

APPLICATION OF THE ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS TO EXEMPT OFFERINGS: DUTIES OF UNDERWRITERS AND COUNSEL

ROBERT W. DOTY*

TABLE OF CONTENTS

I. INTRODUCTION	393
II. THE ANTIFRAUD PROVISIONS AND THEIR APPLICATION TO INVESTIGATORY PROCEDURES IN EXEMPT OFFERINGS	400
A. <i>Applicable Provisions</i>	400
B. <i>Scope of Adequate Disclosure</i>	403
C. <i>Reliance Upon Particular Forms as a Basis for Disclosure</i>	404
D. <i>Relationship of Registration Context Disclosure to Disclosure in Exempt Offerings</i>	407
III. STANDARDS FOR LIABILITY OF UNDERWRITERS UNDER THE ANTIFRAUD PROVISIONS	409
A. <i>Registered Offerings</i>	409
B. <i>Exempt Offerings</i>	410
IV. THE MEANING OF DUE DILIGENCE	417
V. THE ROLE OF COUNSEL	422
A. <i>Introduction</i>	422
B. <i>Theories of Liability of Counsel: Applicability of the ABA Code</i>	424
C. <i>Liability as an Aider and Abettor</i>	429
1. Private actions and Commission enforcement actions	430
2. SEC disciplinary proceedings	440
D. <i>Liability for Malpractice</i>	441
E. <i>Liability in Connection with Delivery of Opinions</i>	446
F. <i>Liability in Connection with Representations in Letters to Auditors</i>	447
G. <i>Summary: Liability of Counsel</i>	448
VI. CONCLUSIONS	448
APPENDIX A: Illustrations of the Concept of Materiality	449
APPENDIX B: Items of Disclosure	453

I. INTRODUCTION

Offers and sales of securities generally are subject to the registration requirements of the Securities Act of 1933 (Securities Act or the 1933 Act).¹ These provisions mandate comprehensive disclosures regarding the offering, the issuer and related matters.² Furthermore, to encourage accuracy and completeness of disclosure, the Securities Act imposes stringent obligations and liabilities upon a broad range of parties to the transaction.³

* B.A., University of Houston, 1964; LL.B., Harvard Law School, 1967; Assistant Professor of Law, Creighton University. This article was prepared as a result of a project funded by Kutak Rock Cohen Campbell Garfinkle & Woodward, Omaha, Nebraska. The author expresses his appreciation to W. Patrick Betterman for research assistance.

¹ 15 U.S.C. §§ 77a-77aa (1970).

² E.g., Securities Act §§ 5-7, 10, Schedule A, 15 U.S.C. §§ 77e-77g, 77j, 77aa (1970).

³ Securities Act § 11, 15 U.S.C. § 77k (1970), provides in pertinent part:

Nevertheless, in certain situations, it has been deemed unnecessary or undesirable to impose the expensive and time consuming requirements of the statutory scheme. Among these situations are intrastate⁴ and private offerings.⁵ These are "transactional" exemptions⁶ which are frequently relied upon, particularly by promotional companies or in small offerings.⁷ Since these are only "transactional" exemptions, the registration requirements may apply, on other

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

- (1) every person who signed the registration statement;
- (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
- (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
- (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
- (5) every underwriter with respect to such security. . . .

(b) Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof— . . .

- (3) that (A) as 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*

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, 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.* . . . [Emphasis added.]

See Securities Act § 12(2), 15 U.S.C. § 77l(2) (1970). Actions under §§ 11 and 12(2) are subject to a particularly short statute of limitations. Securities Act § 13, 15 U.S.C. § 77m (1970).

⁴ Securities Act § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970).

⁵ Securities Act § 4(2), 15 U.S.C. § 77d(2) (1970).

⁶ SEC Securities Act Release No. 4434, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 2270, at 2607 (Dec. 6, 1961); Securities Act § 4, 15 U.S.C. § 77d (1970). See note 18 infra.

⁷ See SEC Securities Act Release No. 4434, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 2270, at 2607 (Dec. 6, 1961); SEC Securities Act Release No. 5450, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 2340, at 2611 (Jan. 7, 1974); SEC Rule 146, 39 Fed. Reg. 15266 (1974); SEC Rule 147, 17 C.F.R. § 230.147 (1974).

occasions, to offerings and sales of the same securities which are not required to be registered in an exempt offering.⁸

In private offerings, a fairly small number of relatively sophisticated purchasers is involved.⁹ These purchasers possess the leverage or other means to obtain and verify a considerable amount of information concerning the issuer.¹⁰ In intrastate offerings, which may involve a large number of unsophisticated purchasers, regulation by state agencies frequently provides a degree of protection for investors. This may take the form of registration requirements,¹¹ antifraud provisions,¹² or even substantive regulation of the terms of the offering.¹³ Limited additional general information may be available since an intrastate offering involves an issuer and investors in the same broadly defined "locality."¹⁴

Additionally, other exemptions are available, frequently based at least in part, upon similar considerations involving alternative sources of investor protection. Some of these exemptions apply to most securities issued by insurance companies subject to state regulation,¹⁵ certain securities issued by common carriers regulated by the Interstate Commerce Commission,¹⁶ and certain securities of those banks subject to supervision by federal or state regulatory authorities.¹⁷ In these cases, the securities are never subject to the registration requirements regardless of the character of the transaction.¹⁸ Consequently, they are considered "securities" exemptions. Another "securities" exemption is provided for securities issued by state and local governmental bodies.¹⁹ In contrast to the regulation of transactions in securities covered by many of the other exemptive

⁸ See SEC Securities Act Release No. 5450, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 2340, at 2611 (Jan. 7, 1974); SEC Rule 144, 17 C.F.R. § 230.144 (1974).

⁹ See SEC Rule 146, 39 Fed. Reg. 15266 (1974).

¹⁰ See *id.*

¹¹ See Uniform Securities Act §§ 301-06.

¹² *Id.* § 101.

¹³ See, e.g., Iowa Code Ann. § 502.10(5) (1971) (permitting denial of registration based on the reputation or business condition of the issuer).

¹⁴ See SEC Securities Act Release No. 5450, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 2340, at 2611 (Jan. 7, 1974); SEC Securities Act Release No. 4434, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 2270, at 2580 (Dec. 6, 1961).

¹⁵ Securities Act § 3(a)(8), 15 U.S.C. § 77c(a)(8) (1970).

¹⁶ Securities Act § 3(a)(6), 15 U.S.C. § 77c(a)(6) (1970).

¹⁷ Securities Act § 3(a)(5), 15 U.S.C. § 77c(a)(5) (1970).

¹⁸ See Securities Act § 3(a), 15 U.S.C. § 77c(a) (1970), which provides in pertinent part: "Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities" This exemption is not as broad as it appears. For instance, SEC Securities Act Release No. 4434, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 2270, at 2580 (Dec. 6, 1961), states that certain "exempted securities" under § 3(a)(11) may require registration, although issued in an intrastate offering, if found to be part of a larger "issue." *Id.* at 2581. As to these, § 3(a) is, therefore, a transactional exemption.

¹⁹ Securities Act § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1970).

provisions, there are no supervisory bodies to ensure that standards of disclosure are enforced for the protection of investors in securities issued by state and local governments. Nevertheless, few defaults occur on the bonds issued by governmental bodies under this exemption.²⁰ There are practical investor protections present in these offerings, for even though offerings of governmental securities are often underwritten, the purchasers of these securities have tended to be sophisticated and small in number,²¹ and frequently are institutions or individuals from the same "locality" as the issuing governmental body.

One type of governmental security which has been issued with increasing frequency in recent years is the "industrial development bond." An industrial development bond offering involves an issuance of securities by a governmental body to provide funds for the acquisition or construction of facilities to be leased or purchased from the governmental body by a specific private enterprise. The amount involved in such an offering may be quite large. The impetus for the offering is provided by the private enterprise, and the governmental body participates as an accommodation. This arrangement provides tax benefits²² to the investors, so that the government can pay interest on the bonds lower than is paid on comparable corporate bonds.²³ The benefits of avoiding the necessity of registration, while perceived as important, are secondary to the tax benefits.

While the registration requirements are inapplicable to exempt offerings, the antifraud provisions contained in the Securities Act, particularly those of sections 12(2)²⁴ and 17(a),²⁵ and in the Se-

²⁰ Bahl & Wasylenko, *Conceptualizing and Measuring Government Credit Strength: A Proposal 5*; and Dearborn, *Cash Flow as a Measurement of Risk 1*, in *Collected Papers for Municipal Credit Information and Credit Quality User/Researcher Seminar* (Municipal Finance Officers' Ass'n, Oct. 31, 1974), on file at the offices of Boston College Industrial & Commercial Law Review.

²¹ Address by SEC Commissioner John R. Evans, *Municipal Finance Officers' Ass'n*, Washington, D.C., Oct. 31, 1974.

²² Int. Rev. Code of 1954, § 103(c) and the related regulations describe conditions under which interest paid on these bonds is exempted from federal income taxation.

²³ Since the interest on industrial development bonds is tax exempt in the hands of the purchaser, the after-tax yield of the bonds is higher than a comparable "corporate" bond at the same interest rate. Thus, tax exempt bonds may be issued at a lower interest rate and yet provide a comparable after-tax yield to the investor.

²⁴ 15 U.S.C. § 77l(2) (1970), which provides:

Any person who . . . (2) offers or sells a security (whether or not exempted by the provisions of [§ 3], other than paragraph (2) of subsection (a) [thereof]), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth

APPLICATION OF THE ANTIFRAUD PROVISIONS

curities Exchange Act of 1934 (Exchange Act or the 1934 Act),²⁶ particularly those contained in section 10(b),²⁷ in SEC Rule 10b-5²⁸ promulgated thereunder, and section 15(c)(1)²⁹ and Rule 15c1-2³⁰

or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

²⁵ 15 U.S.C. § 77q (1970), which provides in pertinent part:

(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) 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. . . .

(c) The exemptions provided in section [3] shall not apply to the provisions of this section.

²⁶ 15 U.S.C. §§ 78a-78j (1970) [hereinafter cited as the Exchange Act].

²⁷ 15 U.S.C. § 78j(b) (1970), which provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

²⁸ 17 C.F.R. § 240.10b-5 (1974). Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

²⁹ 15 U.S.C. § 78o(c)(1) (1970), which provides:

No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

³⁰ 17 C.F.R. § 240.15c1-2 (1974). Rule 15c1-2 provides in pertinent part:

(a) The term "manipulative, deceptive, or other fraudulent device or contriv-

thereunder, are nevertheless applicable. The disclosure documents which are furnished investors in exempt offerings are designed to satisfy the requirements of these provisions as well as the expectations of the investors for information on which to base their investment decisions.³¹ Partially because of the inapplicability of section 11³² of the Securities Act to exempt offerings, issuers, underwriters and others connected with the offerings have traditionally performed an investigation of the accuracy and sufficiency of the information in the disclosure documents that is generally less extensive than the investigation regarding the verification of information included in registration statements for registered offerings. At times, particular forms³³ prescribed by the Securities and Exchange Commission (the SEC or the Commission) for the registration of securities under the Securities Act have been relied upon as general guides in the preparation of these disclosure documents. However, given the relatively small amounts involved in many such offerings, the time and particularly the expense connected with a full investigation and with full compliance with the more general registration forms, such as Form S-1,³⁴ is often viewed by the participants as unnecessary, undesirable, and uneconomical.

In recent years, a number of general developments have occurred in the antifraud area which have an impact on exempt offerings. Several enforcement proceedings of the Commission and several proceedings instigated by buyers and sellers of securities have resulted in both specific applications of the antifraud provisions and interpretations of the extent of disclosure required by those provisions.³⁵ Furthermore, it now appears probable that legislation³⁶ will be passed by Congress to provide for comprehensive

ance", as used in section 15(c)(1) of the act . . . , is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

(b) The term "manipulative, deceptive, or other fraudulent device or contrivance", as used in section 15(c)(1) of the act, is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.

Id.

³¹ See text at notes 52-57 *infra*.

³² 15 U.S.C. § 77k (1970), which prescribes liability for fraudulent statements or omissions in a registration statement. See note 3 *supra*. Since an exempt transaction does not require a registration statement, § 11 does not apply.

³³ E.g., Securities Act Forms S-1, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 7121, at 6201; S-7, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 7190, at 6311; S-16, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 7291, at 6431.

³⁴ Securities Act Form S-1, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 7121, at 6201.

³⁵ See generally text at notes 66-69, 92, 95, 102, 105, 152, 159 *infra*.

³⁶ Municipal Securities Act of 1974, S. 2474, 93d Cong., 2d Sess. (1974).

regulation of activities of municipal securities dealers and to increase the powers of the SEC in this area. Other than the regulation itself, the most immediate result of these developments probably will be greatly increased attention, by the Commission and by private litigants, to transactions in governmental securities, including industrial development bonds.

Additional factors which may intensify the trends in the case of industrial development bonds include: (1) the political controversies which have continuously arisen in this area;³⁷ (2) the increases in the amount of industrial development bonds offered and sold in recent years³⁸ as a result of increased interest rates in the money markets, increased concern with pollution control, and increased awareness of the availability of this financing technique; and (3) a shift in marketing techniques by underwriters of these bonds toward the techniques used in marketing corporate securities.³⁹ This shift in marketing techniques includes greater reliance upon syndication and upon sales to members of the general public rather than to the traditional institutional buyers. This often has become necessary in order to reach new buyers for the larger bond amounts offered and to offset the relative unavailability of funds which the institutional buyers are increasingly experiencing. One consequence has been that underwriters of industrial development bonds now reach investors who are less sophisticated than the institutions which formerly dominated the industrial development bond investor market. In contrast to the institutional investors, these less sophisticated investors do not employ professional analysts with the ability to recognize a need for additional information and do not have the capability, through concentrated purchasing power and direct contact with the underwriters, to demand and receive this desired additional information.

The purpose of this article is to consider certain questions which have been raised regarding the application of the antifraud provisions to exempt offerings. These questions relate particularly to the degree of disclosure and to the extent of investigation which should be undertaken by counsel and by underwriters involved in such offerings. Many of the conclusions may be extended to other parties involved in the offerings, but the implications of the specific roles of these other parties are outside the scope of the article.⁴⁰

³⁷ Cf. Note, 41 Temp. L.Q. 289, 294-97 (1968).

³⁸ See Senate Comm. on Banking, Housing and Urban Affairs, *Municipal Securities Act of 1974*, S. Rep. No. 93-1145, 93d Cong., 2d Sess. (1974).

³⁹ See Address by John R. Evans, *supra* note 21.

⁴⁰ For a discussion of liabilities and investigatory duties of directors, see *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc); *Watson*, *Directors' Liability Under Rule 10b-5*, 12 Section on Corp., Banking & Sec. L. Bull. of Tex. St. Bar Ass'n 1 (1974). Regarding

Because of the special problems relating to governmental securities, especially industrial development bonds, some emphasis will be placed in the discussion upon offerings of these securities. Nevertheless, the discussion will have general applicability to other exempt offerings.

II. THE ANTIFRAUD PROVISIONS AND THEIR APPLICATION TO INVESTIGATORY PROCEDURES IN EXEMPT OFFERINGS

A. *Applicable Provisions*

Since certain offerings are exempt from the registration requirements, the basic regulatory scheme of the Securities Act is generally inapplicable to transactions involving securities issued as a result of those offerings. Consequently, there is no SEC review⁴¹ of disclosures made in connection with exempt offerings. Section 11,⁴² with its liabilities and explicit due diligence defense,⁴³ is inapplicable. There also is no requirement that any particular form promulgated under the Securities Act be used or that any particular pattern of disclosure be followed. However, certain provisions of the Securities Act are applicable to exempt transactions as well as to registered offerings. The most important provisions are contained in section 17,⁴⁴ the general antifraud section of the Securities Act. The existence of private rights of action under section 17 has been recognized by a number of courts.⁴⁵ In addition, under section 17, the Commission may take enforcement action (civil, criminal and administrative)⁴⁶ regarding misstatements or omissions in connection with the offering. Moreover, there is the possibility of an action brought by purchasers or the Commission pursuant to section 10(b)⁴⁷ of the Exchange Act and Rule 10b-5.⁴⁸ The existence of private rights of action under these provisions⁴⁹ is now well-established.

liabilities and duties of accountants, see Gormley, *Accountants' Professional Liability—A Ten-Year Review*, 29 *Bus. Law.* 1205 (1974).

⁴¹ Securities Act § 8, 15 U.S.C. § 77h (1970), only provides for review of disclosure made in registered offerings.

⁴² 15 U.S.C. § 77k (1970). For the text of § 11, see note 3 *supra*.

⁴³ See text at notes 90-97 *infra*.

⁴⁴ 15 U.S.C. § 77q (1970). For the text of § 17, see note 25 *supra*.

⁴⁵ E.g., *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089, 1095 (E.D. Pa. 1972); *Schaefer v. First Nat'l Bank*, 326 F. Supp. 1186, 1189-90 (N.D. Ill. 1970), appeal dismissed, 465 F.2d 234 (7th Cir. 1972); *Barnes v. Peat, Marwick, Mitchell & Co.*, 69 Misc. 2d 1068, 332 N.Y.S.2d 281, 282-84 (Sup. Ct. 1972), modified to grant stay of action, 42 App. Div. 2d 15, 344 N.Y.S.2d 645 (App. Div. 1973). *Contra*, *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890, 903-05 (D. Me. 1971).

⁴⁶ Securities Act §§ 8(b), 19, 20, 15 U.S.C. §§ 77h(b), 77s, 77l (1970).

⁴⁷ 15 U.S.C. § 78j(b) (1970). For the text of § 10(b), see note 27 *supra*.

⁴⁸ 17 C.F.R. § 240.10b-5 (1974). For the text of the Rule, see note 28 *supra*.

⁴⁹ See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

There has been a marked tendency to relax investigatory standards in exempt offerings as compared to registered offerings. This is true as to both municipal bonds and other exempt offerings. Since the issuing governmental bodies generally have access to funds through the taxing power and other sources to secure the payment of general obligation bonds, and since investors in governmental bonds have been relatively few in number⁵⁰ and have usually been highly sophisticated in financial matters, the need for a full investigation has not been felt in the past.⁵¹

In connection with an industrial bond offering, a disclosure document is prepared and distributed to potential investors, a practice not uncommon in exempt offerings. As in other offerings of governmental securities, the disclosure document is usually called an "official statement." This document contains disclosures relating to, among other matters, the bond terms and the governing indenture, a description of the transaction which includes the intended uses of the proceeds of the offering, and financial and descriptive information concerning the company involved. Since the bonds are revenue bonds to be paid from the proceeds of the lease or purchase by the company, the information concerning the company is particularly crucial information for the potential investors. However, reflecting the somewhat relaxed attitude regarding offers and sales of these bonds, official statements frequently contain a legend disclaiming responsibility for the information concerning the company.⁵² At times the legend appears on the first page of the information statement concerning the company. At other times, it appears as part of a longer "boilerplate" legend on the inside front cover of the official statement. In effect, such a legend informs the investor that the underwriter has been given the information by the company, but that the underwriter accepts no responsibility for the accuracy or completeness of the information even though contained in the official statement. This is therefore an attempt by the underwriter to avoid liability for misstatements in, or omissions from, the material

⁵⁰ See Address of John R. Evans, *supra* note 21.

⁵¹ The absence of defaults on general obligation bonds since World War II has undoubtedly fostered this attitude. See authorities cited at note 20 *supra*. The financial difficulties of certain metropolitan areas, such as New York City, and of certain governmental agencies, such as the New York State Urban Development Corporation, an issuer of bonds supported by a moral but not a legal obligation of the state of New York, in themselves suggest a need for reconsideration of these practices. See *Wall Street Journal*, Feb. 28, 1975, at 32, col. 1; *Wall Street Journal*, Mar. 12, 1975, at 28, cols. 1-3.

