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# CUTTING UP THE HUMBLE PIE: A PRACTICAL APPROACH TO APPORTIONING LITIGATION RISKS AMONG UNDERWRITERS

JAMES C. FREUND\* AND HENRY S. HACKER\*\*

## I. A STATEMENT OF THE PROBLEM AND THE PROPOSAL

Underwriters of securities, for many years virtually ignored as the object of lawsuits by disgruntled investors, have lately come into their own as a tempting and solvent target for litigation.<sup>1</sup> In this respect, they are involuntary bedfellows of their professional brethren in the accounting<sup>2</sup> and legal<sup>3</sup> fields, portending an attack that can be expected to intensify in the future.

The essence of modern-day securities underwriting is the syndicate concept.<sup>4</sup> An underwriting firm (commonly referred to as "managing underwriter" or the "manager"<sup>5</sup>) takes the responsibility for forming a syndicate, composed of itself and a number of other underwriters (commonly referred to as "participating underwriters" or "participants"), to market an issuer's securities.<sup>6</sup> Most aspects of the rela-

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<sup>1</sup> See, e.g., *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968) [hereinafter cited as *BarChris*]; *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969), *aff'g* 287 F. Supp. 188 (S.D.N.Y. 1968), *cert. denied*, 397 U.S. 913 (1970) [hereinafter cited as *Globus I*]; *Globus v. Law Research Serv., Inc.*, 318 F. Supp. 955 (S.D.N.Y. 1970), *aff'd*, 442 F.2d 1346 (2d Cir. 1971) [hereinafter cited as *Globus II*]; *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971) [hereinafter cited as *Feit*]; *Financial Indus. Fund Inc. v. McDonnell Douglas Corp.*, 315 F. Supp. 42 (D.C. Colo. 1971), *rev'd*, 474 F.2d 514 (10th Cir. 1973); *Independent Investor Protective League v. New York Sec., Inc.*, 73 Civil No. 2824 (S.D.N.Y. June 27, 1973), summary of complaint reported in [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,039.

<sup>2</sup> See, e.g., *BarChris*, 283 F. Supp. at 697-703. See generally EXPANDING RESPONSIBILITIES UNDER THE SECURITIES ACTS 157-71 (J. FLOM & L. LOSS, Co-Chairmen, N.Y.L.J. 1972); Hallett & Collins, *Auditors' Responsibility for Misrepresentation*, 44 WASH. L. REV. 139 (1968).

<sup>3</sup> See, e.g., *SEC v. National Student Marketing Corp.*, 360 F. Supp. 284 (D.D.C. 1973). See also Freeman, *Liability of Counsel for Issuer*, 24 BUS. LAW. 635 (1969); Henkel, *Liability of Counsel for Underwriter*, 24 BUS. LAW. 641 (1969); Karmel, *Attorneys' Securities Laws Liabilities*, 27 BUS. LAW. 1153 (1972).

<sup>4</sup> See text accompanying notes 28-38 *infra*.

<sup>5</sup> There may be more than one manager in an underwriting, although for uniformity we have used the term in the singular throughout the article. The managing underwriter is also often referred to as the "representative of the underwriters."

<sup>6</sup> The securities may be offered by the issuer itself, consisting of either previously unissued or treasury securities or may be sold for the account of securities holders, or any combination thereof. For purposes of this article, unless otherwise specified, we will assume that the particular offering under discussion is being made directly by the issuer, although the principles involved are generally applicable.

tionship between the managing and participating underwriters are carefully defined in the standard form of agreement among underwriters<sup>7</sup> (which we will refer to, in the jargon of the trade, as the "Agreement Among"). Curiously, the one major area not covered in the typical Agreement Among is the apportionment among underwriters of the risks of litigation brought by investors or others, arising out of the offering.

If there were little likelihood of such litigation, if the risks of ultimate liability on the part of the underwriters were minimal, and if the governing law on the subject were clear, then perhaps the omission of a provision relating to potential litigation might be justifiable. In point of fact, however, none of these conditions exists. At the same time that litigation aimed at underwriters is proliferating, the liability exposure of underwriters has been increased substantially by such recent developments as the greater difficulty of establishing a "due diligence" defense,<sup>8</sup> the possible inability of underwriters to realize on their indemnification agreements with the issuer and selling stockholders,<sup>9</sup> and the intrusion of expanded concepts of rule 10b-5 liability into the underwriting context.<sup>10</sup>

Moreover, the governing law on the subject is exceedingly unclear at the present time, with no fixed answers to a number of questions. For example, do different standards of due diligence exist for managing and participating underwriters?<sup>11</sup> If (as seems to be the case) participating underwriters are not protected from liability in relying on *inadequate* due diligence of the manager, will *adequate* due diligence by the manager protect the participants?<sup>12</sup> Will the result in the *Globus I* case, denying underwriters indemnification from the issuer in situations where the manager's conduct went beyond mere negligence, be extended to instances where the manager is simply careless?<sup>13</sup> Does

<sup>7</sup> For a representative sample of such an agreement, see G. ROBINSON & K. EPPLER, *GOING PUBLIC* § 36 (2d ed. 1973) [hereinafter cited as ROBINSON & EPPLER]. This agreement relates to what is known as a "firm commitment" underwriting (as contrasted with "best efforts" and "rights" or "standby" offerings), which is the prevalent mode of public corporate finance today. This article is directed at firm commitment underwritings, performed on a negotiated basis (as contrasted with those subject to competitive bidding).

<sup>8</sup> See notes 52-53 and accompanying text *infra*.

<sup>9</sup> See text accompanying notes 60-67 *infra*.

<sup>10</sup> This rule was promulgated under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (1970) [hereinafter the 1934 Act]; 17 C.F.R. § 240.10b-5 (1973) [hereinafter cited as the rule or rule 10b-5]. See text accompanying notes 46-50 *infra*.

<sup>11</sup> See SEC Securities Act Release No. 5275 at 10-12 (July 26, 1972); Note, *Section 11 of the Securities Act: The Unresolved Dilemma of Participating Underwriters*, 40 *FORDHAM L. REV.* 869 (1972).

<sup>12</sup> See text accompanying notes 57-61 *infra*.

<sup>13</sup> See note 67 *infra* and accompanying text.

contribution under section 11(f) of the Securities Act of 1933<sup>14</sup> as amended (the "1933 Act"), cover amounts paid by way of settlement and necessary legal fees incurred in defending the claim?<sup>15</sup> What rights of contribution, if any, exist in the context of litigation under rule 10b-5?<sup>16</sup> Should the answer to any of the foregoing questions turn on which of the underwriters is sued?<sup>17</sup>

Recently, in partial response to some of these questions, the Securities and Exchange Commission (Commission) and the National Association of Securities Dealers, Inc. (NASD) have entered the picture through some tentative regulatory attempts to tinker with due diligence.<sup>18</sup> A few underwriters have made initial forays into spreading the litigation risk through contractual provisions.<sup>19</sup>

At the risk of over-generalizing, it would appear that certain characteristics of the investment banking industry suggest the advisability of forging a common solution in advance of the problem. The typical investment banker may act as manager of a particular offering on a Tuesday, and as a participant in several other underwritings on Wednesday and Thursday; a rigid posture in one of these roles could work to his ultimate disadvantage in the other. Traditionally, investment bankers are not disposed toward litigation among themselves, but rather their practice has been inclined toward gentlemanly accommodation.<sup>20</sup> Underwriters have long sought ways and means of avoiding their particular spectre — uncertainty of any kind. Finally, the syndicate itself stands as a time-tested monument to consensual risk-sharing.<sup>21</sup>

In light of these traditions and attitudes, it makes good sense for the industry to come to grips with the questions of comparative litigation risks. To further the necessary dialogue, we are proposing in this article a plausible compromise solution.<sup>22</sup> It takes the form of a new provision for inclusion in the Agreement Among, aimed at: (a) introducing a fair amount of certainty into the picture in advance of the occurrence of particular problems; (b) distinguishing between garden variety negligence and the more egregious types of managing underwriters' behavior such as knowledgeable misrepresentation — relegating the underwriters to their respective legal rights and remedies in the

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<sup>14</sup> 15 U.S.C. § 77K(f) (1970) [hereinafter cited as the 1933 Act].

<sup>15</sup> See notes 88-89 *infra* and accompanying text.

<sup>16</sup> See text accompanying notes 71-72 *infra*.

<sup>17</sup> See text accompanying notes 72-90 *infra*.

<sup>18</sup> See text accompanying notes 91-99 *infra*.

<sup>19</sup> See text accompanying note 100 *infra*.

<sup>20</sup> See text accompanying notes 83-84 *infra*.

<sup>21</sup> See note 28 *infra*.

<sup>22</sup> See Section V *infra* at 482.

latter case, while spreading the burden on an assumption-of-the-risk rationale in the former situation; (c) mitigating any legal distinctions that might otherwise be introduced by the plaintiff's decision as to whom to sue and the statutory basis for the suit; and (d) providing for the problems of legal representation and settlement of the case, together with their attendant costs.

