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"BARCHRIS" AND THE SECURITIES ACTS: PRACTICAL RESPONSES FOR ATTORNEYS¹

The basic purpose of the Federal Securities Acts² is to provide full and fair disclosure in the sale of securities.³ The philosophy of the Acts was enunciated by President Franklin D. Roosevelt in a message to Congress on March 29, 1933. He stated that every new issue of securities which would be sold in interstate commerce must be accompanied by full publicity and information, and that no important element concerning the issue should be concealed from the buying public.⁴ He viewed the effect of the Securities Act of 1933 as adding "to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller."⁵

The Securities Acts promote this policy by requiring full disclosure of pertinent information before trading in a security is allowed to commence. The instrument of disclosure is the registration statement. The Act of 1933 prohibits an individual from use of the mails or any means of interstate commerce to sell a security unless a registration statement is filed as to such security with the Securities and Exchange Commission.⁶ Furthermore, pursuant to the Securities Exchange Act of 1934, brokers and dealers may not effect a transaction on a national securities exchange in any security which has not been registered with such exchange.⁷ Although the informational requirements for a registration statement filed with the Securities and Exchange Commission pursuant to the Securities Act of 1933 are not identical with the informational requirements under the Securities Exchange Act of 1934, they are similar. Generally, both types of registration statements must include information about the issuer such as: its financial condition; the nature of its business; a list of its officers, directors and holders of more than 10 percent of any equity security of the issuer—including their remuneration and interests in the issuer's property; stock options existing or to be created; material contracts; rights and privileges of the various classes of equity securities; and the names of underwriters.⁸ The information which is included in registration statements must be complete and free of material error, or the persons who prepared it may incur substantial liability to purchasers of the security covered by the registration.

¹ The author gratefully acknowledges the assistance given to him by the many law firms which furnished information on the practical responses of the profession to *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), and *Globus v. Law Research Serv., Inc.*, 287 F. Supp. 188 (S.D.N.Y. 1968).

² Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1964); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1964).

³ See Securities Act of 1933, preamble, 48 Stat. 74; Knauss, *A Reappraisal of the Role of Disclosure*, 62 Mich. L. Rev. 607 (1964).

⁴ H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933).

⁵ *Id.*

⁶ Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (1964).

⁷ Securities Exchange Act of 1934 § 12(a)-(b), 15 U.S.C. § 78l(a)-(b) (1964).

⁸ Compare Securities Act of 1933 § 7, 15 U.S.C. § 77g (1964), and Securities Act of 1933 Schedule A, 15 U.S.C. § 77aa (1964), with Securities Exchange Act of 1934 § 12, 15 U.S.C. § 78l (1964).

PRACTICAL RESPONSES TO "BARCHRIS"

The recent decision in *Escott v. BarChris Constr. Corp.*⁹ has focused attention on the possible civil liabilities resulting from misrepresentations of material facts¹⁰ in registration statements. It is the potential magnitude of such civil liabilities which has been the cause of great concern.¹¹ The legal profession is among the many groups troubled about their possible liabilities for such material misrepresentations.¹² Attorneys are not primary targets of the Securities Acts since, in their professional capacity, they are neither issuers nor "buyers" and "sellers."¹³ However, the Securities Acts do attempt to regulate the conduct of individuals who, while they are not "buyers" or "sellers," may become liable because they are peripherally connected with purchases and sales.¹⁴ An attorney, by virtue of the professional advice which he renders in the preparation of a registration statement, is such an individual peripherally connected with purchases and sales. Thus, while an attorney may be liable under the Securities Acts in some other capacity, for example, as a director or officer of a corporation, the following discussion will be limited to the possible liability of an attorney whose sole connection with a security is the rendering of professional advice in the preparation of a registration statement. This comment will examine briefly the statutory bases of attorneys' civil liability under federal securities laws¹⁵ for material misrepresentations in a registration statement, and then will focus specifically upon the practical response which the profession should make in order to minimize financial risk.

I. STATUTORY BASES OF LIABILITY

A. Section 10(b) of the Securities Exchange Act of 1934¹⁶ and Rule 10b-5¹⁷

Section 10(b) of the 1934 Act prohibits the use of manipulative or deceptive devices in the purchase or sale of any security. It authorizes the Securities and Exchange Commission to promulgate rules and regulations to enforce this proscription. Rule 10b-5, promulgated in 1942, makes it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the state-

⁹ 283 F. Supp. 643 (S.D.N.Y. 1968).

¹⁰ For the purpose of this comment, "misrepresentations of material facts" is intended to encompass actual misrepresentations and, in addition, omissions to state material facts.