⁵² A typical legend provides: "The information contained herein as an Appendix to this Official Statement has been obtained from [the company], and the [governmental body] and [the underwriters] make no representations as to the accuracy or completeness of such information."

concerning the company, even though the underwriter may have undertaken no investigatory effort concerning that information.⁵³

Regardless of the legend, investors probably expect the underwriters to verify the information to a reasonable extent.⁵⁴ This is a traditional role of underwriters in registered offerings, and investigatory ability is one of the areas of expertise generally claimed by underwriters in selecting an issue for sale to the public. One SEC release contains adverse references to the use of similar legends in broker-dealer sales literature.⁵⁵ From this release, it appears to be the Commission's view that, while the use of the particular form of legend involved was not objectionable, the legend was of limited utility in avoiding liability. Indeed, the Commission has indicated that, since the protections of the registration requirements of the Securities Act are not present in such situations, brokers and dealers may have increased responsibilities to obtain adequate and accurate information in connection with recommendations made in unregistered distributions of securities, particularly of "obscure . . .

⁵³ Section 17 and Rule 10b-5 impose liability for misstatements in or omissions of material information upon persons who sell a security (and § 17 specifically includes offers). See notes 25, 28 *supra*. To the extent that securities are sold through firm commitment underwritings, as opposed to best efforts underwritings, these provisions are directly applicable to the underwriters since they actually purchase the securities and resell them to the investors using the disclosure documents as sales literature. Furthermore, the definitions of "sell" and "offer" in the Securities Act and the Exchange Act are sufficiently broad to include underwriting activities of even a "best efforts" nature. See Securities Act § 2(3), 15 U.S.C. § 77b(3) (1970); Exchange Act § 3(14), 15 U.S.C. § 78c(14) (1970).

⁵⁴ See Rice, *Recommendations by a Broker-Dealer: The Requirement for a Reasonable Basis*, 25 Mercer L. Rev. 537, 577-80 (1974).

⁵⁵ SEC Securities Act Release No. 3411, reprinted in 2 CCH Fed. Sec. L. Rep. ¶ 25,095, at 18207 (Apr. 10, 1951). The SEC General Counsel was asked to comment on the legality of "hedge clauses":

While the language of these hedge clauses varies considerably, in substance they state generally that the information furnished is obtained from sources believed to be reliable but that no assurance can be given as to its accuracy. Occasionally language is added to the effect that no liability is assumed with respect to such information. . . .

. . . The question arises . . . whether the result, if not the purpose, of such a legend is to create in the mind of the investor a belief that he has given up legal rights and is foreclosed from a remedy which he might otherwise have either at common law or under the SEC statutes.

In my opinion, *the anti-fraud provisions of the SEC statutes are violated by the employment of any legend, hedge clause or other provision which is likely to lead an investor to believe that he has in any way waived any right of action he may have*

Assuming the truth of the representations as to the source of the information and the belief that it is reliable, it is my opinion that the mere use of this legend in connection with a communication supplying information is not objectionable. *This does not mean, of course, that there would be any justification for representing to the investor, either when the information is supplied or thereafter, that the effect of the legend is to relieve the person using it from a liability under the above-mentioned statutory provisions and rules.*

Id. at 18207-08 (emphasis added).

[securities], with regard to which reliable information is not readily available. . . ."⁵⁶ Therefore, it is necessary to examine the degree to which the underwriters have responsibility for the information appearing in the disclosure documents. A threshold question, however, is the meaning of the term "materiality" as used in the antifraud provisions.

B. Scope of Adequate Disclosure

Liability under the securities laws attaches only for the misuse of information that is "material."⁵⁷ Perhaps the most significant observation regarding the meaning of the term "materiality" is that it is almost devoid of concrete meaning of useful value to the practitioner.⁵⁸ The "basic test" of materiality has been said to refer to "whether 'a reasonable man *would* attach importance [to the fact . . .] in determining his choice of action in the transaction in question'"⁵⁹ This "encompasses those facts 'which in reasonable and objective contemplation *might affect the value* of the corporation's stock or securities'"⁶⁰ Whatever the boundaries of even this vague definition, with its ties to the judgment of the market or to what reasonable investors *would* do, the Supreme Court in a recent case constructed even a more elusive definition: "All that is necessary is that the facts withheld be material in the sense that a reasonable investor *might* have considered them important in the making of [his] decision."⁶¹ In addition, disclosure is required not only of facts relevant to "conservative" investors, but also those relevant to speculative investors. "The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders."⁶²

The Second Circuit has given a small degree of substance to the term, although the specificity of the definition may limit its more general application: "[M]aterial facts include not only information disclosing the earnings and distributions of a company but also those

⁵⁶ SEC Securities Act Release No. 4445, reprinted in 2 CCH Fed. Sec. L. Rep. ¶ 22,753, at 16625 (Feb. 2, 1962).

⁵⁷ See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

⁵⁸ See R. Jennings & H. Marsh, Jr., Securities Regulation: Cases and Materials 1127-30 (3d ed. 1972).

⁵⁹ List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965), quoting Restatement of Torts § 538(2)(a), at 86 (1938) (emphasis added).

⁶⁰ 340 F.2d at 462, quoting Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963) (emphasis added).

⁶¹ Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (emphasis added).

⁶² SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities."⁶³ A few more specific determinations may also have some degree of general application. For instance, in *Escott v. BarChris Construction Corp.*,⁶⁴ material omissions included the nonenforceability of certain contracts⁶⁵ and the existence of certain contingent liabilities of the registrant under sale and leaseback arrangements.⁶⁶

While general parameters of the concept of materiality may be derived from specific examples of situations involving its application,⁶⁷ a truly useful definition seems impossible to frame. For the purposes of this article, it seems best to emphasize the generality and encompassing nature of the term. This will become especially apparent in the suggestion of due diligence procedures which are designed to uncover or verify material information.⁶⁸ An adequate understanding of the concept must include proper recognition of the complexity of some companies as contrasted with the simplicity of other companies. Briefly stated, materiality is a relative concept. Its application by the courts to securities transactions should be related both to the absolute amount of information available concerning a particular company, and to the significance of the information in relation to that company and the size of its business. Information which may be totally insignificant for a larger and more complex concern may be extremely material for another concern. A cursory descriptive statement concerning a business, such as that often used in sales literature for exempt offerings, does not necessarily, and indeed frequently does not, disclose all the negative or other information of which investors should be advised in order to make an informed investment decision.

C. *Reliance Upon Particular Forms as a Basis for Disclosure*

The discussion of materiality demonstrates that adherence to a particular form for registration statements under the Securities Act

⁶³ 401 F.2d at 849.

⁶⁴ 283 F. Supp. 643 (S.D.N.Y. 1968); Annot., 2 A.L.R. Fed. 86 (1969).

⁶⁵ 283 F. Supp. at 668-69.

⁶⁶ Id. at 664-65.

⁶⁷ A number of authorities have been reviewed by Paul Douglas Budd of Kutak Rock Cohen Cambell Garfinkle & Woodward, Omaha, Nebraska, for the purpose of extracting specific examples of material and nonmaterial misrepresentations and omissions in the use of information in connection with securities transactions to which the antifraud provisions of the federal securities laws are applicable. The goal is to provide to persons who must make judgments on materiality questions in connection with the preparation of disclosure documents for the offering and sale of securities some guidance apart from the very general "tests" of materiality which have been framed by the courts and the Commission. See Appendix A *infra*.

⁶⁸ See section IV, at 417-22 *infra*.

cannot conclusively provide an adequate basis for disclosure in a particular transaction. Even in registered offerings, the antifraud provisions override the requirements of a particular form regardless of whether reliance upon such a form takes into account the specifications of the Guides for Preparation and Filing of Registration Statements,⁶⁹ Regulation S-X⁷⁰ and the numerous interpretive releases⁷¹ of the Commission. Often, matters not referred to in the items of the form or the other sources are matters sufficiently material that investors should be informed of them. SEC Rule 408,⁷² promulgated under the 1933 Act, specifically directs that, in addition to the information required by a form, other material information must be included in a registration statement "as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."⁷³ Consequently, regardless of the form relied upon, it would not be advisable to conclude that matters not specifically covered by the form require no investigation or disclosure.

At times, in determining the items of disclosure required in an exempt offering, reliance is placed upon an abbreviated registration form such as Form S-7.⁷⁴ Particular problems which do not arise in connection with reliance upon Form S-1,⁷⁵ arise in connection with using Form S-7 as a model. For instance, Form S-7 is designed specifically for use by registrants meeting certain conditions imposed as a part of an intricate pattern of disclosure under the securities laws.⁷⁶ Among these conditions is the requirement that the registrant be a reporting company under the Exchange Act.⁷⁷ The Ex-

⁶⁹ The Guides for the Preparation and Filing of Registration Statements, SEC Securities Act Release No. 4936, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 3760, at 3303 (Dec. 9, 1968) [hereinafter referred to as the Guides]. See SEC Securities Act Release No. 4936, reprinted in [1967-69 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,636, at 83370 (Dec. 9, 1968).

⁷⁰ 17 C.F.R. Part 210 (1974).

⁷¹ See, e.g., SEC Securities Act Release No. 5466, reprinted in [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,699, at 83873 n.2 (Mar. 8, 1974); SEC Securities Act Release No. 5451, reprinted in [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,618, at 83655 (Jan. 7, 1974); SEC Securities Act Release No. 5447, reprinted in [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,607, at 83629 (Dec. 20, 1973).

⁷² 17 C.F.R. § 230.408 (1974), which states: "In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they were made, not misleading."

⁷³ Id. See SEC Securities Act Release No. 4886, reprinted in [1966-67 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,500, at 82895 (Nov. 29, 1967).

⁷⁴ SEC Form S-7, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 7190, at 6311.

⁷⁵ SEC Form S-1, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 7122, at 6201.

⁷⁶ See General Instructions to Form S-7, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 7190, at 6311-12.

⁷⁷ "The registrant [must have] been subject to and [must have] complied in all respects . . . with the requirements of Sections 13 and 14 of the [1934 Act] for a period of at least three fiscal years immediately preceding the filing of the registration statement on this

change Act requires reporting companies⁷⁸ to register securities and to file with the Commission on a continuing basis periodic reports⁷⁹ containing extensive financial and other current information concerning their businesses and related matters and to send to stockholders at least annually proxy material containing similar information.⁸⁰

The reporting requirements under the Exchange Act may differ significantly from those of Form S-7.⁸¹ Appendix B contains a comparison of the items of Form S-1, Form S-7 and the principal current reporting forms under the Exchange Act—Forms 10⁸² (the basic registration form) and 10-K⁸³ (the annual report). From the chart it can be seen that Form S-7 requires information comparable to Form S-1 as to matters specifically relating to the offering, such as: the plan of distribution; underwriting commission; use of proceeds; terms of the securities being registered; expenses of the offering; relationship with the registrant of experts named in the registration statement; and treatment of proceeds from stock being registered. In terms of substantive matters concerning the registrant, very little disclosure is required by Form S-7 as compared with Form S-1. However, it is important to note that in most of the areas where no disclosure or abbreviated disclosure is required by Form S-7, Forms 10 and 10-K (on file with and available for public inspection through the Commission) require disclosure similar to that of Form S-1. This close relationship between Form S-7 and the

form." *Id.* at 6311. See SEC Securities Act Release No. 4886, reprinted in [1966-67 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,500, at 82985 (Nov. 29, 1967). In adopting amendments to Form S-7, the Commission stated:

This form is a short form which may be used for registration of securities to be offered to the public for cash by *certain companies having established records of earnings and stability of management and business.*

The adoption of the amendments operates to broaden the availability of Form S-7 and are a part of a program which includes improvement in the disclosure required in reports under the Securities Exchange Act of 1934.

SEC, Securities Act Release No. 5100, reprinted in [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,927, at 80059 (Nov. 12, 1970) (emphasis added). According to Item 11 of Form S-7, the issuer must state, *inter alia*: that it is a reporting company; the types of information contained in proxy statements and that copies may be obtained from the SEC; on which exchanges the issuer's stock is listed and where reports may be inspected. SEC Form S-7, Item 11, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 7192, at 6319-2.

⁷⁸ See Exchange Act §§ 13, 14(d)(1), 15 U.S.C. §§ 78m, 78n(d)(1) (1970), which require certain companies to file with the Commission periodic reports containing extensive financial and other current information concerning their businesses and related matters and to send to stockholders proxy material containing similar information.

⁷⁹ See, e.g., SEC Form 10, reprinted in 3 CCH Fed. Sec. L. Rep. ¶ 27,301, at 21301; SEC Form 10-K, reprinted in 3 CCH Fed. Sec. L. Rep. ¶ 31,101, at 22051.

⁸⁰ See SEC Reg. 14A, 17 C.F.R. §§ 240.14a-1 to -103 (1974).

⁸¹ See Appendix B for a comparison of the items of Form S-1, Form S-7, and Forms 10 and 10K.

⁸² Reprinted in 3 CCH Fed. Sec. L. Rep. ¶ 27,301, at 21301.

⁸³ Reprinted in 3 CCH Fed. Sec. L. Rep. ¶ 31,101, at 22051.

current reporting forms is underscored by Item 11 of Form S-7, which requires *inter alia*, a reference in the prospectus to the information on file at the Commission and to the means of obtaining copies of that information.⁸⁴ Additional prerequisites for the use of Form S-7 include requirements that there be a continuity of management of the issuer, an absence of defaults under senior securities, and certain levels of earnings.⁸⁵ From these, it is apparent that the Commission does not regard the mere availability of additional information filed under the Exchange Act as sufficient justification for the omission of the information from a registration statement on Form S-7.

D. *Relationship of Registration Context Disclosure to
Disclosure in Exempt Offerings*

The procedural and other safeguards available in registered offerings, such as Commission review of registration statements, are not available in an exempt offering. A consequence is that the logic of the limited permission granted by the Commission for omission of certain information in a registration context (*e.g.*, use of Form S-7) cannot necessarily be extended to an exempt offering context. Many companies involved in exempt offerings are relatively new enterprises with short, if any, earnings history and no history of satisfying the reporting requirements of the Exchange Act. It is especially important that there be consideration of disclosure of many types of information relating to various attributes of these companies, although disclosure of such information would not be required by Form S-7. The inquiry into and search for the proper information to be disclosed should not end even with full consideration of the specific items of the more comprehensive Form S-1 and the Commission's specific releases and rules on disclosure. Nothing short of a full consideration of all the implications of all information of more than incidental importance to a company can satisfy the mandate of the antifraud provisions that all material information be disclosed.

It is probable that, in certain circumstances in an exempt offering, a particular form would call for disclosure of matters which are not "material." For instance, a relatively short descriptive statement may be all that is required concerning the business of a particularly "clean" company. In other cases, a relatively large degree of detail may be required. Although some guidelines may be developed to facilitate disclosure decisions, as indeed the forms and

⁸⁴ SEC Form S-7, Item 11, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 7192, at 6319-22. See note 77 *supra*.

⁸⁵ SEC Form S-7, General Instructions, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 7192, at 6311-12.

other sources are designed to do, ultimately it is necessary to develop a sensitivity of judgment as to issues of materiality in the variety of circumstances which will be encountered.⁸⁶

In many respects, the question of the advisability of refraining from making a disclosure which might otherwise be required by a reporting form in a registration context, or of omitting other information, relates to the strategy of disclosure. In most instances, disclosure of favorable information is advisable from a marketing standpoint, but may not be required from a legal standpoint beyond the provision of information necessary to create a descriptive context for the offering. However, the antifraud provisions normally would require disclosure at least of material information which may be unfavorable from a marketing standpoint. This does not mean, of course, that unfavorable information need always be presented in its worst light or even in a negative light. Techniques of draftsmanship, combined with the proper exercise of judgment as to the degree of materiality of a specific negative fact, often permit presentation in a neutral context, or even in a positive context, as a subtle qualification to a positive statement. Therefore, satisfaction of the requirements of full disclosure of material information, whether pursuant to or outside the requirements of a form, need not always be as painful as is sometimes feared.

Certain conclusions with respect to exempt offerings can be drawn from this discussion. First, in transactions involving companies meeting the requirements of Form S-7, a minimum procedure for disclosure documents prepared with the form as a general guide, should be the inclusion of a reference to information on file with the Commission and prescribed by Item 11 of that form. Appropriate representations of the companies, based on the requirements for the use of Form S-7, should be included in the underwriting agreements. Secondly, in connection with the preparation of disclosure documents for those companies and for companies not meeting the requirements of Form S-7, full consideration should be given to disclosure of information which would be required by Form S-1 in a registration context, as well as to disclosure of information which would be required by the Guides, Regulation S-X⁸⁷ and the various interpretive releases of the Commission. While information of this nature may frequently be nonmaterial for companies meeting the reporting and other requirements of Form S-7, disclosure of the information should be made even by these companies in the instances where it may be material. Consideration of disclosure is

⁸⁶ See note 69 *supra*.

⁸⁷ 17 C.F.R. Part 210 (1974).

particularly important for companies not meeting the requirements of Form S-7. Full consideration in all cases should be given to disclosure of information regarding all aspects of the transaction, the company and the company's business and management, without regard to whether a form or other source would prescribe disclosure of that specific type of information. There should be no automatic rejection of disclosure of any particular type of information. Full consideration of information entails full knowledge of that information and its implications. The only acceptable means for underwriters to gain that full knowledge is through performance of adequate due diligence procedures.⁸⁸

In short, consideration of the implications of the requirements of the antifraud provisions for disclosure of "material" information leads to the conclusion that fulfillment of the requirements of a particular form and other sources of specific examples by the Commission of information which should be disclosed in registration statements, while useful, does not necessarily provide an adequate means for determining sufficient disclosure. Abbreviated forms are particularly inadequate as general guides to disclosure.

III. STANDARDS FOR LIABILITY OF UNDERWRITERS UNDER THE ANTIFRAUD PROVISIONS

A. *Registered Offerings*

Consideration of the applicable investigatory standards and obligations of underwriters in a registration context provides a useful background for considering the development of those standards as applied to exempt offerings. Section 11⁸⁹ of the Securities Act establishes liability for specific classes of parties to a registered transaction. One class is the underwriters.⁹⁰ Section 11 further establishes the criteria for determining liability and provides a "due diligence" defense for efforts performed to prevent misstatements or omissions of material information.⁹¹ In effect, the diligence necessary, "that required of a prudent man in the management of his own property,"⁹² is comparable to that required under a negligence standard.⁹³ A similar defense is provided in section 12(2)⁹⁴ relating to

⁸⁸ See section IV, at 417-22 *infra*.

⁸⁹ 15 U.S.C. § 77k (1970). For the text of § 11, see note 3 *supra*.

⁹⁰ Securities Act § 11(a)(5), 15 U.S.C. § 77k(a)(5) (1970).

⁹¹ Securities Act § 11(b), 15 U.S.C. § 77k(b) (1970). See note 3 *supra*; Annot., 2 A.L.R. Fed. 180 (1969).

⁹² Securities Act § 11(c), 15 U.S.C. § 77k(c) (1970). See note 3 *supra*.

⁹³ 2 A. Bromberg, *Securities Law: Fraud—SEC Rule 10b-5* § 7.2(4)(d), at 154.1-2 (1973). This standard should be contrasted with the standard of an ordinary prudent man "in similar circumstances." See *Selheimer v. Manganese Corp. of America*, 423 Pa. 563, 573-78, 224 A.2d 634, 640-43 (1966).