To be sure, this proposed solution raises certain questions. Should participating underwriters be forced to share the burden of a faulty investigation by the managing underwriter?<sup>23</sup> Should participating underwriters be committed to the manager's choice of counsel in defending the litigation?<sup>24</sup> Are there any ethical conflict of interest problems inherent in one attorney representing both the manager and participants in the litigation?<sup>25</sup> Should all of the underwriters be required to join in a settlement approved by a stated majority?<sup>26</sup> Does the provision violate any public policy as enunciated by the courts or the Commission?<sup>27</sup>

While it is believed that there are suitable answers to the foregoing questions, we also realize that, given the judgmental nature of the subject matter, a variety of different conclusions can be reached. The purpose of this article is to provoke a beneficial discussion of the subject by underwriters and their counsel, which hopefully will lead to a resolution of the issues satisfactory to the industry, the courts and the Commission.

## II. A BRIEF DISSERTATION ON MODERN-DAY UNDERWRITING

### *Origination, Syndication and Distribution*

Underwriting is a tripartite process — consisting of origination, syndication and distribution — through which corporate securities reach the investing public.<sup>28</sup> Within this process, managing and participating underwriters each play a part, but their roles are significantly different.

The origination phase, which involves the advisory and investigatory aspects of underwriting leading up to the filing of a 1933 Act Registration Statement, is handled generally by one or more<sup>29</sup> invest-

<sup>23</sup> See text accompanying notes 135-40 *infra*.

<sup>24</sup> See note 135 and accompanying text *infra*.

<sup>25</sup> *Id.*

<sup>26</sup> See Section V *infra* at p. 482.

<sup>27</sup> See Section V *infra* at p. 482.

<sup>28</sup> For a survey of the underwriting process see THE STOCK MARKET HANDBOOK 54-70, 482-90 (F. Zarb & C. Kerekes eds. 1970); FINANCIAL HANDBOOK §§ 9.9-9.27 (3d ed. J. Bogen 1964). For a history of the development of syndication in the United States see V. CAROSSA, INVESTMENT BANKING IN AMERICA — A HISTORY 51-78 (1970).

<sup>29</sup> See note 5 *supra*.

ment bankers who invariably manage the offering. During this stage a general understanding (which is often embodied in a letter of intent) is reached between the issuer and the manager as to their joint willingness to proceed and the principal terms of the contemplated offering, including a general price range and the level of underwriters' compensation.

When this understanding is reached, the manager, his attorneys, and at times other experts retained by this manager will undertake the bulk of the due diligence investigation<sup>30</sup> (although a continual updating should be performed throughout the underwriting process). The investigation consists of an in-depth probing of the business, financial and legal facts of the issuer's life, involving examination of a plethora of documents, numerous face-to-face meetings with management, auditors and attorneys, on-site inspection of the company's facilities, and independent verification through outside sources of the salient aspects of the issuer's business and finances.

Once the registration statement (including a preliminary prospectus) has been filed with the Commission, and the preliminary prospectus is circulated throughout the investment banking community, the syndication phase begins. It is only at this stage that the participating underwriters enter the scene, and even then usually in a very limited capacity. The manager determines which underwriters will be invited into the syndicate, consistent with the traditions of the bracketing system which determines the relative size of the respective underwriting positions.<sup>31</sup> In most cases, invitees base their decisions to join the syndicate principally on the reputation of the manager, on an analysis of the registration statement and underwriting documents, and perhaps on a brief appraisal by the participating firm's research department of the security being offered.

The dominance of the manager continues through the distribution phase. The manager allocates to the respective participants the amount of securities each will be permitted to sell to their own customers.<sup>32</sup>

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<sup>30</sup> Due diligence takes its name from the defenses contained in sections 11(b) and (c) of the 1933 Act. See Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case* (pts. 1 & 2), 55 VA. L. REV. 1, 199 (1969) [hereinafter cited as Folk]; *Symposium—The BarChris Case: Prospectus Liability*, 24 BUS. LAW. 523 (1969). See generally TECHNIQUES OF DUE DILIGENCE (J. PURCELL, Chairman, PLI 1973).

<sup>31</sup> Although this can vary appreciably, the manager's underwriting position generally amounts to approximately twenty percent of the issue, or, if there are co-managers, to approximately fifteen percent each. For an interesting summary of this little-known and somewhat arcane area of Wall Street see Hayes, *Investment Banking: Power Structure in Flux*, 49 HARV. BUS. REV. 136 (1971) [hereinafter cited as Hayes], in which such matters as the relative sizes of underwriting positions and the reasons therefor are discussed.

<sup>32</sup> This allocation will not necessarily be equal to a participant's underwriting posi-

Although the manager may solicit and certain participants may independently volunteer views as to the ultimate pricing of the issue, all price negotiations typically take place solely between the issuer and the manager.

Generally, the sole contact between the participants and the issuer takes place at a so-called "due diligence" meeting, which normally occurs several days prior to the offering. For the most part, this gathering represents the only opportunity for participating underwriters to meet the company's management and to pose questions directly to the officers. In practice, however, these meetings are usually attended by the participants' most junior associates, who tend to be uninformed about the company and sit mutely while the president waxes eloquently about his company's prospects.<sup>33</sup> It is extremely rare for participants to undertake independent efforts to obtain first-hand information about the issuer.

For their collective efforts, the underwriters will be compensated by the underwriting discount or "gross spread," representing the difference between the price at which the underwriters purchase the securities from the issuer and the public offering price.<sup>34</sup> The size of the spread is negotiated between the issuer and the manager. The spread is then broken down by the manager into three basic components,<sup>35</sup> each of which represents a different functional aspect of underwriting. The management fee, for originating and managing the offering, comprises approximately twenty percent of this spread and is retained by the manager.<sup>36</sup> The underwriting commission, roughly thirty percent of the spread, is allocated to the underwriters (including the manager) on the basis of their respective underwriting participations. The selling concession, approximately fifty percent of the spread, is allocated to the underwriters (including the manager) or selling group members<sup>37</sup> on the basis of the amount of securities sold by each firm.

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tion. Pursuant to authority contained in the Agreement Among, the manager generally withholds a certain quantity of securities from the participants for apportionment to selected dealers or to large institutions on behalf of the group, or to the manager itself (or other underwriters) for distribution to clients. This enables the manager to keep tighter control over the distribution of the issue.

<sup>33</sup> This reality has been explicitly acknowledged by the Commission. SEC Securities Act Release No. 5275 at 12-13 (July 26, 1972).

<sup>34</sup> The spread will vary anywhere from one to ten percent depending on the type of security to be offered, the nature of the offering, the stature of the issuer, and competitive factors. See Hayes, *supra* note 31, at 137.

<sup>35</sup> *Id.*

<sup>36</sup> At times the manager will receive additional compensation from the issuer in the form of warrants or "cheap stock." This type of compensation exposes the manager to greater liability under section 11(e) of the 1933 Act; see note 49 *infra*.

<sup>37</sup> The selling group members are generally smaller or regional investment firms who

In sum, it can be seen that in all aspects of the underwriting process other than the actual retailing of the securities, the participant assumes a secondary and essentially passive role. The underwriting process reflects the expedient delegation by the participants to the managing underwriter of the important decisions of the offering. Practically speaking, the participants impliedly assume the risks of the supervisory and investigatory abilities of the managing underwriter. At least in the crucial due diligence area, this comports with practical realities, since to require each of the numerous participating underwriters to undertake an exhaustive investigation of the issuer would be both redundant<sup>38</sup> and, in terms of each participant's small portion of the overall offering, uneconomical. The Commission, taking administrative notice of this problem, has sanctioned the delegation of the due diligence function, so long as the participants satisfy themselves that the manager has made a thorough and adequate investigation.<sup>39</sup> This practice of extensive delegation, already existing in the underwriting community, forms the basis for our proposed solution to the problems of litigation risk.

### *The Agreement Among Underwriters*

The Agreement Among carries over the concept of delegation into the legal sphere. This document, which is entered into by the underwriters immediately prior to each public offering, defines the relationship between the manager and participants, and provides in minute detail for the delegation of a large measure of authority to the manager.<sup>40</sup>

It is significant to note that the provisions of the Agreement Among

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will purchase a small portion of the issue from the underwriters for distribution to the public, but who have no underwriting or purchase obligations to the issuer. They are not considered to be statutory underwriters under section 2(11) of the 1933 Act. See H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 8.10 (1972) [hereinafter cited as BLOOMENTHAL].

<sup>38</sup> Commentators have frequently pointed out that the value of numerous investigations into the same subject matter would likely be inconsequential. See, e.g., Folk, *supra* note 30, at 57. Moreover, additional probes would cause increased time demands on the issuer's management, over and above the considerable number of hours they already spend in the registration process.

<sup>39</sup> See SEC Securities Act Release No. 5275 at 12 (July 26, 1972); Section IV *infra* at p. —.

<sup>40</sup> See ROBINSON & EPPLER, *supra* note 7, at § 36. In the typical Agreement Among, the manager is authorized to enter into the underwriting agreement with the issuer, to allocate securities, to withhold securities for sale to institutions and selected dealers, to over allot securities, to commence the public offering, to vary the public offering price, to effect stabilizing transactions, and to advance or borrow funds on behalf of the participants for payment to the issuer. On the other hand, the participants' rights are limited; they can only sell the securities in conformity with the terms disclosed in the prospectus, and are prohibited from making stabilizing transactions or otherwise engaging in open market transactions.



are not solely directed to a smoothly functioning public offering. On the contrary, the Agreement Among attempts to isolate and deal with a number of potentially troublesome situations in the underwriting process. For example, the manager is empowered, in the context of an unsuccessful offering, to change the public offering price, to stabilize, and to dispose of withheld or repurchased shares at his discretion after termination of the offering. If an underwriter defaults on his purchase commitment, elaborate substitution provisions can be invoked. Thus, the omission of provisions dealing with litigation risks cannot be rationalized on the ground that underwriters have traditionally maintained an ostrich-like attitude toward problem areas, avoiding contemplation of the unthinkable; the Agreement Among bears witness to the greater concern of underwriters for certainty in their relations.

