresses no objection to the standard indemnification agreement between issuer and underwriter. But under Rule 460, the Commission will deny acceleration if "directors, officers, and controlling persons" may be indemnified unless the prospectus reveals this fact in language specified by the SEC. Rule 460(a), 17 C.F.R. § 230.460(a) (Note) (1968). However, the Rule considers indemnification of underwriters against public policy only where "a director, officer or controlling person of the registrant is such an underwriter." Rule 460(b), 17 C.F.R. § 230.460(b) (Note) (1968). Therefore only when a member of the investment banking firm is a "director, officer, or controlling person" of the issuer is indemnification of the underwriter condemned. Indeed the SEC Corporate Finance Division's Chief Counsel has verified this position: "[I]t is usual practice to indemnify underwriters, and the Commission is not concerned with the indemnification of underwriters as such." Statement by Charles H. Shreve, quoted in PRACTICING LAW INSTITUTE, *supra* note 24, at 147.

Professor Loss suggests that the distinction between the indemnification of corporate officers and the indemnification of underwriters arose because of the fear that underwriters would be unwilling to assume the full risks imposed upon them by § 11. 3 Loss 1835. This distinction has been criticized in Note, *supra* note 10.

88. Note, *supra* note 10, at 410-11. This argument would lose its force if the underwriter was successful in establishing his defense. Since any policy objection to indemnification would be that it detracted from one's diligence in making a reasonable investigation, such objections would disappear in the face of a successful defense. If the defendant has shown that he maintained the required standard of care, no purpose could be served by denying the defendant the right to recover his defense expenses.

It has been argued that defense expenses should be recoverable without regard to whether the defendant is adjudged to be liable. "The liability or fine is levied in large measure according to the defendant's fault, a process of adjustment which is essential to its appropriateness as a regulatory device. Litigation expenses, on the other hand, vary according to the quality and difficulty of the defense asserted and have no necessary relation to the degree of misbehavior involved." Note, *supra* note 13, at 1411.

89. 287 F. Supp. 188 (S.D.N.Y. 1968).

a provision.[90] Law Research, a corporation which provided legal research services by computer, issued stock in a Regulation A offering.[91] This transaction was underwritten by Blair & Co. Under the anti-fraud provisions of the securities acts,[92] a suit was brought, based upon the omission from the offering circular of the fact that Sperry Rand, from whom Law Research leased computer time, had terminated its contract. Sperry Rand was no longer providing such services and was, in fact, planning to litigate the matter.[93]

A jury found that the defendants, including the underwriter, actually knew of the omission, and it assessed both compensatory and punitive damages against all the defendants. The jury also granted Blair indemnification under the terms of the indemnification provision.[94] Judge Mansfield, however, set aside the award with these words:

> After reviewing the matter this Court believes that it would be against the public policy embodied in the federal securities legislation to permit Blair & Co., which has been found guilty of misconduct in violation of the public interest involving actual knowledge of false and misleading statements or omissions and wanton indifference to its obligations and the rights of others, to enforce its indemnification agreement . . . . If an underwriter were to be permitted to

90. The Underwriting Agreement "obligated Law Research to indemnify Blair & Co. for any loss arising out of any untrue statement of a material fact in the Offering Circular, except that Blair was not to obtain indemnification by reason of any willful misfeasance, bad faith or gross negligence in the performance of its duties or by reason of its reckless disregard of its obligations and duties under the agreement." *Id.* at 198.

91. Regulation A was adopted by the SEC pursuant to its authority under Securities Act § 3(b), which expressly allows the Commission to add any class of securities to those exempted from the requirement of registration up to an amount not to exceed $300,000. To comply with Regulation A, the issuer must file a "notification" pursuant to Rule 255, 17 C.F.R. § 230.255 (1968) and an "offering circular" pursuant to Rule 256, 17 C.F.R. § 230.256 (1968). Both the "notification" and "offering circular" are much briefer than their counterparts, the registration statement and prospectus. Nevertheless the same prohibitions against misrepresentations and omissions are present. Rule 261(a)(2), 17 C.F.R. § 230.261(a)(2) (1968) gives the Commission the authority to suspend the exemption if any literature filed contains inaccuracies of material facts. *See generally* 1 Loss 609-34; Glavin & Purcell, *Securities Offerings and Regulation A—Requirements and Risks*, 13 Bus. Law. 303 (1958).

92. The suit was brought under Seeurities Act § 17(a) (general anti-fraud provision in the sale of securities), Securities Act § 12(2) (sale of securities through use of a misleading prospectus or oral communication), Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78(j)(b) (1964) (general anti-fraud provision for the sale or purchase of securities), and Securities and Exchange Act of 1934 § 15(c), 15 U.S.C. § 78(o)(c) (1964) (general broker anti-fraud provision). The plaintiffs also alleged common law fraud.