⁹⁴ 77 U.S.C. § 77l(2) (1970). For the text of § 12(2), see note 24 *supra*.

liabilities for misstatements in or omissions from prospectuses (broadly defined in section 2(10))⁹⁵ or oral communications. Under section 12(2), the person who offers or sells a security using a misleading prospectus must "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission"⁹⁶ This provision applies to most exempt offerings, but, unlike the general antifraud provisions, does not apply to offers and sales of a few exempt securities, including governmental securities.⁹⁷ Under these "due diligence" defenses, if an underwriter or other party who would otherwise be liable can show that a sufficient degree of investigation was made of the accuracy and sufficiency of the information in the registration statement or prospectus, then liability may be avoided. As a practical matter, this means a very substantial investigatory effort is necessary.

B. *Exempt Offerings*

There are several possible levels of culpability at which liability under the antifraud provisions could be imposed upon underwriters for misstatements or omissions in connection with exempt offerings. "Knowledge" is a readily acceptable basis for culpability. Certainly, liability could not be avoided where the underwriters knew information in sales material to be inaccurate or incomplete. Neither could liability be avoided where the underwriters had significant "notice" to this effect.

Whether the underwriters are required to take *affirmative action* and to accept responsibility under the antifraud provisions for investigating the accuracy and sufficiency of the sales material is one of the central questions posed by this section. Such an obligation could be applied at differing levels of culpability. If a duty to investigate is imposed, liability might extend only to matters which would require a minimal effort to verify: in essence, this would constitute a gross negligence or recklessness standard. Culpability might be expanded to encompass acts violative of the duty under an ordinary negligence standard. This would entail a duty to investigate the sufficiency and accuracy of the information in a manner similar to the investigation required to establish a due diligence defense under section 11 as to information contained in a registration statement. Absolute liability would make underwriters insurers of the accuracy or completeness of the information in the disclosure

⁹⁵ 15 U.S.C. § 77b(10) (1970).

⁹⁶ 15 U.S.C. § 77i(2) (1970).

⁹⁷ See note 24 *supra* & text at notes 15-19 *supra*.

documents. This could be accomplished on the theories that the general antifraud provisions⁹⁸ contain no due diligence defense, as sections 11 and 12(2) explicitly do, and that, as between the underwriters and the investors, the risk of loss should fall on the former. An extreme duty of investigation would be imposed by such a standard since any omission or significant misstatement of material information would result in liability. Under such a standard, significant investigatory efforts in which honest and nonnegligent mistakes have resulted in the disclosure of material misleading information would result in the same liability as outright fraud.

Unfortunately, it is not possible to determine with any certainty the direction in which the courts will go in fixing levels of responsibility. The degree of scienter required, if any, for imposition of liability under the antifraud provisions remains very unsettled and the courts themselves have produced perplexing results. The best analyses⁹⁹ of the numerous ambiguous and conflicting decisions note that, while several appellate courts have loosely stated that liability in private damage actions may be imposed for negligence or without evidence of fraudulent intent under section 17 and Rule 10b-5, no single case in which such a statement has been made actually involves conduct less culpable than recklessness, and frequently such cases involve actual knowledge of the falsity or omission in the disclosures made in the securities transactions.¹⁰⁰ In *Lanza v. Drexel & Co.*,¹⁰¹ the Court of Appeals for the Second Circuit explicitly rejected civil liability for damages to private litigants based on a negligence standard.¹⁰² However, the circuits which have stated an acceptance of such a standard are more numerous.¹⁰³ It should also be noted that even the Second Circuit accepts a negligence standard

⁹⁸ See text at notes 24-31 supra.

⁹⁹ See generally 2 A. Bromberg, supra note 93, § 8.4(585), at 204.213-218; Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U.L. Rev. 562, 562-64, 575-90 (1972); Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. Rev. 1206, 1206-20 (1970); Ruder & Cross, *Limitations on Civil Liability Under Rule 10b-5*, 1972 Duke L.J. 1125, 1140-42; Comment, *Lanza v. Drexel & Co. and Rule 10b-5: Approaching the Scienter Controversy in Private Actions*, 15 B.C. Ind. & Com. L. Rev. 526, 527-35 (1974); Note, *Scienter and Rule 10b-5*, 69 Colum. L. Rev. 1057, 1060-66 (1969).

¹⁰⁰ See authorities cited in note 99 supra. See, e.g., *Ellis v. Carter*, 291 F.2d 270, 271, 274 (9th Cir. 1961).

¹⁰¹ 479 F.2d 1277 (2d Cir. 1973) (en banc). See B.C. Comment, supra note 99.

¹⁰² 479 F.2d at 1304-05. In part, this was based upon an analysis of § 10(b), which contains the authority for the Commission to promulgate rules prohibiting "any manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b) (1970). The court opined that "[t]hese words negate a mere negligent omission or misrepresentation." 479 F.2d at 1305.

¹⁰³ E.g., *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961). See *Clegg v. Conk*, 507 F.2d 1351 (10th Cir. 1974) (causation, reliance, and scienter are required in a 10b-5 action).

in enforcement actions brought by the Commission for injunctive or other equitable relief.¹⁰⁴

Even if it is ultimately determined that negligence standards are inapplicable to many defendants in private litigation situations, several considerations may lead to the application of a negligence standard to underwriters. These considerations include: (1) the role of the underwriter as seller of the securities, often in privity with the buyers; (2) the traditional fiduciary responsibilities of underwriters, brokers and dealers imposed by the regulatory scheme of the securities laws; (3) the key position of the underwriter often as a party necessary to the accomplishment of even an exempt distribution of securities; (4) the normal status of the underwriter as the only party both adverse to management and in possession of sufficient expertise, funds, personnel, leverage and access to information to undertake an adequate investigation; (5) the reliance which many investors place upon the underwriter to make investigations in connection with the offering; and (6) the economic motivation of the underwriter for completion of the distribution.¹⁰⁵ Present in the industrial development bond situation is the additional factor of the increasing similarity between bond distribution and distribution of registered corporate securities.¹⁰⁶ This similarity may justify the conclusion that similar responsibility should be imposed in both situations.

In a few cases, the courts and the Commission have considered issues regarding duties of underwriters to investigate information used in disclosure documents prepared for exempt offerings. While these instances clearly establish the existence of a duty to investigate the information, they do not provide any substantial assistance in determining the degree of required investigation—whether liability extends to a negligence level, or merely to a gross negligence or recklessness level. In *Walston & Co.*¹⁰⁷ the Commission disciplined¹⁰⁸ the underwriter of an offering of governmental securities and the vice president and manager of the municipal bond department of the firm. Although it was not the principal underwriter, the

¹⁰⁴ SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-55 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). See authorities cited in note 99 supra.

¹⁰⁵ See Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,574, at 95998-99 (1974); Bucklo, supra note 99, at 595-96; Mann, supra note 99, at 1210-14, 1219-20; Rice, supra note 55, at 549, 551-52, 567-69, 570-72; Comment, 68 Colum. L. Rev. 1411, 1420-22 (1968); Note, 82 Harv. L. Rev. 908, 911-12 (1969) [hereinafter cited as Harvard Note].

¹⁰⁶ See Address by SEC Commissioner John R. Evans, Municipal Finance Officers' Ass'n, Washington, D.C., Oct. 31, 1974.

¹⁰⁷ SEC Securities Exchange Act Release No. 8165, reprinted in [1966-67 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,474, at 82942 (Sept. 22, 1967).

¹⁰⁸ Id. at 82945-46. The Commission's disciplinary powers with respect to nonmember broker-dealers are set forth in § 15(b)(5) of the 1934 Act, 15 U.S.C. § 78o(b)(5) (1970).

firm participated in the offering of bonds of a real estate development district. Its salesmen recommended to customers that the bonds be purchased, and in some instances referred to them as "good," "high grade" or "secure" tax-free municipal bonds. The Commission found, however, that "the bonds were highly speculative and of the most dubious investment quality."¹⁰⁹ According to the Commission, the respondents had a duty to make "diligent inquiry, investigation and disclosure" of material information in the sales literature.¹¹⁰ Certainly the Commission's statements in this release as to these obligations and the obligation to ensure that sales literature is based upon "an adequate investigation so that [it] accurately [reflects] all material facts which a prudent investor should know"¹¹¹ imply a rather thorough investigatory effort. The reference to a need for an investigation of the financial condition of the owner-developer appears to involve a gross negligence level of culpability. However, the reference to a need for investigation of the land which was to be developed with funds from the offering,¹¹² which would have disclosed its distance from schools and shopping areas and its location on an approach to an airport, implies an obligation higher than that imposed at a gross negligence level, particularly for a participating, as opposed to the principal, underwriter. In sum, the required efforts seem to refer to standards applicable in a registered offering. Moreover, the manager-vice president was said to have "willfully" violated the antifraud provisions by failing to undertake the investigation.¹¹³

In *Isthmus Steamship & Salvage Co.*,¹¹⁴ the Commission suspended a Regulation A exemption¹¹⁵ and imposed disciplinary action upon an underwriter in the offering.¹¹⁶ Although certain obvious misstatements and omissions in connection with the sales

¹⁰⁹ [1966-67 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,474, at 82944 (Sept. 22, 1967).

¹¹⁰ *Id.* at 82944-45. The Commission stated in the release:

It is, moreover, essential that dealers offering such bonds to the public make certain that the offering circulars and other selling literature are based upon an adequate investigation so that they accurately reflect all material facts which a prudent investor should know in order to evaluate the offering before reaching an investment decision. The offering circular used by registrant in this situation fell far short of that standard of disclosure.

Id. at 82945.

¹¹¹ *Id.*

¹¹² *Id.* at 82944.

¹¹³ *Id.* at 82945.

¹¹⁴ Securities Act Release No. 4716, reprinted in [1964-66 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,136, at 82132 (Aug. 20, 1964).

¹¹⁵ *Id.* at 82135. SEC Reg. A (SEC Rules 251-63), 17 C.F.R. §§ 230.251-.263 (1974), promulgated pursuant to Securities Act § 3(b), 15 U.S.C. § 77c(b) (1970).

¹¹⁶ [1964-66 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,136, at 82137-38.

presentations cloud the issue to some degree, the Commission did focus upon the degree of investigation of the information contained in the offering circular. The issuer was a salvage company which owned the salvage rights to a sunken vessel. According to the Commission, the underwriter had failed to "fulfill his duty . . . to exercise care, reasonable under all the circumstances, to satisfy himself as to the adequacy and accuracy of the offering circular."¹¹⁷ The failure to verify a version, furnished by the issuer, of a manifest purporting to list the goods on the vessel was considered a "willful" violation of the antifraud provisions.¹¹⁸ In *Albert J. DiGiacomo, d/b/a Albert James Co.*,¹¹⁹ an underwriter was disciplined for participating in an unregistered offering "without making a sufficiently reasonable and diligent inquiry into the nature and worth of the stock."¹²⁰ Again, this was described as a "willful" violation of the antifraud provisions.¹²¹

It is interesting that these violations were considered "willful." Such a finding was, of course, necessary since section 15(b)(5) of the Exchange Act¹²² requires such a conclusion in disciplinary cases.

¹¹⁷ *Id.* at 82137. The Commission stated:

[The underwriter] was aware that such appeal as the offering had lay primarily in the prospects for the salvage of the [vessel's] cargo, and that therefore the representations as to this matter in the offering circular were crucial. The unsigned and undated "Itemized Manifest," [prepared by the issuer] which was the sole basis for the statements in the offering circular, was shown to [the underwriter], but *he made no effort to verify the information contained therein. Neither did he make inquiry of his attorney as to the verity of this document, or as to what constituted the attorney's "investigation" of [the issuer].* We therefore find, as did the hearing examiner, that [the underwriter] did not fulfill his duty. . . .

Id. (emphasis added).

¹¹⁸ *Id.*

¹¹⁹ SEC Securities Exchange Act Release No. 7572, reprinted in [1964-66 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,227, at 82327 (Apr. 12, 1965).

¹²⁰ *Id.* at 82328. According to the Commission:

Such an inquiry would have revealed that the offering circular which he used in connection with this underwriting contained false and misleading statements of material facts regarding the company's business and financial condition, its capital structure and its future prospects. Such facts related to, among other things, the company's expenses and income, agreements to issue stock to a former director and to repurchase stock for the benefit of certain creditors, the book and future value of the stock, the production and sale of engines, the identity of the assignee of the exclusive license to manufacture J-F engines, and the assignment to creditors of title to certain equipment.

Id.

¹²¹ *Id.* See also *Charles E. Bailey & Co.*, 35 S.E.C. 33, 41-43 (1953); *Guardian Inv. Corp.*, SEC Securities Exchange Act Release No. 7284, reprinted in [1961-64 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,992, at 81650 (Apr. 1, 1964); *Heft, Kahn & Infante, Inc.*, SEC Securities Exchange Act Release No. 7020, reprinted in [1961-64 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,897, at 81313 (Feb. 11, 1963); *Alexander Reid & Co.*, SEC Securities Exchange Act Release No. 6727, reprinted in [1961-64 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,823, at 81071 (Feb. 8, 1962).

¹²² 15 U.S.C. § 78o(b)(5) (1970).

Where the "willfulness" is interpreted as a failure to investigate information in some detail, as opposed to a deliberate use of information known to be untrue, a firm due diligence obligation has been established. A finding of willfulness may avoid a relatively complex technical issue raised by the federal district court in *Thiele v. Shields*,¹²³ a decision that is particularly applicable to offerings of governmental securities.

In *Thiele*, the court found that underwriters of governmental securities could be held liable under the general antifraud provisions despite their particular exemption from liability under section 12(2) for misstatements and omissions.¹²⁴ Since section 12(2) liability may be imposed for negligence,¹²⁵ the court reasoned that the section 12(2) exemption from liability for negligent misrepresentations and omissions in offerings of governmental securities must have been intended by Congress to extend as well to section 17(a) of the Securities Act¹²⁶ and section 10(b) of the Exchange Act¹²⁷ although no such exemption is explicitly stated in those provisions.¹²⁸ The court concluded that antifraud liability for misstatements or omissions in connection with the offering and sale of governmental securities must be based upon a "knowing or intentional" misrepresentation and not upon failure to exercise "reasonable care in investigating the truth of a representation."¹²⁹ No other decision seems to have fully considered this narrow issue of statutory construction.

The *Thiele* theory is undercut, however, by several factors. These include (1) the Commission's approach of making a failure to investigate a "willful" violation;¹³⁰ (2) the rapid expansion of the application of the antifraud provisions since the date of the *Thiele* decision; and (3) the numerous decisions and authorities, particularly in the case of Commission enforcement actions, which rely

¹²³ 131 F. Supp. 416 (S.D.N.Y. 1955).

¹²⁴ *Id.* at 418-20.

¹²⁵ See note 24 *supra*.

¹²⁶ 15 U.S.C. § 77q(a) (1970).

¹²⁷ 15 U.S.C. § 78j(b) (1970).

¹²⁸ 131 F. Supp. at 418-20.

¹²⁹ *Id.* at 419. See also *Dorfman v. First Boston Corp.* 336 F. Supp. 1089, 1095 (E.D. Pa. 1972) (reading § 12(2) limitations into § 17(a)(2), but not into §§ 17(a)(1) or (3) which specifically refer to "fraud;" § 10(b) was not in issue); *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94, 98-102 (N.D. Ill. 1967) (reading § 12(2) limitations generally into the antifraud provisions); *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 767 (D. Colo. 1964) (referring in dictum to the requirement in *Thiele v. Shields* of knowing or intentional action in connection with sales of governmental securities). Compare *Montague v. Electronic Corp. of America*, 76 F. Supp. 933 (S.D.N.Y. 1948) (denying relief under § 10(b) in an action to which § 11 was applicable) with *Rosenberg v. Globe Aircraft Corp.*, 80 F. Supp. 123 (E.D. Pa. 1948) (applying requirements of § 11 to an action under § 10(b)).

¹³⁰ See text at notes 107-22 *supra*.

upon a negligence standard in other types of offerings.¹³¹ Adding further doubt and confusion, some courts have explicitly rejected the general principles of statutory construction in securities cases which would extend the limitations found in sections 11 and 12(2) to actions under section 17(a) of the Securities Act, and section 10(b) of the Exchange Act.¹³² Therefore, it is increasingly doubtful that underwriters can avoid liability for misstatements in or omissions from the disclosure documents even in offerings of governmental securities where the error could have been corrected by the exercise of due diligence.

Some support for such a position appears in *SEC v. Texas Gulf Sulphur Co.*,¹³³ where corporate management was held responsible to exercise "due diligence" in verifying information contained in a press release.¹³⁴ This result would seem to be based in part upon consideration of the fiduciary relationship of management to the stockholders and investing public.¹³⁵ Underwriters have a similar fiduciary role. Consequently, it would seem relatively easy for a court, utilizing hindsight, to find that an underwriter had "notice" or "reason to believe" that information was inaccurate or incomplete, or that (even if a negligence standard should be inapplicable) such an error could have been corrected through "minimal" investigatory efforts which were not undertaken.

It must be concluded that underwriters of exempt offerings have a substantial obligation to investigate information furnished by management for use in disclosure documents. The extent of the obligation is probably set at a negligence level, as it is in registered offerings, at least in Commission disciplinary and enforcement actions. Therefore, due diligence procedures, similar to those in registered offerings, should be undertaken in exempt offerings for the protection of the underwriters and their principals. Following less comprehensive procedures would entail a serious and substantial risk of liability in private actions and an even greater risk of penalties in actions initiated by the Commission.

In sum, the risks of liability are considerable. Since underwriters are accustomed to thinking in business terms, it might seem reasonable as a business judgment to prefer, on grounds of practicality, to accept the risks of liability on a gamble that the aggregate cost of investigation in all transactions is likely to be greater than

¹³¹ See text at notes 107-21 supra.

¹³² See, e.g., *Ellis v. Carter*, 291 F.2d 270, 273-74 (9th Cir. 1961).

¹³³ 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

¹³⁴ 401 F.2d at 863.

¹³⁵ See *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 541-42 (2d Cir. 1973) (attorney could be liable on similar considerations for issuing an opinion without an adequate investigation).

liabilities which may be incurred in a few transactions. Such a decision could result in lower ultimate cost to investors and a greater availability of funds to the issuers whose own investigations would be duplicated by the underwriters. However, a decision to accept the status of an insurer fails to take into consideration the potentially severe effects of disciplinary or enforcement actions by the Commission. Additionally, the provisions of section 15 of the Securities Act¹³⁶ and section 20 of the Exchange Act¹³⁷ in many instances impose liability upon "controlling persons" of violators, and it would not seem feasible, financially or professionally, for individual members of underwriting firms to accept the imposition of remedies for violations as a "business risk."

IV. THE MEANING OF "DUE DILIGENCE"

Since underwriters of exempt offerings have a substantial duty to investigate and verify information furnished by management for the disclosure documents, it is appropriate to consider specific due diligence procedures which may be followed to satisfy this duty. Unfortunately, the Commission has not published guides or standards for these procedures, although it has requested the National Association of Securities Dealers (NASD) to do so.¹³⁸ The sole substantial authority appears to be the proposed amendment to the Rules of Fair Practice of the NASD, formulated in response to the Commission's request.¹³⁹ While other sources contain a few useful suggestions,¹⁴⁰ in general they are quite inadequate for a full description of the investigation which should be undertaken. Therefore, to assist in the development of due diligence procedures, a fairly comprehensive list of activities which should be undertaken is set forth below.

Among the important factors to bear in mind in connection with the performance of the procedures are that (1) the procedures

¹³⁶ 15 U.S.C. § 77o (1970).