The basic principle underlying the Agreement Among is the several (as contrasted with joint) liability of underwriters.<sup>41</sup> Each underwriter separately promises to purchase only a specified portion of the total securities underwritten, thus limiting each underwriter's obligations and liabilities to the issuer.<sup>42</sup> This severality concept does not operate to deny contribution under the 1933 Act,<sup>43</sup> nor would it be legally inconsistent with the approach proposed herein. Furthermore, since severality is a means of limiting underwriters' liability to prevent a burdensome and unequal judgment from falling upon one underwriter, a contractual provision to further sharing of the litigation risk would seem to be entirely appropriate.<sup>44</sup>

### III. A SURVEY OF THE LEGAL ASPECTS OF UNDERWRITERS' LIABILITY *The Basis for Liability; Defenses*

The standard weapon in the arsenal of a plaintiff seeking redress against underwriters has long been section 11 of the 1933 Act, which

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<sup>41</sup> See ROBINSON & EPLER, *supra* note 7, at § 36. In this proviso it is also stated that the manager shall be under no liability to the participants, except for obligations expressly assumed in the Agreement Among and for liabilities imposed by the 1933 Act.

<sup>42</sup> I L. LOSS, *SECURITIES REGULATION* 167 (2d ed. 1961) [hereinafter cited as LOSS]. This arose as a contractual device to make operative the provisions of section 11(e) of the 1933 Act (adopted in 1934), limiting each underwriter's liability to its respective purchase commitment. Prior thereto, underwriting obligations were joint, which gave rise to an obligation on the part of each underwriter to purchase the entire offering from the issuer. See *United States v. Morgan*, 118 F. Supp. 621, 647 (S.D.N.Y. 1953).

<sup>43</sup> See § 3 LOSS, *supra* note 42, at 1728 n.149, in which he discusses the interrelationship between limitations on underwriters' liability contained in section 11(e) of the 1933 Act and contribution among underwriters.

<sup>44</sup> The Agreement Among already contains provisions which can be characterized as "joint," relating to, among other things, the apportionment of expenses and the sale by the manager of withheld securities on behalf of the group. See ROBINSON & EPLER, *supra* note 7, at § 36.

covers a multitude of underwriters' sins ranging from negligent omission of a material fact in a registration statement to willful and intentional fraud in connection with a public offering.<sup>45</sup> Although the statutory liabilities imposed upon underwriters were initially met with consternation and dismay,<sup>46</sup> subsequent amendments to the 1933 Act and the passage of time have made these provisions at least tolerable to the investment banking community. With the expansion of the private remedy under rule 10b-5 into the underwriting context,<sup>47</sup> however, an additional blunderbuss was added to the plaintiff's armaments, causing fresh reverberations on Wall Street.<sup>48</sup>

Although the rule has not imposed any additional substantive liability upon underwriters,<sup>49</sup> the class of potential plaintiffs has been broadened<sup>50</sup> and judicial applications have tended to brush aside some of the mitigating elements of section 11, thereby exposing underwriters to additional uncertainties and risks. For example, under the 1933 Act each underwriter's exposure to damages is limited by section 11(e) to the price of the securities it actually underwrites and distributes;<sup>51</sup> and section 11(g) limits the total amount recoverable from all defendants in a section 11 action to the aggregate public offering price of the entire issue.<sup>52</sup> Neither of these limitations exists under

<sup>45</sup> 1933 Act § 11. The general purpose of this section of the 1933 Act was to impose upon those persons involved in the underwriting process liability for negligent conduct, which would not have been actionable under the common law requirements for fraud or deceit. See BLOOMENTHAL, *supra* note 37, at § 8.08.

<sup>46</sup> See Ballantine, *Amending the Federal Securities Act*, 20 A.B.A.J. 85 (1934); Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Markets*, 58 VA. L. REV. 776 (1972) [hereinafter cited as Dooley].

<sup>47</sup> See *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Orn v. Eastman Dillon, Union Sec. & Co.*, 364 F. Supp. 352 (C.D. Cal. 1973). For the Commission's views as to the applicability of rule 10b-5 to the underwriting context and the non-exclusivity of section 11 see a summary of its *amicus curiae* brief in *Orn*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,760. Dooley, *supra* note 46, at 810-27, contains a thorough analysis of the effect of rule 10b-5 on investment bankers.

<sup>48</sup> Dooley, *supra* note 46, at 833-42.

<sup>49</sup> In fact, the scope of liability under rule 10b-5 might well be narrower than under section 11, since at present a substantial controversy exists as to whether negligent behavior is privately actionable under rule 10b-5. The initial interpretations of rule 10b-5 requiring some element of *scienter* (knowledgeable or fraudulent misrepresentation) have for some time now been in the process of erosion. The Ninth Circuit has done away with this requirement altogether, and would impose liability for negligent behavior under rule 10b-5. See *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961). See also Dooley, *supra* note 46, at 814-15, 826-27; BLOOMENTHAL, *supra* note 37, at § 8125[3].

<sup>50</sup> See *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951). See also *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967); *Colonial Realty Corp. v. Brunswick Corp.*, 257 F. Supp. 875 (S.D.N.Y. 1966).

<sup>51</sup> 1933 Act § 11(e). This limitation can, however, be negated for a particular underwriter if he receives additional compensation from the issuer in the form of warrants or "cheap stock." As a result of this provision, certain investment bankers have adopted a policy against taking compensation in this form.

<sup>52</sup> 1933 Act § 11(g). Thus, for example, if investors buy securities covered by a prospec-

rule 10b-5. In addition, the statute of limitations for a section 11 action (contained in section 13 of the 1933 Act) is considerably shorter than under rule 10b-5.<sup>53</sup>

The principal underwriters' shield against claims under the 1933 Act has been the "due diligence" defense, as embodied in sections 11(b) and (c).<sup>54</sup> It is grounded in the "reasonable man" element of the law of negligence, imposing a standard of prudent conduct for the underwriters' actions in connection with the preparation of the registration statement and distribution of the securities. The underwriter will not incur liability if, on the basis of a reasonable investigation into the affairs of the issuer, the underwriter reasonably believes that there are no misstatements and omissions in the registration statement. A successful due diligence defense of this nature would presumably also absolve underwriters in a rule 10b-5 action.<sup>55</sup>

The requisites of preparing and sustaining a due diligence defense on behalf of underwriters are beyond the scope of this article. It should be noted, however, that establishing such a defense is far from simple, inasmuch as there are no fixed standards as to reasonableness, and the adequacy of the investigation is determined from the vantage point of judicial hindsight. Recent cases illustrate this difficulty by insisting on an exhaustive investigation into all aspects of the issuer's business.<sup>56</sup>

As mentioned above,<sup>57</sup> in current underwriting practice the manager is delegated the function of performing the due diligence investigation on behalf of the syndicate. The practical effect of this delegation is that, if the manager fails to perform the investigation properly, the inactive defendant-participant will also be held liable, at least in the context of a section 11 lawsuit.<sup>58</sup> Whether the converse is true, *i.e.*,

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tus in the after-market at a price higher than the original public offering price, and such securities later become worthless, a defendant-underwriter in a rule 10b-5 action would face potential damages based on the full loss to the purchasers, not limited by either the underwriter's participation in the offering or the public offering price. See SEC Securities Act Release No. 45 (Sept. 22, 1933); Dooley, *supra* note 46, at 824-27.

<sup>53</sup> See *Orn v. Eastman Dillon, Union Sec. & Co.*, 364 F. Supp. 352 (C.D. Cal. 1973); Dooley, *supra* note 46, at 822-24. See also Martin, *Statutes of Limitation in 10b-5 Actions: Which State Statute is Applicable?*, 29 Bus. Law. 443 (1974).

<sup>54</sup> 1933 Act § 11(b),(c). See also note 30 *supra*.

<sup>55</sup> Although rule 10b-5 does not explicitly provide for a "due diligence" defense, and although confusion does exist with regard to whether the rule covers underwriters' negligent conduct (see note 49 *supra*), in sustaining a due diligence defense underwriters have in effect proved that they acted in neither a negligent nor fraudulent manner.

<sup>56</sup> In addition to other areas of concern, consider the comprehensive due diligence investigation conducted by the underwriters (consisting of numerous meetings with, and reports by, insurance and disclosure experts) into the area of "surplus-surplus" in *Feit*, 332 F. Supp. at 561-62, 581-83. Judge Weinstein appeared to find such investigation barely adequate. *Id.* at 582.

<sup>57</sup> See text accompanying note 30 *supra*.