¹¹ See, e.g., Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (1964), where liability may be as high as the total offering price of the securities to the public.

¹² Others include: issuers, underwriters, officers and directors of issuers, accountants and other "experts" and signers of registration statements. See Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1964).

¹³ Cf. Knauss, *supra* note 3, at 608-09.

¹⁴ *Id.* at 609-10.

¹⁵ Liability may also be imposed under state law. See Securities Act of 1933 § 18, 15 U.S.C. § 77r (1964). Liability under state law, however, is beyond the scope of this comment.

¹⁶ 15 U.S.C. § 78j(b) (1964).

¹⁷ 17 C.F.R. § 240.10b-5 (1968).

ments made, in the light of the circumstances under which they were made, not misleading. . . ."¹⁸

Although neither section 10(b) nor Rule 10b-5 expressly states that civil liability will be imposed upon those who violate the Rule, a civil remedy (and concomitant private action) has been implied by the courts.¹⁹ It is well to note that a vast number of persons may maintain a cause of action under Rule 10b-5 since the Rule proscribes a wide variety of conduct and suit has not been limited to purchasers of a security.²⁰

Rule 10b-5 speaks in terms of "any person, directly or indirectly" who makes a misrepresentation. Since an attorney could be considered to make a misrepresentation "indirectly" through his participation in the preparation of a registration statement, it is theoretically possible to maintain a cause of action against an attorney for such misrepresentation under the Rule.

A cause of action under 10b-5 resembles the common law tort of deceit in some respects but differs from it in others.²¹ As in common law deceit, there must be proof of reliance upon the misrepresentation before there can be recovery.²² It has been suggested that, although pertinent sections of the Rule fail to mention scienter, a plaintiff would have to establish this element before recovering.²³ It seems clear, however, that the common law scienter requirement of intent to deceive or mislead²⁴ may not be stringently required in an action under 10b-5.²⁵ Thus, a plaintiff might not be required to prove that an attorney had an active intent to mislead, merely that the attorney had been reckless in the preparation of the registration statement.

Finally, the Rule does not require privity,²⁶ as does the common law tort of deceit, but is dependent upon the defendant's connection with a sale rather than his status as a "buyer" or "seller." The lack of a privity requirement further reinforces the theory that an attorney could be liable under the Rule, since it is obvious that an attorney who helps in the preparation of a registration statement would not be in privity with a "buyer" or "seller" of the security. The "no privity" aspect of the Rule, when combined with the notion that an attorney could be considered to make a misrepresentation "indirectly" through his work in preparation of a registration statement, leads to the belief that it is possible to maintain a cause of action against an attorney under the Rule.

¹⁸ *Id.*

¹⁹ See *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); 3 L. Loss, Securities Regulation 1763 (2d ed. 1961) [hereinafter cited as Loss].

²⁰ See Comment, The Expanding Uses of Rule 10b-5, 10 B.C. Ind. & Com. L. Rev. 313 (1969).

²¹ For a statement of the elements of the common law tort cause of action in deceit, see W. Prosser, Torts 699-700, 713-19 (3d ed. 1964) [hereinafter cited as Prosser].

²² 3 Loss at 1765-66.

²³ *Id.* at 1766.

²⁴ See Prosser at 715.

²⁵ See, e.g., Comment, Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law, 9 B.C. Ind. & Com. L. Rev. 137, 163-64 (1967), where it is suggested that reckless and even negligent conduct may be proscribed.

²⁶ See generally 3 Loss at 1767-71.

B. *Section 17(a) of the Securities Act of 1933*²⁷

Section 17(a) of the 1933 Act makes it unlawful for any person in the offer or sale of securities to engage directly or indirectly in any practice which would operate as a fraud or deceit upon a purchaser. The language of section 17(a) is virtually identical with Rule 10b-5 except that section 17(a) is worded to prohibit fraud only in connection with the sale of securities, while Rule 10b-5 merely widened the prohibition to include fraud in connection with either the sale or purchase of securities.²⁸ This limitation under section 17(a) is unimportant here because attorneys who participate in the preparation of registration statements can only perpetrate a fraud in the sale, not purchase, of a security.²⁹ Consequently, since the prohibitions relating to fraud in the sale of a security are virtually identical under section 17(a) and Rule 10b-5, the above analysis relating to the possible liability of an attorney under Rule 10b-5 for a material misrepresentation in a registration statement is equally applicable to the issue of liability for such misrepresentation under section 17(a).