¹³⁷ 15 U.S.C. § 78t (1970).

¹³⁸ SEC Securities Act Release No. 5274, reprinted in [1972-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,905, at 81950-51 (July 25, 1972).

¹³⁹ The proposal has been published in Messer, Roles and Reasonable Expectations of the Underwriter, Lawyer and Independent Securities Auditor in the Efficient Provision of Verified Information: "Truth in Securities" Reinforced, 52 Neb. L. Rev. 429, 473-77 (1973).

¹⁴⁰ See Henkel, Liability of Counsel for Underwriter, 24 Bus. Law. 641, 651-55 (1969); Israels, Preparation of Registration Statement: Issuer's Counsel—Advice to My Client, 24 Bus. Law. 537 (1969); Israels, Checklist for Underwriters' Investigation, 18 Bus. Law. 90 (1962); Whitney, Underwriters' Counsel—Advice to My Client: "That Which Is Impossible Must Go Away!," 24 Bus. Law. 585 (1969); Harvard Note, *supra* note 105, at 910-16; Note, The Underwriter's Duty of "Due Diligence" Under Section 11 of the Securities Act: Reflections on BarChris, 22 Vand. L. Rev. 386, 394-405 (1969); Sommer, Memorandum Re: Escott v. BarChris Construction Corporation (1969) (unpublished) on file at the offices of Boston College Industrial & Commercial Law Review.

should be undertaken up to the date of closing to prevent misrepresentations and omissions resulting from last minute events; (2) one of the most effective safeguards is to become involved in offerings relating only to companies with reliable managements; (3) even in those cases, a healthy and severe skepticism must be exercised regarding the information furnished by management, evidenced by considerable questioning and discussion of that information; (4) a reasonable investigation must be undertaken as to every item of possibly material information, even from the most authoritative sources; (5) financial information (other than that relating to short unaudited periods) should be certified by accountants who are skilled in accounting matters under the securities laws; and (6) the underwriters should always be represented in the preparation of the disclosure documents and in the conduct of their investigation by legal counsel skilled in practicing under the securities laws. The performance of the suggested procedures should be further considered to include a qualification related to the reasonable availability of information, similar to the qualification provided for the preparation of registration statements in SEC Rule 409.¹⁴¹

Some allowance for the financial stability of the company also seems reasonable, and a correspondingly greater duty would appear for an underwriter dealing with a less stable issuer.¹⁴² Companies with managements accustomed to satisfying the disclosure requirements of the federal securities laws are generally more reliable and exercise a greater degree of care in the collection and preparation of disclosure information. Therefore, depending upon the facts in a particular case, it would seem reasonable to modify certain of the verification procedures for the more stable and experienced issuers, such as those meeting the requirements of Form S-7.¹⁴³ Nevertheless, even in these situations, the procedures (subject to appropriate

¹⁴¹ 17 C.F.R. § 230.409 (1974), which states:

Information required need be given only insofar as it is known or reasonably available to the registrant. If any required information is unknown and not reasonably available to the registrant, either because the obtaining thereof would involve unreasonable effort or expense, or because it rests peculiarly within the knowledge of another person not affiliated with the registrant, the information may be omitted, subject to the following conditions:

(a) The registrant shall give such information on the subject as it possesses or can acquire without unreasonable effort or expense, together with the sources thereof.

(b) The registrant shall include a statement either showing that unreasonable effort or expense would be involved or indicating the absence of any affiliation with the person within whose knowledge the information rests and stating the result of a request made to such person for the information.

¹⁴² See Charles E. Bailey & Co., 35 S.E.C. 33, 41-42 (1953); Henkel, *supra* note 140, at 648; Rice, *Recommendations by a Broker-Dealer: The Requirement for a Reasonable Basis*, 25 Mercer L. Rev. 537, 567-69 (1974).

¹⁴³ See text at notes 74-85 *supra*.

modifications) should be carried out as to events and information relating to periods subsequent to prior investigations performed by the firm. The important point is to avoid accepting management's representations as the final authority where verification is reasonably possible.¹⁴⁴

The specific procedures which are recommended are:

1. Review of all basic corporate documents for the company and its subsidiaries, such as articles of incorporation and by-laws, with all amendments thereto, using original or other authoritative sources for each;

2. Joint conferences attended by principal company officials, accountants, company counsel, representatives of the underwriters, and underwriters' counsel (1) to provide background, (2) to consider general issues and (3) to raise specific issues and thoroughly probing questions arising in the course of the performance of other due diligence activities;

3. Separate conferences with each principal company official and the head of each significant subsidiary, division and department regarding his background, company matters under his supervision and the adequacy of descriptive language in the disclosure documents in describing material matters fully and accurately;

4. Obtaining satisfactory written answers by all directors and principal officials of the company to a comprehensive set of questions based on the items in Form S-1, with the questions tied directly to the disclosure documents and passing on the accuracy and sufficiency of those documents and particular portions thereof in providing material information for investors;

5. Review of the minute books and stock records of the company and its subsidiaries covering all meetings and other events prior to the date of closing (unless a transfer agent or registrar is used, in which case basic verification as to amounts of issued securities and numbers of security holders may be obtained from such a source in the form of a certificate);

6. Comparison of previous financial statements of the company and of information (including financial statements and exhibits) regarding the company filed with the Commission within a given period, such as the previous ten years;

7. Review of recent financial statements for information which may have been inadequately disclosed in the text of the disclosure documents and for determination of trends and other issues (such as contingent liabilities) which may need further explanation in the financial statements or in the text. This may include review of

¹⁴⁴ See *Richmond Corp.*, 41 S.E.C. 398 (1963); *Charles E. Bailey & Co.*, 35 S.E.C. 33 (1953); *Harvard Note*, *supra* note 105, at 910.

matters of an unusual nature or complexity, consultation with outside accountants for an explanation of the treatment used in the financial statements and the adequacy and implications thereof;

8. Review of the circumstances surrounding changes in company auditors during the previous ten years;

9. Obtaining an adequate "cold comfort" letter from the accountants covering the period from the end of the period to which the certified financial statements relate to (1) the date of sale and (2) the date of closing, and making adequate comparisons with the periods covered by the certified financial statements;

10. Obtaining available information on the company, its subsidiaries and their officials from recognized services providing financial ratings and other information on corporations;

11. Review of all possibly material company contracts for legal enforceability and for determinations of materiality and adequacy of descriptive language in the disclosure documents. This should include a review of a representative sampling of all groups of similar contracts which are possibly material in the aggregate but not material on an individual basis (*e.g.*, a close review of five to ten of 30 voluminous lease agreements alleged to have substantially similar terms and, if those reviewed are in fact substantially similar, a more cursory review of the remaining agreements for basic terms such as rentals payable, expiration dates and facilities leased and for terms which appear to vary from the basic form of the documents);

12. Review of all employee plans (such as option, pension and profit sharing plans), budgets, backlog information, internal projects (including projected uses of proceeds of the offering), and plans of operation for the company and its subsidiaries (such as projected financing, supply or other needs and means of satisfying these needs);

13. Review of all possibly material patents, trademarks, copyrights, business secrets and other protective devices and the extent to which they protect the business and its confidential information;

14. Review of pleadings and other relevant information, and discussions with company counsel, regarding pending and threatened litigation;

15. Obtaining satisfactory opinions of company counsel on legal matters of particular interest (such as the existence and probable outcome of litigation, title to material properties, and antitrust and securities issues) where significant questions on such matters arise;

16. Where appropriate (*e.g.*, where the company and its subsidiaries may be particularly dependent upon banking relationships

APPLICATION OF THE ANTIFRAUD PROVISIONS

or a very small number of customers or suppliers), discussions with parties having special relationships with the company and its subsidiaries when particular information involving these parties or to which they may have special access appears material;

17. Where adequate information appears available and direct contact with certain parties referred to in paragraph 16 would be especially difficult or sensitive, a review of correspondence files relating to those parties as an alternative to the procedures described in paragraph 16;

18. Obtaining information from bond trustees on relationships with the company;

19. Tours of possibly material facilities (including an adequate sampling of facilities which may be material in the aggregate and which are alleged to be substantially similar), particularly tours of new facilities which have not been previously visited, with a view to (1) understanding the business and methods of operations, (2) verifying the existence and condition of the facilities, (3) determining the adequacy of descriptive language in the disclosure documents and (4) discussing matters of interest with lower level management and employees as a means of verifying information furnished by top management;

20. Obtaining information on the business of the company and its subsidiaries from engineering, production, marketing and other relevant business studies, and from trade publications, trade associations and other sources, including such information as identity, size and importance of principal industry competitors, the overall industry competitive structure, technological trends and supply and consumption problems;

21. Obtaining comprehensive representations and warranties from the company in the underwriting agreements, with certification as to continued accuracy thereof at the closing by the appropriate company officials (*e.g.*, generally, the president and treasurer or comptroller on financial matters and the president and secretary on corporate records and issuances of stock);

22. In general, using every reasonable opportunity for obtaining from the best possible sources documentary and other verification of the accuracy and adequacy of each item of material information furnished by management in connection with the preparation of the disclosure documents, taking into account (with no single factor being fully determinative) (1) the time involved, (2) the expense involved, (3) the amount of money involved in the transaction, (4) the probable importance of the information to be obtained, (5) the reliability of the source, (6) the likelihood of access by the source to accurate and complete information of the nature desired, (7) the

availability of alternative sources, and (8) possible consequences to the company of the inquiries, such as sensitivity of the source to inquiries of the nature which may be made (although at times, the sensitivity of the source may indicate the importance of an inquiry);

23. Retaining and, where necessary, preparing documentary evidence and records in memoranda and other forms describing in moderate detail the investigatory activities to the date of closing and the results of the investigation.

Upon completion of these procedures for each offering, the underwriters should be in a position to convince judicial or administrative officials of the fulfillment of any obligations of the underwriters under the antifraud provisions. It is probable that the present rate structure for underwritings of exempt offerings does not permit the fulfillment of these procedures in any substantial manner. Low commission levels, however, should not be relied upon as a defense against potential actions by private litigants or the SEC. Rather, in view of the developing applications of the antifraud provisions, it will probably become necessary for the rate structure to respond to the expenses incurred in the satisfaction of the due diligence obligations of underwriters. It will also be necessary for the rate structure to respond to changes in marketing techniques such as those used for offerings of industrial development bonds. These changes in marketing techniques have made the present rate structure less profitable than in the past. One result of the strong degree of protection of investors which is being required by the strict application of the antifraud provisions is a greater cost of raising capital.

V. THE ROLE OF COUNSEL

A. *Introduction*

While the underwriters of exempt offerings have a substantial obligation to investigate and verify the information concerning the company, it is likely that they frequently do not fulfill this obligation. In part, this is because the obligation has only fairly recently become apparent through developing trends in the law and changes in the techniques of conducting certain exempt offerings, such as industrial development bond offerings. This failure on the part of the underwriters could result in problems for counsel. It is possible for several law firms to be involved in an exempt offering. For instance, in an industrial development bond offering, the company may be represented by its counsel in connection with the negotiation of the terms of the transaction and the preparation of the disclosures in the official statement. The underwriters may be represented by their counsel on these matters as well. The governmental body is

represented by its counsel to ensure that it will have no obligation for the payment of the indebtedness evidenced by the bonds except to the extent of the proceeds from the lease or sale to the company.

Unlike the usual corporate securities transaction, another type of counsel, called "bond counsel," is generally involved in an industrial development bond offering. Reliance upon such counsel is a tradition stemming from the nature of the industrial development bond transaction as, technically, an issue of a security of the governmental body. Bond counsel has long been responsible for matters regarding the validity of the issuance of the bonds under the applicable state law. Bond counsel also considers tax questions under federal and state law. The opinions of different bond counsel are addressed to various parties, sometimes running to the company or the governmental body, sometimes to the underwriters and sometimes to the investors. Frequently, a particular bond counsel is employed by the company at the insistence of the underwriters. In these circumstances, the identity of the bond counsel's client is not always clear.

In many exempt transactions, particularly the smaller ones, the principals in the offering consider it uneconomical to retain a large number of attorneys. Insofar as the underwriters are concerned, this is in part due to the much lower rate structure for underwriting commissions and discounts in these transactions as compared to registered offerings. As a consequence, company counsel, or, in an industrial development bond offering, bond counsel, may be the only counsel which is relied upon in such a transaction. This means that the underwriters, and even the company, may not be represented by counsel experienced in the preparation of disclosure documents under the federal securities laws despite their responsibility for the preparation of the disclosure documents and the investigation and verification of the information contained therein. The retained counsel may have no securities law expertise. This is particularly true of bond counsel since their opinions generally do not cover such matters. Consequently, it is apparent that the obligations of the parties under the securities laws are not discharged. Retained counsel have responded to these problems in different ways.

Where the securities problems are ignored, counsel, particularly bond counsel, which has become concerned about its participation in what may be violations of the securities laws by the company and the underwriters, has declined to participate in meetings or discussions regarding the information in the disclosure documents except to the extent its opinion directly relates to this information (such as in a "Tax Matters" section). Presumably, this is to minimize inferences of "notice" to counsel of securities law problems arising in

connection with the transaction. In other cases, counsel has insisted that some investigation be conducted. However, this does not always result in performance of an adequate investigation, since the participants in the transaction are unaccustomed to or are unwilling to perform a full-fledged due diligence inquiry. In such cases, the attitude of counsel has been based upon a feeling that some investigation, however inadequate, is better than no investigation at all. In other cases, the underwriters of an industrial development bond offering, fearing liability, may employ bond counsel not only with respect to the issuance of the traditional bond counsel opinion but also to monitor or conduct the investigation.

B. *Theories of Liability of Counsel: Applicability of the ABA Code*

The purpose of this section is to consider the possibilities of successful litigation by private litigants or the Commission against counsel involved in exempt transactions. Several areas which may give rise to liability will be discussed after an initial examination of the implications of professional conduct standards imposed upon these attorneys.

The theories of attorneys' liability which will be discussed are theories which generate considerable controversy among members of the bar. They involve new approaches which could make the task of the securities practitioner extremely difficult considering the fact that the practice of securities law requires numerous fine judgments concerning factual and legal interpretations. These judgments must be made in a very complex and highly-pressured context. This difficulty is intensified by the rapidly changing interpretations of the securities laws which are often being applied expansively and retrospectively.

In part, the controversy has been viewed as a conflict between the interpretations of the Commission and other authorities as to "public interest" responsibilities of attorneys on the one hand and, on the other, the traditional conceptions of the responsibilities of attorneys to their clients under the old ABA Canons of Ethics¹⁴⁵ and the present ABA Code of Professional Responsibility.¹⁴⁶ However, in at least some respects, this conflict may be more apparent than real. The ABA Code itself reflects the conflicting considerations. It must also be noted that the facts upon which the expansive pronouncements by the courts and the Commission are based often

¹⁴⁵ ABA Canons of Professional Ethics.

¹⁴⁶ ABA Code of Professional Responsibility [hereinafter cited as ABA Code].

involve relatively extreme behavior on the part of the attorneys concerned.¹⁴⁷

As a background for the discussion of the various potential theories of liability of counsel, it is useful to review those provisions of the ABA Code pertinent to the issues. One relevant consideration is the obligation of an attorney under Canon 4 to "preserve the confidences and secrets of a client."¹⁴⁸ Adding definition to this, Ethical Consideration 4-1 states:

Both the fiduciary relationship existing between lawyer and client and the proper functioning of the legal system require the preservation by the lawyer of confidences and secrets of one who has employed or sought to employ him. A client must feel free to discuss whatever he wishes with his lawyer and a lawyer must be equally free to obtain information beyond that volunteered by his client. . . . The observance of the ethical obligation of a lawyer to hold inviolate the confidences and secrets of his client not only facilitates the full development of facts essential to proper representation of the client but also encourages laymen to seek early legal assistance.¹⁴⁹

Ethical Consideration 4-5 adds: "A lawyer should not use information acquired in the course of the representation of a client to the disadvantage of the client"¹⁵⁰ Disciplinary Rule 4-101(B)(1)¹⁵¹ states that "[e]xcept when permitted under DR 4-101(C), a lawyer shall not knowingly . . . reveal a confidence or secret of his client."¹⁵²

Disciplinary Rule 4-101(C)¹⁵³ lists certain situations in which a lawyer may reveal confidences or secrets of a client. This Disciplinary Rule does not impose an obligation for disclosure of the information. One class of information which may be revealed by the attorney is "[t]he intention of his client to commit a crime and the information necessary to prevent the crime."¹⁵⁴ While this Disciplinary Rule is framed in permissive terms, it is cross-referenced to

¹⁴⁷ See Karmel, Attorneys' Securities Laws Liabilities, 27 Bus. Law. 1153, 1155-60 (1972).

¹⁴⁸ ABA Code, Canon No. 4.

¹⁴⁹ ABA Code, EC 4-1.

¹⁵⁰ ABA Code, EC 4-5.

¹⁵¹ ABA Code, DR 4-101(B)(1).

¹⁵² Id.

¹⁵³ ABA Code, DR 4-101(C).

¹⁵⁴ ABA Code, DR 4-101(C)(3).

Opinion 314¹⁵⁵ which "indicates that a lawyer *must* disclose even the confidences of his clients [protected by the attorney-client privilege as well as the ethical rules] if 'the facts in the attorney's possession indicate *beyond reasonable doubt* that a crime *will be* committed.'" ¹⁵⁶ Prior to 1974, Disciplinary Rule 7-102(B)¹⁵⁷ had added a further mandatory tone to the obligation to disclose certain confidences and secrets of a client:

A lawyer who receives information clearly establishing that his client has, *in the course of the representation*, perpetrated a *fraud* upon a person or tribunal shall promptly call upon his client to rectify the same and if his client refuses or is unable to do so, *he shall reveal the fraud to the affected person or tribunal.*¹⁵⁸

However, this rule was amended at the 1974 Midyear meeting of the House of Delegates of the American Bar Association to add at the end the phrase "except when the information is protected as a privileged communication."¹⁵⁹ Therefore, where it is indicated beyond a reasonable doubt that a crime will be committed, an obligation of disclosure exists under the ABA Code.

Disciplinary Rule 7-102(B),¹⁶⁰ however, places the attorney in a difficult position in borderline cases involving fraud disclosed to the attorney as committed during the course of the representation, during which time the information may be subject to the attorney-client privilege.¹⁶¹ If it is subject to the privilege, disclosure by the

¹⁵⁵ ABA Comm. on Professional Ethics, Opinions, No. 314 (1965) [hereinafter cited as ABA Opinion 314].

¹⁵⁶ ABA Code, DR 4-101(C)(3) n.16, quoting ABA Opinion 314, *supra* note 155 (emphasis added).

¹⁵⁷ ABA Code, DR 7-102(B).

¹⁵⁸ *Id.* (emphasis added). But see ABA Comm. on Professional Ethics, Opinions, No. 287 (1953) (prohibiting an attorney from divulging perjury committed during a completed divorce proceeding where the other party, but not the court, was aware of the falsehood, but mandating a refusal to continue to represent the client if the client refuses to make disclosure on his own). According to the American Bar Association, the reference to "fraud" in DR 7-102(B) contemplates fraud "in the common law, or, at least in a traditional or conventional sense," thus excluding the broader concepts of fraud under the antifraud provisions. Report on the Code of Professional Responsibility in the Context of the Committee's "Phase I Inquiry," ABA Comm. on Counsel Responsibility, Section of Corp., Banking & Bus. L., 10-11 (unpublished 5th draft, Jan. 22, 1975) [hereinafter cited as ABA Phase I Report].