<sup>58</sup> *BarChris*, 283 F. Supp. at 697.

whether the participants will be protected if the manager sustains his due diligence defense, is somewhat of an open question, although such a result seems clearly reasonable.<sup>59</sup> To arrive at a contrary conclusion in either of these situations would require the creation of differing standards of due diligence for managing and participating underwriters, a dichotomy which the courts have yet to recognize.<sup>60</sup> This concept of derivative liability and absolution is critical to any analysis of the proposed approach to sharing litigation risks.<sup>61</sup>

### *Indemnification*

The traditional method by which underwriters have sought to protect themselves from potential liabilities to investors has been through the indemnification contract with the issuer.<sup>62</sup> The theory of indemnification is to shift liability from one person who may be legally liable to another who, for reasons of equity based on presumably greater fault, should more properly bear its burden.<sup>63</sup> In the underwriting context, the primary responsibility for preparation of the registration statement falls on the issuer, which is in the best position

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<sup>59</sup> See Folk, *supra* note 30, at 57. An analogy can be drawn to the situation in *Feit*, a case involving two dealer-managers in an exchange offer, where the satisfactory due diligence investigation by one dealer-manager was deemed to have absolved the other. 332 F. Supp. at 583.

<sup>60</sup> On its face, section 11 of the 1933 Act does not distinguish between managing and participating underwriters in terms of due diligence obligations. *But see* text accompanying note 39 *supra* for the views of the Commission. If the courts were to adopt the reasoning of the Commission to the effect that a participating underwriter's due diligence burden may not be as heavy as the manager's (*i.e.*, the participant need not actually verify the completeness and accuracy of the information contained in the Registration Statement, but must satisfy himself that the manager has done so), then such derivative liability would not necessarily follow. *See also* note 73 *infra*; Note, *Section 11 of the Securities Act: The Unresolved Dilemma of Participating Underwriters*, 40 *FORDHAM L. REV.* 869, 886-88 (1972), for further discussion of this issue. *See also* note 73 *infra*.

<sup>61</sup> *See* text accompanying notes 137-40 *infra*.

<sup>62</sup> In order to secure an additional degree of protection and particularly to guard against the issuer's insolvency, investment bankers have in the past turned to insurance. Certain well established investment banking firms have purchased blanket policies governing liabilities under the securities laws, some of which apparently remain in effect today; it is understood, however, that new policies of this nature are no longer being issued. *See* Appelbaum & McDowell, *Indemnification Against Securities Act Liabilities*, 27 *BUS. LAW.* 131, 137 (Supp. Issue 1972). Another form of insurance policy can be purchased on an issue-by-issue basis, although these are normally written only in secondary offerings by selling stockholders of highly established companies. *See* Kroll, *Some Reflections on Indemnification Provision and S.E.C. Liability Insurance in Light of BarChris and Globus*, 24 *BUS. LAW.* 681, 686-87 (1969) [hereinafter cited as Kroll]. Because of the limited availability and the spiraling costs of this kind of insurance, it would not appear to be a major factor in resolving the problems raised in this article.

<sup>63</sup> *See* W. PROSSER, *LAW OF TORTS* 310 (4th ed. 1971) [hereinafter cited as PROSSER]; Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 *U. PA. L. REV.* 597, 647 (1972) [hereinafter cited as Ruder].

to know fully and to present adequately the facts concerning its business. Thus, when there are serious deficiencies in a registration statement, the long finger of responsibility usually points at the issuer.<sup>64</sup> In recognition of this concept, underwriters have invariably insisted that their purchase agreement with the company contain indemnification provisions, pursuant to which the issuer will hold the underwriters harmless against any loss resulting from an inaccurate or incomplete registration statement. The only exception is for those few portions of the registration statement specifically prepared by the underwriters (such as the distribution arrangements), as to which the underwriters typically indemnify the issuer.<sup>65</sup>

It has long been recognized in the law that the freedom of parties to contract for indemnification is subject to overriding considerations of public policy.<sup>66</sup> In this regard, the Commission has consistently taken the position that it is contrary to public policy, as expressed in the 1933 Act, for companies to indemnify their officers or directors for securities laws violations.<sup>67</sup> Although the Commission has never adopted this stance with respect to the indemnification of underwriters by issuers, the courts have now seized the initiative from the administrators.

In the *Globus I* case, the Second Circuit concluded that it would be improper for such policy reasons to allow an underwriter indemnification from the issuer in a situation where the underwriter had actual knowledge of material omissions in a disclosure document and had failed to insist upon the inclusion of such material.<sup>68</sup> The court reasoned that to permit indemnification would have the effect of causing

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<sup>64</sup> This inference has been implicitly recognized in the 1933 Act, which denies the issuer a due diligence defense under section 11, thereby imposing virtually strict liability. See BLOOMENTHAL, *supra* note 37, at § 8.13.

<sup>65</sup> See ROBINSON & EPPLER, *supra* note 7, at § 52 for sample indemnification provisions of this nature.

<sup>66</sup> See Ruder, *supra* note 63, at 654-55.

<sup>67</sup> 17 C.F.R. § 230.460 n.a (1973), under the 1933 Act provides that, as a prerequisite to acceleration of a registration statement, the issuer must acknowledge in the registration statement the Commission's position with regard to such indemnification and agree to submit any claim for indemnification to a court for a binding adjudication. See Kroll, *supra* note 62, at 688-89. See also the summary of the Commission's amicus brief in *Feit* (in which both a corporation and certain directors were held liable) concerning its opposition to the payment of the entire judgment by the corporate defendant, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,415. The authors have been advised that the directors ultimately contributed relatively small amounts to the judgment.

<sup>68</sup> 418 F.2d at 1288. *Globus I* involved an offering of securities under the Regulation A exemption, and thus the ensuing claims, based on a false and misleading offering circular, were brought under section 17 (rather than section 11) of the 1933 Act. Presumably, the result would have been the same if a registration statement were involved and the claim brought under section 11 or rule 10b-5. See also Ruder, *supra* note 63, at 657 n.273.

the indemnified party to be less than thorough in his preparation or investigation of the registration statement; and that, by enforcing the indemnification against the issuer, the court would be indirectly harming precisely those persons (namely, the stockholders of the issuer who had purchased their shares in the offering) whom the law seeks to protect.

The denial of indemnification in *Globus I* was for what the Second Circuit characterized as "a sin graver than ordinary negligence"<sup>69</sup> on the part of the underwriters. Such sin would obviously embrace intentional fraud, recklessness and even gross negligence. There is no decision as yet on whether indemnification would be denied in a case where the underwriters were merely negligent, but it is not unforeseeable that such a result could eventually obtain.<sup>70</sup>

### Contribution

The apparent hostility of the Commission and the courts toward indemnification, coupled with the recognition that indemnification is of dubious value when the issuer is in shaky financial condition, has led underwriters to the unhappy conclusion that they cannot safely rely on it to protect themselves against federal securities law liabilities. This has sparked a corresponding rise in interest among underwriters and their attorneys in the principles of contribution, which mandate a sharing of liability among culpable persons.<sup>71</sup>

In contrast to indemnification, which has no statutory basis in the securities laws, contribution is expressly countenanced by section 11(f) of the 1933 Act.<sup>72</sup> The section provides that anyone liable under section 11 can compel others, who if sued separately would have been similarly liable, to share in the ultimate payment;<sup>73</sup> the only exception occurs if the person seeking contribution has been guilty of "fraudulent misrepresentation" and the other has not. There is no similar express statutory basis for contribution in a rule 10b-5 action, but at least one court has implied such a right.<sup>74</sup>

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<sup>69</sup> 418 F.2d at 1288.

<sup>70</sup> See Kroll, *supra* note 62, at 692. It is interesting to note that the Commission makes no distinction between gross negligence and negligence with respect to its position on indemnification of directors and officers. See note 67 *supra*.

<sup>71</sup> For a general discussion of contribution see Ruder, *supra* note 63, at 647-51.

<sup>72</sup> Contribution exists under sections 9(e) and 18(b) of the 1934 Act but neither of these provisions applies directly to contribution under rule 10b-5.

<sup>73</sup> At the time of its enactment, this provision was seen as a direct reversal of the American common law rule which denied contribution among joint tortfeasors. See 3 Loss, *supra* note 42, at 1737. The statutory endorsement of contribution, plus the imposition of joint and several liability on section 11 violators, provides incentive for every person connected with the underwriting to perform diligently.

<sup>74</sup> *deHaas v. Empire Petroleum Co.*, 286 F. Supp. 809 (D. Colo. 1968), *aff'd in part and*

Unfortunately, there are very few cases dealing with this matter under the federal securities laws,<sup>75</sup> and none which speaks to the issue of contribution among underwriters. This creates many uncertainties in both the legal and practical applications of the doctrine.