C. *Section 18(a) of the Securities Exchange Act of 1934*³⁰

Section 18(a) of the 1934 Act imposes liability upon any person who makes, or causes to be made, a material misrepresentation in any document filed under the Securities Exchange Act.³¹ Furthermore, as with Rule 10b-5, an action under section 18(a) is not restricted to purchasers of a security; sellers may also sue. It appears theoretically possible to maintain a cause of action against an attorney under section 18(a), since he could conceivably "cause to be made" a material misrepresentation by his participation in the preparation of a registration statement.

As with the common law tort of deceit, a plaintiff suing under section 18(a) must show reliance on the misrepresentation.³² Furthermore, a plaintiff must show causation between the misrepresentation and his harm, since recovery runs only to those who buy or sell the security at a price which is affected by the misrepresentation.³³ Finally, it appears that there is no privity requirement in an action under section 18(a).³⁴ The lack of a privity requirement, plus the notion that an attorney could "cause to be made" a material misrepresentation, lead to the conclusion that it is possible to maintain an action against an attorney under section 18.

Section 18 does afford statutory defenses, where a cause of action is

²⁷ 15 U.S.C. § 77q(a) (1964).

²⁸ 3 Loss at 1426-27.

²⁹ Both of the possible clients, the issuer and the underwriter, prepare the registration statements for use in subsequent sales of the security to the public.

³⁰ 15 U.S.C. § 78r(a) (1964).

³¹ Id. Liability is imposed under section 18(a) only for material misrepresentations in a registration statement filed pursuant to the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78j (1964).

³² The 1934 Act itself limits standing under section 18(a) to those "who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement. . . ." See 15 U.S.C. § 78r(a) (1964). See also 3 Loss at 1752.

³³ 3 Loss at 1752.

³⁴ Id.

established. An attorney would not be held liable if he could prove that he acted in good faith and had no knowledge that the statement was false or misleading.³⁵ Aside from shifting the burden of proof to the defendant attorney, this defense is closely akin to scienter, since its effect is to make actionable solely those misrepresentations which are intentional.³⁶ An attorney would, therefore, be liable under section 18(a) only where he had knowingly, and with intent to mislead, allowed a material misrepresentation to be included in a registration statement. Thus, one commentator has stated:

Except for avoiding any question that the person making the false statement or causing it to be made can be sued by the buyer or seller notwithstanding the absence of privity between them, it is hard to see what advantage § 18 gives the investor that he does not have in common law deceit . . .³⁷

D. Section 11 of the Securities Act of 1933³⁸

Section 11 of the Securities Act permits the purchaser of a security to sue specified individuals for damages if there has been a material misrepresentation in any part of the registration statement covering such security. It has been suggested that the civil liability provisions of section 11 broaden the common law tort of deceit.³⁹ This common law tort action was modified in four respects: the privity, reliance, causation and scienter elements of the common law tort have been dispensed with in section 11. It is easier, therefore, to establish liability for material misrepresentations in registration statements under section 11 than in a common law action for deceit.⁴⁰ Furthermore, it appears easier to establish liability for such a misrepresentation under section 11 than under Rule 10b-5, Section 17(a) of the Securities Act or Section 18(a) of the Securities Exchange Act, since each of the latter requires proof of at least one of these elements of the common law tort of deceit.

The traditional requirement of privity between the purchaser of the securities and the seller has been dispensed with in section 11.⁴¹ Any person who acquired the security issued pursuant to the registration statement may bring an action against two classes of possible defendants: (1) the issuer,⁴² and (2) those persons who were significantly and publicly connected with the registration statement.⁴³ This latter class of possible defendants includes

³⁵ Section 18(a) imposes liability "unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading." 15 U.S.C. § 78r(a) (1964).

³⁶ 3 Loss at 1752.

³⁷ Id.

³⁸ 15 U.S.C. § 77k (1964).

³⁹ See *Rosenberg v. Hano*, 121 F.2d 818, 819 (3d Cir. 1941).

⁴⁰ See Note, 44 *Notre Dame Law*. 122, 124-26 (1968); 3 Loss at 1729-30.

⁴¹ See Note, *supra* note 40, at 125.

⁴² See Securities Act of 1933 § 11(a)(1), 15 U.S.C. § 77k(a)(1) (1964). Section 6(a) of the Act, 15 U.S.C. § 77f(a) (1964), requires all issuers to sign the registration statement.