93. "In offcring the new issue on March 15, 1965 to the public, the Offering Circular referred prominently (on page 5) to 'the Sperry Rand contract,' which was an attractive feature to the public, since the name Sperry Rand is widely known to the public as a leader in the computer field." Globus v. Law Research Service, Inc., 287 F. Supp. 188, 191 (S.D.N.Y. 1968).

94. Sec note 90 *supra*.

escape liability for its own misconduct by obtaining indemnity from the issuers, it would have less of an incentive to conduct a thorough investigation and to be truthful in the prospectus distributed under its name, than it would be if the indemnity was unenforceable under such circumstances.[95]

Clearly Judge Mansfield based his decision on the premise that economic sanctions encourage diligence. In the court's opinion, the enforcement of indemnity agreements would encourage the underwriter to rely on the information provided by the issuer, rather than independently to verify its accuracy. There is indeed language in the opinion which properly casts doubt on the validity of any indemnification agreement. While the decision in *Globus* rested on Blair's actual knowledge of the material omission, the policy argument stressed by the court would seem applicable both where the underwriter has actual knowledge and where he negligently fails to seek out information. Since Judge Mansfield could have avoided his discussion of public policy, it can be argued that he intended this sweeping condemnation. Because the underwriting agreement denied Blair & Co. indemnification for "any wilful misfeasance, bad faith, or gross negligence," the court could easily have found that actual knowledge was sufficient "bad faith" to prevent recovery and thus avoided casting doubt on the negligence indemnification. It seems likely that the language of *Globus* may be extended to void all indemnification agreements regardless of whether liability is based upon actual knowledge or negligence.

In either case indemnification would clearly defeat the regulatory policy of the Act. Since indemnification clauses cost the underwriter nothing, he takes no financial risk of liability, and consequently, the value of the *in terrorem* policy is negated. The underwriter's duty to make a reasonable investigation into the accuracy of the entire prospectus is alleviated, since the effect of an indemnification provision is to make the underwriter financially liable for only the information which he personally prepares. Protection against liability can be consistent with the policy behind section 11 only if it makes the underwriter investigate the entire registration statement and if it subjects him to some economic sanction if he is found liable.

B. Insurance

In addition to seeking indemnification, underwriters have attempted to purchase liability insurance.[96] Such policies, when

95. Globus v. Law Research Service, Inc., 287 F. Supp. 188, 199 (S.D.N.Y. 1968).

96. For a discussion of insurance against Securities Acts violations, see generally, Note, *supra* note 13, at 1427-30.

obtained, protect the insured against all liability up to the face amount of the policy, with certain stated exceptions. The policy typically does not insure "any loss or liability arising by reason of any dishonest or criminal act on the part of the Assured," and provides that the insuror is not "liable to the Assured . . . if there is a finding in any suit of fraudulent intent on the part of the Assured . . . ."[97] In addition, the company will be liable only for amounts paid in settlements to which it agrees—unless it unreasonably withholds its consent.

Such insurance policies have become very difficult to obtain and are quite expensive.[98] The rates vary with the possibility of error in the prospectus. One commentator thus concluded that "the criteria for deciding whether to issue a policy and what to charge for it are the reputation of the counsel, accountants, and underwriters involved in the issuance."[99]

Liability insurance has been attacked as being just as contrary to the policy of section 11 as indemnification agreements. Because it too relieves the insured from all economic consequences of liability, the argument runs, insurance, like indemnification, would induce the insured to ignore his duty of diligence. Indeed, it is contended that insurance may be more violative of public policy than indemnification, because the threat of the issuer's bankruptcy no longer affects the economic reimbursement.[100] The underwriter is certain of his insurance protection, while he was only certain of indemnification if the issuer remained solvent. Therefore, it is argued that insurance is as objectionable as indemnification, since it relieves the underwriter of the threat of economic sanctions.

It has also been contended that a distinction should be drawn between underwriter's liability insurance purchased by the issuer and such insurance purchased by the underwriter himself. It is conceded that issuer-purchased insurance would be as detrimental to public policy as indemnification agreements, for here the underwriter clearly

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97. Standard policy of Seaboard Surety Co., *cited in* Note, *supra* note 13, at 1427. For a discussion of the standard corporate directors' and officers' policy of Lloyd's of London, see Note, *Public Policy and Directors' Liability Insurance*, 67 COLUM. L. REV. 716 (1967).

98. A 1960 article stated that $1,000,000 worth of liability insurance cost $10,000 and $3,000,000 worth cost $15,000. Wheat & Blackstone, *Guideposts for a First Public Offering*, 15 BUS. LAW. 539, 552 (1960). Since July of 1968, insurance rates have increased by as much as 400%. TIME, Oct. 18, 1968, at 100. *See also* Wall St. J., Aug. 29, 1968, at 1, col. 1 and p. 7, col. 3 (Sw. ed.).