The problems of contribution are less acute, especially for the manager, in a lawsuit in which all underwriters are included in the original action, as contrasted with the difficult third-party questions (referred to below) when the manager alone is sued. Nevertheless, it is conceivable that the manager could be denied contribution in at least two instances where all the parties are before the court. In a case where the manager has been negligent but the participants are able to prove that they were diligent, the manager would not be entitled to contribution under section 11(f), which requires that the person against whom contribution is asserted be liable for the same payment.<sup>76</sup> And in a case under rule 10b-5, where the manager is liable because of conduct amounting to fraud but the participants' negligence is not considered to rise to the necessary standard for liability, contribution would presumably be denied on the theory that the participant was not a joint tortfeasor.<sup>77</sup>

There is a further contribution problem for underwriters in cases where a judgment is rendered against all of them. The 1933 Act provides no guide as to how each is to share in the total liability.<sup>78</sup> It can be presumed that the plaintiff will seek to execute his judgment against one or at most a handful of the most solvent and accessible defendants;

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*vacated in part*, 435 F.2d 1223 (10th Cir. 1970). The court reached this result on the basis of section 11(f) of the 1933 Act and sections 9 and 18 of the 1934 Act. *Id.* at 815-16. Moreover, contribution was also required in *Globus II*, where the original action was brought under section 17, the 1933 Act analogue of rule 10b-5. See note 68 *supra*.

<sup>75</sup> See note 71 *supra*; *Getter v. R.G. Dickinson & Co.*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,185 (S.D. Iowa 1973); *Lyons v. Marrud, Inc.*, [1967-69 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,307 (S.D.N.Y. 1968); *Lyons v. Marrud, Inc.*, 46 F.R.D. 451 (S.D.N.Y. 1968).

<sup>76</sup> 1934 Act § 11(f). As a practical matter, if participating underwriters continue not to undertake any independent due diligence, they will be subject to derivative liability based on the manager's negligence. See *BarChris*, 233 F. Supp. at 697. However, if participants began to assume a more active role or if it were to be judicially accepted that participating underwriters had a lesser standard of due diligence to meet then such a result might not be so uncommon. See SEC Securities Act Release No. 5275 (July 26, 1972). See also note 60 *supra*.

<sup>77</sup> See BLOOMENTHAL, *supra* note 37, at § 8.27[1].

<sup>78</sup> This problem, of course, is not limited solely to contribution among underwriters. Most lawsuits relating to an underwriting will have a full cast of characters, including the issuer, its officers and directors—and perhaps its accountants, as well as the underwriters—among whom contribution must be shared. In the wake of *Globus I*, underwriters have at times sought contractually to provide in advance for contribution between themselves and the issuer. For a representative sample of such a clause (which appears in certain underwriting agreements) see THE MECHANICS OF UNDERWRITING—2d 194-96 (A. BORDEN, Chairman, PLI 1972).

the managing underwriter is likely to find himself among this group. Those who bear the brunt of the levy may then have to bring a second action for contribution under section 11(f) — hardly a desirable prospect following hard upon one traumatic lawsuit.<sup>79</sup> The results of this contribution action would be far from certain, and the court could enunciate a standard for sharing costs that would not comport with the parties' expectations.<sup>80</sup>

The problems relating to contribution become more difficult for the manager when he is the only one among the underwriters to be named in the action. A plaintiff may forego naming each of the underwriters in an action either because of the time and expense of serving a large number of defendants or simply because he feels comfortable with one or several solvent defendants, thereby forcing the manager to claim over against his own group for contribution. The crucial question is whether the manager will want to, or be able to, bring the participating underwriters into the original action.<sup>81</sup> Rule 14 of the Federal Rules of Civil Procedure provides a defendant with a right to join or implead another person who is or may be liable to him for all or part of the plaintiff's original claim against him.<sup>82</sup> Reading rule 14 together with section 11(f), the manager would thus be entitled to have all issues joined in one lawsuit.<sup>83</sup> Since impleader is a permissive

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<sup>79</sup> This state of affairs is precisely what happened in the *Globus* cases. After the initial determination of liability in *Globus I*, and the execution of the judgment against the underwriter, a second court proceeding, *Globus II*, was necessary to determine how to divide the original judgment among the multiple defendants.

<sup>80</sup> *Globus II*, in Solomon-like fashion, provided for a pro rata solution to the problem, simply dividing the amount of liability equally among the culpable parties. 318 F. Supp. at 958. Since only one underwriter was involved, it is not clear how liability would have been apportioned among managing and participating underwriters. While the pro rata solution to the problem may have been appropriate under the particular facts of the *Globus II* case, its general application as a means of apportioning liability among underwriters should be seriously questioned. As noted earlier, most underwriting syndicates are made up of numerous underwriters with varying purchase obligations. See notes 31-32 *supra* and accompanying text. If the rule of *Globus II* was followed, those underwriters with smaller participations would be required to bear a disproportionate share of the litigation liability as compared with those underwriters (including the manager) with larger interests in the syndicate.

<sup>81</sup> It has been argued, based on a somewhat tortured reading of section 11(f), that the right of contribution exists only among those parties named in the original lawsuit. This is not in accord with the rationale for contribution, namely to ensure a fairer allocation of liability among all culpable parties, and has been rejected by the one case on the subject. *Getter v. R.G. Dickinson & Co.*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,185 (S.D. Iowa 1973).

<sup>82</sup> Such third-party claim may be made as a matter of right within ten days after the defendant has filed his answer; thereafter, the defendant must obtain court approval before joining other parties. FED. R. CIV. P. 14.

<sup>83</sup> *Lyons v. Marrud Inc.*, [1967-69 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,307 (S.D.N.Y. 1968); *Lyons v. Marrud, Inc.*, 46 F.R.D. 451 (S.D.N.Y. 1968), for a discussion



practice, the manager would not be barred from bringing a separate action for contribution if he chose not to implead the participants in the original action;<sup>84</sup> however, this could prove more expensive for the manager or potentially lead to differing, less favorable results.

Practical considerations may dictate that the manager not assert his rights of contribution against the participants, either through impleader or in a separate action. In the absence of an explicit contractual provision on the subject among the members of the syndicate, the manager, as a matter of business judgment and ongoing relations in the underwriting community, may not want to exacerbate the effects of an already unsuccessful underwriting by suing his syndicate — preferring for reasons of reputation to quietly assume the potential liability himself, especially where that liability would be limited by section 11(e).<sup>85</sup>

If the manager does decide to implead the participants, there is still a major stumbling block to his ability to consolidate in one forum both the issues of original liability to the plaintiff and his rights of contribution vis-à-vis the participants. This is caused by the fact that most (although not necessarily all) underwriters will be members of the New York and/or American Stock Exchanges. The constitutions of both stock exchanges provide for mandatory arbitration in cases of controversies between members of the respective exchanges whenever one of the parties to the controversy requests such a procedure.<sup>86</sup> Furthermore, in disputes between non-members and members, the New York Stock Exchange requires the member firm to submit to arbitration at the request of the non-member. The courts have rigidly enforced these exchange provisions as agreements to arbitrate.<sup>87</sup> Since these provisions could operate to keep certain members of the underwriting group out of the court litigation, and since it may be against public policy for all member and nonmember participants in the underwriting to agree in advance to arbitration,<sup>88</sup> this may result in the man-

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relating to jurisdiction and statutes of limitation in the context of a third-party claim under the 1933 Act.

<sup>84</sup> See *Union Paving Co. v. Thomas*, 9 F.R.D. 612 (E.D. Pa. 1949); 3 J. MOORE, *FEDERAL PRACTICE* ¶ 14.06 (2d ed. 1972).

<sup>85</sup> See text accompanying note 49 *supra*.

<sup>86</sup> N.Y.S.E. CONST. art. VIII, § 1; AMEX. CONST. art. VIII, § 1.

<sup>87</sup> See *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766 (S.D.N.Y. 1968), a case where one American Stock Exchange member, in a fourth-party action, sought indemnification from another member. In the face of the defendant's objection, however, the court stayed the claim over, pending arbitration. *Id.* at 776. See also BLOOMENTHAL, *supra* note 37, at § 8.28[2].

<sup>88</sup> See *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766, 772-73 (S.D.N.Y. 1968).

ager having no single forum in which to proceed against the participants, unless they all agree to arbitrate after the fact.

In any action where underwriters are named as defendants, the issue of settlement of the action is likely to become quite important. The issuer may be insolvent in which case the burden of an adverse judgment might fall heavily on the underwriters. Or the underwriters may wish to settle in order to avoid besmirching their reputations with a judicial finding of fault.

Putting aside the question of possible conflicts between the underwriters as a group and other defendants with respect to settlement, let us focus on the situation as among the several underwriters who have themselves been sued. Each underwriter, of course, has the theoretical right to compromise the claim against him individually, but in practice there is unlikely to be a settlement unless a sizable portion of the group participates, and each antes up his share.<sup>89</sup> The basic problem here is that there is no mechanic for coercing all participants into a settlement which is approved by a consensus. Thus, the participant who declines to join will likely emerge in the most favorable position, since the settlement will presumably be concluded in any event, he will not have to contribute to the fund, and the case will probably be dropped against all defendants including him. *Quaere*, would the settling underwriters then be entitled to claim contribution from those who did not participate in, but were benefited by, the settlement?<sup>90</sup>

If the manager alone is sued, and does not wish to (or unsuccessfully attempts to) implead the participants, it is an open question whether the manager can obtain contribution from the participants for amounts paid in settlement of the original claim. The answer lies in the proper interpretation of the phrase "becomes liable to make payment" contained in section 11(f). If, as would seem the case, this were construed only to mean payments resulting from a judgment, then the manager would be denied contribution.<sup>91</sup>

Typically, where the several underwriters are named as defend-

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<sup>89</sup> See *Lyons v. Marrud, Inc.*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶93,525 (S.D.N.Y. 1972), for a court-approved settlement involving underwriters.