⁴³ See Securities Act of 1933 § 11(a)(2)-(5), 15 U.S.C. § 77k(a)(2)-(5) (1964). These include every person who with his consent is named as a present or future director or partner of the issuer, every underwriter, and experts who with their consent are named

persons who are not in privity with a purchaser of the security. It should be noted that an attorney, acting solely in his professional capacity, is not a member of either class of persons against whom an action may be brought under section 11.⁴⁴ An attorney could be sued if he were also acting in the capacity of director or officer of the issuer, but such a suit would be bottomed upon his acting in such other capacity. Therefore, a direct action under section 11 by a purchaser of a security may not be brought against an attorney who is acting solely in his professional capacity. However, the principal clients of attorneys in the preparation of registration statements, issuers and underwriters, may be directly liable under section 11. As will be discussed in more detail, an attorney may be indirectly liable under section 11 if he furnishes information to a client which causes the client to be liable. For these reasons the kinds of misconduct actionable under section 11 are important to attorneys.

In general, reliance on the misrepresentation need not be proven.⁴⁵ A plaintiff need only prove that he purchased a security which was issued pursuant to a registration statement. Furthermore, a plaintiff need not prove causation between the material misrepresentation and his damages. Causation, or more properly the lack of causation, is relegated to the role of a partial affirmative defense under section 11.⁴⁶

The plaintiff need not establish scienter in an action under section 11. A detailed series of provisions which are related to reasonable care have been substituted for scienter.⁴⁷ These provisions do not relate to affirmative proof by the plaintiff in establishing his case, but rather relate to affirmative defenses which may be utilized by all defendants except the issuer in an action brought under section 11.⁴⁸

Thus, it is readily apparent that section 11 differs from the common law tort of deceit in its relaxed rules for establishing a cause of action. It differs also in its several affirmative defenses. One such defense, relating to reasonable care, has already been discussed above as a statutory substitute for scienter. This defense may be termed a "due diligence" defense. Another affirmative defense, lack of causation, has also already been noted. Closely related to this latter defense is an exculpatory provision in section 11 which allows any defendant to escape liability by proving that the plaintiff knew of the material

in the registration statement as having prepared or certified parts of the statement or reports or valuations used in connection with it.

⁴⁴ In their professional capacity, lawyers could only be sued under section 11 as "experts." See note 43 supra. However, "neither the lawyer for the company nor the lawyer for the underwriters is an expert within the meaning of section 11." *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 683 (S.D.N.Y. 1968).

⁴⁵ An exception is made for securities purchased after an earnings statement which covers at least twelve months after the effective date of the registration statement has been made available. In such cases, recovery "shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement" rather than the earnings statement. See Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1964).

⁴⁶ 3 Loss at 1729, referring to Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (1964).

⁴⁷ 3 Loss at 1724.

⁴⁸ See Securities Act of 1933 § 11(b), 15 U.S.C. § 77k(b) (1964).

misrepresentation at the time when he acquired the security.⁴⁹ The final defense available under section 11 is the statute of limitations set forth in Section 13 of the Securities Act of 1933.⁵⁰ All actions must be brought within one year after the discovery of the material misrepresentation (or one year after such discovery should have been made in the exercise of reasonable diligence) and in no event may an action be brought more than three years after the security was first offered to the public.

II. SECTION 11 OF THE SECURITIES ACT AND *BarChris*⁵¹

It appears theoretically possible for an attorney, acting solely in a professional capacity, to be held liable for material misrepresentations in an action under Section 10(b) of the Securities Exchange Act of 1934 (and Rule 10b-5 promulgated thereunder), Section 17(a) of the Securities Act of 1933 or Section 18(a) of the Securities Exchange Act of 1934. An attorney may not, however, be held directly liable in an action under Section 11 of the Securities Act of 1933. Yet it is Section 11 of the Securities Act of 1933 which may prove most bothersome to attorneys.

The apparent ease with which a plaintiff might establish liability in a section 11 action against one or more of the specified groups of defendants led Professor Loss to characterize section 11 as "the *bête noir* [*sic*] which was going to stifle legitimate financing. . . ."⁵² The same commentator, however, lists only eleven reported actions pursuant to section 11 from 1933 to 1961. Only two of these cases were decided in the plaintiff's favor.⁵³ Several reasons have been advanced for this scarcity of actions: the care with which attorneys and accountants prepare registration statements; the close scrutiny of registration statements by the Securities and Exchange Commission; the high cost of litigation; and purchasers' apathy.⁵⁴ Nevertheless, Professor Loss stated in 1961 that "there are developments—particularly by way of resort to the 'spurious class action' device—which are giving investors with a mind to litigate an easier row to hoe."⁵⁵ Since 1961 there have been at least six actions brought under section 11.⁵⁶ This apparent trend toward more litigation under section 11 is the source of much concern to attorneys.

A more immediate source of concern is the recently decided case of *Escott v. BarChris Constr. Corp.*⁵⁷ In this case the BarChris Construction Corporation filed a registration statement with the Securities and Exchange Commission on March 30, 1961 covering a bond offering. An amendment to the registration statement was filed on May 11, 1961 and a second amendment

⁴⁹ See Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1964).

