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Current Issues and Developments in the Duties and Liabilities of Underwriters and Securities Dealers -- a Program by the Committee on Federal Regulation of Securities

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Current Issues and Developments in the Duties and Liabilities of Underwriters and Securities Dealers

A Program by the Committee on Federal Regulation of Securities*

PREFACE

[This program was held August 9, 1976 and, generally speaking, speaks as of that date, subject to editing and updating of the transcript. On February 23, 1977, the Supreme Court of the U.S. in *Piper et al. v. Chris-Craft Industries, Inc. et al.* reversed the judgment of the U.S. Court of Appeals for the Second Circuit.¹ In reversing, the Supreme Court held that Chris-Craft, an unsuccessful tenderor, did not have standing to seek monetary damages under section 14(e) of the Securities Exchange Act of 1934, as amended by the Williams Act of 1968, or under rule 10b-6, based upon alleged anti-fraud violations by the successful competitor, its investment advisor, and individuals comprising the management of the target corporation. As a result of the view taken by the Supreme Court concerning Chris-Craft's standing to sue for damages, many of the other issues decided by the Court of Appeals became moot and were not considered by the Supreme Court. The Supreme Court expressly declined to intimate a view whether a suit in equity for injunctive remedy as distinguished from an action for damages would lie in favor of a tender offeror under either section 14(e) or rule 10b-6. The Court also declined to express a view on whether shareholder-offerees of target corporations have an implied cause of action in section 14(e) or on the standing of the target corporation itself. The Court further noted that in light of its holding there was no occasion to pass upon the underlying determination of the Court of Appeals that violations of the securities laws occurred.]

* Presented by the Section of Corporation, Banking and Business Law, at the American Bar Association 1976 Annual Meeting on August 9, 1976 at the Fairmont Colony Square Hotel, Atlanta.

Kenneth J. Bialkin, *Committee Chairman*, Presiding
Stephen L. Dinces, New York
Stephen R. Volk, New York
Neil Flanagan, Chicago
William J. Williams, Jr., New York
Roberta S. Karmel, New York
Martin Lipton, New York
Charles J. Johnson, New York
Alan B. Levenson, Washington, D.C.
William R. Harman, New York
Edward H. Fleischman, New York
Samuel Scott Miller, New York
Elliott Goldstein, Atlanta

1. 97 S. Ct. 926.

MR. BIALKIN: Before we get into the subject matter of this program, I would like to introduce the members of this panel. They are Stephen L. Dinces of the firm of Cleary, Gottlieb, Steen & Hamilton; Stephen R. Volk of the firm of Sherman & Sterling; Neil Flanagan of the firm of Sidley & Austin; William J. Williams, Jr. of the firm of Sullivan & Cromwell; Roberta S. Karmel of the firm of Rogers & Wells; Martin Lipton of the firm of Wachtell, Lipton, Rosen & Katz; Charles J. Johnson of the firm of Brown, Wood, Ivey, Mitchell & Petty; Alan B. Levenson of the firm of Fulbright & Jaworski; William R. Harman, General Counsel of Morgan, Stanley & Co.; Edward H. Fleischman of the firm of Beekman & Bogue; Sam Scott Miller, General Counsel of Paine, Webber, Jackson & Curtis; and Elliott Goldstein of the firm of Powell, Goldstein, Frazer & Murphy.

The general subject of our program this morning is developments in the law and practice of the underwriting of securities. In particular, we will examine the role and exposure of broker/dealers acting as official underwriters or dealers both in the context of registered public offerings and exempt offerings, both public and private. The term registered public offerings refers to offerings that must be registered with the Securities and Exchange Commission; the term exempt offerings refers to both the public offering of securities not required to be registered with the Securities and Exchange Commission and to exempt private transactions such as private placements.

Fourteen years ago this section of the ABA and this committee in particular had a program on this subject. Although I am not a purist in terms of continuity, in light of recent developments in the field, this seemed to be an appropriate time to re-examine the subject matter. For example, certain types of offerings not previously thought to be within the scope of either the registration or disclosure provisions of the Securities Act have, as a result of legislative or administrative activity, perhaps been brought within their purview. I am thinking specifically of developments in the offering of commercial paper which, as you know, enjoyed exemption from the registration provisions of the Securities Act and, in the opinion of many, was not subject to due diligence investigations by broker/dealers. The financial community was thus shocked by the decision of the Seventh Circuit in *Sanders v. John Nuveen & Co., Inc.*² which, as you know, has been vacated and remanded by the Supreme Court for reconsideration in light of its decision in *Ernst & Ernst v. Hochfelder*.³ Thus, the questions concerning the role of broker/dealers and the scope of their obligations in the offering of commercial paper, while very much alive, remain for future delineation.⁴

2. 524 F.2d 1064 (7th Cir. 1975) *vacated and remanded*, 425 U.S. 929 (1976).

3. 425 U.S. 185 (1976).

4. Subsequent to the above panel discussion the case of *University Hill Foundation v. Goldman, Sachs & Co.*, Fed. Sec. L. Rep. (CCH) ¶95,749 (S.D.N.Y. Oct. 27, 1976) was decided, raising some interesting and difficult problems under section 12(2) of the Securities Act of 1933. UHF purchased, from Goldman, Sachs (the exclusive dealer in Penn Central commercial paper) commercial paper issued by the Penn Central

So too, developments in the area of the public offering of tax exempt securities, *i.e.*, municipal obligations, present obvious legal questions, which we plan to examine today. If time permits, we also hope to discuss developments in the traditional offering of securities, such as changes in the nature of the formation of underwriting syndicates and the manner and practices of distribution of such securities. Similarly we hope to have a chance to look into some of the similarities and differences in the types of roles played by underwriters and their potential exposure in each of those roles. Perhaps we can thereby develop some insight into whether, based on the statutes and administrative regulations pertaining thereto, there are in fact distinctions which are, or should be, recognized in the law.

I would like to initiate this program by introducing the first general topic to be discussed; the overall subject of developments in the area of public offerings registered or required to be registered with the SEC. I will ask Charles Johnson to lead off that discussion.

MR. JOHNSON: I would like to start out this afternoon by discussing the problems that underwriters must cope with in distributing equity securities in the face of aggressive selling activity by institutions before and during the distribution. An underwriter assisting a corporation in raising equity capital may find it necessary to equalize the downward pressure on the market caused by the distribution by stabilizing the market price of the securities being distributed. Stabilization is recognized by rule 10b-7 as a legitimate activity. The problem is that stabilization can provide an opportunity for institutions to unload large blocks of stock at a minimum of economic risk by selling into the syndicate bid or, through short sales, to realize economic gain in transactions that are, or come close to being, manipulative.

Not too long ago, the biggest game in town was for hedge funds and other institutions to enter an indication of interest for shares being distributed in an underwriting, to sell short aggressively prior to the effective date of the registration statement in an effort to push down the price of the shares, and to cover their short position with shares purchased in the underwriting. In response to this type of activity, the SEC in early 1974 proposed rule 10b-21,⁵ which, in its revised (but as yet unadopted) form, provides that it is unlawful for any person who makes a short sale of equity securities of the same class as those covered by a registration statement (1) to cover such short sale with securities purchased in the underwriting if the short sale

Transportation Company. The transaction did not involve any written soliciting material and Goldman, Sachs made no specific recommendations or representations regarding the instrument. Upon the bankruptcy of Penn Central, UHF sued Goldman, Sachs alleging, among other things that Goldman, Sachs had falsely represented that it had performed an adequate credit investigation of Penn Central. While the court found that Goldman, Sachs had acted in good faith it held it liable under Section 12(2) on the ground that it had impliedly represented that it had conducted a reasonable credit investigation when, the court found, the investigation was inadequate.

5. Securities Exchange Act Release No. 10636 (February 11, 1974). Revised proposed Rule 10b-21, Securities Exchange Act Release No. 11328 (April 2, 1975).

took place within ten days prior to the commencement of the distribution or (2) to cover such short sale with securities purchased on or before the earlier of the fifth business day after the commencement of the distribution or the date of termination of stabilization arrangements and trading restrictions if the short sale took place within five business days before the commencement of the distribution. On the same date that the SEC proposed rule 10b-21, it commenced a proceeding against the brokerage firm of A. P. Montgomery & Co., Inc. charging that, for its own account or for the accounts of customers, it made short sales of securities prior to the effective dates of registration statements which caused, or contributed to, a decline in the market price for the securities and affected the pricing of the offering. This was alleged by the SEC to be a manipulative practice. Montgomery subsequently consented to SEC sanctions.⁶

Arguments have been made that this type of activity is not manipulative in that by its terms section 9(a)(2) of the 1934 Act applies only to transactions in a security raising or depressing the price of such security "for the purpose of inducing the purchase or sale of such security by others". Even if this type of conduct does not meet the language of section 9(a)(2), it has been held to violate rule 10b-5. In *United States v. Charnay*,⁷ it was alleged in a criminal indictment that, for the purpose of coercing the directors of Air West into approving a proposed tender offer, Howard Hughes and his associates sold or sold short Air West stock with the intention of causing a decline in the market price. The Court stated, with respect to the necessity of alleging and proving a purpose to induce others to purchase or sell securities, that under rule 10b-5, there was simply no requirement for such pleading as there is under section 9(a)(2).

MR. BIALKIN: I would like to pose the following hypothetical question. Assume that I am an ordinary investor and I know that the offering of a security is being proposed for a particular day. Is it illegal for me to make a short sale of that security a day or two in advance of the offering, intending to cover depending, upon the market price of the security, sometime subsequent or is it simply ordinary investor trading practice? Where would the illegality, if any, be, if I, as the investor, did not propose to obtain a participation in the shares of the underwriting syndicate?

MR. JOHNSON: As you posed the transaction, I don't think that it would be manipulative. What we are talking about is a much different kind of a transaction in which institutions progressively sell at lower prices with the intention of driving down the price of the stock. I think it is a different matter if you're talking about an isolated trade by an investor who makes a short sale expecting that the price of the stock will decline because the offering is not likely to be successful.

6. Securities and Exchange Act Release No. 10909 (July 9, 1974).

7. Fed. Sec. L. Rep. (CCH) ¶95,560 (9th Cir., May 7, 1976).

Incidentally, when you said provided he doesn't buy on the offering, I assume you're raising a section 5 question. I don't think an ordinary private investor violates section 5 if he sells short and covers by purchasing on the offering.

Although rule 10b-21 has not been adopted, short selling prior to an offering has apparently become less of a problem, probably because of the impact of the A. P. Montgomery proceeding. A more troublesome problem today is the use by institutions of the stabilizing bid to unload substantial amounts of stock, either owned by them or acquired in the underwriting. For example, I have been told that institutions affiliated with NASD member firms have purchased shares in underwritings, designating their affiliates as the recipients of the selling concession, and immediately resold the shares into the syndicate bid through a discount broker. Discount brokers, who have sprung up since the elimination of minimum commissions, are willing to handle transactions at a very small cost. Accordingly, an institution purchasing shares in an underwriting and designating the shares to an affiliated broker-dealer is able to generate for the combined enterprise a profit equal to the selling concession less the discount broker's commission with substantially no risk. I understand that other institutions have used the same technique to pay off obligations owed to brokerage firms for research. This type of activity became particularly prevalent at the end of last year when the institutions were trying to settle up their accounts before year end. Incidentally, the recent *Papilsky* case⁸ seems to say that a mutual fund has a duty to recapture selling concessions by designating shares to NASD affiliates and recover the concession through a reduction of the management fee. The argument was made in this case, and I think quite convincingly, that this would violate Section 24 of the Rules of Fair Practice of the NASD, but the judge apparently felt otherwise, at least in the absence of an NASD ruling.⁹

Another example, which came up in last fall's AT&T common stock offering, involved foreign banks who bought at the offering price less the selling concession (as seems to be the practice, although I question its legality)¹⁰ and resold immediately into the syndicate bid.¹¹

This is the kind of activity that the standard penalty clause found in any Agreement Among Underwriters is designed to prevent. The standard penalty clause provides that if any stock comes back to the syndicate from a person who purchased from an underwriter or selected dealer, then the underwriter or dealer who did not effectively place its securities will be required to give back its selling concession. The fact is, however, that the penalty clause just does not work today. Particularly with the advent of

8. *Papilsky v. Berndt*, Fed. Sec. L. Rep. (CCH) ¶ 95,627 (S.D.N.Y., June 24, 1976).

9. In the December 6, 1976 issue of *Securities Week*, it is reported that, in a letter to Lord Abnett & Co., the NASD ruled that such an arrangement "flies directly in the face of section 24."

10. See Section 24 of NASD Rules of Fair Practice.

11. Wall Street Letter (May 31, 1976).

central clearing systems, the managing underwriter is simply unable to determine the source of the stock that hits its syndicate bid.

I might ask Bill Harman if he agrees with that. Have you been able to use the penalty clause effectively?

MR. HARMAN: Without commenting on any specific underwriting transaction, it seems to me that one of the problems that the investment community is facing today is the ability to reconcile the capital-raising process—which is central to continued development and expansion of American business—on the one hand; with the implementation of undue restrictions on the securities markets on the other hand. It's a rather delicate balancing act that must be performed and it is being performed with the views and guidance of the Commission as to what are appropriate restrictions in the secondary market in connection with the distribution of securities.

As has been pointed out, it has become quite difficult, if not impossible to trace specific shares, because of the continuous net settlement system, Depository Trust Company, and the netting of transactions by broker/dealers. The underwriting agreement itself provides that a selling concession is not properly earned by a participant in the distribution of securities if those shares are not effectively placed for investment, and placed not in the "private placement" sense, but where the purchasers of those shares in effect have purchased those shares as investors. If shares come back into the syndicate bid or come back to open market purchases, the issuer, as a practical matter, is paying for services that have not effectively been performed.

There are ways of finding out just in terms of general rumor in the marketplace, but it has become more and more difficult to enforce the provisions of the underwriting contract.

MR. JOHNSON: There have been various suggestions, and a lot of time and study has gone into how to cope with these problems, and I must say that I don't think that a satisfactory solution has been arrived at. The problem is sufficiently important that it gave rise to an article in the *Institutional Investor* entitled "Is the Syndicate Bid on the Way Out?"¹² One device that has been tried to cope with the problem is to initially provide for zero re-tentions to the underwriters and to allot shares to them only as they come in with orders that the manager is satisfied come from legitimate purchases. In a few cases the managing underwriter announced that it did not intend to stabilize at any price in excess of the public offering price less the selling concession (in effect a statement of intent not to stabilize at all) on the theory that this would scare off the institutional seller waiting in the wings to hit the expected stabilizing bid. This was done successfully in a 330,000 share initial public offering and tried by another underwriter in a larger secondary that never went through. I doubt that this would work in practice in a very large equity offering. Perhaps the best solution would be for the SEC, in

12. *Institutional Investor* (May 1976) p. 39.

addition to adopting rule 10b-21, to adopt a rule making it unlawful for a person to purchase securities in an underwriting with the intention of re-selling into the syndicate bid. Although such a rule might be difficult to enforce because of its subjective nature, it might well provide a deterrent to this type of activity.

MR. BIALKIN: I understand that in some recent larger offerings, institutions which have been offered participation in particular underwritings have said that although they would like to participate they did not have sufficient liquidity to do so at that time. However, they have proposed to underwriters that if the latter could purchase, for cash, blocks of securities held by such institutions, they would then participate in the distribution being offered. Does such a situation create the risk that a method of distribution is being used which will vary from that described in the prospectus and which might involve an unlawful discount if the brokerage firm in fact does take a block of stock off the hands of the selling institution at a better price than could be obtained in the open market?

MR. JOHNSON: These transactions are known as "swaps". The *Wall Street Letter* of May 31, 1976, in commenting on a recent AT&T common stock offering, alleged that in connection with the AT&T offering the previous October, brokers induced purchases of stock by taking difficult to sell blocks out of institutions' hands at prices equal or close to the last sale in exchange for commitments to buy AT&T shares in the offering. The practice of swaps in and of itself seems to be legitimate and proper. Indeed, the SEC staff issued a no-action letter dated October 8, 1975 in connection with an offering of \$20,000,000 of First Mortgage Bonds, 12½ percent Series due 1981 of Savannah Electric and Power Company, a portion of the proceeds of which were to be used to retire \$15,000,000 of First Mortgage Bonds, 8½ percent Series due November 1, 1975. The underwriters proposed, in effect, to swap the new bonds with holders of the old bonds to be retired. In taking a no-action position under Rule 10b-6 that the old bonds were not "of the same class and series" as the new bonds thereby permitting the swaps, the SEC did not indicate any objection to the practice. It is interesting to note that the Savannah Electric prospectus dated November 8, 1975 contained a statement under the heading "Underwriting" with respect to the underwriters' intention to offer such swaps. The *Wall Street Letter* article that I just mentioned quoted Mr. Stanley Sporkin of the SEC's staff as stating, "Any swap which involves the giving of a concession on underwriting commissions, unless fully explained, is clearly contrary to the law." It would seem to me that if a swap is effected at a price which in effect constitutes a give up of a portion of the selling concession to an institution, this would be contrary to the law whether or not disclosed in the prospectus. This would be prohibited by the NASD Rules of Fair Practice. I do not know of any evidence that would indicate that underwriters are taking securities in swaps at prices

above the current market price, but if so, it is this aspect of swapping that would be prohibited and not swapping *per se*.

MR. HARMAN: Well, the only thing I would add to that is that the NASD rule expressly contemplates swaps and goes on to prohibit "overtrading." "Overtrading" is defined as paying more than the fair market value or the fair value for a security taken in trade for another security. That has been an established guideline and it has been in existence for a rather substantial period of time. I'm not aware that the Commission or the staff of the Commission has taken the position that a transaction done in conformity with that NASD rule constitutes a disclosure problem. Of course, that type of transaction takes place every day in the secondary market. Most institutions do not have a continuing source of cash, like the pension funds—where there is a constantly renewing cash influx; these institutions such as the foundations, which have a fixed amount of capital, obviously have to sell something before they can buy something new. So this is not an unknown technique, and has been fairly well contemplated and dealt with by the NASD Rules.

MR. JOHNSON: One technique that managers have used to prevent short sales into the syndicate bid is to price the offering on a down-tick, thus making short sales unlawful.¹³ To counter this, in cases where options with respect to the shares are traded on the CBOE, the scheme was apparently devised to write call options at a discount, that is where the striking price plus the price of the call is less than the public offering price at which the underwriters were stabilizing. The purchaser would then exercise the call giving him a long position and sell into the syndicate bid. This would afford him a sure profit. The writer of the call would hope to cover in the open market after the syndicate had folded and the stock was trading at a discount. To prevent this type of activity, in last fall's AT&T common stock offering, a provision was inserted in the Agreement Among Underwriters which provided that no underwriter could effect a transaction for a customer involving the writing of a naked call at parity or at a discount. In addition, the CBOE adopted a special temporary rule prohibiting uncovered writing transactions in CBOE contracts for AT&T common stock at a price less than the amount by which the last sale price exceeded the exercise price. The prohibition of uncovered discount option writing was made applicable by the CBOE during the time that the underwriters had the stabilizing bid in effect. Similar contractual provisions and special CBOE rules have been used in subsequent transactions, and the CBOE can be expected to be accommodating to the extent that they are convinced that restrictions are necessary. It

13. Securities Exchange Act Rule 10a-1. The SEC has concluded that the continuation of the short sale rules may no longer be required except in certain limited circumstances such as in connection with underwriting offerings. Rule 10a-1 continues in effect but the SEC is studying the question. Exchange Act Release No. 12384 (April 28, 1976).

may be noted that in the most recent AT&T financing, the Agreement Among Underwriters prohibited syndicate members from assisting customers in writing any naked option, whether parity options, discount options or otherwise.