<sup>90</sup> See note 88 *infra*. This also raises another question: if the participants settled while the manager did not, and the manager was ultimately held liable in the suit, could the manager still obtain contribution? See generally PROSSER, *supra* note 63, at 309.

<sup>91</sup> Certain states permit a settling tortfeasor to recover contribution if he can prove (1) that he and the contributors would have been liable on the original claim, (2) the amount of damage that would have been awarded on such claim in a judgment, and (3) the reasonableness of the settlement—not an insubstantial burden. See PROSSER, *supra* note 63, at 308-9.

ants in a lawsuit, the practice has been for the manager to assume the laboring oar in coordinating the defense. In this regard, the manager usually selects legal counsel, who is then retained individually by each of the participants.<sup>92</sup> A fee-sharing arrangement is worked out, which may (but need not necessarily) be in relation to the respective underwriting positions.

Of course, no participant need accept representation by the common counsel, and each can insist on selecting his own attorney. This is particularly pertinent if there is likely to be an issue raised as to the relative degrees of fault as between the manager, on the one hand, and the participants, on the other—an issue which would place a single law firm in a rather delicate conflict of interest position. Where separate counsel is chosen, his fee is paid by his client; and presumably that client does not share in the fee of the common counsel, although such client may benefit from the efforts undertaken by the common counsel on behalf of all the underwriter-defendants.

In a lawsuit where only the manager is named, if he successfully impleads the participants, they will presumably retain independent counsel and not share in the fee of the manager's counsel. If all are then found liable, although there will be contribution for the judgment, it would seem unlikely that the manager will be able to seek contribution for his legal fees. If impleader is unsuccessful, it is an open question whether the participants can be forced to contribute to the manager's legal fees.<sup>93</sup>

#### IV. SOME RECENT ATTEMPTS TO DEAL WITH THE PROBLEM

##### *The Intervention of the Commission and the NASD*

Not to be outdone by the courts, and spurred on by the "hot issue" abuses of that now almost forgotten era (1966-1968) of Adam Smith's *The Money Game*,<sup>94</sup> the Commission has singled out the due diligence investigation as a possibly effective means of preventing the prolifera-

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<sup>92</sup> In *BarChris*, for example, all of the underwriters were represented by one firm. 283 F. Supp. at 651. It should be noted that certain problems may be raised if the counsel selected to defend the action is the same law firm which acted as counsel to the underwriters in connection with the offering which is the subject of the suit. See ABA CODE OF PROFESSIONAL RESPONSIBILITY DR 5-101(b). This rule provides that a firm should not accept employment in pending or contemplated litigation if it is apparent that an attorney in the firm ought to be called as a witness, unless such refusal would cause a substantial hardship to the client. The matter is particularly sensitive where it can be reasonably foreseen that some of the key issues in the lawsuit will be the adequacy of the due diligence investigation by such attorneys. See *BarChris*, *supra*, at 692-97; *Feit*, 332 F. Supp. at 582-83, in which attorneys figured prominently in the due diligence investigation.

<sup>93</sup> See text accompanying note 88 *supra* relating to the interpretation of the phrase "becomes liable to make payment" contained in section 11(f).

<sup>94</sup> See A. SMITH, *THE MONEY GAME* (1968).

tion of highly speculative issues and excesses of the after-market.<sup>95</sup> The Commission appears to view the due diligence investigation as, in effect, quality-control testing of securities, the results of which should find its way into the hands of the investing public.

To implement this concept, the Commission directed the NASD<sup>96</sup> to consider and propose regulations concerning the nature and scope of the due diligence investigation itself, the qualifications of those making the investigation, the need for a report of the results by the manager to the participants, and the function of the due diligence meeting.<sup>97</sup>

In response to the Commission's concerns, the NASD has proposed<sup>98</sup> that each managing underwriter establish written procedures which it would be required to follow in connection with its investigation of a particular issuer.<sup>99</sup> These procedures would include, as a minimum, a review of and investigation into some fifteen items, such as corporate books, financial statements, budgets, backlog and business relationships. Rather than requiring the manager to report the results of such investigations to the participants, the NASD has proposed that the manager certify in the Agreement Among that it has developed adequate procedures and has in fact followed such procedures in connection with that particular underwriting.<sup>100</sup>

This certification concept raised the ire of the Securities Industry Association (SIA), the trade association of the investment banking community. In the SIA's view, implicit in the proposed certification is the shifting of the entire risk of the due diligence investigation from the participants to the manager, for all practical purposes depriving the manager of the benefits of limited liability under section 11(e) of the 1933 Act.<sup>101</sup> In place of certification, the SIA suggests that the manager be required to make an oral presentation about its investigation at the due diligence meeting, thus attempting to breathe new life into that tired gathering and to provide a basis for the participants' own due diligence defense.<sup>102</sup>

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<sup>95</sup> See generally SEC Securities Act Release No. 5275 (July 26, 1972).

<sup>96</sup> *Id.*

<sup>97</sup> *Id.* Presumably, the existence of the report and an upgrading of the due diligence meeting would be helpful to the participants in establishing their due diligence defense. See note 73 *supra*.

<sup>98</sup> See generally Notice to All NASD Members and Interested Persons (March 14, 1973), proposing certain additions and amendments to the Rules of Fair Practice.

<sup>99</sup> *Id.* at 9-13.

<sup>100</sup> *Id.* at 12.

<sup>101</sup> Letter from Stephen M. DuBrul, Jr., Chairman, SIA, Corporate Finance Division, to Donald H. Burns, Secretary of the NASD, April 10, 1973, at 5, on file at *St. John's Law Review*.

<sup>102</sup> *Id.* at 6.

The status of these various proposals is currently in limbo, although it is understood that the Commission and the NASD are engaged in discussions with regard to the SIA's objections. Prior to the adoption of any NASD due diligence policy, it is expected that new amendments will be circulated for comment.

### *Contractual Efforts by Underwriters*

Some managing underwriters have attempted to remedy this situation by inserting provisions in the Agreement Among relating to the matters herein discussed.<sup>103</sup> In general, those that we have reviewed tend to give far-reaching power to the manager, enabling him unilaterally to select counsel, handle all litigation, make the decision to settle, and require all the participating underwriters to share proportionately (on the basis of underwriting commitment) in any judgments, settlement amounts and expenses incurred by the manager as a result of the underwriting, regardless of whether or not the participating underwriters are named.

It can be argued that this approach centralizes too much power in the hands of the manager and is unfair to the participants. There are no requirements for notice, no recognition is given to the degree of the manager's fault, and the participants have no say in the all-important question of settlement. Furthermore, a number of nuances and necessary mechanical provisions are omitted.

### *The Model Federal Securities Code*

In recent years, a number of eminent legal scholars and attorneys, under the leadership of Professor Louis Loss and the auspices of the American Law Institute, have been engaged in drafting a proposed Federal Securities Code. One of the stated major purposes of this comprehensive revision of the federal securities laws is "to correlate and clarify the bases and the scope of liability and of defenses, proposing reasonable limits . . ." <sup>104</sup> to the liabilities existing under the present framework.

The primary provision of the proposed Code relating to underwriters' liability for a misrepresentation or a material omission in an offering statement (the successor under the new framework to the current Registration Statement and Prospectus) is generally similar to

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<sup>103</sup> See, e.g., Agreement Among Underwriters 5-6 (April 10, 1972), filed with the Commission in connection with the public offering of 1,300,000 common shares of Integrated Resources, Inc.

<sup>104</sup> ALI FEDERAL SECURITIES CODE at vii (Tent. Draft No. 2, 1973).

section 11,<sup>105</sup> and carries forward the limitations on liability currently contained in sections 11(e) and (g).<sup>106</sup> The Code adopts the basic underwriters' defense of due diligence, emphasizing the reasonableness of the underwriters' investigation,<sup>107</sup> but with a new twist: the standard of reasonableness is that of a prudent man "under the circumstances" (rather than the existing phrase, "in the management of his own property"); and one of such circumstances referred to specifically is "the role of a particular defendant as an underwriter."<sup>108</sup> Although the Comment to this section<sup>109</sup> refers only to permitted discrimination between "ordinary and 'technical' underwriters,"<sup>110</sup> it would appear that the draftsmen may possibly be laying the groundwork for the establishment of differing due diligence standards as between managing and participating underwriters.

On the issue of indemnification, the proposed Code follows the lead of *Globus I* in declaring an indemnification contract unenforceable if the indemnified party is guilty of, in the words of the Code, "bad faith, willful misfeasance, gross negligence, or reckless disregard of the duties involved in the conduct of his office."<sup>111</sup> Subject to this limitation, the proposed statute explicitly provides that persons liable under the Code may contractually allocate liability among themselves, either before or after liability is imposed.<sup>112</sup> Significantly for our purposes, the relevant Comment<sup>113</sup> indicates that, although section 11 of the 1933 Act contains no similar express provision sanctioning contractual contribution before the fact, the draftsmen believe that such a right can be implied under section 11(f) and under sections 9(e) and 18(b) of the 1934 Act.<sup>114</sup>

In the absence of a contract governing contribution, the Code permits the court wide discretion to order contribution among multiple defendants in a "just and equitable" manner, on the basis of the rela-

<sup>105</sup> *Id.* § 1403. See also Introductory Memorandum at xx, xxvii-xxviii.