¹⁵⁹ ABA, 1974 Midyear Meeting: Summary of Action and Reports to the House of Delegates, Reports 118 and 127 (1974). The "privileged communications" which are protected may be only those covered by the attorney-client privilege, rather than the broader obligations under the Code to protect the "confidences" and "secrets" of clients. ABA Phase I Report, *supra* note 158, at 11.

¹⁶⁰ ABA Code, DR 7-102(B).

¹⁶¹ After noting that ABA Opinion 314, *supra* note 155, seems to have established, as of 1965, a new obligation to disclose prospective illegal activity and that Disciplinary Rule 7-102(B), as it existed prior to the 1974 amendment, appeared "to make a clean break with the

attorney is forbidden by Disciplinary Rule 4-101(B)(1). If the information is not subject to the privilege, disclosure is required by Disciplinary Rule 7-102(B). An erroneous determination as to the existence of the privilege could mean a violation of a Disciplinary Rule. However, there is a safety valve. If there remains a reasonable doubt that a crime will be committed, the obligation ends and the permissive provisions of Disciplinary Rule 4-101(C) become applicable so long as there is merely an "intention" of the client to commit a crime. This may save the attorney from liability in a securities context when the client's actions reflect an intention to commit an act which would constitute a crime, presumably even though a reasonable doubt may exist that a crime actually will be committed. If the ABA Code did not at least *permit* disclosure by the attorney under such circumstances, positions taken by the Commission requiring disclosure of such information,¹⁶² if applied

past view of an attorney's obligation to disclose his client's fraud," one commentator has stated: "It is probably fair to say that few lawyers appreciated the increased emphasis on public accountability manifested in [ABA Opinion 314] and Disciplinary Rule 7-102(B)." Freeman, *Opinion Letters and Professionalism*, 1973 Duke L.J. 371, 433. Since the amendment to Disciplinary Rule 7-102(B) was passed, it is apparent that this failure has now been appreciated and that the ABA Code no longer emphasizes "public accountability" to the same extent.

If we bear in mind the recognition by the ABA Code of the considerations placing conflicting demands upon an attorney, and the manner in which it resolves these matters, we will be assisted in the development of a rational analysis of the potential theories of liability of counsel.

¹⁶² Regarding the duty which the Commission is attempting to create, one commentator has stated:

[It] would conflict with one of the basic social policies underlying the attorney-client privilege: that of encouraging clients to seek legal advice. Indeed, to burden securities lawyers with a general burden of public disclosure could be counterproductive. The corporate securities bar today, because of its skills in fact gathering and dissemination and its high standard of professional responsibility, plays a vital role in realizing the goals of the securities laws and ensuring that the flow of information to the investing public is as complete and accurate as possible. Were corporate managers to feel that their attorneys were no longer entitled to act in their traditional role of confidential counselor to corporate clients, they might be less inclined to communicate with their attorneys and become overly cautious about what they would reveal. The end result might then be less, rather than more disclosure of material information. Of course, it does not follow that the issuer client will never be liable where the attorney is not obligated to report a nondisclosure.

Small, *An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?*, 61 Calif. L. Rev. 1189, 1227 (1973). The ABA Report takes the position that disclosure *must* occur when the client's conduct is part of a "patently fraudulent continuing scheme" and the attorney continues the representation. However, "since the lawyer must *know* that the client's conduct is illegal, it seems apparent that the lawyer must be protected in his conduct where he acted in good faith. Unless it clearly appears that the client's conduct is illegal, the lawyer is not free to reveal his secrets." Further, unless acting in bad faith, if the attorney fails to recognize the problem in a determination of materiality through inadvertence, or even simple negligence, his conduct should not amount to a violation of DR 7-102(B)(2) whatever the result of an action for negligence or malpractice. ABA Phase I Report, *supra* note 158, at 12, 17, 19.

to counsel, would require the attorney to choose between violating his obligation to preserve client confidences and violating Rule 10b-5.

A further issue arises from the SEC's position that attorneys have duties running to investors as well as to their clients. Canon 5 of the ABA Code provides that the lawyer's duties and loyalties should run to the client.¹⁶³ However, Canon 7 contains the offsetting consideration that "[a] lawyer should represent a client zealously *within the bounds of the law*."¹⁶⁴ Ethical Consideration 7-5 further reveals the advisor-advocate dual role:

A lawyer as adviser furthers the interest of his client by giving his professional opinion as to what he believes would likely be the ultimate decision of the courts on the matter at hand and by informing his client of the practical effect of such decision. *He may continue in the representation of his client* even though his client has elected to pursue a course of conduct contrary to the advice of the lawyer so long as he does not thereby knowingly assist the

¹⁶³ Ethical Consideration 5-1, ABA Code, EC 5-1, states:

The professional judgment of a lawyer should be exercised, within the bounds of the law, solely for the benefit of his client and free of compromising influences and loyalties. Neither his personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute his loyalty to his client.

A relevant consideration supporting this rule appears in a note citing *Grievance Comm. v. Rattner*, 152 Conn. 59, 203 A.2d 82 (1964), to the effect that "[w]hen a client engages the services of a lawyer in a given piece of business he is entitled to feel that, until that business is finally disposed of in some manner, he has the undivided loyalty of the one upon whom he looks as his advocate and his champion. . . ." *Id.* at 65, 203 A.2d at 84. See also ABA Code, DR 5-105, & DR 5-107.

¹⁶⁴ ABA Code, Canon No. 7 (emphasis added). Disciplinary Rule 7-101, ABA Code, DR 7-101, prohibits a lawyer from "intentionally" failing to "seek the lawful objectives of his client through reasonably available means," and Disciplinary Rule 7-102, ABA Code DR 7-102, prohibits a lawyer from counselling or assisting "his client in conduct that the lawyer knows to be illegal or fraudulent." This is repeated in Ethical Consideration 7-1, ABA Code, EC 7-1, which states:

The duty of a lawyer, both to his client and to the legal system, is to represent his client zealously within the bounds of the law, which includes Disciplinary Rules and enforceable professional regulations. The professional responsibility of a lawyer derives from his membership in a profession which has the duty of assisting members of the public to secure and protect available legal rights and benefits.

Ethical Consideration 7-3, ABA Code, EC 7-3, adds:

Where the bounds of law are uncertain, the action of a lawyer may depend on whether he is serving as advocate or adviser. A lawyer may serve simultaneously as both advocate and adviser, but the two roles are essentially different. In asserting a position on behalf of his client, an advocate for the most part deals with past conduct and must take the facts as he finds them. By contrast, a lawyer serving as adviser primarily assists his client in determining the course of future conduct and relationships. While serving as advocate, a lawyer should resolve in favor of his client doubts as to the bounds of the law. In serving a client as adviser, a lawyer in appropriate circumstances should give his professional opinion as to what the ultimate decisions of the courts would likely be as to the applicable law.

*client to engage in illegal conduct or to take a frivolous legal position. A lawyer should never encourage or aid his client to commit criminal acts or counsel his client on how to violate the law and avoid punishment therefor.*¹⁶⁵

Therefore, under the ABA Code an attorney cannot assist a client in illegal conduct, and if such conduct is to be engaged in by the client, the lawyer should disclose this and may discharge the client.

C. *Liability as an Aider and Abettor*

The Commission and private litigants have sought to impose obligations under the securities laws upon an everwidening circle of participants. For instance, a consent decree has been entered against a public relations firm which agreed to investigate the information it publicizes on behalf of its clients.¹⁶⁶ The Commission has also censured a bank for "willfully" violating the antifraud provisions and aiding and abetting violations through sales of unregistered securities on behalf of an account maintained at the bank.¹⁶⁷ Although the bank was not aware of the violation, the Commission reasoned that banks should take precautions similar to those taken by brokers to avoid misuse of such accounts.¹⁶⁸ For the first time, the Commission has acted against bond counsel in a financing arrangement similar to an industrial development bond offering,¹⁶⁹ as well as against the underwriter, the company and their principals.¹⁷⁰ The order against the bond counsel in proceedings pursuant to Rule 2(e)¹⁷¹ of the Commission's Rules of Practice states the Commission's view that the counsel had *inter alia* a previous relationship with the developer involved and "should have known, if he did not know" of material omissions in the disclosure documents for the offering.¹⁷² The settlement offer of the counsel included adoption of certain investigatory procedures.¹⁷³

¹⁶⁵ ABA Code, EC 7-5 (emphasis added). See also Disciplinary Rule 2-110(C), ABA Code, DR 2-110(C), which permits, but does not require, withdrawal from representation where a client "seeks to pursue an illegal course of conduct," ABA Code, DR 2-110(C)(1)(b), or "insists" that the attorney pursue such course. ABA Code, DR 2-110(C)(1)(c).

¹⁶⁶ SEC v. Pig 'N Whistle Corp., [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,384, at 91969-3 (N.D. Ill. 1972).

¹⁶⁷ Southern Cal. First Nat'l Bank, SEC Securities Exchange Act Release No. 9289, reprinted in [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,204, at 80593 (Aug. 16, 1971).

¹⁶⁸ Id. at 80594.

¹⁶⁹ Jo M. Ferguson, SEC Securities Act Release No. 5523 (Aug. 21, 1974). See SEC v. R.J. Allen & Associates, Inc., Civil No. 74-1273-Civ-CF (S.D. Fla., Dec. 1974); SEC Litigation Release No. 5656 (Dec. 27, 1974).

¹⁷⁰ SEC v. Senex Corp., Civil No. 74-53 (E.D. Ky., filed July 24, 1974).

¹⁷¹ SEC Rule 2(e), 17 C.F.R. § 201.2(e) (1974).

¹⁷² SEC v. Senex Corp., Civil No. 74-53 (E.D. Ky., filed July 24, 1974).

¹⁷³ The firm agreed to the following procedures in the decree:

The question of potential liability of counsel in exempt offerings due to failure to discharge obligations under the antifraud provisions of the federal securities laws is therefore a highly relevant and timely issue. The settlement offer described above¹⁷⁴ recognizes a duty of bond counsel to the investors, and indeed evidences a recognition by counsel that it represents the investors. However, it is interesting to note that any investigation required of bond counsel as a result of the settlement offer is much more like that necessary to avoid liability under a gross negligence than under a negligence standard. The investigation consists of obtaining audited financial statements, investigation of the background of the parties to the transaction and obtaining assurances of the parties and counsel to the company as to completeness of information in the official statement.¹⁷⁵

1. *Private Actions and Commission Enforcement Actions*

In a comprehensive and careful analysis of the elements of aiding and abetting, Professor Ruder lists the elements as (1) an independent wrong by the primary violator, (2) "knowledge" by the defendant of the wrong and (3) assistance by the defendant to the wrongdoer in the completion of the wrong after such knowledge.¹⁷⁶ The "knowledge" requirement may be satisfied by a reckless refusal to consider and investigate facts indicating the wrong.¹⁷⁷

Indeed, the rapidly developing law in this area is tending toward the establishment of a duty to investigate under certain

(1) Every two weeks, members of the firm meet and discuss all of their active cases. Affirmative approval of each partner is required before the issuance of any legal opinion. (2) The firm will *undertake an appropriate investigation* in connection with acting as bond counsel including, among other things, obtaining independently-audited financial statements and inquiring into the background of the various parties connected with the offering. Written evidence of such investigations and the results thereof will be reviewed by the partners of the firm. (3) An appropriate "engagement letter" will be sent to all interested parties, *emphasizing that the firm's duty is to the issuer and the bondholders*. It will define the scope of the firm's work as bond counsel and *required submission to it of certain pertinent information*. (4) The firm will require that it receive independently-audited financial statements, *representations from appropriate interested persons concerning the accuracy and completeness of the statements about them* in any offering circulars, and a *statement from counsel for any lessee or guarantor that such counsel has reviewed the offering circular and is aware of no inaccuracies therein*. (5) Partners and associates of the firm will attend, at least annually, municipal bond workshops and seminars.

Id.

¹⁷⁴ See note 173 *supra*.

¹⁷⁵ See note 173 *supra*.

¹⁷⁶ Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, *In Pari Delicto*, Indemnification, and Contribution, 120 U. Pa. L. Rev. 597, 620-38 (1972).

¹⁷⁷ Id. at 634-35, 638. See Johnson, The Expanding Responsibilities of Attorneys in Practice Before the SEC: Disciplinary Proceedings Under Rule 2(e) of the Commission's Rules of Practice, 25 Mercer L. Rev. 637, 660 (1974).

circumstances even where there is no indication of an independent wrong. Such a duty, for instance, may be imposed upon accountants certifying financial statements if they wish to avoid aider and abettor status.¹⁷⁸ The result is a weakening of both the knowledge and assistance requirements so that even a negligent failure to investigate information which one has a duty to investigate could satisfy both requirements.

However, a strict reading of the requirements of an aider and abettor violation may be excessively narrow. Despite Professor Ruder's careful analysis, the court in *SEC v. Spectrum, Ltd.*¹⁷⁹ would make it easier for the Commission to establish a violation on the part of attorneys. The court rejected the position that knowledge or a reckless refusal to view the facts is required to establish a violation by counsel rendering certain opinions.¹⁸⁰ Although the conflicting evidence in the case could show actual knowledge or recklessness on the part of the defendant attorney regarding the failure of the issuer to comply with the registration requirements of the Securities Act, the court apparently sought to establish a duty of investigation for attorneys issuing opinions similar to that which may exist for accountants certifying financial statements. According to the court, a *negligent* failure to investigate the facts supporting an opinion for the sale of the securities without registration could give rise to an injunctive remedy in a Commission enforcement action.¹⁸¹

In a statement indicating a more extreme position, the court in *Black & Co. v. Nova-Tech, Inc.*¹⁸² held that under the Oregon securities laws,

[an attorney] need not have actual knowledge of an illegal securities transaction in order to become a "participant" in such sale. The fact that [the attorney] did not know, and could not have known, of the illegal quality of a securities

¹⁷⁸ See *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974); Ruder, *Aiding and Abetting*, 7 Rev. Sec. Reg. 882 (1974); News & Comment, *Seventh Circuit Applies "Flexible" Duty Standard to Auditors Charged with Aiding and Abetting Fraud*, BNA Sec. Reg. & L. Rep., Sept. 11, 1974, at A-8.

¹⁷⁹ 489 F.2d 535 (2d Cir. 1973).

¹⁸⁰ *Id.* at 541.

¹⁸¹ *Id.*

In the distribution of unregistered securities, the preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience. The public trust demands more of its legal advisers than "customary" activities which prove to be careless. And, . . . where expediency precludes thorough investigation, an attorney can prevent the illicit use of his opinion letter by prohibiting its utilization in the sale of unregistered securities by a statement to that effect clearly appearing on the face of the letter.

Id. at 542.

¹⁸² 333 F. Supp. 468 (D. Ore. 1971).

transaction, while relevant to the issue of his liability, is not relevant to the issue of his participation.¹⁸³

In effect, such a position would turn the attorney *participating* in a securities transaction into a policeman.¹⁸⁴ The Commission has stated its view of what it considers to be the attorney's policing function in *Emanuel Fields*,¹⁸⁵ where the Commission referred to "the peculiarly strategic and especially central place of the private practicing lawyer in the investment process and in the enforcement of the body of federal law aimed at keeping that process fair . . ."¹⁸⁶ and added: "Members of this Commission have pointed out time and time again that the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders."¹⁸⁷ The Chairman of

¹⁸³ Id. at 472. This is similar to the *Spectrum* court's view. See note 184 *infra*.

¹⁸⁴ "The securities laws provide a myriad of safeguards designed to protect the interests of the investing public. Effective implementation of these safeguards, however, depends in large measure on the members of the bar who serve in an advisory capacity to those engaged in securities transactions." 489 F.2d at 536. See also Johnson, *supra* note 177, at 667.

¹⁸⁵ SEC Securities Act Release No. 5404, reprinted in [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,407, at 83172 (June 18, 1973).

¹⁸⁶ Id. at 83175 n.20.

¹⁸⁷ Id. The Commission continued:

These were statements of what all who are versed in the practicalities of securities law know to be a truism, i.e., that this Commission with its small staff, limited resources, and onerous tasks is peculiarly dependent on the probity and the diligence of the professionals who practice before it. Very little of a securities lawyer's work is adversary in character. He doesn't work in courtrooms where the pressure of vigilant adversaries and alert judges checks him. He works in his office where he prepares prospectuses, proxy statements, opinions of counsel, and other documents that we, our staff, the financial community, and the investing public must take on faith. This is a field where unscrupulous lawyers can inflict irreparable harm on those who rely on the disclosure documents that they produce. Hence we are under a duty to hold our bar to appropriately rigorous standards of professional honor.

Id. See Distribution By Broker-Dealers of Unregistered Securities, SEC Securities Act Release No. 4445, reprinted in 2 CCH Fed. Sec. L. Rep. ¶ 22,753, at 16625 (Feb. 2, 1962).

[The] practice of responsible counsel not to furnish an opinion concerning the availability of an exemption from registration under the Securities Act for a contemplated distribution *unless such counsel have themselves carefully examined all of the relevant circumstances and satisfied themselves, to the extent possible, that the contemplated transaction is, in fact, not a part of an unlawful distribution. Indeed, if an attorney furnishes an opinion based solely upon hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct.*

Id. (emphasis added). In *American Fin. Co.*, 40 S.E.C. 1043 (1962), the Commission had indicated a more traditional view: "Though owing a public responsibility, an attorney in acting as the client's adviser, defender, advocate and confidant enters into a personal relationship in which his *principal concern is with the interests and rights of his client*." Id. at 1049 (emphasis added). This was contrasted with the role of the accountant: "The requirement of the [Securities] Act of certification by an independent accountant, on the other hand, is intended to secure for the benefit of public investors the detached objectivity of a disinterested person." Id. at 1049. See also Cohen, *The Lawyer's Role in Securities Regulation*, 24 Bus. Law. 305, 307 (1968); Cooney, *The Implications of the Revolution in Securities Regulation for Lawyers*, 29 Bus. Law. 129, 130, 132-34 (Special Issue, Mar. 1974).

the SEC has referred to the Commission's desire to "rely on a small government police force" and that to do so it "must keep the pressure on the professionals to do a major part of the job—the protection of investors."¹⁸⁸

Taken literally, these views could impose a serious degree of liability upon legal practitioners for what are, in the context of a lengthy, complex and very difficult representation, relatively minor errors or lapses of judgment. Burdens of this nature are serious enough when placed upon the underwriters. Requiring secondary participants to duplicate the efforts of the primary participants seems unnecessary and would add little actual investor protection. These somewhat idealistic positions demand a degree of perfection which is very difficult to achieve, particularly since administrative and judicial judgments are made with hindsight and by viewing the particular errors in isolation from the context of the entire transaction. These positions would seem likely to have the unfortunate result of instilling such a degree of caution in counsel as to lengthen considerably and to add uneconomically to the expenses of the process of raising capital by small and new companies.¹⁸⁹ One may question whether such a result meshes with national economic policies of encouraging competition and new ventures through the antitrust laws¹⁹⁰ and whether such developments were intended by Congress in adopting the federal securities laws.

Certainly the ABA Code does not carry responsibilities of attorneys to the public nearly so far as do the more recent Commission and judicial pronouncements. Indeed, the ABA Code's emphasis upon protecting confidences and secrets of clients and giving clients undivided loyalty in legal representation¹⁹¹ places obligations upon attorneys directly counter to those which the Commission and the

¹⁸⁸ Garrett, *New Directions in Professional Responsibility*, 29 *Bus. Law.* 7, 10 (Special Issue, Mar. 1974).