Increased interest in call options has given rise to a number of other problems in connection with distributions of securities. For example, option writing has been used as a selling tool in connection with underwritten offerings of shares of companies with respect to which options are traded on the AMEX or CBOE. The registered representative, in seeking to interest a customer in stock being distributed by his firm, will often point out to the customer that he can use his position in the stock as a basis for writing call options and thereby generate additional income. In my view, such a practice has no manipulative potential whatsoever and raises no questions under Rule 10b-6. I understand, however, that the SEC's staff has questioned whether the distribution of the common might be deemed to be continuing so long as the calls are outstanding. It is my feeling that if a member of the public is free to immediately sell stock purchased in an offering without delivering a prospectus, as is the case apart from any presumptive underwriter problems, a member of the public should be free to write a call on his stock without delivering a prospectus either at the time the call is written or if and when it is exercised. If this type of selling practice is sufficiently pervasive so as to be an integral part of the distribution process, which I doubt is the case, then perhaps a purist might argue that some reference to the practice should be made in the prospectus. I fail to see, however, how this type of disclosure is important to an investor. But if the SEC feels that such disclosure should be made, it should so advise the industry so that a uniform practice can be adopted.

Another question that has come up is whether call options are "rights" for purposes of Rule 10b-6. In other words, is an underwriter or prospective underwriter in a particular distribution of common stock precluded from purchasing for its own account or inducing customers to purchase AMEX or CBOE options covering shares of the same class. It is my understanding that the staff of the SEC is studying this question and they have not yet taken the position that options are "rights". It is my view that such a position should not be taken. The language, history and purpose of Rule 10b-6 does not lead to a conclusion that call options are "rights" within the meaning of the Rule. The closest analogies are convertible debentures, convertible preferred stock and warrants; and the SEC's staff has consistently taken a position that if there is an offering of common stock, it is not necessary for the underwriters to get out of the market with respect to convertibles or warrants. Call options should fall into the same category. It would seem to me that as a matter of policy the SEC should not impair the liquidity of the options market during a distribution unless it has real evidence that trading in call options may have an effect on the price of the underlying common stock. Restrictions should not be imposed based on an unfounded fear that

this might conceivably be the case, but only after hard evidence demonstrates that trading in call options might raise the price of the common.

MR. BIALKIN: I would like to ask Edward Fleischman to pick up here and discuss some of the recent developments in the securities market as reflected by changes in standard underwriting documents.

MR. FLEISCHMAN: Ken, the other day one of my partners was talking about a session with Mr. Berle some 25 years ago, in which Mr. Berle walked into the classroom one morning with only one document in his hand. He held the document up to be seen and he said, "This is a mortgage trust indenture, gentlemen. I'd like to read from it to you for a few minutes." Then he opened to the habendum clause and droned on, stopping after about ten minutes to remark: "I'm not sure any of you will ever see one of these again, but I think you ought to have been exposed to it." And he walked out of the room.

I'm not sure any in this audience would want to read underwriting agreements for their literary merit. The orotund style is not reminiscent of James Joyce, nor of Mr. Piccione in *Penthouse*; it is a style peculiar unto itself. But these are living documents, and, surprisingly enough, they do tend to change as underlying economic realities change. Both the "agreement among" and the "purchase agreement" have seen some changes during our working lifetimes, particularly in the last twelve months. They are therefore quite dissimilar, except in structure, to the forms that were prevalent fifteen or twenty years ago. Of the many major changes, perhaps I'll deal with two or three in the next few minutes—and pass on to Steve Volk for treatment of more substantive legal matters.

"Cold comfort letters" are, of course, a creature of the underwriting agreement itself. You all know what they are. I think the major change in this area in the last couple of years has been that more underwriting agreements call for two letters, whereas years ago only one letter was normally required, for delivery at the closing date.

MR. BIALKIN: If two letters are called for, when would the first one be delivered?

MR. FLEISCHMAN: On the date that the underwriting agreement is actually signed.

MR. BIALKIN: That is, before the syndicate releases the securities?

MR. FLEISCHMAN: Yes. Actually, delivery of the first letter will probably precede the execution of the contract, and simply be reflected in the contract itself.

MR. WILLIAMS: As a result of practical experience, some underwriters get comfort letters the day before they sign the underwriting agreement.

MR. FLEISCHMAN: As a result of changes in the accountants' prescribed procedures,¹⁴ however, accountants have become unwilling to "char-

14. See A.I.C.P.A. Committee on Auditing Procedure, Statement on Auditing Procedure No. 48, *Letters for Underwriters* (10/71).

acterize” changes that have ensued between the dates of these two letters or that are found by comparing financial statements as of the date reflected in the prospectus with the cold comfort review as of a date five days before the rendering of the particular letter. To “characterize”, I mean, in the sense of indicating that there has been a change and then characterizing it as a material or an adverse change.

There are some forms of comfort letters today in which the language of the comfort letter itself is quite neutral, and then there is a separate provision of the underwriting agreement which says to the underwriters: gentlemen, you may review the comfort letter and, as to any changes which the accountants have described, you may then make the determination as to whether those changes are material. In certain agreements that provision concludes: if in your sole discretion you deem the change to be material, why then you can call off this deal. I would like to dwell on that point for just a moment, because there are various approaches focussing on the determination of materiality of changes (whether in the financial data or in the textual portions of the prospectus) which have occurred since the dates as of which information is given in the prospectus but prior to the closing date.

There are some forms of underwriting agreements which state simply that the offering need not be closed if there has been a misstatement or omission of a material fact; it is a condition of the underwriter's obligation to go forward that no such misstatement or omission has been found. But these forms of agreement frequently fail to assign the responsibility for making the determination as to whether or not a material change, normally a material adverse change, has occurred. The assignment of that responsibility to the managing underwriter has, I think, been increasing as underwriting contracts are reviewed. There is one fairly-traditional form of contract which says to the underwriters: gentlemen, if any of the changes that you find or that are brought to your attention are material “in the opinion of your counsel”, then you have the right to call off the deal. Of course there are other approaches, including at least one form of contract which, in effect, says to the managing underwriter: review, investigate, do all the “diligence” you feel responsible for doing, and if you do determine that there has been a material adverse change, in your sole discretion or in your sole judgment, then you are empowered to call off the deal.

As I see it, this type of provision is not, and should not be taken to be, a supplement to or substitute for the old-fashioned “market out” clause. Rather, it evidences a substantial effort, on the part of the underwriting confraternity faced with increasing exposure to “hindsight” liability, to clarify to the issuer or the selling securityholders the seriousness of the issue and the seriousness of the consequences of an erroneous determination of materiality, via an argument essentially to the following effect:

(1) under *Kaiser-Frazer*,¹⁵ this underwriting agreement will not be enforceable if there has been a material omission or misstatement of fact in the prospectus,

(2) we, the underwriters, are the professionals in the securities business, with far more than money to lose if the determination of materiality or non-materiality is made without the most careful and unbiased consideration, and

(3) we therefore believe that the managing underwriter is the correct locus of decision-making on this matter, and we want the contract to reflect the fact that the manager's judgment will be the determining factor so that, if you, the seller, subsequently seek to litigate the issue of materiality (as opposed to the issue of the underwriters' good faith), the contract will be seen to have spoken directly to the matter.

MR. BIALKIN: Wouldn't you though, as a matter of caution, advise your underwriting client that any judgment he makes would have to be based on a reasonable standard and that it is not simply a one-way out for the underwriter?

MR. FLEISCHMAN: I don't think anybody takes it, Ken, as a one-way out. I think it is a question of identifying the *locus decidendi* for materiality decisions. These underwriters, after all, have their professional reputations at stake. One would hesitate to assume that any major or well-reputed underwriting firm would use the discretion afforded by any such clause as an excuse to walk away from a contract for a business or market reason.

To move to another topic, there has even been evolution in the "market out" clause, particularly after last year's New York City problems. A number of market-out clauses, where they do exist (I am sure that you are aware that there are some underwriters who do not put a market-out into their contract), have been broadened to take into account that particular situation, which might have a real impact upon the economy of the country, in which a major city such as New York declares bankruptcy between the time of the signing of the underwriting agreement and the closing itself.

Market-out clauses can, of course, be written to encompass a much broader parade of economic horrors, each of which is prominent and self-evident. In some instances, the list of objective occurrences concludes with a phrase to the following general effect: "or any similar event which the representative deems to render impractical or inadvisable the completion of the offering." That additional language constitutes a fairly broad market-out, but, again, I don't believe any of us has known a single underwriter of repute to exercise the market-out in the last 25 years, not even in 1962 when, virtually overnight in the first week of June, the market changed so very badly.

15. *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F.2d 838 (2d Cir. 1952).

A further topic which is of substantial interest, although of fairly narrow application, is the set of provisions within the agreement among underwriters which reflects the many lawsuits which have been brought against individual underwriters or individual managers, or against the underwriters as a group—lawsuits initiated long after the particular underwriting was closed (frequently just prior to the expiration of the one-year statute of limitations under section 13 of the Securities Act), challenging the completeness of the prospectus. The old-fashioned forms of “agreement among” did not in terms empower the manager to levy upon his group a year or two later in order to defend, or to defray the expenses of defending, against such a suit. The manager’s plaint is quite simple: fellows, we’ve been sued; you may not have been sued but I’ve been sued; you all shared in the fruits of this labor and now you must help me bear the effort and expense here. This problem presents a number of very provocative questions which, for those of you who are interested, are the subject of an excellent article by Jim Freund and Henry Hacker entitled “Cutting Up the Humble Pie,” in *St. John’s Law Review* somewhat more than a year and a half ago.¹⁶

I believe you will find, in dealing with the current forms of “agreement among”, that managers have on the whole become much more careful to bind the participating underwriters to assist in the defense of any, or all, who may subsequently be sued, rather than allowing some or all of the members of the group to be exposed alone if a lawsuit is brought. Some of these provisions also take into account the kind of erosion that occurred in 1973 and 1974, when so many of the members of the underwriting syndicates had withdrawn from business in the period intervening between the underwritten offerings and the commencement of litigation. In addition, some of these provisions address the possibility of conflict of interests among the several underwriters to ensure that, when such conflicts develop (for example, between the interests of the managers and those of other participating underwriters), no participant is saddled with counsel who may be party to the conflict and no participant is deprived of the protection which is necessary in the circumstances.

MR. BIALKIN: Suppose that in a particular underwriting the underwriters have been held to be negligent and therefore liable under section 11. Is it within the purview of these new provisions for a non-managing member of the syndicate to claim that he should have no liability vis-à-vis the manager and should not share in the manager’s liability because, if the underwriters were negligent, the managing underwriter was the one who committed that negligent act, in violation not only of his duty under the statute but also of his duty to the members of the syndicate?

16. J. C. Freund and H. S. Hacker, *Cutting up the Humble Pie: A Practical Approach to Apportioning Litigation Risks among Underwriters*, 48 *St. John’s L. Rev.* 461 (1974).

MR. FLEISCHMAN: I know of at least one situation, Ken, in which the "agreement among" contemplates that the participants may have separate counsel from the time of the initiation of the lawsuit, deliberately to preserve the possibility of asserting that claim for the non-managing participants. The basic structure, of course, arises out of section 11(f), which creates a right to recover contribution but not in favor of someone who has been held to be the "violinist", if I may use that term.¹⁷

MR. BIALKIN: But since it could be disastrous for a managing underwriter to have to face this sort of claim by a syndicate member, isn't there a provision that, despite negligence, but in the absence of gross negligence or willfulness, there will be a sharing of liability? Would such an undertaking be enforceable?

MR. JOHNSON: I think most agreements, Ken, are silent on that. The standard clause suggested in Jim Freund's article contains language covering the effect of gross negligence on the part of the managing underwriter. Most people, however, are loathe to even suggest in an agreement among underwriters that the managing underwriter might be acting other than properly.

MR. FLEISCHMAN: There is a question which I might leave with this panel, Ken, on a slightly different topic. Underwriting agreements today still say, in the last or next to last paragraph, that their provisions shall be governed by, and construed in accordance with, the laws of the Commonwealth of Massachusetts or Pennsylvania or Virginia, or the State of New York or Washington or California. One wonders, wherever the lawsuit might be brought (particularly if the forum is a court abroad), how a court would apply the laws of any particular jurisdiction to govern a contract of this nature, when essentially the issues which are in dispute are matters of federal law only.

MR. BIALKIN: With that question, I would like to move on to a discussion of developments in the role of underwriters in different types of registered offerings and their duty to exercise due diligence with respect to their various roles. That is, how does the role of the underwriter in a fully syndicated, negotiated offering under an S-1 or an S-7 differ as compared to his role in a distribution under an S-14 or an S-16 or in a sale under a stock option prospectus. Stephen Volk will lead that discussion.

MR. VOLK: I would like to make just one comment on contractual liability before I start on the due diligence discussion. On the question of relative liability of the managing underwriter, on the one hand, and the participat-

17. "[E]very person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation." Securities Act of 1933 § 11(f). See Douglas and Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171 at 178-181 (1933).

ing underwriters, on the other, I think that inherent in most agreements among underwriters is a negation of the notion that the manager is responsible to the rest of the group for any failure to perform the due diligence function. The agreements typically provide that all underwriters share in Securities Act liability based upon their underwriting share. There is no laying off of that liability to the managing underwriters as a matter of contract.

My topic today concerns the contrast between what I will call the traditional structured and syndicated underwriting and the less structured casual distribution pursuant to a Form S-16 where one or more broker-dealers nevertheless have underwriters liability. The traditional underwriting is a firm commitment syndicated offering led by a managing underwriter or underwriters, with a group of participating underwriters who buy the securities for resale to the public. The offering takes place only after the managing underwriters, assisted by counsel, have had an opportunity to make a thorough investigation, to review the registration statement with appropriate company personnel, and to examine other pertinent information necessary to verify information in the registration statement. The managing underwriters will have received comfort letters from the company's auditors, opinions from its counsel, and opinions from other experts, if appropriate. The registration statement in the traditional offering is typically on Form S-1, S-7 or S-9. The distribution of this is completed within a short time after the registration statement is declared effective.

The Form S-16 has been used in the past several years for sales by affiliates and by statutory underwriters on a widespread basis. Form S-8 has also been used for casual distributions by affiliates of shares acquired upon exercise of restricted or qualified stock options. Also, to some extent, the Form S-14 has been used for resales by affiliates of the acquired company.

With respect to resales on Form S-8, the Commission in Securities Act, Release 5724, proposed amendments to Form S-8 which, among other things, would eliminate the use of the Form S-8 for resales by affiliates or underwriters. The Release suggests that, if these amendments are adopted, the appropriate form for resale would be the S-1 or the S-16 if the issuer qualifies for the Form S-16.¹⁸

In the casual distribution pursuant to Form S-16, there is often no formal syndicate. The dealer or dealers handling the transaction may complete the sale in a few hours, a few weeks, or a few months. He usually acts as agent, but he may purchase all or part of the securities as principal. He often does not become involved in the transaction until after the registration statement is declared effective and he may have little or no opportunity to verify the information contained, or incorporated by reference, in the registration statement.

18. See Securities Act Release 5767, November 22, 1976, adopting the revised Form S-8 and providing for resales on a separate prospectus filed with the registration statement on Form S-8.

A broker-dealer's role in the casual distribution is different than in the traditional underwriting principally because normally the broker is an after-thought to the transaction. He usually gets involved in a sale under an S-16 after the registration statement has been filed and it has become effective. As opposed to the traditional underwriting where he can conduct an independent investigation with the extensive assistance of his counsel, where he can get one, two or three "comfort" letters, as well as legal opinions, representations, warranties and indemnities, in the typical S-16 distribution, the broker is in a marketing situation. He is bidding for a block of stock which has become available on the market, and if he is to act on a timely basis, he is not usually going to have the time, the financial resources in light of his potential profit, or the opportunity to conduct an independent investigation.

MR. BIALKIN: Why do you say that he would not have the opportunity? If the selling stockholder, in a situation involving an already effective S-16, approaches an underwriter with respect to the latter undertaking the sale, is there anything that prevents the underwriter from undertaking an investigation of the company and delaying his acceptance of the distribution responsibility until he has satisfied himself that the prospectus is accurate?

MR. JOHNSON: He will probably lose the business.

MR. VOLK: If he were the only underwriter in the world I think he could do that Ken, but I think he will find that competitive conditions prevent it.

MR. BIALKIN: Section 11 imposes a due diligence responsibility on anyone who is an underwriter. Now, are you suggesting that the statute is hospitable to a flexible standard of due diligence, depending upon whether the underwriter for competitive reasons has, or does not have, opportunity to conduct a due diligence investigation?

MR. VOLK: That issue has not been litigated to my knowledge. I would hope that the courts would find a flexible standard of due diligence in light of the circumstances of the distribution including the reasonable expectations of the purchaser. Section 11(c) of the 1933 Act appears susceptible to this argument; it talks about a reasonable investigation by a prudent man in the management of his own property. The investigation required of a prudent man should vary depending upon the circumstances. One of the most important circumstances here is the form being used—the S-16—which typically contains no financial information and little else in the way of basic disclosure. Presumably, the investor looks to the 1934 Act filings incorporated by reference in the S-16 for the basic disclosure. I question whether a reasonable investor would expect a prudent underwriter to verify these other documents with the kind of painstaking detail customary in the traditional underwriting.

My view is that it is worthwhile for a broker in this situation who, for competitive reasons, is compelled to take on the business without being able to carry on an extensive investigation of the issuer, to make a case that he's nevertheless met his due diligence defense under the circumstances. One key to this is to establish that it is reasonable for the broker under these circum-

stances to rely on the people who did prepare the S-16 and the 10-K and other filings which are incorporated by reference in the Form S-16.

MR. BIALKIN: In the situation where the underwriter is asked to be an S-16 distributor, would he be any more protected if he simply sold under an S-16 in which he is not named, as opposed to amending the S-16 in the prospectus by a sticker, and naming himself as an underwriter. In other words, is he protecting himself if he obscures or at least does not draw attention to the fact that he is acting in a distributing role? And, may he do so?