<sup>106</sup> *Id.* § 1403(g)(1)(C) & (B).

<sup>107</sup> *Id.* § 1403(e)(4).

<sup>108</sup> *Id.* § 1403(f)(6).

<sup>109</sup> *Id.* § 1403, Comment 10(c).

<sup>110</sup> "Technical" presumably refers to a person who is not underwriting an offering of securities in the traditional sense but who has underwriter status thrust upon him; e.g., under Staff interpretations, a person who purchases more than 10% of a registered offering and then turns around to resell the securities.

<sup>111</sup> ALI FEDERAL SECURITIES CODE § 1418(e)(3)(B) (Tent. Draft No. 2, 1973). Moreover, the proposed statute explicitly gives the Commission broad rule-making power to render indemnification contracts unenforceable or enforceable only after judicial approval. *Id.* § 1418(e)(4).

<sup>112</sup> *Id.* § 1418(f)(1).

<sup>113</sup> *Id.* § 1418(f), Comment (1).

<sup>114</sup> *Id.*, citing Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 178 (1933).

tive responsibility of each person for the loss incurred.<sup>115</sup> If this concept of comparative fault were to be enacted into law, one would expect it to provide managing underwriters with compelling incentives to adopt the kind of contractual approach recommended in this article, rather than undergo the vagaries of unpredictable judges and jurors.

In any event, the Federal Securities Code remains today in the tentative draft stage, and will not even be submitted for consideration to legislative authorities for some years.<sup>116</sup> Thus, the emphasis at the present time must focus on solutions derived by the parties at risk.

## V. A SUGGESTED PRACTICAL APPROACH

### *Synopsis of the Situation*

We have seen, in the prior discussion, how the underwriting community, which is being subjected to an increasing volume of lawsuits, also faces the unhappy prospect of emerging bloody *and* bowed from these tribulations—even where the underwriters in question have not been intentionally or recklessly derelict in fulfilling their obligations. Among the factors contributing to this gloomy outlook have been the increasing difficulty (as illustrated in the *BarChris* and *Feit* cases) of establishing judicially their due diligence defense;<sup>117</sup> the exposure to larger judgments caused by plaintiffs' reliance on rule 10b-5, which has eroded underwriters' statutory damage limitations;<sup>118</sup> and the now questionable ability of underwriters, in the wake of *Globus I*, to shift the liability burden to other parties involved in the underwriting through indemnification provisions which may be deemed contrary to public policy.<sup>119</sup>

Coupled with these discernable trends toward greater monetary exposure, there has been a recognition that the numerous uncertain aspects in such a fragmentary and fast-changing area of the law greatly exacerbate an already difficult situation. A good deal of vagueness still exists with respect to (1) the scope and direction of rule 10b-5 liability,<sup>120</sup> (2) the availability of contribution in the rule 10b-5 context as a means of liability sharing,<sup>121</sup> (3) possible differing due diligence standards between managing and participating underwriters,<sup>122</sup> and (4) the

<sup>115</sup> ALI FEDERAL SECURITIES CODE § 1418(F)(2) (Tent. Draft No. 2, 1973).

<sup>116</sup> See Loss, *Status of the Federal Securities Code*, 170 N.Y.L.J. 110, Dec. 10, 1973, at 1, col. 2.

<sup>117</sup> See text accompanying note 56 *supra*.

<sup>118</sup> See text accompanying notes 47-54 *supra*.

<sup>119</sup> See text accompanying notes 69-70 *supra*.

<sup>120</sup> See note 49 *supra*.

<sup>121</sup> See text accompanying note 74 *supra*.

<sup>122</sup> See note 76 *supra*.

means of handling such issues as settlements, legal representation and legal fees.<sup>123</sup> Compounding these problems further are the additional uncertainties introduced by the happenstance of who among the underwriters gets sued.

The burdens of increased liability and uncertainty descend with particular force on the managing underwriter. He will invariably be a subject of the lawsuit, perhaps with others but very possibly alone. Since his employees undertake the principal due diligence activities,<sup>124</sup> he will be asked to bear direct responsibility for any mistakes. He will be forced to retain attorneys in any dispute, and the attorneys will look to him for their fees. He will be particularly interested in the question of settlement, both to protect his own reputation and to reduce any potential monetary liability.

#### *A Rationale for Risk Sharing*

The central issue that must be addressed in attempting to frame a practical approach for removing the subject of relative underwriters' liability from the existing confusion is whether the manager should be placed in the position of bearing the full risk of litigation liability — in effect, indemnifying the participants against liabilities resulting from the manager's handling of a particular offering — or whether some sharing of the litigation risks is more appropriate.

Undoubtedly, a plausible argument could be fashioned in favor of shifting the full weight onto the shoulders of the managing underwriter. After all, it is the manager who makes the basic decision to bring an issuer public — introducing it, so to speak, to the Street — or, in the case of a secondary offering, to return the company to the public fount. By placing his name on the cover page of the prospectus, the manager puts his reputation for acumen and probity on the line with the issuer, for all investors to see and heed. Since the managing underwriter is charged with the duty of making the due diligence investigation on behalf of the syndicate,<sup>125</sup> it does not seem illogical that the manager should bear the responsibility for a faulty decision or investigation. The essence of the system is that participating underwriters have almost no opportunity to undertake an independent investigation and possess little more information upon which to base their underwriting decision than is furnished to the average investor.<sup>126</sup> The manager reaps the principal rewards from the underwriting, both financial (in

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<sup>123</sup> See text accompanying notes 89-93 *supra*.

<sup>124</sup> See text accompanying note 30 *supra*.

<sup>125</sup> *Id.*

<sup>126</sup> See text accompanying note 33 *supra*.



terms of his management fee and presumably greater share of the securities offered)<sup>127</sup> and nonfinancial (in the sense of peer recognition for shepherding the offering to successful consummation). Finally, to the extent that such an approach might impose greater financial risks on the manager, this can be ameliorated in classic self-insurer fashion by permitting the manager to retain additional compensation in the form of higher management fees, or a separate charge to the participants for the costs of the due diligence investigation, or otherwise.<sup>128</sup>

In our view, however, this approach is not ultimately supportable and would produce unwarranted results. It runs counter to the theoretical basis of syndication, which developed as a means of protecting individual investment banking houses against undue risks in an underwriting. It can be viewed as being inconsistent with the same kind of public policy considerations that have decimated issuer-underwriter indemnification agreements.<sup>129</sup> In practical terms, it could have the effect of undermining the financial stability of particular underwriters, to the detriment of the investment banking community as a whole; the potentiality of a number of small litigation losses seems decidedly preferable to the prospect of one or two possibly fatal judgments.

On the other hand, a contractual undertaking designed to spread the risk among the manager and participants, provided it contains appropriate safeguards against abuse, is peculiarly well suited to an industry which abhors uncertainty and unnecessary litigation, which much prefers the discipline of self-regulation to the twin spectres of judicially imposed solutions and regulatory fiat, and in which any particular investment banker can never be sure whose ox is being gored as he shifts from manager to participant on a daily basis.

#### *Certain Criteria for the Accord*

In attempting to draft a provision for use in the Agreement Among to resolve the problems of litigation risk sharing, we had in mind the necessity that it should fulfill several basic criteria in order to function properly. The principal aims (in no particular order of priority) are as follows:

1. To create a maximum of certainty, consistent with brevity and an appreciation of the inherently fluctuating nature of abstruse legal concepts;

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<sup>127</sup> See note 31 *supra*; text accompanying notes 36-37 *supra*.

<sup>128</sup> See Note, *Section 11 of the Securities Act: The Unresolved Dilemma of Participating Underwriters*, 40 *FORDHAM L. REV.* 869, 895-96 (1972).

<sup>129</sup> See text accompanying notes 66-70 *supra*. Under such an approach the manager could be viewed to be indemnifying the participants.

2. To fairly allocate the risks of litigation, striving to balance interests reasonably in rough proportion to potential rewards;
3. To define the types of claims and actions which are subject to risk sharing;
4. To minimize, to the extent possible, substantive distinctions based on who is sued and upon what statutory basis;
5. To be consistent with public policy, as enunciated in the statutes and cases;
6. To agree in advance upon an expeditious and fair means of settling claims; and
7. To provide for the selection of counsel and payment of legal fees and other litigation expenses.

### *The Proposed Provision*

To deal with this issue, we propose that the following section<sup>130</sup> be inserted in the typical Agreement Among:

[10.] *Litigation.* The following provisions shall apply in the event that one or more claims (the "Claim") involving the Underwriters generally shall hereafter be asserted against you, as Managing Underwriter or otherwise, or any or all of the Underwriters (including you), pursuant to any provisions of law, relating to any Preliminary Prospectus, the Prospectus, the Registration Statement, the public offering of the Stock, or any transaction contemplated by this Agreement:

(a) You shall notify each of us promptly of the assertion of the Claim (or, if any claim is asserted against any of us but not you, the Underwriter against whom the Claim is asserted shall notify you promptly thereof), and you shall keep each of us reasonably informed of all material developments during its pendency.

(b) We hereby authorize you to make such investigation, to retain such counsel, to defend the Claim, and to take such other action as you shall deem necessary or desirable under the circumstances.