⁵⁰ 15 U.S.C. § 77m (1964).

⁵¹ *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

⁵² 3 Loss at 1721.

⁵³ *Id.* at 1687-88 & n.11. He admits that there must have been many pre-trial settlements during this period, but does not attempt to estimate the number of such settlements. *Id.* at 1689.

⁵⁴ *Id.* at 1690-92.

⁵⁵ *Id.* at 1692.

⁵⁶ See Note, *supra* note 40, at 127.

⁵⁷ *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

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was filed on May 16, 1961, the effective date of the registration statement. The net proceeds of the bond offering were received by the BarChris Construction Corporation on May 24, 1961 at the close of the financing. At that date, BarChris was having some difficulties in collecting amounts due from its customers. Collection difficulties worsened as time went on and led to a deterioration of the financial position of BarChris. Finally, on October 29, 1962, BarChris filed a petition for an arrangement under Chapter XI of the Bankruptcy Act.

Nine plaintiffs, who were all purchasers of the bonds, began suit on October 25, 1962 under section 11. Other purchasers were subsequently allowed to intervene as plaintiffs, and at the time of trial there were over sixty plaintiffs. The suit was brought against the issuer, signers of the registration statement, directors of the corporation, underwriters and the auditors who prepared the financial statements used in the registration statement. It is noteworthy that although one defendant was an attorney, he was not being sued in that capacity but in his capacity as a director and signer of the registration statement.⁵⁸

The court found ten misrepresentations in the registration statement.⁵⁹ Of these, eight were held to be material,⁶⁰ because if the information had been correctly stated or disclosed, it "would have deterred or tended to deter the average prudent investor from purchasing the securities in question."⁶¹ The court devoted most of the remainder of its opinion to a consideration of the "due diligence" defenses which were available to all defendants except the issuer, BarChris.⁶² The court deferred decision on all other affirmative defenses pleaded by the defendants.⁶³ Since BarChris, as the issuer, did not have available a defense of "due diligence," it was liable unless it could prove some other affirmative defense.

The part of the court's opinion which deals with the "due diligence" defense of the underwriters⁶⁴ has particularly important implications for attorneys. The court held that the underwriters or their investigating agents must make some reasonable effort to verify the data submitted to them by the company and may not rely solely on the company's officers or company counsel.⁶⁵ It found further that the underwriters' attorneys who were their investigating agents did not make a reasonable investigation. Therefore, the court concluded that because the underwriter delegated to its attorneys, "as its agent[s]," the business of examining the corporate minutes and contracts, the underwriter must bear the consequences of its agents' failure to make an adequate investigation.⁶⁶ The inadequacy of the attorneys' investigation was based upon several shortcomings: their failure to insist upon the production of the minutes of the executive committee meetings; their failure to examine

⁵⁸ *Id.* at 690.

⁵⁹ For a summary, see *id.* at 679-80.

⁶⁰ *Id.* at 681-82.

⁶¹ *Id.* at 681, quoting Charles A. Howard, 1 S.E.C. 6, 8 (1934).

⁶² See Securities Act of 1933 § 11(b)(3), 15 U.S.C. § 77k(b)(3) (1964).

⁶³ 283 F. Supp. at 704.

⁶⁴ *Id.* at 692-97.

⁶⁵ *Id.* at 697.

⁶⁶ *Id.*

the financing agreements and correspondence with BarChris' factor; their failure to examine the contracts which comprised the "backlog" figure; and their failure to inquire about any new officers' loans.⁶⁷

The implication arising from *BarChris* is that, if an underwriter is not able to sustain its "due diligence" defense in an action under section 11 because it relied upon its attorney as its agent and the attorney was not duly diligent, then the underwriter is able to sue its attorney in malpractice under a negligence theory for any damages which it might incur pursuant to a section 11 liability.⁶⁸ Furthermore, there is no reason why the issuer, even though it is not permitted a "due diligence" defense under section 11, might not also sue its attorney for malpractice under a negligence theory if the issuer has been found liable under section 11 because of the negligence of its attorney. After all, the issuer does rely upon its attorney to select materials for inclusion in the registration statement, as well as the actual drafting of the registration statement. Therefore, the significance of *BarChris*, from the standpoint of an attorney's liability, is that it implicitly recognizes the malpractice action by a client against its attorney in section 11 cases. It is likely that an increasing awareness of such malpractice action, when combined with the apparent increase in the number of actions brought under section 11, will lead to an increasing number of malpractice actions brought by issuers and underwriters against their attorneys. The problem confronting attorneys is to determine what practical solutions may be available to avoid this increased potential liability incurred in the preparation of a registration statement.