MR. VOLK: First, as to the question as to whether he is protecting himself, I guess that if he is not named, and as a result is never sued because it is not recognized by any prospective plaintiff that he had a role in the situation, then, as a practical matter, he has protected himself. The issue is whether, under the circumstances, he should be named. Assuming he had no arrangements with the selling stockholder prior to the time the registration statement became effective and therefore was not named at that point, the question of whether he should be named depends on two factors. First, is the manner of the proposed sale adequately described in the registration statement? If it is not, then an amendment is in order and the amendment, to be complete, should name the selling broker. Second, is the participation of the selling broker of such significance that it is important to an investor to know that he's involved? There are various rules of thumb that have evolved here. My understanding is that at the present time the SEC Staff will not insist on a broker-dealer being so named, assuming (1) a normal manner of distributing, say, sales as agent on an exchange, and (2) the amount he sells is not significant in terms of either the amount outstanding (*i.e.*, not more than 1 percent of the outstanding) or of the trading volume (*i.e.*, not more than the trading volume for the prior five weeks). But this is just a rule of thumb.

MR. HARMAN: Steve, would you say an underwriter or a broker-dealer is running a more substantial risk if he goes out and solicits the buy-side of that transaction and then goes to the seller? And wants to do it as a cross?

MR. VOLK: No, I don't think so, although I suppose it could be argued that a more diligent investigation is required if the broker is seeking out the buyer, who may feel justified in relying upon him. This gets to a suitability question. If he does solicit the buy-side, it seems to me that whether you're talking about Section 11, or the various relevant sections of the '34 Act, he has more of a suitability function and may have to satisfy himself as to the appropriateness of the securities for the buyer involved. Obviously, if the buyer is a sophisticated institution which fends for itself, this problem diminishes in significance.

MR. HARMAN: If he solicits the buy-side in that situation, does he run into problems of rule 10b-6 where he, perhaps has not named himself as an underwriter in the supplement to the prospectus?

MR. VOLK: Assuming 10b-6 applies to the situation, and it doesn't apply

to every shelf-registration, I don't see why he can't solicit the buy-side of the transaction. This activity is perfectly proper under Exception (6) to rule 10b-6.

MR. HARMAN: Steve, what if he positions a proportion of that in order to facilitate that cross? Say, there is 80 thousand for sale and he has found buyers for 50 thousand and he positions the remaining 30 thousand in order to facilitate the transaction? Is he any more of an underwriter?

MR. VOLK: I think that in all of these cases he is an underwriter, Bill, irrespective of whether he is principal or agent. Arguments can be made that, if all he does is sell as agent for a statutory underwriter, he comes within the exception in section 2(11) of the '33 Act and is accordingly not an underwriter. However, I am not very comfortable with that argument. I think the important practical issue is whether he has to be named as an underwriter.

MR. HARMAN: And if he is deemed to be an underwriter how does he establish his due diligence, if, for example, he calls up the treasurer of the company, says, I'd like to fly out next week and spend an afternoon with you and the president of the company to talk about the financial condition of your company, and the treasurer responds that, I'm sorry, Goldman-Sachs is our regular investment banker and we're not about to take the time to sit down to talk with you. Is the reading of the 10K in the annual report adequate for due diligence purposes?

MR. DINCES: Steve, along those lines, is it implicit in your analysis that the underwriter read or examine the underlying '34 Act documents?

MR. VOLK: That was certainly the suggestion in the Wheat Report. It seems to me that the broker-dealer should have read the S-16 and the underlying documents. Most of the broker-dealers handling this kind of work have a research department and normally will not participate in such a transaction unless their research department has either followed the company or has followed the industry in such a way that they can get up on the company very fast. But this is not the kind of analysis and verification that you would have in the traditional underwriting situation.

If he has read all these documents and satisfied himself as to their consistency and he is not aware of any materially misleading information, this would be very helpful in establishing a due diligence defense. It is also important as indicated previously, for the broker-dealer to satisfy himself that the persons preparing the documents did so on a competent, professional basis.

MR. LEVENSON: Yes. This type of situation involves the exercise of business judgment. The broker/dealer recognizes that time is of the essence and that under the circumstances he is not going to have sufficient opportunity to make the independent verification. Accordingly, he is going to assess risk-reward, and go ahead and do the business if it makes sense from a practical standpoint. As to future directions, in view of the Supreme Court's liability limitation attitude, it would appear that "under the circumstances"

would be implied by the court in construing the "reasonable investigation" language in Section 11 under the Securities Act of 1933. Accordingly, I believe that the concept of differential liability will evolve, should the issue be litigated.

MR. BIALKIN: Neil Flanagan, did you have a comment that you wanted to make on that subject?

MR. FLANAGIN: I was going to ask Steve about a shelf S-16, particularly in the over-the-counter area. How do you deal with the rule 10b-6 problem, in light of the recent limitations on the *Jaffee*¹⁹ case by the Commission.

MR. BIALKIN: Perhaps you could explain the recent limitation of the *Jaffee* case.

MR. FLANAGIN: *Jaffee* was a decision that came out of the Commission about five years ago holding that any shelf registration under the '33 Act necessarily involved a distribution for the purposes of rule 10b-6. In an over-the-counter security, this ruling had a tendency to dry up the market because almost everybody in sight had to get out. In the recent *Collins*²⁰ case, the Commission backed off that per se approach in the shelf registration and has now held that a shelf-registration may or may not be a distribution for purposes of 10b-6, depending upon the circumstances.

MR. BIALKIN: So there is no longer a flat rule that a market maker in the security is prohibited from participating in a registered distribution of that security?

MR. VOLK: Well, he is no longer prohibited per se by the fact that the deal is registered. He must apply the same test that the SEC has traditionally applied in connection with unregistered distributions. The question is whether, taking into account such factors as market conditions, the nature of the selling efforts, compensation paid, it all adds up to something which constitutes a "distribution". It seems to me that a market maker can still have a problem, depending upon how those factors come out. However, the practical significance of this problem is very limited in light of *Collins*, unless the market-maker's activities are unusual. However, if he determines that a distribution may be in progress, the question of how to deal with 10b-6 becomes

19. *Jaffee & Co.*, 44 S.E.C. 285 (1970), [1969-70 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,805, *aff'd in part, rev'd in part*, *Jaffee & Co. v. SEC*, 446 F.2d 387 (2d Cir. 1971). In that case a dealer was retained as exclusive agent to effect sales on behalf of selling stockholders under a shelf registration. A second dealer, in the course of market making activities, purchased and resold some of the registered shares. The Commission held that the market maker violated Rule 10b-6 and the dealer-agent who sold the shares to the market maker aided and abetted the violation. The Second Circuit apparently approved the finding of a violation by the market maker, who had not appealed the Commission decision. 446 F.2d 387 at 391, n.2.

20. In *Collins Securities Corp.*, Securities Exchange Act Release No. 11766, October 23, 1975, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,327, the Commission overruled *Jaffee* insofar as it held that a 1933 Act registered offering is necessarily a distribution for the purposes of rule 10b-6, adopting the concurring and dissenting opinion of Commissioner Smith in *Jaffee* and reverting back to the test enunciated in *Bruns, Nordman & Company*, 40 S.E.C. 652 (1961), which turns on the magnitude of the offering and the selling efforts and selling methods utilized.

important. If a broker is a market-maker in, or has an outstanding research report on, the security involved, what does he do when he's asked to sell a block of the registered security the next day or the next week?

At one time, the Staff of the Commission took the position that he had to get out of the market for ten days, making the ten days exception in 10b-6 an absolute requirement, and there's a no-action letter issued in 1972 called *Victory Markets, Inc.* (Sept. 21, 1972), which talks about this. I think that the practice generally has been to ignore the ten-day rule suggested by *Victory Markets* and to make a practical judgment as to how long it is necessary to be out of the market. The question is: how long will it take once the broker has withdrawn from the market for the effect of what he's been doing in the market to be dissipated. In many securities, this can be less than one hour and in some cases, it can be as much as two or three days. The judgment must be made in light of the circumstances.

MR. FLANAGIN: I think that we are likely to see more and more S-16s, particularly in the acquisition area. There's a very nice dovetailing between rule 146 and the S-16. We're involved in an acquisition by a publicly held company that qualifies for S-16, of a small company with fewer than 35 stockholders, but who insisted on getting free stock at some point. The alternatives were filing an S-14 before the deal or relying on rule 146 and giving them a shelf S-16 after the deal, and the cost differential is dramatic. You can cut the cost way down and still achieve substantially the same result and protect the parties by going the S-16 route.

The current Commission proposal²¹ to expand the availability of the S-16 to a larger class of companies than can now use it may further increase the use of this technique. It's a very handy way of skinning the cat, and doing it with the least amount of expense and burden for everybody concerned. I think more and more brokers are going to be presented with after the fact S-16 registered stock to sell, and they're going to have to wrestle with what they do about it.

MR. BIALKIN: Neil, I wonder if you might summarize the present law with respect to the sale of securities upon exercise of stock options registered under an S-8, and the right of employees or affiliates of the company to resell those securities without further registration.

MR. FLANAGIN: Well, the current S-8, as distinguished from the proposed amendment,²² permits the use of the prospectus for resales by optionees of qualified option stock, and it makes it very easy if you're dealing with

21. Securities Act Release No. 5728, July 26, 1976. The proposal was adopted in Securities Act Release No. 5791, December 20, 1976.

22. In Securities Act Release No. 5723, July 2, 1976, the SEC proposed amendments to Form S-8 which would, among other things, eliminate its use for resales of the registered shares by purchasers who may be underwriters and subject to prospectus delivery requirements. The amendments to Form S-8 were adopted in Securities Act Release No. 5767, November 22, 1976. The form as adopted, like the proposal, eliminates the use of the S-8 prospectus for resales, but it permits a Form S-16 prospectus

listed securities. There is an undertaking²³ which provides that in the event of a resale by a statutory underwriter, otherwise than on a national securities exchange, you must amend the S-8 to include the information required by an S-1. Neither the form, nor the rules, nor the statute is very precise on who is or who is not an underwriter.

With a listed stock, you don't ever have to face that question; you simply put a boiler-plate paragraph on the front page and file seven copies with the stock exchange under rule 153. If the seller is an underwriter, you have complied with the prospectus delivery requirements for sales on the exchange; and if he's not an underwriter, you didn't need to. So the question is academic.

It gets more complicated with an over-the-counter stock, because you don't have the benefit of rule 153 or the undertaking. I understand the SEC staff does apply a rule of thumb geared to the rule 144 volume limitations,²⁴ and if your over-the-counter seller is below that, you don't worry; if he's over it, then you've got a problem.

MR. BIALKIN: I would like to present the following question to Alan Levenson. Suppose you have an issuer which is an over-the-counter company whose issue was registered on a Form S-8 and whose stock options might or might not be qualified. Assume further that it is provided in the registration statement and on the face of the prospectus that the prospectus is to be used in connection with resales in the open market by employees or affiliates of the issuer, who might be deemed to be underwriters on resale. Is it your understanding that under present law, the Commission would object to the free resale of those securities by the employee or affiliate, provided he delivered a prospectus?

MR. LEVENSON: Well, let's assume for discussion purposes that the category of seller falls within the class set forth in undertaking C, *i.e.*, the underwriter. He is deemed to be an underwriter for that purpose. It's my understanding that in connection with that over-the-counter company's resale by that category of person, that additional information, for example, the S-1 information, would have to be included in the prospectus in order for that prospectus to be used by those persons for resale.

MR. FLANAGIN: I was getting to the distinction of who is and who is not

under certain circumstances. The Release also adopts the position with respect to prospectus delivery described in note 23, *infra*, provided the Form S-8 registered offering was public.

23. Undertaking C to Form S-8.

24. It is understood to be the general position of the Staff that optionees who are not affiliates of the issuer are free to resell the shares purchased under an S-8 registration without prospectus delivery or any other limitations applicable to them on the theory that they occupy the same position as a member of the public who purchases shares in a registered offering. Affiliates of the issuer may, without delivering a prospectus, resell shares within the rule 144 volume limitations (which would be applicable to them in any event) but without a holding period, since the registered shares are not restricted securities.

an underwriter; in other words, with an optionee who has 100 shares to resell, applying any quantitative concept to the definition, you would say he is not an underwriter. He is treated more or less as a member of the public who has registered stock which he can sell without compliance with the prospectus delivery requirements. When you move away from the casual sale of a modest amount, at some point, you have to decide whether the seller is an underwriter subject to undertaking C.

My understanding is that the staff, in resolving that question, applies the Rule 144 quantitative test to affiliates, non-affiliates being free.

MR. WILLIAMS: Steve, I wonder if you could comment on the extent to which the S-16 is used for organized, underwritten, registered secondary offerings and if my assumption is correct that it's used very little, why? Perhaps you could also discuss the problems in beefing up an S-16.

MR. VOLK: My understanding is that the implication of your question is correct; the S-16 is not used extensively in connection with organized underwritings. Among other things there is a marketing reason for this. In connection with a syndicated, widespread offering, investors are used to getting a document which looks and feels like a traditional prospectus; they're not used to a two-page flyer. Accordingly, the underwriters want a beefed-up prospectus. The problems of beefing-up an S-16 by adding materials are difficult. You wander away from the pleasantly restricted confines of what is required into an area with no applicable guidelines, except perhaps conformity with the full S-7 requirements. Once you start adding information, where do you stop? When you start adding S-7 type information in one area, is there an implication that you've included all that's material for the issuer in response to S-7? There are no generally accepted guidelines as to where you can add information without creating obligations to add more information.

MR. BIALKIN: Sam Miller, or Bill Harman, does that answer comport with your experience?

MR. HARMAN: Well, yes, it is. I might add one related comment, and that is, I think underwriters feel very uncomfortable with an S-16 in a situation where they are working with an issuer for the first time. If they have the opportunity I think they're going to want to use a more extensive form.

MR. VOLK: It's very difficult, even if you have the time, to conduct a really good due diligence investigation with the Form S-16. This is because the underwriter will normally not have an opportunity to participate in the preparation of the Form 10K and the other basic disclosure documents incorporated by reference in the Form S-16. An important procedure to smoke out and resolve disclosure problems is for competent representatives of the managing underwriter and of counsel for the underwriters to participate in the collective group process of preparing and vetting the disclosure document, to review the language carefully, to ask questions, propose or review riders, and hopefully achieve full and fair disclosure through this collective

process. This is usually pretty much missing in connection with an S-16 registration statement. Of course, the underwriters can and should review the 10-K and the other disclosure documents and ask questions about them. However, if changes are suggested the underwriters are likely to meet a high threshold of resistance from company officers in light of the fact that thousands of shareholders arguably are relying on the documents in their form as issued.

MR. HARMAN: We have frequently had the opportunity of working with the Company in the preparation of its Form 10-K, if it's an offering that's going to take place shortly after the end of their fiscal year. In these circumstances, we have been allowed to have some input into the 10-K, and done a fairly full due diligence not too different from the normal kind you would normally do.

MR. BIALKIN: If the S-16 is a form promulgated by the Commission for certain high-grade issuers, and if the information that would ordinarily be required in the prospectus is abbreviated, and if presumably the underwriter's diligence need not extend beyond the scope of the form S-16, why is it that underwriters are so reluctant to use the form which the Commission has apparently made available for them?

MR. WILLIAMS: I think that no underwriter feels very comfortable with a 10-K which, in many cases, he has had no role in preparing. One also may not know whether there are any subsequent events which should be disclosed in an 8-K. I think the S-16 was promulgated by the Commission to impose a less administratively burdensome way of registering shares and secondary distributions. It seems to me that it is almost anomalous to continue to hold the underwriter to a standard that really can only be met by having worked on a Form S-1 or Form S-7.

MR. VOLK: It seems to me this gets back to the question of the reasonable expectations of the public. Does the prospective investor think that the underwriter has performed his diligent function in the traditional manner in connection with an S-16 registration statement? It seems to me that, if you have a firm commitment syndicated offering where the managing underwriter's name appears in at least as large type as that of the company on the cover page, if not in lights, you may induce high expectations on the part of the investor, who might reasonably be thought to expect that the managing underwriter has done all he possibly can do in the way of an independent investigation. On the other hand, if his name appears in small type as the selling broker or is not required to appear at all, the public's reasonable expectations as to his investigation are arguably much lower.

MR. BIALKIN: On the other hand, the '33 Act does provide expressly that a person may rely in good faith upon the rules and regulations of the Commission, one of which is the adoption of Form S-16 and the limited disclosure necessitated by the use of that form. Are you suggesting that that is not a sufficiently stable basis upon which to rest a due diligence defense?

MR. JOHNSON: Let me address this. The thing is that the S-16 does incorporate by reference the '34 Act filing and I suppose the underwriter is as responsible for that as he is for what is in the two-page document. I do think that there is a differential standard that can be applied. In other words, if a brokerage firm is approached with a fait accompli by a customer who says he has this shelf registration S-16 and who wants the broker to sell, perhaps the broker can't do anything and is really going to run a business risk competitively if he can't do it. If he really has the business locked up, and he has the time, he may be able to do some limited due diligence, which hopefully after the fact, he can argue meets the statutory standard.

If you're talking about a fully syndicated firm commitment underwriting of a substantial number of shares of common stock in a secondary, where the S-16 is technically applicable, in my experience, managing underwriters prefer not to use the Form S-16. For business reasons, they seem to feel that some fuller story is required. They often say, well, we'd like to beef up the S-16, and as you talk and as you discuss it, it turns out that it's just as easy to go a full S-7 as it is to beef up the S-16, and at least, by going the S-7 you're sticking within the limitations of the form and not picking and choosing the additional information you put in.

MR. BIALKIN: I'd like to give Alan Levenson the last word on this topic before moving to the next topic.

MR. LEVENSON: The Commission and its staff have traditionally emphasized the importance of the registration of securities. Since 1970, emphasis has been placed on integrating the disclosure requirements of the Securities Act of 1933 and those of the Securities Exchange Act of 1934. Practical problems involved in marketing registered securities and the liability exposure that the distributors have in connection with the marketing of such securities have not been adequately focused on by the SEC. The SEC's Advisory Committee on Corporate Disclosure should consider these matters and make appropriate recommendations with respect to such concepts as differential investigation and differential liability under the Securities Act.

MR. BIALKIN: Thank you. Another form of underwriter involvement is the registered exchange offer, where one company seeks to acquire another company by offering its shares in the market. Related to that is the unregistered cash tender offer and the duty and role of the broker/dealer in that exercise. That subject is now to be discussed by Martin Lipton.

MR. LIPTON: In the cash tender offer and exchange offer situation, the investment banker or the broker-dealer is a supporting player in a drama that generally has three principal characters: the target of the takeover attempt; the bidder (sometimes called the raider); and a competing bidder who comes on in the second act and is sometimes called the "White Knight". The takeover drama has a participating audience—the securityholders of the target. In the exchange offer, the investment banker acts as dealer-manager for the bidder's offer and is a statutory underwriter with respect to the se-

curities of the bidder. As an underwriter, the dealer-manager has the usual Section 11 liabilities to the securityholders of the target to whom the bidder's securities are offered. I'm not going to talk about that. That is a Securities Act of 1933 problem that does not differ significantly from the other types of underwritings that are subject to section 11.

The principal issue that I'm going to talk about is the scope of the dealer-manager's or investment banker's responsibilities and liabilities to the principal players in the takeover drama.