¹⁸⁹ In most cases, the alleged aider and abettor . . . will merely be engaging in customary business activities, such as . . . giving legal advice. If [the attorney] will be required to investigate the ultimate activities of the party whom he is assisting, a burden may be imposed upon business activities that is too great. Although such a duty might contribute to the protection of investors by creating another level of private investigators, creation of such a duty through use of aiding and abetting . . . should take place only through the sound foundation of judicial precedent in analogous fields or express statutory language.

Ruder, *supra* note 176, at 632-33. Another commentator has suggested that requiring the bar to become an enforcement arm of the securities laws would reduce them to "one-armed sheriffs" because "sophisticated clients would quickly develop a system of . . . arcane disclosure to the lawyer" and the lawyer would frame answers to his client's questions in terms of his personal safety. Cooney, *supra* note 187, at 133. See also the excellent discussion in Messer, *supra* note 139, at 446-58.

¹⁹⁰ See generally 15 U.S.C. §§ 1-33 (1970).

¹⁹¹ See text at notes 148-65 *supra*.

Spectrum court seem to envision in situations not clearly involving fraud arising in the course of the representation or intended future violations of the law.¹⁹²

A more moderate, albeit indefinite, position than that stated by the *Spectrum* court and the Commission was taken by the court in *SEC v. Frank*.¹⁹³ There, the Commission brought an action against an attorney for alleged violations of the antifraud provisions and obtained an injunction in the lower court.¹⁹⁴ The alleged violations involved statements in disclosure documents concerning chemical processes and related tests and reports. The attorney took the position that he had no knowledge of the misrepresentations and had merely been a "scrivener" and attempted to place "in proper form" the position of the issuer's management as to the information. In remanding for a hearing to resolve issues of conflicting evidence, the court stated:

[A] lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand Whether the fraud sections of the securities laws go beyond this and require a lawyer passing on an offering circular to run down possible infirmities in his client's story of which he has been put on notice, and if so what efforts are required of him, is a closer question on which it is important that the court be seized of the precise facts, including the extent, as the SEC claimed with respect to Frank, to which his role went beyond a lawyer's normal one ¹⁹⁵

¹⁹² ABA Comm. on Professional Ethics, Opinions, No. 335 (1974) concludes, in issuing opinions on exemptions from the registration requirements for offers and sales of securities:

[A] lawyer should make adequate preparation including inquiry into the relevant facts . . . , and while he should not accept as true that which he should not reasonably believe to be true, he does not have the responsibility to "audit" the affairs of his client or to assume, without reasonable cause, that a client's statement of the facts cannot be relied upon.

Id. See also ABA Phase I Report, *supra* note 158, at 12-14, 17-19.

¹⁹³ 388 F.2d 486 (2d Cir. 1968).

¹⁹⁴ Id. at 487.

¹⁹⁵ Id. at 489. The court continued:

A lawyer has no privilege to assist in circulating a statement with regard to securities which he knows to be false simply because his client has furnished it to him. At the other extreme it would be unreasonable to hold a lawyer who was putting his client's description of a chemical process into understandable English to be guilty of fraud simply because of his failure to detect discrepancies between their description and technical reports available to him in a physical sense but beyond his ability to understand. The instant case lies between these extremes.

Id. One commentator observes:

In a very critical sense, [the attorney] is involved as the "first line of enforcement" in this facet of his craft. He can no longer take comfort as the "mere" scrivener. He must have a clear understanding of his role in this regard. . . . [A]s an investigator

Additional indications of developing responsibilities of securities attorneys are less certain. One of these appears in *Escott v. BarChris Construction Corp.*,¹⁹⁶ in which the court concluded that attorneys were not liable as "experts" for the purposes of section 11 of the Securities Act in connection with the preparation of a registration statement.¹⁹⁷ However, the court further concluded that an attorney who was also a director of the corporation and who participated in writing the registration statement was required to engage in a degree of investigation greater than that required of a director not connected with this work.¹⁹⁸ In *Blakely v. Lisac*,¹⁹⁹ a number of defendants, including a director of the issuer who was also an attorney, were sued for violations of the antifraud provisions. After noting a number of misstatements and omissions in the prospectus, the court held one defendant liable "both as a lawyer and as a director" for "misleading financial information in the prospectus which he should have investigated" in preparing the prospectus for the issuer.²⁰⁰ The attorney was found liable to stockholders who purchased in reliance on the prospectus and the reports, and was also required to account for profits from his own sale of stock of the issuer.²⁰¹

In an action which has implications for the theory of aider and abettor liability in exempt offerings, the Commission filed a highly controversial complaint in *SEC v. National Student Marketing Corp.*²⁰² Many of the duties which may be imposed upon counsel in

into the factual data, and as the sculptor of the written product, the cases have turned this aspect of the practice into an adversary process, involving attorneys and accountants on one side (though not always), and the issuer on the other, with the battle lines capable of shifting on occasion, and counsel mandated to be an advocate for the public "interest."

Johnson, *supra* note 177, at 664.

¹⁹⁶ 283 F. Supp. 643 (S.D.N.Y. 1968).

¹⁹⁷ *Id.* at 683.

¹⁹⁸ *Id.* at 690. A similar position was taken in *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 575-79 (E.D.N.Y. 1971).

¹⁹⁹ 357 F. Supp. 255 (D. Ore. 1972).

²⁰⁰ *Id.* at 266. After stating that the attorney (Gygi) was also a director, the opinion concluded:

[Gygi] relies on a statement by the plaintiffs that he is being sued as an attorney and not as a director. I am not bound by such statement, and I find that he is liable *both as a lawyer and as a director*.

Both as an attorney and as a director, Gygi knew or should have known of the misleading financial information in the prospectus which he should have investigated. Here Gygi's role was "beyond a lawyer's normal one," and he is held to even a higher standard of care. . . .

Gygi is also liable for the errors in the March 20 Report and the Annual Report. He, more than any other defendant, knew the importance of carefully investigating the validity of the statements in these reports.

Id. at 266-67 (emphasis added). See text at notes 193-95 *supra*.

²⁰¹ 357 F. Supp. at 267.

²⁰² Civil No. 225-72 (D.D.C., filed Feb. 3, 1972), complaint reprinted in [1971-72

exempt offerings under the expanding and developing law may have their roots in this complaint. In the complaint, the Commission requested injunctive action against certain attorneys and prominent law firms, charging that they violated and aided and abetted violations²⁰³ of certain provisions, including the antifraud sections, of the federal securities laws.

A brief review of the most important allegations of facts will assist in analyzing the complaint and its bearing on obligations of counsel. The central allegations concern a merger involving National Student Marketing Corporation (NSMC). The Commission alleged that proxy material, mailed to the shareholders of the merging corporation and the NSMC shareholders prior to the vote approving the merger included financial statements of NSMC reflecting an income of \$700,000 on an unaudited basis for a nine month period which ended only a few months prior to the vote. The merger agreement included in the proxy material required, as a condition to closing, a "cold comfort" letter from the accountants to NSMC as to the unaudited financial statements. The cold comfort letter was to state that the accountants had no reason to believe that the unaudited financial statements had not been prepared in accordance with generally accepted accounting principles or required material adjustments to fairly present the results of operations of NSMC for the nine month period and further that NSMC had suffered no material adverse change from the end of the unaudited period until five business days prior to the merger. The proxy material indicated that conditions placed upon the merger also included the delivery of opinions of counsel to NSMC and counsel to the merging corporation stating satisfaction of all other conditions to closing and compliance with federal and state securities laws. The merger agreement permitted waivers of conditions to closing.

At the closing, the accountants, after some confusion, delivered a qualified cold comfort letter disclosing that adjustments in the unaudited financial statements would be necessary. The accountants also disclosed to NSMC and its counsel (but not to the others present at the closing) that, if the adjustments were made, a net loss would be reflected for the nine month period and a "break-even" would be reflected for the year ended August 31, 1969. Nevertheless, counsel to NSMC delivered the required approving opinion, as did counsel to the merging corporation. Other controversial opinions and actions by the attorneys are alleged.

Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,360, at 91913 (1972). See *SEC v. National Student Mktg. Corp.*, 360 F. Supp. 284, 287-90 (D.D.C. 1973).

²⁰³ The bases of aider and abettor liability are described in *Ruder*, *supra* note 176, at 620-38.

According to the Commission, proceeding with the closing without disclosure of the information in the cold comfort letter to the public, to the shareholders of NSMC, or to the merging corporation, was a "fraudulent scheme" because the "defendants knew shareholder approval of the merger had been obtained on the basis of materially false and misleading financial statements of NSMC" ²⁰⁴ The Commission further contended that "[a]s part of the fraudulent scheme" the attorneys and firms "failed to refuse to issue their opinions . . . and failed to insist that the financial statements be revised and shareholders be resolicited, and failing that, to cease representing their respective clients and, under the circumstances, notify the plaintiff Commission concerning the misleading nature of the nine month financial statements." ²⁰⁵

The novelty of the complaint lies in the fact that prestigious law firms previously have not been the subject of such action by the Commission. An analysis of the alleged facts (assuming the truth of the allegations and viewing only those allegations) leads to the conclusion that there is a substantial possibility that the Commission is correct. NSMC and counsel had been involved in a very large number of mergers over a short period of time and such transactions frequently tend to require unanticipated last minute judgments of a complex nature. ²⁰⁶ Nevertheless, it does not seem that any serious question can be raised as to the "materiality" of the errors in the unaudited financial statements disclosed in the cold comfort letter. ²⁰⁷ Furthermore, the accountants had caused counsel to focus

²⁰⁴ [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,360 at 91913-16.

²⁰⁵ *Id.* at 91913-17.

²⁰⁶ See Johnson, *supra* note 177, at 655.

²⁰⁷ The materiality of the nondisclosure appears sufficiently obvious so that the intent necessary for commission of a crime might be found. If that is the case, the requirements of preservation of confidentiality of information relevant to that intent would not exist by virtue of Disciplinary Rule 4-101(C), ABA Code, DR 4-101(C). Permission to disclose the information would thus exist. Additionally, Ethical Consideration 7-5, ABA Code, EC 7-5, recommends withdrawal by the attorneys from the matter and Disciplinary Rule 7-102(B), ABA Code, DR 7-102(B), and ABA Opinion 314, *supra* note 155, require disclosure of the fraud to the shareholders of the merging corporation. See Meyerhofer v. Empire Fire & Marine Ins. Co., 497 F.2d 1190 (2d Cir. 1974) (an attorney was held to have acted in compliance with Disciplinary Rule 4-101(C) by disclosing facts surrounding possible violations of the Securities Act to defend himself. *Id.* at 1195. The disclosures were made to plaintiffs' counsel in an action brought by private litigants against a number of parties, including the attorney. Prior disclosure had been made to the Commission.). But see Karmel, Attorneys' Securities Laws Liabilities, 27 Bus. Law. 1153, 1162 (1972). Where the materiality of an omission or misstatement is not sufficiently clear to entail criminal intent on the part of the client, the information would be privileged and disclosure would be forbidden by the ABA Code.

Furthermore, it would appear that there is a substantial possibility that the individual attorneys participating in the matter did in fact aid and abet violations of the securities laws. Based upon such an analysis, there is no substantial conflict between the position of the Commission and the ABA Code on these matters. On the other hand, the SEC apparently feels that where criminal intent on the part of the client is absent but civil liability may be

sharply on, and to discuss, the particular figures in the financials.²⁰⁸ *National Student Marketing* does not involve a failure to recognize the importance of a figure buried in a mass of other material. Unless the misstatements were corrected, it seems inevitable that fraud had been or would have been committed. This appears to be a knowledge or gross negligence level of culpability rather than simply a negligence level.

Although the formulation of a legal opinion does not necessarily entail a duty of investigation by attorneys similar to that apparently developing for accountants, all three elements of an aider and abettor violation²⁰⁹ appear present in the facts alleged in the *National Student Marketing* complaint.²¹⁰ There was an independent wrong, the defendants can be said to have "known" of the independent wrong and the defendants issued their opinions and took other actions which assisted in furthering that wrong.²¹¹

It can be seen that attorneys as yet have no clear duty to investors at a negligence level, as opposed to a gross negligence level, for investigation and verification of information used in disclosure documents they prepare or used in transactions in which they participate. Nevertheless, there is sufficient developing precedent for counsel to proceed with considerable caution in an exempt offering, unless there is a reasonable assurance that someone is conducting such an investigation on behalf of the company and the underwriters. Such caution is necessary even if it is assumed that knowledge or recklessness is the appropriate level of culpability.

Applying the analysis used respecting the *National Student Marketing* facts to the circumstances frequently surrounding the involvement of counsel in an exempt offering, a serious question arises as to the aider and abettor status of counsel. It is clear that there is an independent violation by the underwriters where no investigation or an inadequate investigation of the material contained in the disclosure documents is made. The question of the knowledge or recklessness of the counsel is more complicated. In many cases, counsel is involved in numerous transactions involving the same underwriter. Over the course of time, it would seem inevitable that serious misrepresentations and omissions would be

imposed, the attorney is still subject to liability for nondisclosure as an aider and abettor. It seems unlikely that the ABA Code and its policies would prevail in a conflict with the federal securities laws and the policies supporting them.

²⁰⁸ In the trial of officers and accountants of NSMC completed in November 1974 in the Southern District of New York, convictions resulted on a number of counts. *Wall Street Journal*, Nov. 15, 1974, at 8, col. 2.

²⁰⁹ See text at note 176 *supra*.

²¹⁰ See Freeman, *supra* note 161, at 426, 429-31.

²¹¹ See *id.* at 424-25.

made on a repeated basis in many of these offerings. Counsel may not be aware of any particular misrepresentation or omission in any particular transaction. However, it would not seem necessary that counsel have such specific knowledge to be in violation as an aider and abettor. Rather, knowledge that the underwriter failed to investigate and verify information and the inevitability of the consequences of that failure would seem to be sufficient scienter, and certainly a sufficient degree of recklessness, to satisfy the "knowledge" requirement for an aider and abettor violation.²¹²

The third element of the violation²¹³ consists of taking action which assists in the consummation of the violation. Counsel may not, and bond counsel does not, advise the underwriters on all securities law matters except in circumstances where the employment is specifically directed to that end. Nevertheless, counsel furthers the violation by participating in the transaction and bond counsel does so by issuing its opinion as to tax consequences and validity of the issuance of the bonds. This would seem sufficient to meet the "assistance" element. A requirement that counsel actually participate in the preparation of inaccurate or insufficient disclosure documents to be connected with a securities law violation would be overly technical where counsel significantly assists in completing the transaction in other ways. Accordingly it must be concluded that counsel participating in an exempt transaction, with knowledge or clear notice that the underwriter is violating its obligation by not conducting a sufficient investigation of the material in the disclosure documents, would itself be subject to liability and penalties as an aider and abettor of the underwriter's violation.

Counsel should at least be satisfied that: (1) the company and the underwriters understand their obligations under the securities laws, including their investigatory obligations; (2) the company and the underwriters are attempting in good faith to satisfy those obligations (including obtaining advice from experienced securities attorneys); and (3) counsel itself has no notice of material misstatements or omissions in the disclosure documents or any other securities law violations in connection with the transaction. These conclusions are consistent with the procedures established by bond counsel in the consent decree in *Jo M. Ferguson*,²¹⁴ and should protect counsel from liability as an aider and abettor. However, they also require a drastic change in the procedures currently utilized in many exempt offerings.

²¹² See text at note 176 supra.

²¹³ See text at note 176 supra.

²¹⁴ SEC Securities Act Release No. 5523 (Aug. 21, 1974). See text at note 169 supra.

2. SEC Disciplinary Proceedings

The concomitants of liability or of injunctive action in a Commission enforcement proceeding are not the only risks to which counsel are subject as a result of securities law violations. Under Rule 2(e) of the Commission's Rules of Practice,²¹⁵ if the Commission finds a violation of the securities laws, it may temporarily or permanently deny to any person, including attorneys, the "privilege" of appearing or practicing before it.²¹⁶ The violation of the securities laws, rules or regulations must be "willful" or the person must have "willfully aided and abetted" the violation.²¹⁷ As noted previously,²¹⁸ the term "willful" has been used in disciplinary proceedings in a very broad sense to include a failure to conduct an investigation of information in disclosure documents as opposed to knowledge of the falsity or insufficiency of information or any other evidence of "evil motive."²¹⁹

Under the Rule, the Commission may also temporarily suspend from practice before it attorneys (1) subject to permanent court injunctions in connection with suits initiated by the SEC²²⁰ or (2) who are otherwise found by a court or by the Commission to have violated willfully or aided and abetted the violation of the securities laws.²²¹ The temporary suspension will become permanent after the elapse of 30 days if a petition is not filed by the attorney or, if a petition is filed and the Commission decides against the attorney, he may be "censure[d] . . . or disqualified" from appearing or practicing before the Commission for a period of time or permanently.²²²

The procedures which the Commission has recently created for hearings²²³ under the rule place an attorney at a severe disadvantage.²²⁴ In effect, through reliance upon an injunctive proceeding, the Commission can "place the [attorney] in a position of proving

²¹⁵ 17 C.F.R. § 201.2(e) (1974). See generally Comment, SEC Disciplinary Rules and the Federal Securities Laws: The Regulation, Role and Responsibilities of the Attorney, 1972 Duke L.J. 969.

²¹⁶ The term "practicing" is defined in SEC Rule 2(g), 17 C.F.R. § 201.2(g) (1974), to include, but not to be limited to, "(1) transacting any business with the Commission; and (2) the preparation of any statement, opinion or other paper by any attorney . . . filed with the Commission in any registration statement, notification, application, report or other document with the consent of such attorney . . ." Id.

²¹⁷ SEC Rule 2(e)(1)(iii), 17 C.F.R. § 201.2(e)(1)(iii) (1974).

²¹⁸ See text at notes 113-21 *supra*.

²¹⁹ See Johnson, *supra* note 177, at 643-44; Ruder, *supra* note 176, at 636-37.

²²⁰ SEC Rule 2(e)(3)(i)(a), 17 C.F.R. § 201.2(e)(3)(i)(a) (1974).

²²¹ SEC Rule 2(e)(3)(i)(b), 17 C.F.R. § 201.2(e)(3)(i)(b) (1974).

²²² SEC Rule 2(e)(3)(iii), 17 C.F.R. § 201.2(e)(3)(iii) (1974).

²²³ SEC Rules 2(e)(3)-26, 17 C.F.R. §§ 201.2(e)(3)-26 (1974).

²²⁴ See Comment, *supra* note 213, at 994-1022. Such procedures appear to be an attempt to avoid the adverse effects of a reversal of previous disciplinary action against an attorney on the grounds that improper evidence as to misconduct had been considered. Cf. *Kivitz v. SEC*, 475 F.2d 956, 960, 962 (D.C. Cir. 1973); Johnson, *supra* note 177, at 645-47.

that he should not have his license taken away from him" while preventing him from relitigating the facts underlying the injunction or other determination.²²⁵ Of course, the settling of injunctive actions through consent decrees, a common practice in which the defendant is subjected to a remedy without admitting or denying the allegations against him, has now become a very risky alternative. Additionally, the Commission has proposed to amend the rule to provide that it may, on its own motion, hold nonpublic hearings.²²⁶

Although appearance or practice before the Commission does not usually occur in an exempt offering, violations giving rise to discipline may arise from such an offering and affect counsel's ability to handle securities matters which do involve appearance or practice.