III. PRACTICAL SOLUTIONS

A. Refusal to Handle Registration Work

It is submitted that registration work should be refused only in speculative circumstances which present no reassuring elements such as representation by reliable counsel for the other client, the issuer or underwriter. Many companies have chosen to make public offerings of their securities to acquire needed capital in preference to making a private offering. Probably this preference stems from the fact that larger sums of money can be raised in a public offering and that any interest which might be paid for debt capital is likely to be lower in a public offering. The increasing preference for public offerings can be seen partially in the number of filings of registration statements with the Securities and Exchange Commission pursuant to the Securities Act of 1933: 781 filed in fiscal 1936;⁶⁹ 449 filed in fiscal 1948;⁷⁰ 913 filed in fiscal 1958;⁷¹ and 2473 filed in fiscal 1968.⁷² In addition to these annual statistics, it is noteworthy that 840 registration statements were filed for the first quarter of fiscal 1969, as compared to 507 for a similar period in fiscal 1968.⁷³

⁶⁷ *Id.* at 695-96.

⁶⁸ For a general analysis of the liability of an attorney for malpractice, see Wade, *The Attorney's Liability for Negligence*, 12 *Vand. L. Rev.* 755 (1959); Note, *Attorney Malpractice*, 63 *Colum. L. Rev.* 1292 (1963).

⁶⁹ 2 *SEC Ann. Rep.* 31 (1936).

⁷⁰ 14 *SEC Ann. Rep.* 8 (1948).

⁷¹ 24 *SEC Ann. Rep.* 33 (1958).

⁷² *SEC Securities Act Release No.* 4934 (Nov. 21, 1968).

⁷³ *Id.*

Only under the speculative circumstances described above need registration work be refused. The work must be performed by someone. Consequently, the satisfaction of a legitimate need of clients requires a solution which will permit registration work to be done in non-speculative situations and in speculative situations where reassuring elements are present.

In conjunction with a suggestion that attorneys should refuse to handle registration work, it could also be suggested that attorneys should limit their work to providing purely legal services, distinct from the examination of documents and agreements which do not require special legal knowledge for understanding. Such a suggestion could go further, and could have attorneys be responsible for examination of only those legal matters which other non-legal personnel, who would perform the basic investigation, might bring to them.

This suggestion lacks merit because the ultimate criterion of whether a piece of information must be disclosed in a registration statement is whether that information is "material." A determination of "materiality" is a legal question to be answered by attorneys. Furthermore, a determination of materiality cannot be made on the basis of an incomplete understanding of the issuer's situation. Information which may not in itself be material may become material when it is seen in light of all the facts. It would be nearly impossible for an individual without expertise in the area to select the information to give to an attorney. Therefore, the attorney cannot make judgments on materiality solely on the basis of information given to him, but, on the contrary, must make an independent investigation.⁷⁴

B. *Obtaining Indemnification Agreement*

An indemnification agreement is one by which a party agrees to secure or hold harmless some other party against loss or damage of a specified character.⁷⁵ Actually there is only one situation where an indemnification agreement covering an attorney's liability to his client for malpractice might practically be sought: the attorney for the underwriter might seek one from the issuer. If one begins with the premise that the issuer needs a public offering to raise money, then the underwriter and its attorney should be able to compel the issuer to grant an indemnification agreement to the underwriter's attorney. Furthermore, it is the issuer who must ultimately supply almost all information which is in the registration statement and it is the issuer who is most familiar with his total situation and, therefore, is in the best position to inform counsel of the relative importance of individual facts. For these reasons, the issuer should not object as much as the underwriter if counsel for the underwriter demands protection from liability for misrepresentations.

Although it is conceptually possible for the issuer's attorney to obtain an indemnification agreement from the underwriter, once it is assumed that the issuer needs a public offering, it remains difficult to see how the issuer and its attorney would be able to exert enough pressure to compel the underwriter to grant such an indemnification agreement. Also, since the issuer's counsel plays a more important role in the determination of information to be

⁷⁴ It was precisely this mistake which was made by the underwriter's attorney in *BarChris*. See 283 F. Supp. at 697.

⁷⁵ See *Keesler v. Peckskill*, 1 Misc. 2d 744, 746, 152 N.Y.S.2d 919, 922 (1955).

released, issuer's counsel is at a further disadvantage when he seeks to obtain indemnification from the underwriter. The underwriter can argue, with some justification, that it will in no way be responsible for most misrepresentations and should not indemnify a more culpable participant.