The Supreme Court decision in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), confines Rule 10b-5 liability to actual purchasers or sellers. Accordingly, the principal focus in the takeover situation has shifted to section 14(e) of the Securities Exchange Act of 1934. Section 14(e) basically tracks the operative language of rule 10b-5 and applies to any cash tender offer or exchange offer and is not limited by the purchaser-seller requirement of rule 10b-5.

The basic issues with respect to section 14(e) as applied to the dealer-manager in a tender offer or exchange offer are:

- (1) Is there an implied civil damage action and, if so, does it extend to anyone other than a securityholder of the target?
- (2) If there is an implied civil damage action, is liability predicated on scienter or on negligence?
- (3) Is a dealer-manager subject to greater liability under § 14(e) than it would be under Section 11 of the 1933 Act?
- (4) How are the damages suffered by a losing bidder to be measured?

Only a limited number of cases have considered these issues.²⁵ *Chris-Craft Indus. Inc. v. Piper Aircraft Corp.*²⁶ presents each of these issues in the context of a typical, hard-fought takeover battle. The best approach to our subject is an analysis of the *Piper* case and of certain of the questions pending before the Supreme Court.

On January 23, 1969, after accumulating more than 200,000 Piper shares (about 10 percent of Piper's outstanding shares), Chris-Craft announced a \$65 cash tender offer for 300,000 or more shares. The tender offer price was approximately \$12 above the price at which Piper had been trading. Piper insiders and members of the Piper family who were officers and directors of Piper, opposed the Chris-Craft offer and, on behalf of Piper, retained the investment banking firm of First Boston Corporation to advise them.

25. *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975); *H. K. Porter Company, Inc. v. Nicholson File Co.*, 482 F.2d 421 (1st Cir. 1973); *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970). *See also*, *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); *Sargent v. Genesco, Inc.* 492 F.2d 750 (5th Cir. 1974).

26. 480 F.2d 341 (1973); *cert. granted*, 425 U.S. 910 (1976) [*reversed* 97 S.Ct. 926 (1977)].

During the first few days after the Chris-Craft offer, the Piper insiders sent Piper's public stockholders three letters opposing the tender offer. One of the letters stated, among other things, that the \$65 offer was "inadequate," but none of the letters disclosed that First Boston had privately advised the Piper insiders that a \$65 price was "fair and equitable" or that First Boston was trying to arrange for Piper to sell 300,000 Piper shares to Grumman Aircraft Engineering Corp. at the identical price. In finding these letters to be misleading in violation of section 14(e), the Second Circuit stated:

The Piper family's culpability regarding these shareholder letters is clear. Corporate officers and directors in their relations with shareholders owe a high fiduciary duty of honesty and fair dealing. . . . The Piper family obviously disregarded this obligation when they sent out these shareholder letters knowing that they were materially misleading.²⁷

On January 29, the Piper insiders issued a press release stating that Grumman "has agreed to purchase" 300,000 Piper shares at \$65 a share. The Grumman press release was inaccurate in that Grumman had the right to "put" the 300,000 shares back to Piper at the purchase price plus interest. The Grumman agreement was terminated shortly after the close of Chris-Craft's tender offer.

The district court and the Second Circuit stated that Chris-Craft's tender offer, which attracted only about 300,000 of the 900,000 shares owned by the public, was "adversely affected" by the publicity concerning the Grumman agreement that was never consummated. In condemning the Piper press release concerning Grumman, the Second Circuit stated:

But Piper's failure to describe the put in its press release, or in its subsequent letter to shareholders, constituted a material omission in violation of section 14(e). . . . The Piper family recklessly disregarded its obligation to shareholders in failing to disclose with substantial accuracy a transaction which was likely to affect the attitude of Piper shareholders toward the CCI tender offer.²⁸

Next, Piper agreed to issue almost 470,000 shares of stock—about 30 percent of Piper's then outstanding stock—to acquire two companies. Piper did not seek stockholders' approval, as required by its listing agreement with the NYSE. As a result, the NYSE initiated delisting proceedings against Piper and suspended all trading. Piper finally rescinded the agreements.

In late February 1969, Chris-Craft began processing a registration statement for an exchange offer in order to obtain a majority of Piper's shares. Shortly thereafter, the Piper insiders turned to Bangor Punta, recruited by First Boston.

27. 480 F.2d 341 (1973) at 364.

28. *Id.* at 365.

Under an agreement dated May 8, the Piper insiders exchanged their 500,000 shares (about 31 percent of Piper's outstanding shares) for a package of Bangor Punta securities. Bangor Punta agreed to use its best efforts to acquire additional Piper shares in order to attain a more than 50 percent interest in Piper. Bangor Punta agreed to make an exchange offer to Piper's public shareholders for a package of unspecified securities. On May 8, Piper and Bangor Punta announced in a press release that the latter would offer a package of securities to Piper's public shareholders "to be valued in the judgment of First Boston Corporation at not less than \$80 per Piper share".

The SEC brought an action against Piper and Bangor Punta charging that the \$80 value press release violated the rule 135 proscription against "gun-jumping", because it placed a dollar value on an unspecified package of Bangor Punta securities as to which no registration statement had been filed. Bangor Punta and Piper consented to an injunction.

Thereafter, Bangor Punta agreed to pay the Piper insiders additional consideration for their shares aggregating about \$13 million if Bangor obtained more than 50 percent of Piper's stock. The insiders sent letters and telegrams and issued press releases in June and July urging the Piper stockholders to accept the Bangor Punta offer. These communications did not mention the \$13 million. Finding that this was a material omission contrary to section 14(e), the Second Circuit stated:

Under these circumstances, the Piper shareholders were entitled to receive information sufficient to make an informed judgment on the weight to be given the personal recommendations of the Piper family.²⁹

Approximately 120,000 Piper shares (approximately 7½ percent of the outstanding shares) were held by three investment funds. The SEC took the position that rule 10b-6 prohibited both Chris-Craft and Bangor Punta from making purchases of those blocks during their respective outstanding exchange offers.

On May 5 the SEC issued a public notice specifically pointing out that such cash acquisitions were forbidden. The SEC release, proposing rule 10b-13, stated that existing rule 10b-6 also prohibited such purchases. Bangor Punta and the Piper insiders learned of the SEC release shortly after its issuance. Counsel advised Bangor Punta that rule 10b-6 did not prohibit such purchases.

Between May 14 and 23 Bangor Punta purchased the three blocks for in excess of \$9 million cash. The Second Circuit later held these cash purchases to be violative of rule 10b-6.

In addition to the 7½ percent cash blocks, Bangor Punta acquired an additional 7 percent of Piper's stock (110,000 shares) by means of its

29. *Id.* at 366.

exchange offer, the prospectus for which the district court and Second Circuit later found to have been materially misleading.

Bangor Punta's exchange offer registration statement, which named First Boston as dealer-manager, contained a balance sheet which carried the Bangor and Aroostock Railroad ("BAR"), a railroad subsidiary, at \$18.4 million. Bangor Punta did not disclose that it had been trying to sell BAR for some time; that the only interested buyer offered \$5 million; and that Bangor Punta was then contemplating a sale at about that price—a sale it authorized shortly after it took control of Piper.

Bangor Punta's board minutes describing the BAR matter show that on April 1, the Bangor Punta board appointed a committee headed by Curtis Hutchins to study disposition of the unprofitable railroad. After reviewing the options, the committee reported its conclusions to the board on May 21. It recommended a sale of BAR to Amoskeag, Inc., a railroad company headed by F. C. Dumaine. Hutchins stated that Dumaine was "the only person whom he knew might be interested" and that Dumaine "had indicated he might be willing to pay \$5,000,000." Bangor's Chairman asked if Dumaine would pay \$7,000,000. Hutchins replied that Dumaine would probably stand fast at \$5 million. The board then authorized Hutchins to negotiate a deal, subject to board approval and a study of accounting and tax ramifications.

Hutchins then resumed negotiations with Dumaine and actually gave him an unsigned letter for a sale at \$5 million dated May 27, 1969. On June 16, while Bangor Punta's exchange offer was in registration, Dumaine wrote the following inter-office memo of his conversation with Hutchins that day:

Curtis Hutchins said we definitely have a deal—they are in registration: he hopes to be out of registration in ten days—of course that is questionable. He was informed by his lawyers that a definite commitment should not be made within two months of registration. We agreed that in the meantime I should go over the railroad with whomever I want to see the overall condition of the property and to meet the staff so that I will be prepared to select a staff on consummation date, if and when we have a consummation date.

The district court concluded that the Bangor Punta board had not made a firm decision to sell BAR for \$5 million during the control contest, saying that "Dumaine and Hutchins who negotiated and desired the sale, believed what they wished to believe, that their personal agreement concluded all but the formalities." Nevertheless the district court found that the representation that BAR had a "fair market value" of \$18.4 million was materially misleading:

[T]he circumstances do indicate a sufficiently serious consideration of the possibility of sale at a figure some \$13 million below the then carry-

ing value of the BAR stock on Bangor Punta's books so as to force the conclusion that the Bangor Punta directors could not, at the time, have believed that the \$18.4 million figure (based on an appraisal of 1965 fair market value) any longer represented a responsible appraisal of market value of the BAR holding. [T]he \$18.4 million carrying figure of the BAR holding was obsolete to the point of being misleading.³⁰

The district court stated that it was

aware of no principle of accounting or of fair disclosure which would justify a failure to up-date a constructed carrying figure which may have reflected approximate fair value in 1965 but which was almost four times the offer of a willing buyer (and the only willing buyer) in 1969—an offer which the Board, despite its efforts in good faith to find alternatives—was constrained ultimately to accept. Consistency of fair disclosure required exposure of circumstances which so clearly rendered obsolete an appraisal made four years earlier.³¹

The district court found that the \$13 million loss in the value of BAR was material. When the BAR sale was disclosed the market price of Bangor Punta went up in reaction to the sale.

The Second Circuit referred to the BAR misrepresentations as follows:

We believe that the officers of BPC greatly transgressed their allowable area of discretion in not disclosing the BAR negotiations and other circumstances reflecting the value of the BAR. The officials in charge of the exchange offer were well aware of the discussions with Amoskeag and the activities of the special BAR committee. They also were aware of all the other circumstances that indicated that the book value of the BAR was deceptive and unrealistic. . . . They showed reckless disregard for the import of their activities concerning the BAR. They knew that the book value of the BAR set forth in the registration statement was no longer realistic.³²

First Boston had read the minutes of Bangor Punta's board disclosing that Bangor Punta was prepared to sell BAR for \$5 to \$7 million. First Boston discussed the matter with Bangor Punta's management and was assured that the sale had been tabled. First Boston did not contact Dumaine. There was no finding that the BAR matter was deliberately concealed.

Having summarized the Chris-Craft/Piper drama and identified the players and their respective roles, let us turn to the claimed violations of section 14(e) by First Boston.

30. 331 F. Supp. at 1154, 1161.

31. *Id.* at 1161.

32. *Supra* n. 27, at 369.

Chris-Craft argued that First Boston was liable to it, Chris-Craft, on two different bases. First, on the ground that First Boston had aided and abetted the gun-jumping violation of Piper and Bangor Punta, the false and misleading letters and press release relating to the Grumman agreement and the pecuniary interest of the Piper insiders in the Bangor Punta exchange offer, as well as the rule 10b-6 violations of Bangor Punta, and, second, that First Boston was liable under section 14(e) with respect to the BAR disclosure matter. The Second Circuit rejected the claim of liability predicated on First Boston being involved in the violations other than the BAR disclosure as follows:

We agree with the district court that there is no merit to CCI's other claims against First Boston, essentially that it was the chief strategist for Piper and BPC in the control battle. The district court found, based on substantial evidence, that in its capacity as investment banker First Boston merely provided professional services to these companies. The business decisions that led to violations of the securities laws were initiated by these companies, not by First Boston in its role as investment banker. We are aware of no authority for holding First Boston liable in that capacity.³³

While the "chief strategist" in the *Piper* case was rejected, it is important for investment bankers to take heed of the possibility of such liability and limit their activities when advising a target or competing bidder to professional services that do not make them a participant in possible violations by their client.

The Second Circuit held that a defeated bidder had standing under section 14(e) to bring a civil damage action against the dealer-manager for the successful bidder and awarded damages with interest totally over \$37,000,000, despite that the maximum exposure under section 11 was \$24,000,000 which was the total amount of Bangor Punta securities issued under the exchange offer registration statement. The court stated:

Our holding on the standing of CCI to sue for damages may be summarized as follows. The statutory language of § 14(e) is silent on standing; it neither confers nor excludes standing with respect to one in the position of CCI. As a distinguished commentator said years ago, in such a situation there is no need to try to discover 'supposed legislative intent'; '[w]hether his offenses shall have any other legal consequence has not been passed on one way or the other as a question of legislative intent, but is left to be determined by the rules of law.' Thayer, *Public Wrong and Private Action*, 27 Harv. L. Rev. 317, 320 (1914). Under common law tort principles, we hold that a claim for relief under federal laws is stated where, as here, a defeated contestant for control

33. *Id* at 373.

has been put in a minority shareholder position because of the wrongdoing of its opponent and the margin of victory is only 7 percent. CCI has shown that it had a reasonable chance of obtaining control of Piper, but lost the opportunity because its opponent gained control through means illegal under federal law. This is a case of first impression with respect to the right of a tender offeror to claim damages for statutory violations by his adversary. And our holding is premised on the belief that the harm done the defeated contestant is not that it had to pay more for the stock but that it got less stock than it needed for control.³⁴

Then the court went on to find that First Boston did not meet the standard of care for underwriters under section 14(e)—a standard which the Second Circuit fixed as a negligence-due diligence standard rather than as a scienter standard. The court said:

... We believe that § 14(e) imposed liability upon an underwriter in favor of a competing offeror, specifically where the misrepresentation occurs in the context of a contest for control. An underwriter is liable under § 14(e) as an aider and abettor of the issuer if he was aware of a material falsity in the registration statement or was reckless in determining whether material falsity existed.

Section 14(e) provides that '[i]t shall be unlawful for any person to *make* any untrue statement of a material fact' or to mislead by omitting 'to state any material fact' [emphasis in original]. An underwriter or dealer-manager for a securities issue does not actually prepare the registration materials. Thus, in a literal sense, it does not 'make' statements to potential investors. But we do not read § 14(e) so narrowly. An underwriter by participating in an offering constructively represents that statements made in the registration materials are complete and accurate. The investing public properly relies upon the underwriter to check the accuracy of the statements and the soundness of the offer; when the underwriter does not speak out, the investor unreasonably assumes that there are no undisclosed material deficiencies. The representations in the registration statement are those of the underwriter as much as they are those of the issuer.

* * *

We turn now to a determination of whether First Boston violated § 14(e). Since we already have concluded that the BPC registration statement and prospectus were materially deficient, the remaining issue to be determined is First Boston's culpability. First Boston is a skilled, experienced and well respected dealer-manager and underwriter. It had an obligation with respect to the BPC exchange offer to reach a careful, independent judgment based on facts known to it as to the accuracy of the registration statement. Moreover, if it was aware of

34. *Id.* at 361.

facts that strongly suggested, even though they did not conclusively show, that the registration materials were deceptive, it was duty-bound to make a *reasonable further investigation* [emphasis added].

"We hold that First Boston did not adequately perform its duty in these respects. The minutes of the April 1 and May 21 board meetings, which were examined by the underwriting department of First Boston, disclosed the early discussions and negotiations concerning the disposition of the BAR. At the April 1 meeting, the board considered disposing of the BAR and appointed a committee to study the alternatives. At the May 21 meeting, a possible sale to Amoskeag was discussed extensively. The board showed considerable interest in the sale at the time and gave the impression of strongly favoring it. These minutes, if not sufficient in themselves to lead a reasonable person to believe that the registration statement was misleading, certainly would have impelled a reasonable person to explore further. The only additional investigation by First Boston was to question company officials about the possible sale of the BAR. First Boston did not seek verification of the officials' answer that a sale was not anticipated at that time. *Cf. Escott v. Bar-Chris*.³⁵ It did not make a more careful search of BPC's records, nor did it talk to officials at Amoskeag after it discovered from the minutes that Amoskeag was the likely buyer. Under these circumstances, First Boston's certification of the PBC registration statement carrying the BAR at \$18.4 million amount to an almost complete abdication of its responsibility to potential investors, to CCI, and to others who relied upon it to detect misrepresentations. We hold that First Boston possessed enough information reasonably to deduce that the BPC registration statement was materially inaccurate.

We hold that the conduct on the part of First Boston and its officers violated § 14(e).³⁶

Returning to the four questions with which I began, the Second Circuit in *Chris-Craft* answered them as follows: (1) there is an implied civil cause of action under section 14(e) which extends not only to a securityholder of the target but also to a defeated bidder; (2) willful and affirmatively fraudulent conduct is not the standard of culpability to be applied in such an action—at least with respect to the liability of the dealer-manager; (3) a dealer-manager's liability under section 14(e) is not limited to the value of the securities issued in connection with the exchange offer; and (4) the damage suffered by the losing bidders is the diminution of the value of the securities acquired resulting from his failure to have had a fair chance to obtain control.

With these issues pending before the Supreme Court, there is not much more that can be said other than to hazard a guess as to the outcome. I be-

35. 283 F. Supp. 643, 697 (S.D.N.Y. 1968, McLean D.J.).

36. *Supra* n. 27, at 370-3.

lieve that the civil damage cause of action under section 14(e) should extend only to securityholders of the target and should not be applicable to any of the other players in the takeover drama. However, the Supreme Court may not decide the *Piper* case on this issue but rather may reverse as to First Boston on the scienter issue on the authority of *Ernst & Ernst v. Hochfelder*.³⁷

MR. BIALKIN: Underwriters and broker/dealers are frequently called upon to give written advice as to the value of securities or the fairness of exchange ratios and, in so doing, have been sued with increasing frequency for certain errors in judgment in giving that advice. Alan Levenson is going to discuss that development and perhaps some of the elements of safeguard inherent to it.

MR. LEVENSON: My designated topic is a broker/dealer's expert fairness or valuation opinion which is included in a registration or proxy statement involving an exchange offer, a parent-subsidiary merger, or a "going private" type transaction. I shall briefly identify the problems in this area, discuss certain unresolved disclosure issues that have caused these problems, make suggestions with respect to proposed disclosure, and recommend an approach to resolve the disclosure questions.

Succinctly stated, the problems of the broker/dealer rendering an expert opinion are (1) potential litigation; and (2) exposure to civil liability. In two of the types of transactions that I have identified, namely the parent-sub-sidiary merger and the "going-private" transaction, these problems are exacerbated because of the self-dealing nature of the transactions. Generally speaking, in these conflict of interest cases, the broker/dealer's expert opinion would be of actual significance to stockholders. The broker/dealer's reputation provides support for management and the proposed transaction, as expressed in the registration or proxy statement. Accordingly, there is a substantial likelihood that a reasonable stockholder would consider the opinion important in making his investment or voting decision.