99. Note, *supra* note 13, at 1428.

100. *Id.*

assumes no economic risk of liability.[101] But, it is argued, an underwriter does assume an economic risk if he himself purchases the insurance policy. Not only is the initial cost of the policy high, but also subsequent insurance would be much more expensive if he were ever found liable. He is encouraged, therefore, to be diligent. But the weakness of this argument is that the cost to the underwriting firm can be easily passed on to the issuer through an increase in the underwriter's discount, as an expense initially included in the issue.[102]

Insurance, however, may be consistent with public policy in some circumstances.[103] Because insurance guarantees the compensation of the victim, it does perform a useful function. Furthermore, insurance protects the underwriter from "a potentially overwhelming liability emanating from a single negligent act."[104] Thus, if underwriter's liability insurance could be drafted to provide a "substitute system of sanctions," which would provide an incentive for the underwriter's diligence, it might be permissible in a way indemnification is not, since it would encourage adherence to the duty of care, while at the same time providing compensation for the victim.

"Substitute sanctions" would not be difficult to devise. In the first place, more effective regulation could be placed in the insurance contract. At present, the insurance company will reimburse all liability in the absence of "dishonest" conduct or a court adjudication of fraud. The policy could, however, be worded in a way which would deny coverage for liability based on "actual knowledge"—regardless of whether liability is determined by suit. It should deny coverage for "gross negligence," including failure to attempt to verify the accuracy of the registration statement (as in *BarChris*). In this way, the policy coverage itself would demand a good faith compliance with the duty to make a reasonable investigation.

Certain other sanctions are also available. The policy could make a certain significant amount of the liability deductible. This would continue the underwriter's economic risk, but insure him against

101. *Id.*

102. *Id.* at 1429; Note, *supra* note 10, at 412.

103. Much of the following discussion is drawn from Note, *supra* note 13, at 1429-30. It should be noted that that discussion was concerned with the propriety of insuring company officials, not investment banking firms. In view of the fact that underwriters have less access to the proper documents for independent verification than do company officials, their chances of detecting inaccuracies in a registration statement are less, and consequently, the role of insurance for them is greater.

104. *Id.* at 1429. "It is possible, for example, to envision a very large money liability under section 11 for what may seem to be a comparatively minor violation." *Id.* at 1420.

crippling liability.[105] In addition, insurance could be denied after an underwriter had once been held liable under section 11, thus further encouraging him to be diligent. Furthermore, the cost of additional insurance could be raised following liability, since rates are based upon the likelihood of liability.[106] In the above ways, then, insurance would protect the public by continuing to demand care in preparing registration statements and in compensating victims, while at the same time protecting the underwriters against liability which they would be unable to meet.

Insurance can also play a helpful role when a suit is terminated by settlement, rather than by an adjudication on the merits. Evidence exists that part of the reason for the lack of section 11 cases is the fact that such actions are settled.[107] In some situations settlement is a means of reducing the amount of a certain liability, since it saves the plaintiff litigation expenses and eliminates his lingering fear that he might lose. In other instances, however, settlement may be a means of avoiding the expense and risk of a large lawsuit by allowing the underwriter to pay a small amount.[108] These two types of situations are distinct. In the former, the underwriter clearly foresaw his breach of duty and consequent liability. In the latter, the defendant did not concede a breach of duty, but merely wished to avoid litigation. That is, in the former there was fault; in the latter there may not have been fault. In the abstract, then, settlement fines based on fault should be borne by the party at fault without indemnification. But fines which are not based on fault should be open to indemnification. As a practical matter, however, the basis of settlement is never clear—the determination of the presence or absence of fault has been eliminated.

To allow reimbursement for all settlement fines would violate public policy. If the underwriter could settle without economic loss he would be very reluctant to litigate. Furthermore, his eagerness to settle would increase with the merits of the plaintiff's case, thus

105. The deductible amount could have the effect of a "fine" or set amount for liability. The regulatory purpose to ensure that the underwriter suffer some economic sanction when adjudged liable under § 11 has led one court to term § 11 as "penal." Wogahn v. Stevens, 236 Wis. 122, 294 N.W. 503 (1940). *See also* Douglas & Bates, *supra* note 12, at 177, where the authors refer to the remedy under § 11 as "strictly and wholly punative."

106. This suggestion seems specious, though, since, as noted earlier, the underwriter can cover the increased cost by raising the discount of future issues.

107. See cases cited in note 18 *supra.*

108. Note, *supra* note 13, at 1422. *See also* Wall St. J., Oct. 22, 1968, at 3, col. 2-3 (Sw. ed.) (brokerage firm Merrill, Lynch, Pierce, Fenner & Smith, Inc., trying to settle the action brought against it by the SEC).

defeating the purpose of the statute. But to deny recovery of all such fines would also be unfair to the corporation who settled without being at fault.

Insurance could solve just such a dilemma. The insurer could serve as an "independent board of review" to determine any fault of the underwriter because, as noted earlier, the proper insurance policy should contain sanctions against misconduct.[109] These sanctions should then be operative in the settlement context.

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109. In the standard insurance policy currently in use, a court determination of fraud or dishonesty is necessary to release the insurance company from its duties, so amounts paid in settlement would seem to be covered by the policy. Note, *supra* note 13, at 1427-28.