Even if an indemnification agreement can be obtained, it may not be enforceable. Any analysis of the enforceability of indemnification agreements between an attorney and either the issuer or underwriter must examine the importance which courts have given to the notion of public policy in their examination of agreements which generally relieved against the financial consequences of civil liability. In the leading case of *Railroad Co. v. Lockwood*,⁷⁶ the Supreme Court invalidated a contract exempting the railroad from liability to a passenger for injuries arising from negligence of the railroad. Two reasons were given for the decision: first, relief from liability would contradict the very purpose of liability in promoting carefulness;⁷⁷ and second, the passenger, because he was in an inferior bargaining position, would be unfairly deprived of compensation for his injury.⁷⁸ Clearly, the first reason for the decision is applicable to indemnification agreements, since agreements which release attorneys from liability encourage them to be less careful. Part of the second reason for the decision in *Lockwood* may also exist—inferior bargaining position. However, indemnification agreements differ from the exculpatory agreement considered in *Lockwood*. Where there is an indemnification agreement, the injured parties, the purchaser of the securities and the attorney's client, will still be compensated. Thus, where indemnification agreements have subsequently been challenged under the *Lockwood* doctrine, the courts have generally refused to invalidate them, apparently because they were not inconsistent with the compensation policy fostered by the *Lockwood* decision.⁷⁹ Thus, in cases of strict liability or liability for negligence, where compensation of the injured party would effectively undo the harm caused by the conduct, fostering the deterrent effect of liability was considered too unimportant by itself to be determinative. Therefore, courts held that indemnification by a third party would not offend public policy.⁸⁰ Where, however, upholding the agreement would violate some explicit public policy, then, regardless of the compensation factor, such an agreement should be invalidated.⁸¹

One writer has applied the above reasoning to indemnification agreements obtained by underwriters from an issuer to cover section 11 liabilities.⁸² The conclusion was reached that since the avowed policy of Section 11 of the Securities Act of 1933 and, consequently, the reason for the imposition of liability, was the encouragement of investigation and disclosure, the section was intended to have an *in terrorem* effect. It was felt that if this policy were

⁷⁶ 84 U.S. (17 Wall.) 357 (1873).

⁷⁷ *Id.* at 377-78.

⁷⁸ *Id.* at 379-80.

⁷⁹ Note, Indemnification of Underwriters and Section 11 of the Securities Act of 1933, 72 Yale L.J. 406, 409 (1962).

⁸⁰ *Id.*

⁸¹ Cf. *Akin v. Business Title Corp.*, — Cal. 2d —, — P.2d —, 70 Cal. Rptr. 287 (1968).

⁸² See Note, *supra* note 79.

to be sustained, courts should not enforce indemnification agreements obtained by an underwriter from an issuer.⁸³

In an analysis of the enforceability of an indemnification agreement obtained by an attorney from either the issuer or underwriter, it is well to recall that the basis of the attorney's liability is not section 11 but rather his common law duty to exercise reasonable care. It could be argued, therefore, that the policy of section 11 should be irrelevant. However, it is submitted that the policy of section 11 is still relevant. Since it is the attorney who actually prepares the registration statement in his capacity as an agent for his client, and since it is the attorney who does much of the investigating, it appears that if the overriding section 11 policy of disclosure and investigation, a prophylactic policy, is to have any *in terrorem* effect in prevention of misrepresentation, the same underlying policy must be applied to the work performed by the attorney. Thus, an indemnification agreement obtained by an attorney from either an issuer or underwriter is unlikely to be enforceable.

No court has yet considered the validity of indemnification agreements between an attorney and an issuer or an attorney and an underwriter. It is possible that courts will ascribe more importance to the remedial purpose of section 11 and less to its prophylactic functions. If courts do adopt this emphasis, it would appear that, since indemnification agreements obtained by attorneys cover liabilities similar to those in indemnification agreements already upheld by the courts, the attorney's indemnification agreements would likewise be enforceable. It is doubtful, though, that the courts will minimize the prophylactic function of section 11.

Even if the courts do place more importance upon the remedial purpose of section 11 and less upon the prophylactic purpose, a constant danger remains, as is suggested by the case of *Globus v. Law Research Serv., Inc.*⁸⁴ In that case, the court did not allow an underwriter to enforce an agreement against an issuer "at least under circumstances where he has been found guilty of misconduct evincing actual knowledge or reckless disregard of the falsity. . . ."⁸⁵ If an attorney were to rely only upon an indemnification agreement, he might find that he had no protection at all since a jury might find that he was not merely negligent, but was either reckless or even conscious of the falsity. Moreover, a finding of recklessness is not unlikely where a jury is asked to consider and judge activity in highly complex and sophisticated transactions with which they are unfamiliar. A relatively harmless error in an unfamiliar setting may appear to the jury as reckless conduct. Also, it may be difficult for many juries to see how a "little" mistake could result in a \$100,000,000 error. Therefore, the greater the magnitude of liability and the need for protection, the less likely it is that the indemnification agreement will be held valid under *Globus*.