I assume for purposes of this discussion only that the investment banker, the financial consultant, the investment advisor, or the broker/dealer who renders the fairness or valuation opinion is a person whose profession gives authority to a statement made by him and that such person is named in the registration or proxy statement as having prepared the opinion for use in connection with such documents. Based on this assumption, should, for example, the registration statement covering an exchange offer contain an omission of a material fact or otherwise be materially misleading, the broker/dealer may be sued under section 11(a)(4) of the Securities Act by any person who acquired the registered securities. In addition, the purchaser of the registered security at this time has an implied right of action under section 10(b) of the Exchange Act. The Supreme Court has not, but shortly may

37. *Supra*, n. 3.

decide the question whether an implied right of action also exists under section 14(e) of the Exchange Act.³⁸

The concern about involvement in potential litigation and exposure to civil liability has been generated by unresolved disclosure issues. Uncertainty as to adequate disclosure exists because disclosure requirements have been developing as a result of litigation, rather than being established by amendments to the SEC registration statement Forms and to the proxy statement Schedule.

Litigated cases have involved the following disclosure issues: (1) the basis for the investment banker's fairness opinion;³⁹ (2) the furnishing of the investment banker's report as distinguished from the statement of and reference to his opinion in the registration or proxy statement;⁴⁰ (3) the updating supplements by the investment banker to his opinion;⁴¹ (4) the relationships between the investment banker and management; (5) the extent of the investment banker's inquiry; (6) the doctrine of "equal prominence" of disclosure;⁴² and (7) the reference to the investment banker's opinion in the document in question.

When an investment banker renders a fairness opinion concerning an exchange ratio in connection with a registered exchange offer, must such opinion be disclosed in the prospectus? In *Kaufman v. Lawrence*,⁴³ the president and chief executive officer of White Weld, the dealer/manager of Wells, Rich & Green's exchange offer, furnished his opinion to the company concerning the exchange ratio. However, this fact was not disclosed in the prospectus. Plaintiff claimed that this omission constituted a violation of sections 10(b) and 14(e) under the Exchange Act. The court held, on a motion for preliminary injunction, that such omission was not material. Judge Carter stated, when referring to White Weld's "go-ahead opinion" letter, that plaintiff's allegation was to "obviously make-weight arguments on the issue of sections 10(b) and 14(e) materiality."⁴⁴ However, I doubt that the same conclusion would apply to a situation where the investment banker's opinion had been unfavorable. In this regard, the decision in *SEC v. Senex Corporation*⁴⁵ re-

38. *Chris-Craft v. Piper*, *supra* n. 26.

39. *See*, *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438; *Gould v. American Hawaiian Steamship Company*, 535 F.2d 761 (3rd Cir. 1976); *Denison Mines Ltd. v. Fibreboard Corp.*, 388 F. Supp. 812 (D. Del. 1974).

40. *See*, *Tanzer Economic Associates, Inc. v. Haynie*, 388 F. Supp. 365 (S.D.N.Y. 1974); *cf.* *Universal Capital Corp. v. Barbara Lynn Stores, Inc.*, 74 Civ. 4460 (S.D.N.Y., filed Oct. 25, 1974), [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶94,949 (S.D.N.Y. 1975).

41. *See*, *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255 (3rd Cir. 1972), *cert. den.* 409 U.S. 874; *Tanzer Economic Associates, Inc. v. Haynie*, *supra*, n. 40; *Gerstle v. Gamble-Skogmo*, 298 F. Supp. 66 (E.D.N.Y. 1969), *modified and aff'd*, 478 F.2d 1281 (2d Cir. 1973).

42. *See*, *Robinson v. Penn Central Co.*, 336 F. Supp. 655 (E.D.Pa. 1971); *Kohn v. American Metal Climax, Inc.*, *supra*, n. 41.

43. 386 F. Supp. 12 (S.D.N.Y. 1974).

44. *Id.* at 16.

45. 399 F. Supp. 497 (E.D. Ky. 1975), *aff'd* 534 F.2d 1240.

lating to disclosure of a favorable feasibility report and to non-disclosure of two negative feasibility studies should be noted.

Must the basis for an investment banker's opinion be disclosed in a proxy statement? In *Denison Mines v. Fibreboard Corporation*,⁴⁶ involving a proposed merger of Yuba River Lumber and Brunswick Lumber Products Company into Fibreboard, the district court granted plaintiff's motion for preliminary injunction and held that the bare reference to Lehman Brothers' opinion that the transaction was "fair to the company and its stockholders," without any further reference to the basis for that opinion, was materially misleading. The opinion letter was not reproduced either in the proxy statement or in the appendices. However, it should be noted in connection with the failure to disclose the basis of the investment banker's opinion, that Yuba's timber assets were of particular importance, and in this regard, Lehman, in evaluating the transaction had relied only upon information supplied by management.

On the other hand, in April, 1976, the court of appeals in *Gould v. American Hawaiian Steamship Company*,⁴⁷ involving the merger of MacLean Industries into R. J. Reynolds Tobacco Company, held that the failure to disclose the basis of Lazard Freres' "fairness opinion" was not a violation of section 10(b) or 14(a) under the Exchange Act. Moreover, in June, 1976, the Supreme Court in *TSC Industries v. Northway*⁴⁸ held that the Court of Appeals erred in granting Northway's motion for summary judgment, in connection with the omission in a proxy statement of the basis for Hornblower & Weeks-Hemphill, Noyes "fairness opinion." The court concluded that such omission was not materially misleading as a matter of law. However, Justice Marshall did state that, "Still, we cannot assume that a TSC stockholder would focus only on the 'bottom line' of the opinion, to the exclusion of considerations that produced it."⁴⁹

When a proxy statement refers to an investigation by the investment banker and includes his opinion, must the investment banker's report be furnished to the stockholders whose votes are solicited in connection with a merger? The district court, in *Universal Capital Corporation v. Barbara Lynn Stores*⁵⁰ held that the failure to provide the shareholder with the expert's report that was discussed extensively in that proxy statement was misleading. However, in *Tanzer Economics Associates v. Haynie*⁵¹ decided one month later in the same district, the court on a motion for preliminary injunction reached a different result, indicating, but not deciding, that it might be misleading or confusing to the shareholder who might not possess the necessary knowledge,

46. *Supra*, n. 39.

47. *Supra*, n. 39.

48. *Supra*, n. 39.

49. *Id.* at page 2137.

50. *Supra*, n. 40.

51. *Supra*, n. 40.

experience, and background to be furnished with the investment banker's investigatory report.

There also is the question of equal prominence or placement of disclosure. In *Kohn v. American Metal Climax Corporation*,⁵² the court of appeals held that the proxy statement did not give sufficient emphasis to the basis for the investment banker's opinion. The endorsement by the investment advisor, M. N. Rothchild and Sons, of the amalgamation of Roan Selection Trust and American Metal Climax was set forth in the Explanatory Statement, and the basis for the recommendation was disclosed in Appendix Q to the proxy statement. There was no cross-reference in the Explanatory Statement to the Appendix. The court stated that the stockholders should have been directed to the Appendix, which set forth the basis of the investment banker's opinion, and that omission to do this violated rule 10b-5 under the Exchange Act. However, it should be noted that in this case, the investment advisor had a prior relationship with Roan Selection Trust, relied solely on data supplied by Roan's management, and did not conduct an independent survey of Roan's assets and operations.

I briefly want to comment now on suggestions with respect to proposed disclosure. In transactions involving conflicts of interest, the investment banker's expert fairness or valuation opinion would be considered important by stockholders. Accordingly, because of the substantial likelihood of litigation, care must be taken in rendering such opinion. The opinion letter, in my view, should set forth generally what the investment banker did in his study of the company and the assumptions upon which the valuation or fairness opinion is based. When the investment banker relies solely on management for information, this fact also should be disclosed in the text of the proxy or registration statement. Any relationship between the investment banker and the parties to the transaction also should be disclosed. Rule 146 provides an analogous guideline for such disclosure in connection with that Rule's disclosure requirements relating to the relationship between an offeree representative and the issuer.

As to future disclosure directions—in view of the uncertainty as to what should be disclosed, the nature and extent of such disclosure, and the placement of disclosure—the SEC should propose amendments to its registration statement Forms and proxy statement Schedule. This would be, in my view, in the interests of investors and at the same time would curtail costly and time-consuming litigation. As a matter of disclosure policy, it is preferable to establish requirements through rule-making than through private litigation.

As to culpability and liability of the investment banker under Section 10(b) of the Exchange Act in connection with rendering an expert opinion, should the Supreme Court grant *certiorari* in *Green v. Santa Fe Industries*,⁵³

52. *Supra*, n. 41.

53. 533 F.2d 1283 (2d Cir. 1976).

and I believe it will, we might have additional clarity and standards in this area. It would appear that the *Hochfelder* decision portends for liability limitation, rather than for liability creation, in this regard.

MR. HARMAN: I would like to ask Alan a practical question: Would you advise an investment banker, whose opinion is going to be referred to, or included in an exchange offer registration statement, or merger registration statement to have itself identified as an expert, or not? As I understand it, the staff will require the consent of that investment banker, but will not insist on it being identified as an expert.

MR. LEVENSON: I would not advise the investment banker to identify itself as an expert in the registration statement because of the express cause of action provided by section 11(a)(4) under the Securities Act for the person who acquires the registered securities against experts.

There is another legal question in this area which I did not previously discuss, *i.e.*, whether the investment banker's activities are such that he also might be deemed to be an underwriter—to be participating in a distribution.

MR. BIALKIN: That problem is of course reminiscent of the problem of some years ago, when investment bankers were acting as valuation experts for purposes of self-underwriting of brokerage firms and there was a contradiction with the Commission at that time as to identification as an underwriter.

MR. JOHNSON: Could I ask one question, Ken? Just to follow up on this expert question; you did say in the beginning, Alan, I think, that you thought that an investment banker was an expert for purposes of section 11.

MR. LEVENSON: I said “assume” for purposes of discussion only. I did not express an opinion on that point.

MR. JOHNSON: Well, I'm not sure what would follow from that. In other words, your traditional expert is passing upon statements of fact, and even if the investment banker is characterized as an underwriter, and if he does sufficient investigation so that he can form a reasonable basis for opinion, and if he renders his opinion objectively and fairly, what is added by perhaps bringing him into the section 11 as an expert? What would be the misstatement in effect that he would be expertising?

MR. WILLIAMS: Your question is designed to raise the point whether you're better off being identified as an expert with respect to the issue of whether you are an underwriter.

MR. HARMAN: Exactly. It's a hard choice, I think. If you're identified as an expert, you can presumably limit the scope of that liability to the expertised portion, if you will, the valuation, and be judged by the standard of an expert. On the other hand, it's not clear whether you would or would not be an underwriter. If you were an underwriter, then your responsibility might go to the whole document.

The other thing I would mention is that I'd prefer to take my chances on the argument that you're not an underwriter, but just in case the investment

banker ought to do some due diligence and get an indemnity from the company.

MR. BIALKIN: Indemnities are always good. I'd like to pass on . . .

MR. LIPTON: I think we should not leave that without making one other point. One of the great problems with identifying someone as an expert other than a lawyer or an accountant is the problem of not having a body of learning like the auditing standards, for determining whether or not the expert has performed in accordance with his profession.

MR. BIALKIN: Yes, there is no such standard for such expert valuation of the securities. In our present discussion we have been advocating and attempting to ascertain a flexible standard of liability to be applied in cases where underwriters concededly are underwriters and concededly subject to section 11. However, we have also discussed cases involving the '34 Act, such as those relating to section 14(e) where the courts have implied underwriter due diligence liability, notwithstanding the inapplicability of the '33 Act.

With that in mind, we now pass to a consideration of those securities offerings where neither section 11 of the '33 Act nor section 14 of the '34 Act is applicable. Specifically, we are going to consider, in tandem, the application of underwriter due diligence standards to the implicitly exempt offerings of tax-exempt bonds, municipal securities and commercial paper. Steve Dinces will initiate that discussion.

MR. DINCES: Thank you. The disclosure requirements in connection with the sale of municipal securities stem primarily from section 10 of the '34 Act and rule 10b-5 thereunder. (Section 17 of the '33 Act does apply to exempt securities but from a practical standpoint it really is not that important; section 10 of the '34 Act actually expands the scope of section 17 to include transactions in connection with the *purchase* as well as sale of securities). The registration provisions of the '33 Act, are of course not applicable to the sale of tax-exempt securities. I think, however, it is useful, by way of analogy and as a guide to the responsibilities imposed by the '34 Act, to look at section 11 of the '33 Act and some of the practices thereunder.

It has become commonplace to talk about underwriters' "due diligence" obligations in connection with the sale of municipal and other securities exempt from registration under the '33 Act. But due diligence, as Ken has said, is not a '34 Act concept. How then does it fit in to a disclosure pattern mandated by the '34 Act? As a matter of fact, the words "due diligence" do not even appear in the '33 Act. The "due diligence" concept stems from the provision in section 11 for relief from liability under that Section as a result of discovering no material misstatements or omissions after "reasonable investigation." It is most important to note that the section 11 "reasonable investigation" is a defense and not an affirmative obligation. (It should also be noted that a section 11 cause of action can be based on negligent behavior, which is not the case under § 10 of the '34 Act, *Ernst & Ernst v. Hochfelder*.⁵⁴)

54. *Supra*, n. 3.

It is therefore, in my view, a mistake to use the expression “due diligence” in a non-’33 Act context, particularly with respect to competitive bid tax-exempt underwritings, where it is almost impossible for underwriters to employ effective investigatory and other procedures to check the accuracy and completeness of issuers’ documents. I think this underscores two things; a kind of varying concept of underwriters’ investigatory duties depending upon the fact circumstances (*e.g.*, competitive bid versus negotiated deals), and perhaps even more important in the tax-exempt area, the importance of the issuer’s primary responsibility for disclosure.

It’s interesting to note another analogy in section 11 of the ’33 Act to practices that have been developing in underwriting municipal securities. Section 11 provides for reliance on statements of public officials, provided that those relying on such statements have no reasonable grounds to believe that the statements being made (in registration statements) are untrue or that there is a material omission. There is a growing trend for municipal underwriters to request “Section 11” types of certificates from public officials, reciting 10b-5 type language to the effect that the officials giving the certificates participated in the preparation, or had responsibility for the preparation, of the official statement and that nothing has come to their attention which would lead them to believe that there is a misleading statement or a material omission.

There are two other references to the ’33 Act I would like to make. Schedule B thereof provides a checklist of disclosure items required of foreign governments that are registering their securities under the ’33 Act, and I think that it is clearly worth looking at such schedule as a guide for rule 10b-5 type disclosure for domestic municipalities.

Finally you should keep in mind that while the ’33 Act provides for reduced disclosure under certain circumstances, for example, Reg. A offerings for smaller issues, there is no exemption that I know of, either statutory or by way of “judicial gloss”, for reduced disclosure under section 10 in connection with the omission of material information. In other words, while the market risk for underwriters is obviously less for small issues than for large ones, the large concept of materiality does not differ in theory depending on the size of the issue.

Turning to the disclosure requirements of section 10 of the ’34 Act, the test and theory are very simple. The key is materiality. Issuers and underwriters have an obligation to provide investors with material information about the issuer and the securities being offered.

Incidentally, I am aware that a respectable argument can be made that in competitive bid situations, which comprise the bulk of tax-exempt financing, the underwriters have no investigatory duty whatsoever. The argument would be based on the fact that the underwriters cannot possibly give detailed review to the many dozens of competitive bid deals that are offered each week. I personally would like to preserve this argument for use in a litigation

defense, but I find it hard to advise clients prospectively that they can do nothing.

I think *Hochfelder* has clarified, to some extent, the nature of the investigation required in both competitive bid and negotiated situations. Section 10 and rule 10b-5 have been interpreted under *Hochfelder* as being addressed to practices involving some element of scienter, and not negligent conduct alone. What then constitutes scienter or more than negligent misfeasance (willful, knowing or purposeful conduct?) with respect to disclosure when a professional sales organization underwrites tax-exempt securities?

In a footnote to the *Hochfelder* opinion, the Supreme Court said:

[I]n this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate or defraud. In certain areas of the law, recklessness is considered to be a form of intentional conduct for the purposes of imposing liability for some acts. We need not address here the question whether in some circumstances reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.⁵⁵

I think the important point for the underwriter to keep in mind is that repetitive negligent conduct may perhaps be susceptible to being interpreted as "reckless." Can underwriters, for example, merely rely on a good rating and just sit back and do nothing, and say, "Gee, this is a double-A security; so rated, we don't have to do anything; here is the rating stamped on the cover—that's enough." My personal view is no; that that would be a very dangerous practice to follow. Cf. Judge Ward's apparent adoption in *SEC v. Bausch & Lomb, Inc.* (reported in 370 Securities Regulation and Law Report Page G-1 September 22, 1976) of Judge Friendly's position in *Texas Gulf Sulphur* that only "the kind of recklessness that is equivalent to willful fraud" will serve as a basis for liability.

I think as I analyze the situation, you have a case where, in the changing world municipal underwriters are facing, rule 10b-5 perhaps is going to merge in and blend together with the "shingle" theory. In other words, when you hang out your shingle as an underwriter, there is an implication that you will deal fairly with the public. And perhaps this means that the courts will find that when you (a banker, investment banker, dealer, etc.) sell to the public, employing your name, your reputation and perhaps a specific recommendation—you represent that you know something [or have made an investigation?] about the underlying credit.

At a minimum in competitive bid situations, I would advise underwriters to review the notice of sale and the official statement, and other available public information about the issuer for purposes of establishing that the security they are contemplating buying and reselling is a good credit. Having done that, consideration should be given to following up material gaps and

55. *Id.* at 194, n. 12.

inconsistencies or errors with representatives of the issuer. There are many practical problems which underwriters in this area are just beginning to face up to. For example,

- a. What do you do if an official statement is deficient? How do you correct?
- b. No official statement—should underwriters bid?
- c. When (in point of time) do you send a customer an official statement?
- d. When do you send a preliminary statement and follow it up with the final?
- e. Is it ever prudent not to send a customer an official statement where one exists?
- f. What, if anything, does an underwriter-dealer state by legend on a statement or confirmation, etc. as to the role played in competitive bid transactions, *e.g.*, does the underwriter state that an official statement has been prepared by the issuer and that the underwriter has not verified its accuracy? Should the underwriter's name appear on the cover of a competitive bid document?

In negotiated transactions, I think underwriters should follow prudent investigatory procedures, which I suspect in practice, will not be very different than those procedures employed in the '33 Act registration context.

One very topical subject in connection with municipal sales and underwritings is the role of sovereign immunity. In other words, is there a constitutional argument that the federal securities laws (including of course section 10 of the '34 Act) do not in fact apply to municipal issuers. *Cf. National League of Cities v. Usery*.⁵⁶

MR. BIALKIN: Before you get off the 10b-5 question, and move on to the question of sovereign immunity, I wonder if I could put a brief question to you, and ask you for a brief answer in view of our time situation. The comments you have been making about the applicability of Rule 10b-5 cannot seriously be disputed, namely, that 10b-5 applies to any involvement of the broker/dealer with a security. But, in the light of the history of the offering of municipal bonds and exempt securities of this kind, and in light of the fact that for generations they have been sold without this kind of disclosure, are you prepared to concede the argument that 10b-5 now suddenly imposes upon a broker/dealer the obligation to undertake a due diligence investigation and work out a disclosure which would meet the standards of a corporate document disclosure, without giving any credence at all to the history of the practice in this particular industry?