D. *Liability for Malpractice*

In some cases counsel, pursuant to a specific agreement of employment with the underwriter, undertakes an investigation of the information in the disclosure documents to provide some check as to the accuracy and sufficiency of that information. In agreeing to prepare disclosure documents and perform portions of the investigation, counsel should also exercise care to prevent misunderstandings as to the nature of the employment. Counsel employed to conduct such an investigation should carefully review with the underwriter the particular aspects of the investigation to be conducted by counsel.²²⁷

Such a review can serve two purposes. First, it would carefully and specifically delineate the nature of the investigation to be undertaken by counsel much in the same fashion as the particular matters investigated by accountants are limited in cold comfort letters. This would prevent any misconceptions by the underwriter as to the particular matters to be investigated and the procedures to be followed by counsel. Second, the review would ensure that the underwriters would focus upon the remaining investigatory procedures which would not be completed by counsel so that the underwriters may protect themselves from liability and avoid aider and abettor liability of counsel. This is particularly important since the underwriters are better equipped than are the attorneys to conduct certain procedures, such as investigating information of a predominantly financial nature. If the underwriters rely upon counsel for the performance of "nonlegal" activities, they must realize the conse-

²²⁵ Johnson, *supra* note 177, at 656.

²²⁶ See generally *id.* at 637-69. But see Securities Act Release No. 5572 (Mar. 4, 1975).

²²⁷ See Small, An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?, 61 Calif. L. Rev. 1189, 1209 (1973).

quences of the creation of this agency relationship. According to *BarChris*, the underwriters must accept responsibility for any inadequacy in the investigation by their agents, including legal counsel.²²⁸

However, once counsel has been employed to conduct those aspects of the investigation which can adequately be conducted by legal counsel, there arise certain duties which must be fulfilled to perform those activities in a competent manner. Some of these duties are professional obligations arising under the ABA Code.²²⁹ Apart from the ethical issues, liability to the client may be incurred at common law if the representation by the attorney is performed negligently.²³⁰ However, the securities laws are extremely complex and involve many difficult judgments. Thus, a relevant consideration is the standard to which the attorney will be held.

In *Lucas v. Hamm*,²³¹ the test applied to an attorney in a case involving alleged negligence in drafting a will was that of the "skill, prudence, and diligence [which] lawyers of ordinary skill and capacity commonly possess and exercise in the performance of the tasks which they undertake."²³² The court remarked:

The attorney is not liable for every mistake he may make in his practice; he is not, in the absence of an express agreement, an insurer of the soundness of his opinions or of the validity of an instrument that he is engaged to draft; and he is not liable for being in error as to a question of law on which reasonable doubt may be entertained by well-informed lawyers.²³³

In *Lucas*, the court refused to impose liability upon an attorney for a mistake in applying abstruse rules relating to the devolution of property.²³⁴ According to the court, the rules were sufficiently difficult that the average attorney exercising ordinary care could have made a similar mistake. If, however, counsel holds itself out

²²⁸ 283 F. Supp. at 697. See text at notes 196-98 *supra*.

²²⁹ ABA Code, Canon No. 6 provides that "[a] lawyer should represent a client competently." Ethical Consideration 6-1, ABA Code, EC 6-1, states: "Because of his vital role in the legal process, a lawyer should act with competence and proper care in representing clients. He should strive to become and remain proficient in his practice and should accept employment only in matters which he is or intends to become competent to handle." Disciplinary Rule 6-101, ABA Code, DR 6-101, states: "A lawyer shall not: (1) Handle a legal matter which he knows or should know that he is not competent to handle without associating with him a lawyer who is competent to handle it. . . . (3) Neglect a legal matter entrusted to him."

²³⁰ See Small, *supra* note 227, at 1211.

²³¹ 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961) (en banc), cert. denied, 368 U.S. 987 (1962).

²³² 56 Cal. 2d at 591, 364 P.2d at 689, 15 Cal. Rptr. at 825.

²³³ *Id.*

²³⁴ *Id.* at 592-93, 364 P.2d at 690, 15 Cal. Rptr. at 826.

as having particular experience or expertise in the securities law area,²³⁵ it seems entirely plausible that the applicable degree of care would be that which would be exercised by the average specialist rather than that exercised by the average attorney.²³⁶

There is another major consideration in the malpractice area. That is the question of whether the attorney could be liable not only to his clients, but also to investors for mistakes in the preparation of the disclosure documents or for conducting inadequate investigations. Direct support for such a theory in the securities area is presently lacking. However, a view of a foreseeable trend in the development of liability under the securities laws, as discussed in the preceding section,²³⁷ raises questions as to whether courts will create such a duty. There is a developing notion that attorneys can and do cause substantial losses to others in the course of representing their clients.²³⁸ Harm to the specific purchasers in a particular securities offering is reasonably foreseeable in the event of an error in the investigation and the class, while not necessarily small, is easily defined.

Two theories could give rise to duties of attorneys to these purchasers. First, the investors could be considered third party beneficiaries of the contract of employment between the underwriter and the attorney. This basis for liability could be avoided by counsel by explicitly providing in the contract of employment that such a third party status is not intended. Nevertheless, the second theory of a tort nature would not be so easy to negate. In such a case, a

²³⁵ Ethical Consideration 2-14, ABA Code, EC 2-14, and Disciplinary Rule 2-105, ABA Code, DR 2-105, permit attorneys to hold themselves out as specialists only in very limited situations.

²³⁶ See Henkel, *Liability of Counsel for Underwriter*, 24 *Bus. Law.* 641, 646 (1969); Lathrop & Rinehart, *Legal Malpractice and Rule 10b-5 Liability: Pitfalls for the Occasional Securities Practitioner*, 5 *Loyola U.L.A.L. Rev.* 449, 468 (1972).

²³⁷ See text at notes 166-214 *supra*.

²³⁸ In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar. Of course, Congress did not mean that any mistake of law or misstatement of fact should subject an attorney or an accountant to criminal liability simply because more skillful practitioners would not have made them. However, Congress equally could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.

United States v. Benjamin, 328 F.2d 854, 863 (2d Cir. 1964). See text at note 194 *supra*. In *Heyer v. Flaig*, 70 Cal. 2d 223, 449 P.2d 161, 74 Cal. Rptr. 225 (1969) (en banc), the intended beneficiaries under a will were held to have stated a cause of action against an attorney for negligent preparation of a will which prevented them from obtaining their intended interests. 70 Cal. 2d at 229, 449 P.2d at 165, 74 Cal. Rptr. at 229. In *Lucas*, the interests of the plaintiffs were contingent, so that harm was not as readily foreseeable as in *Heyer*. In both cases, however, the class of third party plaintiffs was small and easily defined. See *Small*, *supra* note 227, at 1195-96.

standard of care would be established as to these readily identifiable investors. The standard of care might be set at a negligence level, although a gross negligence or recklessness level would seem more appropriate considering the remote relationship of investors to the attorney and the number and aggregate dollar amount of potential claims. The *Lucas v. Hamm*²³⁹ and *Heyer v. Flaig*²⁴⁰ decisions indicate, however, that a negligence standard may be applied at least where a small number of potential claimants is involved. Both decisions also indicate that relevant factors in establishing liability include the following: "[T]he extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury, and the policy of preventing future harm."²⁴¹ Two commentators have concluded that in many offerings these factors would lead to imposition of liability on investors for negligence of attorneys rendering legal services in the transaction.²⁴²

The *Lucas* decision, however, also indicates the need to consider another factor, *i.e.*, "whether the recognition of liability . . . would impose an undue burden on the profession."²⁴³ Undoubtedly, extending a right of recovery to purchasers of the securities, for negligence of counsel in preparing disclosure documents and conducting an investigation, would be an extremely onerous burden. Liability for staggering amounts would be imposed for mistakes in collecting, reviewing, summarizing and describing massive and complex documentary and oral information. This liability would extend to a relatively large number of claimants, as opposed to the smaller number of clients of the erring counsel. Such a result would be unfortunate, unless "negligence" is defined to take into account the realities of an offering context, with the volume and complexity of judgments to be made and mass of material to be digested. Indeed, the test of negligence framed in *Lucas*²⁴⁴ appears to be based upon a recognition of such factors. For these reasons, imposition of liability for culpable knowledge or recklessness in such matters is easier to accept than liability for ordinary negligence.

This attitude was assumed by the court in *Ultramares Corp. v. Touche*.²⁴⁵ The court indicated that negligence would, because of

²³⁹ 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961) (en banc), cert. denied, 368 U.S. 987 (1962). See text at notes 229-34 *supra*.

²⁴⁰ 70 Cal. 2d 223, 449 P.2d 161, 74 Cal. Rptr. 225 (1969) (en banc). See note 238 *supra*.

²⁴¹ 56 Cal. 2d at 588, 364 P.2d at 687, 15 Cal. Rptr. at 823.

²⁴² Lathrop & Rinehart, *supra* note 236, at 466-67.

²⁴³ 56 Cal. 2d at 589, 364 P.2d at 688, 15 Cal. Rptr. at 824.

²⁴⁴ See text at note 232 *supra*.

²⁴⁵ 255 N.Y. 170, 174 N.E. 441 (1931) (Cardozo, C.J.).

direct privity of contract, support a claim by a company whose inaccurate financial statements had been certified by an accounting firm.²⁴⁶ However, knowledge or recklessness amounting to fraud was held to be necessary if the accountants were to be liable to the larger, indefinite class of creditors and others who dealt with the company on the basis of the certified financial statements, even though the accountants knew generally that the financial statements would be used by such persons for such purposes.²⁴⁷ Yet such limitations as the *Ultramares* reasoning would place on liability to persons not in direct privity with an attorney are undercut by section 552 of the Restatement of Torts.²⁴⁸ The privity argument in the *Ultramares* decision has been criticized and section 552 has been quoted approvingly in two cases in which claimants received damages for negligence of accountants.²⁴⁹ While not in privity with the accountants, the claimants in these cases had been specifically identified to the accountants as parties who would rely upon the financial information to be developed. An analogy may be drawn to counsel's ability to identify purchasers in an offering—particularly

²⁴⁶ *Id.* at 189, 174 N.E. at 448.

²⁴⁷ *Id.*

²⁴⁸ Section 552 of the Restatement (Second) of Torts (Tent. Draft No. 12, 1966) states:

(1) One who, in the course of his business, profession, or employment . . . supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon such information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in subsection (3), the liability stated in subsection (1) is limited to loss suffered

(a) by the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them. [Emphasis added.]

According to one commentator, § 552 establishes liability where "the maker [of the representation] knows that the information is intended for repetition to a certain group or class of persons, and that the plaintiff proves to be one of them, even though the maker never had heard of him when the information was given." Freeman, *Opinion Letters and Professionalism*, 1973 Duke L.J. 371, 383 n.47. Professor Ruder, on the other hand, believes the drafters of § 552 were of the opinion "that when a misrepresentation is merely negligent the actor should be liable to a narrower class of persons and for a lesser amount." Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597, 616 (1972).

²⁴⁹ *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 90-92 (D.R.I. 1968); *Ryan v. Kanne*, 170 N.W.2d 395, 401-03 (Iowa 1969). See Freeman, *supra* note 248, at 381-85. See also *Fisher v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967). For a discussion of trends toward greater liability of accountants, see generally Gormley, *Accountants' Professional Liability—A Ten-Year Review*, 29 Bus. Law. 1205 (1974).

in an exempt offering where the number of purchasers may be small.

E. Liability in Connection with Delivery of Opinions

In connection with employment of counsel to conduct an investigation on behalf of the underwriters and to prepare the disclosure documents for an exempt offering, the underwriters may desire that a written opinion be given as to the sufficiency of the information in the disclosure documents and to the sufficiency of the investigation. In contrast to registered offerings, delivery of opinions touching on these matters is not the rule for exempt offerings.

While excellent procedures for drafting opinions are available,²⁵⁰ certain general points warrant emphasis. First, broad statements as to the sufficiency of the information in the disclosure documents should be avoided at all costs. It is not possible for counsel to have more than second-hand acquaintance with the information, even after a full due diligence investigation. Any statements in this regard should be limited to statements that counsel is not "aware" of any misstatements or omissions after conducting certain investigatory procedures. Second, the investigatory procedures which were conducted should be described with specificity, and the description should eliminate any impression as to their adequacy to discharge the entire underwriter's obligation. The practice of making a general reference to conducting "such procedures as we deemed adequate in the circumstances" entails increasingly greater risks of misunderstanding. Third, counsel should conduct a sufficient examination of the facts supporting the opinion to resolve any doubts or eliminate any notice to the effect that the facts are not as described in the opinion, and should disclaim in the opinion any responsibility for the factual material. Fourth, counsel should conduct sufficient legal research to support the legal conclusions expressed in the opinion. Fifth, the opinion should permit reliance by, and be directed only to, the underwriters to prevent unintended reliance by persons not represented. The opinion should also explicitly prohibit its reproduction in whole or in part and any reference to it in the disclosure documents or otherwise.²⁵¹

The description of the role of counsel in the disclosure documents probably has value in selling the securities. Any such reference to the role of bond counsel, however, should be strictly limited

²⁵⁰ See Freeman, *supra* note 248, at 433-39.

²⁵¹ See *Black & Co. v. Nova-Tech, Inc.*, 333 F. Supp. 468 (D. Ore. 1971) (attorneys could be "participants" in violations of the Oregon securities laws due to the use of their firm's name as company counsel in the issuer's annual report). See also *Adams v. American Sec. Co.*, 3 CCH Blue Sky L. Rep. ¶ 71,072, at 67337 (Ore. 1973).

to "passing on the validity of the issuance of the bonds and certain tax questions on behalf of the underwriters" or "on behalf of the company."²⁵² No impression should be created by the language in the disclosure documents that any activities, particularly activities relating to the securities laws, by any counsel are for the benefit of the investors.²⁵³ The practice of using phrases describing the role of counsel in general terms, such as passing "on certain legal matters," or "on securities matters" is unwise. Rather, a simple statement that a firm "has acted as counsel to the underwriters [or other party] in connection with the offering" would seem less likely to be misinterpreted. By following these procedures, counsel will be able to minimize the possibility of common law liability resulting solely from rendering opinions in connection with an offering.

F. *Liability in Connection with Representations in Letters to Auditors*

Where counsel may have a relationship with the issuing company, the accountants in the transaction may request the company to authorize counsel to disclose certain matters, including threatened or pending litigation and contingent liabilities. However, the concept of "contingent liabilities" can be extremely broad and may include matters disclosed to counsel on a confidential basis.²⁵⁴ Disclosure of such matters, e.g., a theoretical antitrust violation, may not only be embarrassing to a company but also may remove the contingent nature of the liability by providing potential claimants with essential information. These potential claimants will be more than willing to act when the client has made a statement against its interests in its own disclosure documents.

In many cases, the accountants refer to the letter from the attorneys in the notes to the financial statements. This may foster reliance by investors upon the letter. Consequently, it is necessary that care be taken with regard to the preparation of such a letter. It is necessary for each counsel to make its own determinations on subtle and difficult issues regarding responses to these inquiries. In any case, the same degree of care should be exercised in the preparation of these letters as in the preparation of opinions.²⁵⁵

²⁵² Id. at 944.

²⁵³ See Cooney, *The Implications of the Revolution in Securities Regulation for Lawyers*, 29 Bus. Law. 129, 133-34 (Special Issue, Mar. 1974).

²⁵⁴ See the exposure draft, *Guidelines for Lawyers' Responses to Auditors' Requests for Information*, Comm. on Corporate Law and Accounting, *Scope of Lawyers' Responses to Auditors' Requests for Information*, 29 Bus. Law. 1391, 1397-1400 (1974). The revised exposure draft of the Guidelines was adopted at the Jan. 22-23, 1975 midyear meeting of the Section's Council and Committee Chairmen, see 30 Bus. Law. 513 (1975) (rejecting ¶ 2 dealing with "deficient public disclosure").

²⁵⁵ See Freeman, *supra* note 248, at 434; Small, *supra* note 227, at 1210.

G. *Summary: Liability of Counsel*

Present and past practices of counsel participating in exempt offerings raise serious possibilities of liability of such counsel to the investors or in SEC enforcement or disciplinary actions. It is recommended that counsel refuse to participate in any exempt offering without receiving adequate assurances that the underwriter is fulfilling its investigatory obligations. The underwriter's employment of experienced securities counsel to represent it in connection with the transaction generally should be sufficient evidence of the fulfillment of the underwriter's obligations to satisfy the securities laws and prevent liability of counsel, unless there is notice of the inadequacy of the investigation.

If counsel is employed to conduct the investigation, certain duties arise to the client to conduct it in a nonnegligent manner. Care is necessary in rendering opinions on securities law issues, both in limiting the scope of the opinions and in performing the procedures necessary to support them. Similar care should also be taken in responding to company requests to provide information to accountants.

VI. CONCLUSIONS

The degree of participants' responsibility for the accuracy and completeness of the information used in selling the securities in an exempt offering has been a neglected topic. Primary emphasis has been placed upon responsibilities in registered offerings. Meanwhile, as a result of the impetus provided by the Commission and as a result of greater reliance upon exempt offerings as a means of raising capital, the issues of duties under the antifraud provisions have gained considerable importance. Many of the recent developments have been unforeseen and unforeseeable to practitioners.

Nevertheless, this is a time of increasing concern with protecting the "public interest;" the Commission and the courts are creating duties heretofore nonexistent under the federal securities laws. While many underwriters and counsel oppose these trends, new or increased duties will continue to be placed upon them. Underwriters must accept responsibility for accurate disclosure of all material information pertaining to an offering at a level of culpability which may well be set at a negligence level. Counsel cannot, without risking liability as an aider and abettor, participate in an offering without assurances of compliance by the underwriter with its obligations or the absence of notice of violations of duties by the underwriter. If counsel assists the underwriter in conducting an investigation and in preparing the disclosure documents, a common law duty

APPLICATION OF THE ANTIFRAUD PROVISIONS

to the client may exist at a negligence level and a duty to investors, while not existing at present, may be found at a gross negligence, if not a negligence, level.

The emphasis has been placed upon encouraging disclosure, in some cases without regard to the costs which must ultimately be passed to the investors. That sweeping changes in long standing procedures will be required is seen as a benefit, rather than a detriment. It can only be concluded that the conduct of an exempt offering will come to be a much more expensive and time consuming process.

APPENDIX A

Illustrations of the Concept of Materiality

The compilation of examples does not purport to be exhaustive. Instead, examples were selected on the basis of the following criteria: (1) their value in providing a broad range of situations to reflect the numerous problems which are likely to arise; (2) their relative simplicity and ease of adaptation to a memorandum of this nature; and (3) their exemplary value for those concerned with these issues in the context of the preparation of adequate disclosure documents. Many of the misrepresentations and omissions could have been prevented through adherence by the underwriters and others to due diligence procedures. In some cases, however, particularly those involving outright fraud by management, no degree of investigatory activity would have uncovered the problems. Nevertheless, even those situations are useful in providing examples for those who bear judgmental obligations.

The specific examples follow.

1. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), involved an issuer in the business of building and selling bowling alleys. The issuer publicly sold its 5-1/2% convertible subordinated debentures and soon thereafter filed a petition in bankruptcy. A number of misrepresentations and omissions occurred in the registration statement for the offering:

(a) *Errors in sales and earnings.* In the preparation of the financial statements, several errors were made: (1) the treatment of buildings as fully complete, although they were only 78 to 82% complete under the "percentage of completion" accounting method; (2) the addition to the sales price of a building of the amount of a loan made by the issuer for the benefit of the landlord of the buyer when the additional amount was unrelated to the construction price and there was little evidence of repayment; (3) the inclusion in sales of the proceeds of a "sale" of a bowling alley to a factor who had leased it to a consolidated subsidiary of the issuer; and (4) the inclusion in sales of the proceeds of a "sale" of a bowling alley annex which was actually only leased to the "buyer." As a cumulative result of these errors, sales, profits, and earnings per share were overstated. *Id.* at 656-59. The court held, however, that the misstatements resulting from these errors were not material because the debentures were rated "B." *Id.* at 681-82. The court felt that an average prudent investor would view bonds with this rating as speculative, and that actual investors had probably viewed the issuer as a growth company and had bought the debentures for their conversion features. Under these circumstances, the court was satisfied that investors would not have been deterred by disclosure of the correct information. *Id.*

(b) *Errors in the balance sheet.* Two major errors occurred in the preparation of the balance sheet, the first being an overstatement of net current assets. This was due in part to (1) the failure to create a reserve for certain receivables which should have been treated as uncollectible; (2) the inclusion in "trade accounts receivable" of an amount due under the lease of a bowling alley to a subsidiary; and (3) the inclusion in current assets of factors' reserves (amounts withheld on customer notes discounted with the factor), even though a portion of the reserves would not be released to the issuer within a year because the maturity of the factored notes extended beyond that time. *Id.* at 661-62. The second major error in the

balance sheet was a failure to disclose certain contingent liabilities and a failure to reflect certain direct liabilities. The prospectus stated that the issuer had guaranteed 25% of the payments due under certain leases of facilities involving as lessor a factor who had purchased the facilities from the issuer. The leases were (1) directly to operators of the facilities and (2) in other cases, through subsidiaries of the issuer to other operators. Under the second type of lease, the issuer's express guarantee actually applied to 100% of the lease payments. In addition, another liability was reflected as "contingent" under a lease guarantee, when in fact the facility was leased to a consolidated subsidiary so that the liability of the issuer was direct. Direct liabilities should also have been increased by \$325,000 to account for a building sold to a subsidiary. Contingent liabilities should have totaled \$1,125,795 instead of \$750,000. *Id.* at 664-65. However, the figures actually disclosed showed a high ratio of contingent liabilities to total assets. The court reasoned that buyers willing to purchase the debentures in the face of this information would not have been deterred if they had been told that contingent liabilities were even higher; it therefore held the errors to be not material. *Id.* at 682. The remaining balance sheet errors were determined to be material since they caused the current ratio to be reflected as 1.9 to 1 rather than the correct ratio of 1.6 to 1 (an overstatement of 18.8%). According to the court, "[t]here must be some point at which errors in disclosing a company's balance sheet position become material, even to a growth-oriented investor. On all the evidence I find that these balance sheet errors were material" *Id.*

(c) Overstatement of backlog. The prospectus stated that the issuer had unfilled orders amounting to \$6,905,000. There were, however, no legally enforceable contracts for more than half of these orders, and in at least one other case no contract could be found. In the latter case, the alley had been completed and was operated by the issuer. *Id.* at 669-70. The court held the resulting overstatement of 185.9% to be material. *Id.* at 681.

(d) Officers' loans. The prospectus stated that loans had been made by officers to the issuer during the previous three years, and that all such loans had been repaid. In fact, "repayment" of these loans had been made in the form of delivery of checks to the officers on the condition that the checks be retained until money was deposited to cover them. Additionally, after the date as of which the prospectus purported to speak, but prior to the date the registration statement became effective, other loans were made and similarly "repaid" on a conditional basis. The court held that the prospectus was materially misleading as to both groups of loans because the conditional repayment was not repayment in fact and because the prospectus, by mentioning "repayment" of the first group of loans, impliedly represented that there were no other such loans made prior to or outstanding on the effective date. *Id.* at 671-72, 681.

(e) Use of proceeds. The prospectus stated that proceeds would be used for construction, development of a new equipment line, a loan to a subsidiary and additional working capital. In fact, the issuer was short of cash and used much of the proceeds to pay a substantial amount of its indebtedness, including the loans to officers discussed above. After finding that the issuer had intended to so use the money when the debentures were sold and that the defendants had failed to establish fully that eventually other working capital had been used for the purposes set out in the prospectus, the court held the misstatements to be material. *Id.* at 673-76, 681.

(f) Dealings between issuer and factor. The prospectus stated that the issuer had been "required to repurchase" less than 1/2 of 1% of its discounted notes. The court found that this statement was literally true because a letter from a factor with which the issuer was having difficulty did not include a demand for immediate repurchase. *Id.* at 677. But the court held that the prospectus was "impliedly false" to a material extent on this matter because it gave the impression that the issuer's problems concerning customer defaults were minimal when in reality the factor was postponing the demand for immediate repurchase only because of skillful negotiation by the issuer and knowledge of the forthcoming sale of debentures. *Id.* at 677-78, 681.

(g) Description of business. The prospectus stated that the issuer was "engaged in the design, manufacture, construction, installation, modernizing and repair of bowling alleys and the manufacture and sale of related equipment." It failed to add that, due to business failures of customers and changes in the bowling alley market, the issuer was also engaged in the operation of alleys. In holding this to be a material omission, *id.* at 681, the court said: "Operating an alley is obviously quite a different business from constructing one, with

APPLICATION OF THE ANTIFRAUD PROVISIONS

different problems and different risks. . . . It was something that purchasers of the debentures were entitled to know." *Id.* at 678.

2. Failure to correct, in connection with transactions in securities, misleading information already in the public domain can also result in violations of the securities laws. In *SEC v. Shattuck Denn Mining Corp.*, 297 F. Supp. 470 (S.D.N.Y. 1968), negotiations concerning a material corporate acquisition had been reported as agreeably concluded. The situation changed, however, and new terms were to be negotiated. While the acquisition that had been reported as imminent had now become only a possibility, defendant, an insider, sold stock. The court held that he had failed to disclose material information and enjoined future such transactions. *Id.* at 476.

3. In *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969), directors and other insiders of the issuer were enjoined from further trading and were required to offer rescission after acquiring the issuer's securities without disclosure of material inside information concerning extraordinary drill cores indicating the probable discovery of an extremely valuable ore body. 401 F.2d at 843-47. The situation was aggravated by public releases by the issuer which excessively emphasized the inconclusive nature of the results of the drilling. The court found that the information "might well have affected the price of [the issuer's] stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold." *Id.* at 850. See Annot., 2 A.L.R. Fed. 190 (1969).

4. In *Wechsler v. Southeastern Prop., Inc.*, [1972-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,555, at 92688 (S.D.N.Y. 1972), a motion to dismiss was overruled and a purported class action was allowed to proceed to discovery upon plaintiff's complaint that the issuer did not disclose that it had been negotiating for its acquisition by another corporation. *Id.*

5. In *Gould v. Tricon, Inc.*, 272 F. Supp. 385 (S.D.N.Y. 1967), plaintiff was granted rescission because the issuer's prospectus had failed to reveal that the issuer's president, chairman of the board and major stockholder, began work during previous employment on a device which constituted the issuer's major asset. Although there had been no patent infringement suit brought by the previous employer, the court concluded that, in light of the evidence concerning assignment of rights to inventions by the officer-stockholder to his previous employer, the plaintiff had a right to be informed of the possibility of such litigation. *Id.* at 391. In addition, representations in the prospectus went beyond mere "puffing" into the area of material misrepresentations when the design and development of the device was incorrectly described as complete. *Id.* at 392.

6. In *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971), defendant wished to acquire an insurance company so that a holding company could be formed to take advantage of the insurance company's "surplus surplus" (surplus in excess of the amount required by the applicable state insurance laws to be kept on reserve by insurance companies for the protection of the policy holders). In its prospectus for the exchange offer, defendant disclosed its intention to form the holding company to utilize the acquired company's assets, but there was no disclosure of the amount or the importance of the "surplus surplus." Defendant argued that the disclosure could not have been made at the time of the offer because the amount of "surplus surplus" was impossible to estimate accurately. But the court ruled that a range of estimates which had been obtained from different sources could have been released, and the importance to the acquisition of the "surplus surplus" could have been disclosed. *Id.* at 574-75. The prospectus was thus held to be materially misleading. *Id.* at 575. Even though estimates of the "surplus surplus" could have been obtained by investors from other sources, the court felt that "non-insurance oriented, albeit professional investment advisors" could not be expected to remember reports which they had seen a year earlier and that the investors were entitled to the disclosure. *Id.*

7. Although disclosure had been made in the offering circular, the Commission in *Del Consol. Indus. Inc.*, SEC Securities Act Release No. 4795, reprinted in [1964-66 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,267, at 82404 (July 26, 1965), found an offering circular to be materially misleading because of its manner of presentation of the information. In the "Business and Property" section, the issuer explained that its options to purchase "working interests" in four proven oil leases averaged only 33% of all oil and gas produced therefrom instead of the customary 87½%. But the introductory statement merely stated that the issuer had the option to purchase the working interests without disclosure of the reduced percentage.

The Commission held that the introductory statement violated § 17 of the Securities Act, 15 U.S.C. § 77q (1970), *id.* at 82405, explaining:

Even though an offering circular contains all the essential facts, it still may not satisfy the disclosure requirements if the facts are not presented so clearly that they will be plainly evident to the ordinary investor. . . . The burden should not be placed on the investor to examine the offering circular for qualifying language to counteract the misleading nature of a statement in its introductory material. . . .

Id. at 82406.

8. In *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971), promoters were held liable in connection with sale of stock of franchise sales centers. *Id.* at 695. Material misrepresentations and omissions were made as follows: (1) the firm which the promoters had recently left had been described as "very successful," although the firm was in fact under investigation by the Commission; (2) the cost of rights to the franchise sales centers, which were purchased from an affiliated corporation, included a lump sum payment of \$25,000, which had been disclosed, but also included a monthly payment of \$1,000, which had not been disclosed; (3) one of the promoters advising the franchisees was not an expert in capitalization consulting as he had been represented to be; and (4) the promoters' operations in other states had been described as successful, although they were in fact under investigation by various state securities commissioners. The court held that availability of the full and accurate information from other sources did not excuse misleading or incomplete statements in the disclosure documents used in connection with the offering. *Id.* at 696.

9. In *SEC v. R.A. Holman & Co.*, 366 F.2d 456 (2d Cir. 1966), cert. denied, 389 U.S. 991 (1967), defendant, a registered dealer, was permanently enjoined from committing further securities law violations for, among other things, informing the investor of a price rise in the stock during two previous annual industry exhibitions in which the issuer had participated, without disclosing that the price had dropped before the end of the exhibitions. 366 F.2d at 458. The court found that this was an omission to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading. *Id.* at 458-59. Therefore, even though there had been no initial duty to disclose this decrease, its disclosure became necessary after disclosure of the increase. The lower court's finding of a material misrepresentation in the dealer's failure to disclose that it had originally purchased the securities for investment and not for resale was reversed on appeal. *Id.* at 457.

10. In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), defendants were held liable under Rule 10b-5 for failure to disclose to plaintiffs that, in purchasing plaintiffs' stock, the defendants (transfer agents for the stock) were not only acting as market makers but had already found a buyer for a higher price than defendants were paying to plaintiffs. *Id.* at 152-53.

11. In *Mutual Fund Distribs., Inc.*, SEC Securities Exchange Act Release No. 6862 reprinted in [1961-64 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,859, at 81190 (July 25, 1962), the Commission revoked the registrations of broker-dealers who were found to have made materially misleading statements when, in selling shares of an investment company, they used a prospectus which stated that the issuer's investment policy would result in a "normal turnover in securities held" without disclosing that the "normal turnover" was defined in terms of the issuer's experience rather than in terms of industrywide experience. *Id.* at 81192. Also found to be material was the failure to disclose that two individuals generally directed the affairs of the issuer independently of the board of directors. *Id.*

12. In *Hafner v. Forest Labs. Inc.*, 345 F.2d 167 (2d Cir. 1965), a holder of restricted securities exercised an option requiring the issuer to repurchase shares and later sued the issuer for rescission and damages, alleging that the issuer had violated Rule 10b-5 by failing to disclose a forthcoming 4% stock dividend. The circuit court affirmed the trial court's decision that this information as a matter of law was immaterial, but used a different rationale. While the lower court reasoned that stock dividends have no intrinsic value, the appellate court recognized that in some instances the market may place a value on them. The appellate court found this nondisclosure immaterial, however, because the issuer had not initiated or negotiated the repurchase. Instead, the plaintiff had initiated the transaction and the issuer had merely accepted the option request. *Id.* at 168.

13. *Robinette & Co.*, SEC Securities Exchange Act Release No. 7386, reprinted in [1964-66 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,118, at 82057 (Aug. 11, 1964),

APPLICATION OF THE ANTIFRAUD PROVISIONS

involved misrepresentations by a broker-dealer in the sale of convertible debentures. The Commission implied that one of the facts which should have been disclosed concerning the issuer was that its management was continually troubled by internal friction. *Id.* at 82058-59.

14. In *SEC v. Bennett & Co.*, 207 F. Supp. 919 (D.N.J. 1962), an underwriter was enjoined from further sale of stock in a construction loan business after the court found, among other things, that the offering circular and other disclosures used in connection with past sales had failed to mention that a salesman who was employed by the underwriter was also an officer, director, promoter and principal shareholder of the issuer; that the shares being offered had no voting rights; that the issuer had not yet established permanent offices; and that the issuer had as yet no operating history. *Id.* at 922-24.

15. *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956), involved purchases by the defendant of securities of an issuer in which defendant was already a controlling stockholder. The purchases were made without disclosure: (1) that the value of the issuer's inventory had appreciated to a much higher level than that reflected on the balance sheet in the issuer's most recent annual report; or (2) that defendant intended to liquidate the issuer after purchasing the stock, thus obtaining for itself the benefit of the increased inventory value. The omissions were treated as material. 99 F. Supp. at 828-29.

16. In SEC Securities Act Release No. 5449, reprinted in 4 CCH Fed. Sec. L. Rep. ¶ 72,173, at 62390 (Jan. 3, 1974) ("Disclosure of Inventory Profits Reflected in Income in Periods of Rising Prices"), the effects of changing economic trends are discussed as matters which must be taken into account in making materiality judgments. In the release, the Commission recognized that during a period of rapidly rising prices the profits of many companies are artificially high because of the inclusion therein of "inventory profit." *Id.* This is a profit resulting from a rise in prices on inventory items between the time of purchase of the inventory and the time of sale. This "profit" may be reflected as inflated earnings in the current year's financial statement; however, this earnings level may never be repeated because the increased inventory costs will affect the succeeding year's earnings. While declining to prescribe new accounting methods or formal requirements for disclosure to deal with this problem, the Commission urged disclosure of such amounts when they reach material levels, after describing these profits as "potentially unrepeatable" and as profits which "do not reflect an increase in the economic earning power of the business." *Id.* at 62390-91.

It is impossible to predict with certainty whether information similar to that in the situations discussed above would consistently be held to be material. Because each fact situation is unique, and because some of the examples are judicially untested positions of the Commission, judgmental determinations on materiality issues must be made independently. The examples do, however, emphasize the serious need for recognition and proper treatment of these matters.

Appendix B

Items of Disclosure

Following is a comparison of the items of Form S-1, Form S-7 and Forms 10 & 10-K:

<i>S-1 Item</i>	<i>S-7 Item</i>	<i>Items of Forms 10 and 10-K</i>
1. Distribution Spread	1	Not applicable
2. Plan of Distribution	2	Not applicable
3. Use of Proceeds to Registrant	3	Not applicable
4. Sales Otherwise than for Cash	Not applicable	Not applicable

BOSTON COLLEGE INDUSTRIAL AND COMMERCIAL LAW REVIEW

<i>S-1 Item</i>	<i>S-7 Item</i>	<i>Items of Forms 10 and 10-K</i>
5. Capital Structure	None	Item 6 of Form 10-K (Increases and Decreases in Outstanding Securities—applies only to changes during preceding fiscal year)
6. Summary of Earnings	6 (Statements of Income)	Item 2 of Form 10 (Summary of Operations) Item 2 of Form 10-K (Summary of Operations)
7. Organization of Registrant	None	Item 1(a) of Form 10
8. Parents of Registrant	None	Item 4 of Form 10 Item 4 of Form 10-K
9. Description of Business	5 (but only requires identification of business, with much less information on matters such as competition, marketing, research, backlog, raw materials, capital expenditures, etc.)	Item 1 of Form 10 Item 1 of Form 10-K (primarily an updating of Form 10 information)
10. Description of Property	None	Item 3 of Form 10 Item 3 of Form 10-K
11. Organization Within 5 Years	None	Item 9(d) of Form 10
12. Legal Proceedings	5(e) (somewhat less disclosure required than in Form S-1)	Item 10 of Form 10 Item 5 of Form 10-K
13. Capital Stock Being Registered	7	Item 14 of Form 10
14. Long-Term Debt Being Registered	8	Item 15 of Form 10
15. Other Securities being Registered	9	Item 16 of Form 10

APPLICATION OF THE ANTIFRAUD PROVISIONS

<i>S-1 Item</i>	<i>S-7 Item</i>	<i>Items of Forms 10 and 10-K</i>
16. Directors and Executive Officers	None	Item 6 of Form 10 Items 8 and 12 of Form 10-K
17. Remuneration of Directors and Officers	None	Item 7 of Form 10 Item 13 of Form 10-K
18. Options to Purchase Securities	None	Item 8 of Form 10 (Management Options to Purchase Securities—applies only to options held by management personnel and requires less disclosure as to the terms of the options than does Form S-1) Item 14 of Form 10-K (Options Granted to Management to Purchase Securities—very similar to Form 10)
19. Principal Holders of Securities	None	Item 5 of Form 10 Item 11 of Form 10-K
20. Interest of Management and Others in Certain Transactions	None	Item 9 of Form 10 (very similar to Form S-1, but more disclosure required than by Form S-1, especially in the areas of indebtedness of insiders to registrant and transactions with pension and other plans of the registrant) Item 15 of Form 10-K (an updating of Form 10 information)

BOSTON COLLEGE INDUSTRIAL AND COMMERCIAL LAW REVIEW

<i>S-1 Item</i>	<i>S-7 Item</i>	<i>Items of Forms 10 and 10-K</i>
21. Financial Statements (requirements are comparable to Form S-7 requirements for large reporting companies, but not for other companies)	10 (Balance Sheets) 6(c) and instruction 10 to Item 6 (Statements of Source and Application of Funds) (instructions for financial statements under Form S-7 are less comprehensive than those for financial statements under Form S-1, but the basic Form S-1 statements are also required by Form S-7)	Item 18 of Form 10 (instructions are very similar to those in Form S-1) Instructions to Financial Statements of Form 10-K (an updating of Form 10 information)
22. Marketing Arrangements	None	Not applicable
23. Other Expenses of Issuance and Distribution	12	Not applicable
24. Relationship with Registrant of Experts Named in Statement	13	Not applicable
25. Sales to Special Parties	None	Not applicable
26. Recent Sales of Unregistered Securities	None	Item 13 of Form 10 Item 6(b) of Form 10-K (an updating of Form 10 information)
27. Subsidiaries of Registrant	None	Item 4 of Form 10. Item 4 of Form 10-K

APPLICATION OF THE ANTIFRAUD PROVISIONS

<i>S-1</i>	<i>S-7 Item</i>	<i>Items of Forms 10 and 10-K</i>
28. Franchises and Concessions	None	None
29. Indemnification of Directors and Officers	14	Item 17 of Form 10 Item 9 of Form 10-K
30. Treatment of Proceeds from Stock Being Registered None	30 11 (Statement of Available Information— requires a ref- erence on the cover of pros- pectus to infor- mation contained in disclosure documents under the Securities Exchange Act of 1934)	Not applicable Not applicable
Exhibits (very comprehensive requirements regarding every document "material" to the registrant or its busi- ness)	Exhibits (re- quires only doc- uments relevant to the offering)	Exhibits to Forms 10 and 10-K are comparable to the requirements of Form S-1