C. Obtaining a Release from a Client

Such a solution would have the attorney obtain an agreement from his own client (either the issuer or underwriter, as the case may be) in which the

⁸³ Id. at 411-12.

⁸⁴ 287 F. Supp. 188 (S.D.N.Y. 1968).

⁸⁵ Id. at 199.

client would agree to waive or release any possible future causes of action against the attorney for negligence arising from the legal services either performed or failed to be performed in the preparation of the registration statement.

The validity of such agreements between an attorney and his client has never been litigated. Outside of the attorney-client relationship, courts generally have not invalidated releases from liability in the absence of legislation or settled public policy.⁸⁶ But since the relationship of attorney to client rests upon the good faith and trust placed upon the attorney, and because this relationship gives the attorney opportunities for self-dealing, public policy dictates that agreements between attorney and client in the course of the relation are prima facie presumed to be fraudulent.⁸⁷ Therefore, it is submitted that since it contravenes general public policy for an attorney to make agreements with his client, other than possible fee or representational agreements, a release obtained from a malpractice liability by an attorney from his client should be held invalid.

A conscientious attorney may feel that agreements with clients to hold harmless offend his sense of professional ethics. There is, however, no explicit prohibition in the Canons of Professional Ethics which would prohibit this kind of agreement. An attorney whose sense of ethics is offended would be wise to follow the dictates of his conscience, since a client's release from liability will likely be found invalid anyway.

D. Insurance

Another possible solution would be to rely upon some form of malpractice insurance. As with indemnification agreements and releases, the basic question is whether the malpractice insurance policy is enforceable. The same analysis used to determine the enforceability of an attorney's indemnification agreement applies to the determination whether an attorney will be able to collect on his malpractice insurance for his liability for misrepresentation in a registration statement.⁸⁸ It has been suggested that, because of the prophylactic policy of section 11, an attorney's indemnification agreement would be unenforceable. It would follow that an attorney would be unable to enforce his malpractice insurance policy.

There are, however, two considerations which relate to malpractice insurance but which do not relate to indemnification. These considerations militate in favor of enforceability of an attorney's malpractice insurance policy in this situation: the likelihood that the policy will not cover total liability; and the fact that the future premiums will rise if the insurance company must pay.⁸⁹ These two factors would tend to discourage breach of duty, in accordance with the policy of section 11, and thus might make the insurance policy enforceable. However, it is these very same factors—lack of total coverage⁹⁰

⁸⁶ See, e.g., *Sinclair Ref. Co. v. Stevens*, 123 F.2d 186, 192 (8th Cir. 1941), cert. denied, 315 U.S. 804 (1942).

⁸⁷ *Bell v. Ramirez*, 299 S.W. 655, 658 (Tex. Civ. App. 1927).

⁸⁸ Note, *supra* note 79, at 412 & n.49.

⁸⁹ See *id.* at 412.

⁹⁰ At least one law firm in Boston, Massachusetts has increased the coverage of its

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and higher future premiums—which illustrate the inadvisability of relying upon a malpractice insurance policy for protection in this situation. Ideally, the attorney wants total, not partial, protection and since his premium is already high he does not wish to pay higher premiums in the future.

CONCLUSION

It is submitted that spending more time in the preparation of registration statements and charging higher fees for added time and risk is the best practical solution to the problem. Added time spent in preparation of a registration statement will reduce the likelihood of negligence by the attorney and thereby reduce the likelihood of success by his client in an action of malpractice. At the same time it will serve as the best protection for the client by reducing the likelihood of a misrepresentation in the registration statement. Since the added time spent in preparation of a registration statement benefits both attorney and client, a commensurately higher legal fee appears to be a small price for the client to pay for his *own* best protection.

It is unfortunate that there is no easier answer to the problem, or that there is no sure means to avoid the liability which may result from the inevitable errors that sometimes occur. But it appears unavoidably true that "a scrupulous processing of the registration statement is the best sort of insurance they [attorneys and clients] have against § 11 actions."⁹¹

RICHARD A. ABORN

Professional Liability Insurance to \$15 million. See letter from David Z. Webster to Richard Aborn, December 3, 1968, on file with the B.C. Ind. & Com. L. Rev.

⁹¹ 3 Loss at 1690.