MR. DINCES: Of course you have to give a lot of credence to what's gone on before. I believe, however, that (unless the sovereign immunity argument prevails) rule 10b-5 always applied to the sale of municipal securities. I

⁵⁶ 426 U.S. 833 (1976).

think we have had situations where underwriters have relied upon the ultimate result of whether or not the bonds or the notes have been "money good." Since there have been very few defaults on the part of municipalities, disclosure to the public just was not an issue. Now there is more fear of defaults. Cities are aging, unfunded pension liability is being "discovered", etc. Moreover, there is a growing secondary market in municipal securities. One unanswered question is whether or not somebody is going to be able to prevail in court on a loss of market value theory with respect to tax exempt securities. The public buys a bond at a particular price, unfavorable information comes out about that particular municipal issuer with respect to facts which may have existed when the security was first offered; the public still gets paid interest and ultimately principal, but during the intervening time period, until the security is due, the public finds that it cannot dispose of that security in the secondary market at what it ordinarily could if the security were just being valued and traded on the basis of its interest rate yield, etc.

I think that you have had, within the period stemming, I guess, from the Depression Years, a period of time when the ability of municipal issuers to pay has not been questioned very much. And I think we are now in an era where that subject has come to the fore. We have gone through an era of moral obligations securities, Ken, which as you know, are or are not, depending upon your point of view, debt of a state. I think all of these things have resulted in a changed atmosphere.

MR. BIALKIN: Do you want to discuss the question of sovereign immunity?

MR. DINCES: Well, I don't want to dwell too much on it. I know that, for example, Marty Lipton might have some comments on the subject since he's very much involved in it, but there is the argument that the Federal Securities Laws do not apply to municipal issuers. The argument has been raised by the City of New York, and I believe, also by the City of Philadelphia. It's based on a constitutional point, raised in the *Usery* case, where the U.S. Supreme Court held that Congress may not exercise its power to regulate commerce so as to force directly upon states, its (Congress') choices as to how essential decisions regarding the conduct of governmental functions are to be made. And there is this question of whether or not this same kind of reasoning could apply to the applicability of Section 10, and rule 10b-5 with respect to municipalities and government officials. I personally do not think the argument will stand up.

MR. BIALKIN: Well, for purposes of this discussion, let it be known that there is a disagreement, at least on the panel, as to the question of sovereign immunity which we will leave for future discussion. If I may interrupt, I would like to ask Sam Miller to discuss the role of the broker/dealer and the question of his responsibility with respect to the issuance of commercial paper, which, as you all know, is exempt from the registration requirements of the '33 Act.

MR. MILLER: Thank you, Ken. In order to do that, I shall deal primarily with the *Sanders* decisions. The Supreme Court recently remanded *Sanders v. John Nuveen & Co., Inc.*⁵⁷ with the simple instruction, “the case is remanded . . . for further consideration in light of *Ernst & Ernst v. Hochfelder*.” I’ll call that case *Sanders II*, and I’ll call the predecessor decision in the same litigation *Sanders I*.⁵⁸

Commercial paper is unsecured promissory notes, usually sold at a discount, with a stated maturity of less than 270 days. The commercial paper market serves to use the temporary surplus of some firms and banks to meet the temporary deficits of others. In the years after adoption of the Securities Act of 1933, the commercial paper market has grown spectacularly. Although banks constituted the bulk of the buyers in 1933, they have been since supplanted in large measure by nonfinancial corporations, institutions of all kinds and a growing number of individuals. Recently a few—albeit dramatic—displays of weaknesses in that market have led some courts and commentators to suggest that the federal regulatory scheme for commercial paper should be reevaluated.⁵⁹

In the meantime, dealers in commercial paper must determine their responsibilities by reference to existing law. These responsibilities would be substantially augmented under the two opinions issued by the Seventh Circuit in *Sanders*.

In this case the plaintiff had purchased a promissory note with a maturity of 90 days from the defendant dealer. Shortly thereafter the issuer became insolvent, and the plaintiff brought a class action alleging that the dealer had violated section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder in the sale of a “security.”⁶⁰

In *Sanders I*, the Seventh Circuit held that such a note may be a “security” subject to the antifraud provisions of the 1934 Act, even though section 3(a)(10) of that act specifically excludes “any note . . . which has a maturity at the time of issuance of not exceeding nine months.” The Supreme Court denied review of this decision. Then in *Sanders II*, the court of appeals further held that a dealer in such notes is an underwriter, subject to liability under rule 10b-5 if it fails to make an adequate investigation of the financial position of the issuer.

57. *Supra*, n. 2.

58. 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

59. *See, e.g.* Exchange National Bank v. Touche Ross & Co., Fed. Sec. L. Rep. (CCH) ¶95,614, at 90,063; Note, *The Commercial Paper Market and the Securities Acts* 39 U. Chi. L. Rev. 362 (1972); Schweitzer, *Commercial Paper and the Securities Act of 1933: A Role for Registration*, 63 Georgetown L. J. 1245 (1975); *but see* Cloud, *A Larger Role for Commercial Paper*, J. Com. Bank Lending, April 1969, at 2, 13.

60. The plaintiff also asserted claims under §§ 12(2) and 17 of the 1933 Act, but the holding of the court of appeals was based solely on rule 10b-5 under the 1934 Act (except that the liability of certain persons was based on their status as controlling persons under section 20 of that act).

Following the decision of the Supreme Court to remand *Sanders II* for further consideration in light of *Hochfelder*, this liability is less certain. *Hochfelder* does not deal, however, with all those issues in *Sanders* that trouble commercial paper dealers. In order to present those issues, I shall first set forth very briefly the regulatory framework for the offering and sale of commercial paper and mention the judicial interpretations of that framework. Next I shall offer a prognosis of the outcome of *Sanders*, and then I shall discuss procedures designed to sustain a commercial paper dealer's defense of reasonable care under section 12 of the 1933 Act.

Statutory Provisions and Interpretations: Commercial paper is a "security" within the definition of section 2(1) of the 1933 Act. Section 3(a)(3), however, exempts from the registration and prospectus provisions of the statute any note

which arises out of a current transaction or the proceeds of which have been used or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months.

Notwithstanding that section, section 12(2), which imposes civil liabilities for misrepresentation in the offer or sale of a security, and section 17, the general antifraud provision, both expressly cover securities that are otherwise exempt, with the exception that section 12(2) does not apply to government and municipal securities.

As I mentioned before, the 1934 Act excludes from the term "security" any note with a maturity at the time of issuance of not more than nine months. Accordingly, a straightforward reading of the 1934 Act would lead to the conclusion that a commercial paper note of not more than nine months maturity is not a security for *any purpose* of the 1934 Act. Indeed, this conclusion was stated by the SEC staff in its report on the financial collapse of the Penn Central Company.⁶¹ The validity of that conclusion is now doubtful, however, because of recent judicial decisions, including *Sanders*, and the issue was not mentioned by the Supreme Court in its terse remand of the case.

In *Sanders I* the Court held that if commercial paper does not meet all the standards for an "exempted security" under section 3(a)(3) of the 1933 Act, it is a security within the meaning of section 3(a)(10) of the 1934 Act. The court referred to Securities Act Release No. 4412, which I shall describe later, for definition of these standards. This came as a shock to commercial paper dealers. Subsequent to *Sanders I*, however, there has been general agreement by courts presented with the question that a promissory note with a maturity not exceeding nine months is a security under the 1934 Act unless it fits the general notion of commercial paper reflected in Release 4412.⁶²

61. Staff Report of the SEC to the Special Subcommittee on Investigations, Committee on Interstate and Foreign Commerce, *The Financial Collapse of the Penn Central Company* (Aug. 1972) at viii (hereinafter called the "Penn Central Report.")

62. *E.g.* *Zeller v. Bogue Electric Manufacturing Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Alton Box Board Co. v. Goldman Sachs & Co.*, Fed.

Similarly, some cases have held that notes with a maturity of longer than nine months were *not* securities.⁶³ Marty Lipton and George Katz said in April 1975:

The literal reading approach has been abandoned. The short-term note exception has been abandoned. An economic realities approach has been adopted. A note (even a short-term note) issued in connection with an *investment* type transaction is a security. A note issued in a *commercial* transaction (at least in the Fifth Circuit, even a long-term note) is not a security.⁶⁴

In June, the Second Circuit in *Exchange National Bank v. Touche Ross & Co.*⁶⁵ took a different tack in determining that three unsecured subordinated notes with maturities longer than nine months, issued by a broker-dealer, were "securities" within the definition of the 1934 Act. The court pointed out that

[T]he definition sections of both statutes, § 2 of the 1933 Act and § 3 of the 1934 Act, begin with the words: . . . unless the context otherwise requires.

Rejecting the "commercial-investment" dichotomy and other attempts to provide meaningful criteria in lieu of a literal reading⁶⁶ and referring to "the hope of bringing a modicum of certainty into . . . a field in bad need of it," the court stated,

[T]he best alternative now available may lie in greater recourse to the statutory language. The 1934 Act says that the term "security" includes "any note . . . [excepting one] which has a maturity at the time of issuance of not exceeding nine months," and the 1933 Act says that the term means "any note" save for the registration exemption in § 3(a)(3). These are the plain terms of both acts, to be applied "unless the context otherwise requires." A party asserting that a note of more than nine

Sec. L. Rep. (CCH) ¶95,737, at 90,586 (E.D. Mo. 1976); *Franklin Savings Bank v. Levy*, 406 F. Supp. 40 (S.D.N.Y. 1975); *Welch Foods, Inc. v. Goldman, Sachs & Co.*, 398 F. Supp. 1393 (S.D.N.Y. 1974).

63. *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1360 n. 13 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *McClure v. First National Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

64. Lipton and Katz, *Notes Are Not Always Securities*, 30 Bus. Law. 763 (1975); *see also* their predecessor article, "Notes" Are (Are Not?) Always Securities—A Review, 29 Bus. Law. 861, 866 (1974). The Supreme Court specifically rejected the literal reading approach to the definition of "security" as used in § 3(a)(10) of the 1934 Act in *United Housing Foundation v. Forman*, 421 U.S. 837 (1975).

65. *Supra* n. 59.

66. *See, e.g.*, *Great Western Bank & Trust v. Katz*, 532 F.2d 1252 (9th Cir. 1976) (where bank receives a note in the exercise of its lending function, the securities laws do not apply); Comment, *Commercial Notes and Definition of "Security" under Securities Exchange Act of 1934: A Note is a Note is a Note?* 52 Neb. L. Rev. 478, 510-24, (1973).

months maturity is not within the 1934 Act (or that a note with a maturity of nine months or less is within it) or that any note is not within the anti-fraud provisions of the 1933 Act has the burden of showing that "the context otherwise requires."

The court said that it would "leave for another day the status under the 1934 Act of a note with a maturity of nine months or less." Despite its obeisance to "plain terms" of the statutes, the Second Circuit's approach would not necessarily lead to a different result from that reached in *Sanders I*. Using this analysis, courts might easily conclude that commercial paper not meeting the requirements of Release 4412 is not entitled to the exemption under section 3(a)(10) of the 1934 Act because "the context otherwise requires."⁶⁷

Section 10 of the 1934 Act and rule 10b-5 thereunder complete the recital of applicable statutory and rule provisions. As these provisions are firmly embedded in our collective consciousness, it is unnecessary for me to reinflict their litany on you; and we shall now turn to release 4412.

In this release, the Commission stated that section 3(a)(3) of the 1933 Act applies only to a short-term note meeting the following criteria:

- A. It must be prime quality, negotiable commercial paper;
- B. issued to facilitate well recognized types of current operational business requirements;
- C. eligible for discounting by Federal Reserve banks; and
- D. of a type not ordinarily purchased by the general public.

Legislative history may be adduced to support these criteria,⁶⁸ although the intent of Congress is open to question.⁶⁹

67. § 6(c)(3) of the proposed amendments to the Securities Investor Protection Act of 1970 defines "security" by tracking the definition in § 3(a)(10) of the 1934 Act, but adding specifically commercial paper. H.R. 8064, S. 1231, 94th Cong., 1st Sess. In *Exchange National Bank* the court endorsed the proposed exclusion of "a note or other evidence of indebtedness issued in a mercantile transaction" of the ALI's Federal Securities Code, § 297(b)(3). (See *supra*, n. 59.) It has since been reported that the SEC staff may seek authority to conduct a study of the commercial-paper exemption and to cease issuing interpretative letters on that subject pending outcome of the study. 369 BNA Sec. Reg. L. Rep. Y-1 (Sept. 15, 1976).

68. See Schweitzer, *Commercial Paper and the Securities Act of 1933: A Role for Registration*, 63 Geo. L. J. 1245, 1246-8 (1975). Schweitzer states that the "operating assumption in the legislative history appears to have been that all commercial paper is based on current transactions and therefore all commercial paper is self-liquidating." *Id.* at 1247. As he points out, this is a fallacy: "Commercial paper always has been a complex device used by many companies on an almost continuous basis to meet some or all of their credit requirements. For these companies, commercial paper is not truly self-liquidating because it is not tied to actual transactions that would generate specific funds earmarked to retire the paper before it became due." *Accord*, *Exchange National Bank of Chicago v. Touche Ross & Co.*, *supra* n. 59 at 90,064.

69. See *SEC v. Perera Co.*, 47 F.R.D. 535 (S.D.N.Y. 1969), see also Schweitzer, *supra* n. 68, at 1251; 1 Loss, *Securities Regulation* 567 (2d ed. 1961); 4 *Id.* 2591 (1969 Supp.); Brief for Appellants, *on remand*, at 70-81, *Sanders II*.

Prognosis of Sanders: In light of the Supreme Court's remand of *Sanders II*, the "underwriter" concept would not appear relevant in a private civil action brought under the antifraud provisions of the 1934 Act. Like *Hochfelder*, *Sanders* involves an alleged breach of duty to make an inquiry, not an affirmative misrepresentation. *Hochfelder* would require a finding of intentional fraud—or at least reckless conduct or knowledge of another's fraud—before a securities firm could be found liable for damages under rule 10b-5. Indeed, a federal district court sitting in Missouri has already applied *Hochfelder* in requiring that "scienter" be proved under rule 10b-5 in order to subject a dealer of commercial paper to liability.⁷⁰

Since *Hochfelder* leaves open the possibility of a lesser standard in administrative proceedings, it is conceivable that the "underwriter" concept may still be employed in that context under rule 10b-5 or under section 17 of the 1933 Act.⁷¹ But the analysis of section 10(b) of the 1934 Act and rule 10b-5 that was used in *Hochfelder* was based on their text and legislative and administrative histories and would seem to be inconsistent with an analysis based upon the role of the particular defendant.⁷² On the other hand, underwriter status will continue to be important in determining the scope of the burden of reasonable care under section 12(2) of the 1933 Act.⁷³

In any event, the discussion of due diligence in *Sanders II* is of little practical use as the court utilized hindsight to such an extent in examining the obligation of reasonable inquiry. The investigation found necessary in *Sanders II* is not required of traditional underwriters of registered offerings. The court of appeals concluded that the dealer's investigation was inadequate since it failed to examine the issuer's income tax returns or its auditor's work papers.⁷⁴ Yet these are items that underwriters ordinarily would not examine

70. *Alton Box Board Co. v. Goldman, Sachs & Co.*, *supra* n. 62.

71. *Cf. SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); *Investors Research Corporation*, SEC Admr. Proc. File No. 3-4669 (July 19, 1976); SEC General Counsel's Memorandum, 354 BNA SRLR F-1 (April 26, 1976).

72. *Cf. SEC v. Bausch & Lomb*, Fed. Sec. L. Rep. (CCH) ¶95,722, at 90,499.

73. Subsequent to this presentation, the Commission has provided an extensive analysis of this obligation. Brief of the Securities and Exchange Commission, *Amicus Curiae*, pp 60-76, *Sanders v. John Nuveen & Co.*, (7th Cir. 1976) [hereinafter called SEC Br.]. The Commission acknowledges that a lesser degree of investigation is required by an underwriter under § 12(2) than under § 11. It states that the burden imposed on an underwriter under § 12(2) is higher than that imposed on an ordinary broker dealer (of having an adequate and reasonable basis for recommending a security) and that in any particular case the scope of this burden "depends upon several factors, such as the nature of the market involved, the particular exemption relied upon, the type of security, the issuer, the underwriter and the sophistication of the purchasers." SEC Br. 69.

74. In its brief in *Sanders*, the Commission expressly disavows the duty of inquiry previously posited by the court of appeals, recognizing that "a standard that would impose liability in every underwriting for failure to have examined 'federal income tax returns, corporate minute books [or] accountants work papers,' . . . could prove too strict and too rigid" and "to require an underwriter of unregistered commercial paper to examine all of the corporate minutes, schedules for delinquencies, correspondence with creditors and customers, financing agreements, inventories, and the like, would

because they are not experts in accounting. Unless there is reason to believe that the financial statements are inaccurate, an underwriter is entitled under the 1933 Act to rely on the reports of auditors who are experts in such matters.⁷⁵

The court of appeals' conclusion that the exclusion for short-term notes contained in section 3(a)(10) of the 1934 Act applies only to notes of the kind exempted by section 3(a)(3) of the 1933 Act would appear not to be affected by *Hochfelder*, hence not within the purview of the Supreme Court's instructions on remand. But the linkage of the antifraud provisions of the two acts posited by the court of appeals in *Sanders II* does not bear analysis. Commercial paper that fits the 1933 Act exemption is still subject to the antifraud provisions of sections 12(2) and 17 of the 1933 Act, and, more important, if the notes do not meet the test for exemption in the 1933 Act, the purchaser can simply seek rescission under section 12(1) for failure to register.

Defense of Reasonable Care: Notwithstanding that the unreasonable standard of liability imposed by the *Sanders* cases under rule 10b-5 has been alleviated by *Hochfelder*, it is nonetheless important for a commercial paper dealer to be able to meet the burden of proof assigned by section 12(2) of the 1933 Act.

Section 12(2) provides that any person who:

[O]ffers or sells a security . . . 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 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. . . .* (emphasis added)

It is sufficient to impose the burden of reasonable care that a material misstatement was made or that there was a material omission. That burden is likely to be related to the role of the commercial paper dealer in the issue and sale of that paper.

While there is no reason to doubt that a commercial paper dealer would be an "underwriter" within the meaning of the definition found in section 2(11) of the 1933 Act, this does not lead us to conclude that the duty of an underwriter in a registered offering to perform a "reasonable investigation" under section 11 is tantamount to the "reasonable care" standard under sec-

impose such an onerous burden upon them as conceivably to make impracticable the market for such securities." SEC Br. pp. 68, 71.

75. § 11(b)(3)(c); *Escott v. BarChris*, *supra* n. 35.

tion 12(2). Referring to a dealer in commercial paper, the SEC staff compared practices of disclosure and investigation in the Penn Central Report as follows:

In the absence of registration requirements, there are no customary standards requiring disclosure of material information, to the extent the same is disclosed in a statutory prospectus, to purchasers. . . . Furthermore, there is no investigation undertaken by the dealer which would even approximate that which is required of an underwriter of a security offering registered . . . pursuant to the 1933 Act.⁷⁶

In *Sanders II*, the court of appeals grafted concepts of due diligence onto rule 10b-5, relying on precedents under section 11.⁷⁷ This superaddition is inappropriate for several reasons. A prospectus is not prepared for the sale of commercial paper, and the dealer does not have the assistance of legal counsel, as an underwriter does in a public offering. The dealer cannot afford to exercise the same degree of diligence as the underwriter in a registered offering or undertake the material legal and other costs that are involved in such an offering, as the dealer compensation is typically $\frac{1}{8}$ of 1 percent per annum—significantly less than normal underwriting compensation. Lastly, sales of commercial paper are made on a continuous basis, generally over a long period of time.

Let us now turn to a consent decree issued against one commercial paper dealer and a no-action letter obtained by another dealer. These documents provide, I believe, the most helpful exposition available of the Commission's view of a dealer's duties in the marketing of commercial paper.⁷⁸

Goldman, Sachs Statement of Policy: The Statement of Policy is part of a consent decree that resulted from an SEC enforcement proceeding.⁷⁹ The proceeding charged that material misstatements and omissions were made by Goldman, Sachs in connection with its sale of Penn Central commercial paper in violation of section 17 of the 1933 Act.

The statement of policy applies when Goldman, Sachs acts as broker for the issuer of commercial paper or as dealer purchasing from the issuer for resale. Upon an initial offering, Goldman, Sachs (i) will use reasonable care to assure that the paper is duly authorized and that the exemption under the 1933 Act is applicable, and (ii) will obtain such information (including current reports of the issuer filed with the SEC) and conduct such an investigation as may be required under the circumstances to believe reasonably that such issuer will have the ability to pay such commercial paper as it matures.

76. Penn Central Report at 273-274.

77. *E.g. Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D. N.Y. 1971) and *Escott v. BarChris*, *supra*, n. 35.

78. A further, consistent, exposition of this view has been provided by the Commission in its brief in *Sanders*. *Supra* n. 73.

79. *SEC v. Goldman, Sachs & Co.*, Litigation Release No. 6349 (May 2, 1974), S.D.N.Y. 74 Civ. 1916.

So long as Goldman, Sachs offers the issuer's paper (i) it will use its best efforts to obtain copies of all reports filed pursuant to section 13(a) of the 1934 Act or comparable information and whatever other current information may be required under the circumstances, and (ii) it will review these reports and other current information so as to conclude, after exercising reasonable care, that "it has no reason to believe that such issuer will be unable to pay its commercial paper as it matures." Lastly, it will furnish information to purchasers consistent with that on which it bases its belief that the issuer will be able to repay at maturity.

The preamble to the statement of policy recites that it "has not been approved or disapproved by the Securities and Exchange Commission . . . nor has the Commission passed upon the adequacies of the procedures set forth . . . as constituting compliance with applicable federal securities laws"; nonetheless, it may be said to indicate the elements of a defense of reasonable care that should provide substantial protection against civil liabilities or administrative proceedings by the Commission.

Becker No-Action Letter: In a recent no-action letter to a major commercial paper dealer, the Commission staff has given implicit sanction to more detailed guidelines for reasonable care.⁸⁰ The dealer, A. G. Becker, was permitted to use the lesser haircut percentages provided by the net capital rules⁸¹ in respect of commercial paper held by it despite that paper not having the requisite rating in one of the three highest categories by *two* nationally recognized statistical rating services. Based on the dealer's "review process and established guidelines to assure that it is completely aware of the quality of a commercial paper issuer as well as the quality of the commercial paper," only *one* such rating was required for an interim period. Referring to the commercial paper analyst, the letter stated:

1. He analyzes full financial data including both interim and annual data and performs ratio [sic] analyses;
2. He visits the financial management of each issuer as often as four times annually;
3. He obtains from each issuer a monthly report on bank lines of credit short-term borrowings plus other selected data for specific industries;
4. He confirms reported bank lines of credit directly with the banks.
. . . ;
5. He conducts annual industry studies on each major industry for which he is responsible.

A thorough review of all AGB commercial paper issuers is conducted at least quarterly. No currently approved name, active or inactive, may

80. A. G. Becker & Co., no-action letter dated December 30, 1975.

81. Rule 15c3-1(c)(2)(vi)(E) under the 1934 Act.

go beyond a quarter without specific review and approval by the [Commercial Paper Credit Review Committee] . . .

This committee is composed of three senior officers of the dealer who have the ultimate authority to make credit decisions. None is directly involved in marketing commercial paper.

These guidelines are reasonably designed to provide the dealer with adequate information about commercial paper handled by the dealer and the issuer of the paper. They provide a thorough basis for a recommendation of such paper to customers, although they still fall short of the unattainable standards indicated by Judge Stevens in *Sanders II*.

Securities Act Release No. 4412: The *Goldman, Sachs* statement of policy and the *Becker* no-action letter provide useful due diligence guidelines for reasonable care. As provided in the statement of policy, a dealer must use reasonable care to assure that the exemption under the 1933 Act is applicable. Accordingly, inquiry in the commercial paper situation must be directed at the requirements of Securities Act Release No. 4412. These requirements have been diluted considerably over the years since their promulgation, and one commentator has pointed to the practice of the Commission staff "in issuing no-action letters with respect to fact situations which flatly contradict the Release's criteria."⁸² Nonetheless, the staff has been unwilling to acknowledge its demise, and a dealer or issuer would be ill advised to ignore the four requirements set forth in the release, at least as they are currently interpreted. I shall briefly discuss these requirements.

(A) *Prime Quality:* The major ingredient of course is that the paper be of "prime quality". This suggests ratings by national credit rating services but also includes independent investigation of the company's business along the lines suggested by the *Goldman, Sachs* statement of policy and the *Becker* no-action letter. Amusingly, the court of appeals in *Sanders II* reasoned that because of the company's insolvency, it was unlikely that the paper was of prime grade. If this retroactive analysis is used, dealers would become virtual insurers of paper they sell. No investigation can guarantee continued solvency, and the dealer could thus never *know* at the time he sold the note that it was exempt from registration.

(B) *Not Marketed to General Public:* As to the requirement that the paper be "of a type not ordinarily available to the general public,"⁸³ it

82. Harrington, *Use of the Proceeds of Commercial Paper Issued by Bank Holding Companies*, 29 Bus. Law. 207, 224 (1973).

83. *But see* SEC v. Perera Co., *supra* n. 69, at 537, which indicated that a sale of unregistered short-term paper to the general public did not violate the registration requirements of the 1933 Act. The court in this case said that "the SEC appears suspect in the foundation of the release [4412], inasmuch as the release interprets § 3(a)(3) as exempting from the registration requirements only commercial paper which is not intended to be marketed to the public." The legislative history of § 3(a)(3) reveals

has generally been accepted that this can be met by establishing a minimum denomination for issuance of each note and by a due regard for suitability in selling the notes. Usually the notes are issued in denominations of \$100,000 and as a practical matter never in denominations less than \$25,000 because the SEC will not give a no-action letter for anything smaller. In *Sanders I* the court found that notes purchased by 42 persons, in denominations as low as \$1,000, had been offered to the general public.⁸⁴ And in *Welch Foods v. Goldman, Sachs & Co.*,⁸⁵ the court declined to find that the Penn Central commercial paper was of a type not ordinarily purchased by the general public. The court said that "individuals and businesses of medium size could and did purchase the paper, not only directly from Goldman, Sachs, but also through banks and trust companies, which in turn purchased from Goldman, Sachs. Partners of Goldman, Sachs were aware that these banks were purchasing not solely for their own account. . . ." ⁸⁶ In a footnote⁸⁷ the court appeared to equate two corporate plaintiffs, each of which "had a full-time financial officer and at various times of the year invested substantial amounts in short-term paper," with the general public, insofar as their expertise as investors is concerned.

(C) *Current Transactions*: The 1933 Act speaks in terms of any note "which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions," which the SEC interprets as "paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks." Unfortunately, the staff's interpretations of this requirement have undergone such frequent change that some issuers and dealers feel that they cannot safely market paper without a current no-action letter.⁸⁸

(D) *Discountability*: Commercial paper may be discounted at a Federal Reserve bank by members of that system if it meets certain eligibility requirements set forth in Regulation A.⁸⁹ These requirements are similar to the criteria used to ascertain that commercial paper is used for current transactions, and the staff has sometimes looked at the Federal Reserve Board's position as to eligibility for discounting as

that an early draft required that exempt short-term notes not be sold to the public but this was dropped. 77 Cong. Rec. 2987 (1933). See also, *supra*, nn. 68 and 69.

84. The Commission asserts that Congress contemplated a commercial paper market of "sophisticated, institutional, investors purchasing prime quality, discountable commercial paper" and describes in juxtaposition the purchasers in *Sanders* as: "unsophisticated, individual, investors purchasing nonprime quality, nondiscountable, commercial paper." SEC Br. pp. 69-70.

85. *Supra*, n. 62.

86. *Id.* at 1398.

87. *Id.* at 1399, n. 1.

88. See Note, 39 U. Chi. L. Rev. 362, 388 (1972).

89. 12 C.F.R. 201 (1973).

pivotal in determining compliance with the current-transactions test. Regulation A has been expanded in recent years,⁹⁰ and the staff evidently has shifted its reliance accordingly.

Conclusion: To conclude, it is clear that there is substantial potential liability involved in dealing in commercial paper. No one should be in the business unless prepared to perform an investigation at least equal to the standards of the *Goldman, Sachs* statement of policy. The *Becker* no-action letter sets forth specific guidelines that can be used to fill in the interstices of the statement of policy.

A securities firm disregards current interpretations of Release 4412 at considerable peril. Although courts are likely to read *Hochfelder* to require *scienter* on the part of an underwriter in cases charging vendors of commercial paper with violations of rule 10b-5, the growing jurisprudence that requires compliance with Release 4412 in order to exclude commercial paper from the definition of “security” contained in the 1934 Act has been unaffected.

As the court of appeals said in *Sanders II*:

An underwriter’s relationship with the issuer gives the underwriter access to facts that are not equally available to members of the public who must rely on published information. And the relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security.⁹¹

While we might disagree with the appellation “underwriter”, we cannot dispute the principles.

MR. BIALKIN: Thank you, Sam. Prior to the remand of *Nuveen*, while the Seventh Circuit opinion was still extant, a broker/dealer in an exempt offering was essentially bound by the underwriter due diligence requirement of a section 11 offering notwithstanding that such an offering was exempt from registration and therefore did not fall within the purview of section 11. There also existed the question of whether the same requirement as to due diligence was applicable to broker/dealers who had a role in the offering or the sale of private placements, since they, like commercial paper dealers, relied on the exemption from the '33 Act as an exemption from section 11 obligations. Perhaps, as a result of the remand, that worry no longer exists. However that may be we intend now to examine the role and exposure of the broker/dealer in the private placement situation and in the sale of special types of securities such as real estate, oil and gas. Bill Harman will introduce that subject.

MR. HARMAN: Thank you, Ken. Part of our sub-panel will be Roberta Karmel, Bill Williams, and Elliott Goldstein.

90. 38 Fed. Reg. 9076 (1973).

91. *Supra* n. 2, at 1069-70.

As you know, the topic of the panel discussion this afternoon is current issues and developments in the duties and liabilities of underwriters and securities dealers. My segment of the panel will deal in the next number of minutes with the role and liability of investment bankers in the context of private placement of securities. We've heard during the course of discussion this afternoon about the legal environment in which we function as practitioners on a day-to-day basis. It has become more and more complex, and the legal relationships between the investment banker, the issuer and the purchaser of securities, whether in the context of registered public offerings, mergers and acquisitions, sales of commercial paper, or private placements, have become charged with ever-expanding liabilities.

Marty Lipton discussed in an earlier portion of the program the fact that the courts have come to look upon investment bankers as professionals, who are held to a high standard of conduct in the performance of their business activities. Those of you who advise investment bankers have, I am sure, become increasingly sensitive to the legal questions to which your clients are exposed by these activities.

Our panel today will explore some of those activities undertaken by an investment banker in the private placement area which could subject him to liability arising out of such transactions. As a general proposition, and though there is no case law on this specific topic, in my judgment the degree of exposure to liability will depend upon the role of the investment banker in the preparation of the transaction, the nature of the selling effort or the sponsorship of the securities, the relative sophistication of the purchaser, the nature of the investment banker's prior relationship with the issuer, and the availability of information about the issuer from public sources.

In the private placement area, for example, an investment banker may perform a variety of roles on behalf of his issuer-client. In a large private placement of debt securities of a seasoned public company, the role of the investment banker may be merely to bring the issuer and the purchasers together without the use of a private placement memorandum, or, more often, his role will be to prepare a single page containing a summary of terms, to which is attached a copy of the company's most recent prospectus, annual report to shareholders, or Form 10-K. The investment banker will send this abbreviated form of investment circular to a relatively small number of sophisticated institutional offerees in the process of distribution of those securities. On the basis of the information furnished by the broker/dealer to the purchaser, the purchaser may make what is essentially a credit decision to purchase the securities being offered. Such a decision is based on some prior knowledge of the company, the rating of the company's securities and the interest rate and maturity of the securities being offered.

The broker/dealer, to some degree, relies upon the sophistication of the portfolio manager of the purchaser to make an informed investment decision.

If the broker/dealer in question has managed a recent public offering of the issuer, or is otherwise familiar with the financial affairs of the issuer, any due diligence may have been conducted over a period of time in connection with other transactions, and the broker/dealer may simply bring that information up to date.

The role of the broker/dealer becomes a little bit more complicated in the preparation of a private placement memorandum for a non-public company, or a company which is either non-seasoned, or with which the firm has not had a prior relationship. Such a memorandum is generally prepared after extensive discussions with the company and its counsel, and in the case of a non-public company, the broker/dealer may utilize its own counsel in the preparation of the offering document. In most such cases, investment bankers will seek to disclose to the purchasers of the securities the same type of information which would be available in a registration statement filed with the SEC.

In the context of this type of private placement, institutional purchasers as well as their counsel will become more involved in the discussions with the company and the examination of its financial condition.

Still a third form of private placement may involve a special type of project financing, such as a very large leveraged lease with special tax benefits, where the investment banker may perform a special role in structuring the transaction and in preparing sophisticated tax and rate of return analyses for institutional investors. In financings of this variety, there may be both equity and debt participants, each of whom have different investment expectations. Naturally, in a more complicated transaction the purchaser and purchaser's counsel may individually examine the nature of contractual commitment and determine whether the deal works, as a financial transaction. An investment banker may be called upon to furnish the equity participant with a computerized analysis of the rate of return, assuming a variety of contingencies and tax consequences.

Finally, the fourth role in which investment bankers might become involved, and certainly the most complicated, is the preparation and sale of tax-shelter private placements, like the real estate, oil and gas and cattle deals we've seen in recent years, for sales to wealthy individual investors.

In this regard, the investment banker plays an essential role in structuring, managing and marketing such programs. Both because of the more expanded role that the broker/dealer assumes in such transactions and the characteristics of the purchasers, the duties and liabilities of the broker/dealer become more acute.

I think it might be interesting to examine very quickly the legal standard governing the role of the investment banker in a private placement. As compared to the elaborate and specifically defined responsibility of underwriters in a registered public offering under section 11 of the 1933 Act, the investment banker's duties in a private placement are less clear.

Most private actions in this area have been brought under section 12(2)

of the 1933 Act, or section 10 of the 1934 Act, and rule 10b-5 thereunder. During the recent past, as you know, rule 10b-5 was used as the vehicle for enlarging the investment banker's obligations to the public in a variety of contexts. We saw this with the underwriting of commercial paper in the *Nuveen* case; the dealer/manager function in the *Chris-Craft* litigation; and in the private placement field, in *Herzfeld v. Laventhal*.⁹² In these situations, the court imposed almost a "shingle" theory of responsibility on investment bankers. Marty quoted from the *Chris Craft* case earlier in the program,⁹³ and I thought there was one quote he was going to get to but didn't and it's worth quoting here. The court said, "An underwriter, by participating in an offering, constructively represents that statements made in the registration materials are complete and accurate. The investing public properly relies upon the underwriter to check the accuracy of the statement and the soundness of the offer. When the underwriter does not speak out, the investor reasonably assumes that there are no undisclosed material deficiencies. The representations in the registration statement are those of the underwriter as much as they are of the issuer."⁹⁴

This trend in the rule 10b-5 context has been stemmed, in my judgment, by *Hochfelder* and the Supreme Court remand of the *Nuveen* case. Moreover, as Marty has also pointed out, it's likely that the Supreme Court will reverse the *Chris Craft* decision.

For other reasons, which I will discuss subsequently, it seems that we should focus our discussion not on rule 10b-5, but on section 12(2) of the 1933 Act. Section 12(2) provides that any person who offers a security by means of a prospectus or oral communication which contains an untrue statement of a material fact, or which fails to state a material fact necessary in order to make the statements not misleading, in the light of the circumstances under which they are made, shall be liable to the person purchasing such security from him, the purchaser not knowing of such untruth 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.

As long ago as 1940, *Cady v. Murphy*,⁹⁵ the Federal court decided that a broker may be deemed a person who "sells a security by purpose of this Section." In a case decided in 1969 in the Third Circuit, *Johns Hopkins v. W. E. Hutton*,⁹⁶ the Federal court held an investment banker liable for a material omission in a private placement brochure which failed to disclose certain material facts in connection with the purchase by Johns Hopkins of an oil

92. 378 F. Supp. 112 (S.D.N.Y., 1974); modified 540 F.2d 27 (2d Cir., 1976).

93. *Supra* n. 27, at 370.

94. *Id.*

95. 113 F.2d 988 (1st Cir., 1940); cert. den. 311 U.S. 705 (1940).

96. 422 F.2d 1124 (4th Cir., 1970), on remand 343 F. Supp. 245 (D.Md., 1972), modified 488 F.2d 912 (4th Cir., 1973), cert. denied, 416 U.S. 916 (1974).

and gas production payment of 1.3 million dollars. The case itself is worth rereading. It contains an extensive discussion of the liabilities of an investment banker and deals with the question of whether the sophistication of an institution provides any comfort to the seller. The court discusses the statutory requirements that the purchaser not know of the untruth or material omission, and points out that section 12(2) does not place upon the purchaser a duty to investigate. In the language of the court, "The Securities Act relieves the purchaser from the common law obligation of using reasonable prudence. All the purchaser must show is that he did not know of the untruth or omission. The seller, on the other hand, 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." Congress in enacting Section 12(2) put a burden on the seller to investigate, but no such burden upon the buyer.

MR. BIALKIN: May I ask you a question about that?

MR. HARMAN: Sure.

MR. BIALKIN: In the *Johns Hopkins* case,⁹⁷ as I recall, the broker/dealer represented to the purchaser that a study of oil reserves was being undertaken by a firm acting as the purchaser's independent engineer when in fact, the firm was employed by the broker/dealer. Do you think that in a 12(2) situation where the broker/dealer is not in fact aware of the omission or misleading statement, the same broad duty of due diligence would be imposed?

MR. HARMAN: You correctly point out, Ken—and I think it is a basis for distinguishing this case from others—that the broker/dealer had constructive or actual knowledge of the fraud that was being committed. It seems to me that this poses an interesting question as to which there has been no resolution.

I think it's certainly fair to say that section 12(2), unlike rule 10b-5, contains no scienter standards, although the Supreme Court indicated in *Hochfelder* by way of dictum that section 12(2) embodies a negligence standard. If the placing broker knew or reasonably should have known of a misstatement, he may be liable under section 12(2), but that leaves the further question of whether the placing broker has an affirmative duty of investigation under section 12(2) comparable to that expressly set forth by section 11.

MR. WILLIAMS: In the Section 11 context, an underwriter is protected to a large extent in relying upon experts, *e.g.* auditors who certify financial statements. Section 12(2) speaks more simply and generally of sustaining the burden that in the exercise of reasonable care the broker dealer could not have known. Would you think that the benefits of an auditor's certificate would carry over to section 12(2) and reduce the broker dealer's risk of liability with respect to audited financial statements?

97. *Id.*

MR. HARMAN: I'm going to ask Roberta Karmel to answer that.

MS. KARMEI: I do think an argument could be made that there is a lesser standard of care imposed on a broker/dealer under section 12(2) than under section 11. In a section 11 suit, there is the due diligence defense to a liability that is otherwise nearly absolute. The plaintiff is not required to prove scienter. There is not a scienter requirement in a section 12 case either, but section 12 liability can be imposed in a situation where there is not a formal underwriting; for example, in a private placement.

It seems to me that it could be argued that the reasonable care that is specified in section 12(2) is something less than the reasonable investigation that is specified in section 11. However, I'm not aware of any cases in point.

MR. HARMAN: I would suggest that in general, although there are no cases in point on this, an investment banker's duty should vary with his role in the transaction, and with the other factors enumerated at the outset, including the sophistication of the purchaser and the availability of information about the purchaser from public sources.

MR. BIALKIN: Can you properly say that, though? In a private placement, the only question, at least under the statute itself, is whether the broker/dealer is a seller. If he is a seller, 12(2) applies to him and then the question becomes one of whether that same flexible standard of liability that you talked about before applies to a 12(2) situation. Is there any basis for saying that the duty of the broker/dealer should depend on the role he plays in the private placement, other than as it relates to the question of whether or not he is a seller?

MR. HARMAN: Well, I think it may be a broader question. It seems to me that the purchaser in placing reliance upon the broker/dealer in the transaction is entitled to make certain assumptions depending upon the role which the broker/dealer performs in selling the securities. Clearly, in the ordinary brokerage transaction which takes place on a national securities exchange, the purchaser of securities really does not have great expectations as to what role the broker/dealer may have performed, except to execute a brokerage order. I don't think that one could argue that a broker/dealer in that context has a due diligence standard under section 12(2) that is anywhere comparable to that under section 11.

But it seems to me the private placement responsibility really falls somewhere in between section 11 liability on the one hand, and the brokerage transaction on the other side.

MR. WILLIAMS: Ken, I would read the language about reasonable care to mean reasonable care under the circumstances. To me, it would be one thing if it is a sale by a utility of the seventeenth series of its first mortgage bonds to Metropolitan Life Insurance Company which had bought bonds of each of the previous 16 series. It would be quite something else if it is an initial sale by a start-up, high technology company of its common stock to venture capitalists.

MR. BIALKIN: Section 12(2) provides that a seller of a security shall be liable for misrepresentations or omissions in connection therewith unless he sustains 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." What you're saying is that the more important part of that sentence is the concept of reasonable care, rather than the fact of whether the seller did not and could not have known. Stated otherwise is the standard whether the seller knew or could have known, or is the standard whether he used reasonable care. If the standard is one of reasonable care how do you derive that judgment?

MR. WILLIAMS: In short, I think you have to read the words together, namely, ". . . in the exercise of reasonable care could not have known . . ."

MS. KARMEL: I would further suggest, although I'm not aware of any statutory basis for this, that the reasonable care under the circumstances might relate to the nature and amount of the broker dealer's compensation. In a registered public offering, the broker dealer is getting sufficient compensation to pay for an extensive due diligence investigation. In many other kinds of transactions which we have been discussing here today, the broker dealer is not getting much more than an ordinary commission, and there is not the money available to pay for or justify, on a business basis, the same kind of due diligence investigation that is customary in a registered public offering.

MR. LIPTON: The court didn't buy that in the *Chris Craft* case, though.

MS. KARMEL: Well, maybe the Supreme Court will. We'll just have to see.

MR. HARMAN: I think that at the other pole here there is a high degree of involvement by the broker in structuring, packaging and marketing a tax-shelter deal, which is a much more difficult case—witness the dozen or more enforcement cases initiated by the SEC in recent times. Elliott Goldstein, I think it might be helpful to have your view in terms of the role of the promoter in the structure of such tax shelter deals and his duty of investigation.

MR. GOLDSTEIN: Well, in the case of the private placement, by and large, at least in the case of oil deals, real estate and cattle deals, the promoter or the program manager will have a list of wealthy clients with whom he has dealt in the past. If he has been reasonably successful he can go back to see them, and he will undertake to sell a deal to them, without going through an underwriter; unless, perhaps, he is an underwriter himself.

It is a little different when you get into a situation where there is a registered offering of an oil and gas or real estate deal, where there is no underwriter or even a best efforts underwriter, and the deal is put on the approved list in four or five offices in New York, so that brokerage houses can offer the deal. In that situation, it's pretty much like municipal securities, the opportunity of making an investigation is extremely limited. The deal is already structured and packaged. The dealer has a limited choice, either to sell it or

not to sell it. The prospective dealer looks at it and attempts to determine whatever he can from reading the prospectus, and then perhaps if an independent agency such as an oil and gas rating service has examined the deal and has said that this is a good deal, he may take that into consideration.

In that situation, the duty, if there is a duty at all, of the broker/dealer is, it seems to me, merely to examine the facts that he has before him, and make a good faith effort to determine whether or not this is a purchase that he can recommend to his client.

The third transaction would be where the dealer actually becomes an underwriter. In almost all transactions, it is as a best efforts underwriter, but he puts his name on the front of the prospectus. In that situation, he undoubtedly takes on deeper obligations and I'll talk about those a little later.

MR. HARMAN: It might be useful now to turn to the role of the broker/dealer in marketing of the securities in a private placement. There are easily as many types of purchasers as private placements, and each of us has probably dealt with a number of them in practice. Obviously, the large private placements are made with institutional purchasers such as lending institutions, insurance companies, pension funds, and foundations. In this regard, this type of purchaser generally has, as part of its investment staff, analysts in the industries of the issuer, and they are able to fend for themselves in making a determination as to the investment merits of any given offering.

Tax-shelter private placements on the other hand are designed for wealthy individuals, each of whom individually or through the means of an offeree representative must evaluate the investment characteristics of the offering. Investment bankers placing large debt offerings or projects financings typically will rely upon the exemptions afforded by section 4(2) of the 1933 Act. In most cases, an attempt will not be made to comply with the more restrictive provisions of rule 146, although there has been a growing tendency to incorporate some of the aspects of rule 146 into section 4(2) private placements. I'm sure that we have all read the two papers which appeared in the November issue of the *Business Lawyer* which discussed the continued availability and the desirability of having section 4(2) continue available as an exemption.

One of the aspects that investment bankers must bear in mind is the potential liability for failure to comply with section 4(2). Roberta, would you like to comment on that area, please?

MS. KARMEL: Yes, I would. There is very little authority on this subject, but there is one very interesting case, *Woolf v. S. D. Cohn & Company*.⁹⁸ This case has now been remanded to the Court of Appeals by the Supreme Court for reconsideration⁹⁹ in light of *TSC Industries, Inc. v. Northway, Inc.*¹⁰⁰

98. 515 F.2d 591 (5th Cir.), rehearing denied, 521 F.2d 225 (5th Cir. 1975).

99. 426 U.S. 944.

100. *Supra*, n. 39.

In this case, some purchasers in a private placement, who had improperly represented that they were purchasing some convertible debentures for themselves for investment, sued the broker dealer under rule 10b-5 for failure to comply with section 4(2). It's a very curious case. The Circuit Court all but said to the plaintiff, "You made a mistake. You could have sued under section 12, and then this would be an easy case because we could have imposed liability under that section. Instead, you sued under rule 10b-5 and so now you've presented this court with the rather interesting and novel question of whether there can be 10b-5 liability imposed upon a broker dealer for failure to comply with section 4(2) in making a private placement." A lot of the decision had to do with the question of whether there was an *in pari delicto* defense. The plaintiffs apparently were at least in part responsible for the failure to comply with the private placement offering, because they secretly had been acting for a whole group of purchasers in the purchase of these convertible debentures. The court held that rule 10b-5 was broad enough to encompass this kind of liability.

The case is somewhat the obverse of the decision in *SEC v. Manor Nursing Centers, Inc.*,¹⁰¹ in which the court held that a false and misleading prospectus in a registered offering was not a statutory prospectus for purposes of section 10(a) of the '33 Act, and therefore, could result in a section 5 violation. Both cases are troubling because they bootstrap a violation of one part of the securities laws into a violation of other sections, where a defendant has different liabilities and defenses.

Now, the Supreme Court seems to be telling all of us in its recent decisions to go back and reread the statutes. I think that if the lower courts did so in cases like this, they would observe that section 12(1) and section 12(2) are really quite different from rule 10b-5 in the way in which they impose liability on a broker dealer for a sale of securities in a situation that does not comply with section 5 and in a situation where there has been fraud. *Wolf v. S. D. Cohn & Company* seems to run those two bases of liability together in a 10b-5 context.

There is one other recent case, *International Shareholders Services Corp.*¹⁰² which perhaps is worth mentioning here. This was a broker-dealer administrative proceeding, which involved a defective intrastate offering; rather than a defective private placement. The broker dealer believed that it was making an offering in compliance with the intrastate exemption. Unbeknownst to the broker dealer, the issuer was making sales of securities to residents out of the state. In that case, the Commission said that since the broker dealer was unaware of the issuer's actions and had no control over them, its conduct did not constitute a willful violation and it should not be held liable because there was a defective intrastate offering.

101. 458 F.2d 1082 (2d Cir. 1972).

102. Exch. Act Rel. No. 12389 (April 29, 1976).

I would hope that some court would take this approach in contrast to the approach of the *Woolf v. S. D. Cohn & Company* case, in an appropriate case which tried to impose liability on a broker dealer for failure to make a proper private placement. If the suit were brought under section 12(1) instead of Rule 10b-5, the basis for alleging illegality would be clearer.

MR. HARMAN: Ken, I think it would be useful to comment briefly on rule 146, because a number of institutional lenders have raised questions relating to the legend provisions required by rule 146, and as a consequence have not availed themselves of the safe harbor provided by rule 146.

Although the Rule states that it is not exclusive, we're beginning to see rule 146 language creep into the conventional section 4(2) private placement. Some feel that rule 146 and its interpretations may unfortunately become a gloss on the original interpretation of Section 4(2). And although the rule is non-exclusive, an interesting question is raised whether a transaction that borrows some, but not all, of the aspects of rule 146 might be judged by a court to be an attempted, but unsuccessful, compliance with the rule and judge the availability of the exemption on the basis of the rule.

MR. BIALKIN: You have been a most attentive and patient audience. Although the hour is getting late, we will continue, but those of you who do have plans, feel free to leave.

MR. HARMAN: Elliott Goldstein, I think you probably have a number of things. . . .

MR. GOLDSTEIN: The principal reason motivating an investor's purchase of an oil and gas or real estate partnership interest is to secure a tax advantage. Regardless of any claimed profit motivation, none of these transactions would be entered into if it were not for the tax benefits. In discussing them we must recognize that they fall in two main classes. The first is the true "shelter" investment. This is an investment which provides a deduction in excess of the investor's dollar investment, which has the effect of reducing taxes payable on income from other sources. The second is the deductible investment. This is an investment in an oil and gas or real estate partnership, all or part of which may be deducted from ordinary income. Both of these may combine with the opportunity to receive non-taxable income—that is income eventually received from the investment will be partially or totally free from tax, such as oil or gas income subject to a depletion allowance, or receipts from real estate paid from depreciation reserves.

The underwriters' problems are compounded by the juxtaposition of two factors. One is that the customer, in buying a "tax deduction" is counting not only on receiving the shelter or the deductible investment that he has been offered, but also on not having any problems with the Internal Revenue Service. If two years later his Federal tax return is examined in connection with an audit of his oil and gas or real estate investment he is not terribly happy. Second, the future income from the investment is in many cases unknowable, and, particularly in real estate, the customer is counting on a fixed

return, in a situation where the return may not be available in future years.

As to taxes, there is a popular feeling that it is reprehensible for persons with large incomes to pay no income taxes. This is fostering a general attack on shelter arrangements, both administratively and in Congress. I will not try to cover all of the proposals, or guess whether the Senate Bill will pass the House or whether the more stringent House provisions will become law. It is clear, however, that this is a subject that will be considered again next year. We can guess that perhaps the shelter arrangement will be the most restricted, and that the deductible deals and the tax-free income transactions (those involving depletion and depreciation) will continue.

Meanwhile, the Internal Revenue Service is fully aware of the public mood. They have responded with increased audit activity and with Revenue Rulings to eliminate or curtail some shelter activities. They are particularly active in the oil and gas area with respect to the deductibility of intangible drilling and development costs paid prior to year-end for work to be performed in the following year. In the general area, they are questioning deductibility of sales expenses, allocation of losses, and the "sale of losses" by admitting partners at year end. In addition, there is increased scrutiny by the Internal Revenue Service of expenditures to make certain that they are being spent for the purposes stated in the books of the promoter or program sponsor.

The underwriters' response to this has been an increased awareness of the risks involved in an offering which undertakes to supply a tax shelter. That the tax opinion is a crucial part of the selling document is pointed out by the consent judgment and stipulation in *Securities and Exchange Commission v. Geo Dynamics Oil and Gas Incorporated*.¹⁰³ You may recall that in that case the Securities and Exchange Commission charged two partners of a law firm with aiding and abetting the allegedly fraudulent sale of certain oil and gas partnership interests. The attorneys were accused of preparing tax opinion letters for the defendant which did not accurately or fully describe the tax consequence of the offering. The letters dealt with a "leverage deduction" which would result in shelter far in excess of the investor's investment. The Complaint filed by the Commission on June 1 stated that over 2,000 investors may lose \$80 million in deductions to which they thought they were entitled under the opinion letters. The attorneys consented to the entry of an order prohibiting their rendering tax advice in connection with any tax-oriented securities offerings without taking reasonable care after inquiry and investigation to make certain that there was full and complete disclosure of the risks connected with the deductions. They also agreed to obtain "review by experienced and knowledgeable securities counsel of the adequacy of disclosure in opinion letters and offering documents before rendering any opinions or advice."¹⁰⁴ Whatever the merits or lack of merit of the charge against

103. Fed. Sec. L. Rep. (CCH) ¶ 95,565 (D. DC, June 1, 1976).

104. Fed. Sec. L. Rep. (CCH) ¶ 95,565.

the attorneys may be, the proceeding clearly points up the importance of the tax opinion. Indeed, one federal district judge in *Bayoud v. Ballard*¹⁰⁵ said, in response to a claim under section 12(2), 17(a) and rule 10(b)5 made by two investors in a private drilling transaction which was unsuccessful that even though oil was not obtained in any quantity, the investors received what they bargained for. The Court said:

In considering the plaintiffs' evidence, the Court finds it difficult to determine what constituted "asset mismanagement" for an oil and gas tax shelter that has an ostensible purpose of producing "tax losses" for its limited partners. The most obvious method for B & C to produce these "tax losses" was to drill dry holes, or, in other words, to fail to discover oil.¹⁰⁶

The case is on appeal, and the Court's statement was dicta, but it does raise the question in our minds as to whether an investor who bargained for a deduction and did not get one has a claim against the program manager. The problem is compounded by the fact that since this is a developing area and in many cases the tax opinion may be silent on an issue which is just emerging, the issue which may eventually jeopardize the deduction, if it is recognized, is usually only covered by disclaimers in the "Risk Factors" and "Tax Aspects" sections of the Prospectus.

Because of the tax problems, and because of the well-publicized peccadillos of certain oil drillers (or non-drillers) and the collapse of the real estate market and many of those connected with it, "due diligence" is assuming some new dimensions.

Since there is usually no managing underwriter, dealers cannot in many cases rely on the usual due diligence investigation by the managing underwriter. Some principal underwriters and most dealers rely on screening by some outside expert, such as an oil and gas evaluation organization or a real estate firm, put those deals which pass muster on an approved list, and assume this to be sufficient for a due diligence defense. However, when the underwriter's name is on the Prospectus, most underwriters have felt that to support a due diligence defense they must do more. In many cases they have, in addition to employing outside experts, employed their own staff geologist, accountants, and real estate experts. Even if all of this is done, as I said originally, we are attempting to know the unknowable. In the case of oil and gas, the most unlucky drilling contractor may, after drilling 100 dry holes, hit a gusher, and the promoter who has had a successful year in one year may have an unsuccessful one in the next. The real estate operator who has built three successful shopping centers may stub his toe on the fourth, to the discomfiture of his investors. Disclosures as to the promoters, their previous records, conflicts of interest and information as to their net worth and income

105. 404 F. Supp. 417 (N.D. Tex., 1975).

106. *Id.* at 426.

still cannot answer the unknowable, which is the future. Even in real estate, there is no guarantee that a new project will be rented or that its tenants will succeed. For that reason, some underwriters have undertaken, either through their own staff or independent consultants, to monitor the deal after it is sold, going so far as to inspect each drill site to be sure that a well is drilled and to monitor expenditures to be sure that they are in fact expended for the purposes claimed. While commending the manner in which they discharge this obligation to their customers, we wonder, when there is no clearly defined statement of their obligations in this area, whether a failure to uncover fraud may not result in involving them where there would have been no involvement had they not followed up the investment. While there was no enthusiasm for its passage at the time, it may well be that legislation such as the proposed Federal Oil and Gas Act of 1972 may be passed in the future in order to provide regulatory oversight of program managers.

One other question which does occur, is whether or not there may be some hidden underwriters who have yet to learn that they are in fact statutory underwriters under the 1933 Act by virtue of their participation in the offering and sale of the tax shelter securities. Some lawyers and accountants specializing in tax planning have been known, while acting as the offerees' representative, to solicit participation in deals which they have uncovered from their lists of clients. We leave to the future whether they do in fact have a problem.

MR. BIALKIN: The concept that emerges from our discussion here today and from this panel's discussions elsewhere is that the Supreme Court has been engaged in a process of defining and clarifying the interpretations of the Securities Law. Section 12(12) emerges as one of the areas that is most unknown as to its extent and reach and as a field very ripe for and in deep need of clarification. With that, I would like to express my very deep thanks to each and every member of the panel for its preparation and delivery, and to you, for being a very patient audience. Thank you very much.