(c) Without limiting the generality of the foregoing, we hereby authorize you to enter into a settlement of the Claim which shall be binding upon each of us, provided that you receive the written consent of such settlement of Underwriters

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<sup>130</sup> Obviously, the form of the quoted provision will differ according to the style of the draftsman and the necessity of integrating it with the remainder of the Agreement Among. The quoted provision is intended for use in an Agreement Among which is in the form of a letter from the participating underwriters (referred to as "we") to the manager (referred to as "you"). The structure of a series of subparagraphs was utilized to point up the components of the provision; if and when used in practice, the paragraph can obviously be rendered in more discursive form.

representing at least 66- $\frac{2}{3}$ % of the underwriting obligations hereunder.

(d) Upon request by you made from time to time, we agree (subject to subparagraph (f) hereof) to pay our proportionate share (as defined in subparagraph (e)) of (i) all expenses incurred by you (including, but not limited to, the disbursements and fees of counsel retained by you) in connection with the activities referred to in subparagraph (b), and (ii) any liability incurred by you or any of the Underwriters in respect of the Claim, whether such liability shall be the result of a judgment or the result of any settlement pursuant to subparagraph (c).

(e) For purposes of subparagraph (c), "proportionate share" shall mean a fraction of which the numerator shall be the underwriting obligation hereunder of the contributing Underwriter and the denominator shall be the aggregate of the underwriting obligations hereunder. If any of the Underwriters defaults in the payment of its proportionate share, any amount of such payment remaining ultimately uncollected shall be apportioned among the remaining underwriters in accordance with the prior sentence (except that the denominator shall be reduced by all or an equitable portion of the defaulting underwriter's obligations hereunder).

(f) Nothing contained herein shall require any of us to make any payment to you of any such expenses or liability incurred by you as a result of a judgment against you or settlement, if you have been adjudged by a court of competent jurisdiction (which judgment has not been reversed on appeal) to be guilty of fraudulent misrepresentation, intentional wrongdoing, wanton or reckless behavior, or gross negligence, and the Underwriter otherwise required to make any such payment hereunder has not been adjudged to be guilty of any of the foregoing. In such instance, you will refund promptly all partial payments of expenses previously made by us.

(g) Nothing contained herein shall in any way be construed to limit any rights you or we may have to recover contribution under the provisions of applicable law.

Let us now examine certain aspects of the proposed paragraph.

**Litigation Situations to Which Applicable:** The provision comes into play where any claim is "asserted against you, as Managing Underwriter or otherwise, or any or all of the Underwriters (including you)." Thus, no distinction is drawn between a claim solely against the manager, or against the underwriters generally (including the manager), nor does it matter whether the manager is sued in his individual or representative capacity.

**Type of Claim Covered:** The provision covers claims, relating to

the offering and offering documents, "involving the underwriters generally." This is intended to limit its operation only to those claims which apply to the underwriting syndicate as a whole. Thus, claims based on violations peculiar to an individual firm or its employees, such as improper sales activity involving breaches of the suitability<sup>131</sup> or margin rules,<sup>132</sup> would not be covered by the provision. Among the more common types of claims within the scope of the clause would be those based on violations of section 11, section 12(2)<sup>133</sup> and section 17<sup>134</sup> of the 1933 Act and rule 10b-5 under the 1934 Act. Others include those resulting from violations of the "blue sky laws"<sup>135</sup> and of rules 10b-6<sup>136</sup> and 10b-7<sup>137</sup> under the 1934 Act relating to market making and stabilization during the offering. The provision does not operate with respect to claims concerning the underwriting agreement between the underwriters and the issuer (such as failure on the part of the underwriters to perform their purchase obligation), since this could be deemed to be an intrusion on the concept of severality.<sup>138</sup>

**Losses Subject to Allocation:** There is mandatory contribution for all expenses incurred by the manager in connection with the defense of the claim, including fees of counsel of his choice, as well as any liability. The liability may be the result of a judgment against the manager, or any of the underwriters, or of a settlement pursuant to the applicable provisions of the clause.

**Allocation of Losses:** Each underwriter's proportionate share of liability and expenses is based on his respective underwriting obligation.

**Litigation Procedures and Settlement:** The clause enables the manager to assume a large measure of control with respect to any resulting lawsuit. The manager may select counsel, investigate the claim, and defend against it. The provision does not prohibit the participants from retaining their own counsel, but they nevertheless remain obligated to pay a proportionate share of the manager's litigation expenses. The manager would be in a position to negotiate a proposed compromise, but would have to obtain written consent to any binding

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<sup>131</sup> NASD MANUAL—RULES OF FAIR PRACTICE art. III, § 2, CCH NASD SECURITIES DEALERS MANUAL ¶ 2152 (1968).

<sup>132</sup> 1934 Act § 7; Federal Reserve Board, Reg. T, 12 C.F.R. § 220.1 *et seq.* (1973).

<sup>133</sup> 1933 Act § 12(2).

<sup>134</sup> 1933 Act § 17.

<sup>135</sup> However, a blue sky violation based on the claim that an individual underwriter sold securities in a state in which the issue was not registered (after having been advised by the manager of such lack of registration) would not come under the operative provisions of the clause. *See generally* L. LOSS & E. COWETT, BLUE SKY LAW (1958).

<sup>136</sup> 17 C.F.R. § 240.10b-6 (1973).

<sup>137</sup> 17 C.F.R. § 240.10b-7 (1973).

<sup>138</sup> *See* text accompanying notes 41-44 *supra*.

settlement by underwriters (including the manager himself) representing a minimum of 66- $\frac{2}{3}$  percent of the underwriting obligations. These procedures would operate both where the manager alone was named in the action and where other underwriters were joined.

Exceptions: No contribution is required under the provision if the manager is adjudicated to be "guilty of fraudulent misrepresentation, intentional wrongdoing, wanton or reckless behavior, or gross negligence"<sup>139</sup> and the potential contributor is not. The purpose of this clause is to draw a distinction between ordinary negligence on the manager's part and more grievous standards of behavior, limiting his contractual right of contribution from the participants in most cases to the former situation. The purpose of the final proviso in subparagraph (g) is to negate any inference that the manager would be restricted from asserting any statutory right that he might have against the participants, or vice versa.

### *An Appraisal of the Provision*

We will now examine the provision in terms of the various criteria postulated above.

#### A. Certainty

While not solving all possible problems, the provision creates a substantially greater degree of certainty than exists in the current underwriting context. It extends contribution to cases under rule 10b-5 and other areas not covered by section 11(f). It encompasses within the ambit of risk sharing amounts paid by way of settlement and litigation expenses incurred. And it attempts to clarify certain other aspects of contribution that might otherwise be subject to question.<sup>140</sup>

On the other hand, in denying the manager's right of contribution in those instances where he alone is judged to have been grossly negligent or worse, certain additional variables based on behavioral distinctions are introduced. The problems in making determinations on the basis of a characterization of behavior, however, would seem less troublesome than the difficult question raised by uncertainty as to the existence and scope of contribution. The concept of "fraudulent misrepresentation" already exists in the statutory scheme of contribution, and judges and attorneys are often called upon in other situations to make the kinds of distinctions introduced by the provision; *e.g.*, the

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<sup>139</sup> The proposed Federal Securities Code contains an essentially similar characterization, "bad faith, willful misfeasance, gross negligence, or reckless disregard of the duties involved in the conduct of his office." See text accompanying note 111 *supra*.

<sup>140</sup> See text accompanying notes 143-45 *infra*.

decision by a court whether or not to award punitive damages; and the decision by counsel (which may ultimately be subjected to judicial scrutiny) in advising a corporation as to whether it may or should indemnify a director.

An analysis of the due diligence process should enable underwriters and their attorneys to reach some conclusions so as to make this aspect of the clause work smoothly in practice. For example, any underwriter who has not established adequate procedures with respect to an investigation or who, having established such procedures, has made little or no attempt to carry them out, would certainly fall into the gross negligence category. On the other hand, a manager who had adopted proper procedures but who failed to consider or discover some adverse fact or who made an error in judgment, while perhaps negligent, should still retain the right of contribution.

#### B. Fairness

The provision represents an attempt to strike a rough balance between the extremes of (1) subjecting the manager to total liability without any contractual rights to contribution, and (2) providing for contractual contribution in every case, notwithstanding the circumstances. The device employed to draw that line is the distinction between negligence and more odious forms of behavior. In effect, participating underwriters are being asked to assume the risk that the manager's due diligence investigation and prospectus-writing skills do not measure up to the high standards imposed by law in this complex area — just as they assume the risk of the manager's acumen in analyzing the business and prospects of the issuer in terms of the quality of its securities over the longer term. However, the participants should not be, and are not being, asked to assume the risks that the manager will knowingly participate in a fraudulent scheme or will be so derelict in the performance of his functions as to exceed the bounds of ordinary negligence.

By relating the sharing of the litigation risk to the respective underwriting obligations, the provision seeks a rational apportionment of potential liability among the underwriters in terms of what they stand to gain from the transaction. This is in contrast to more arbitrary possibilities with respect to sharing losses.<sup>141</sup>

There are, to be sure, other logical possibilities for risk sharing. For example, certain underwriters do profit from an offering in greater proportion than their respective underwriting positions; the manager receives a special fee for the discharge of his responsibilities, and par-

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<sup>141</sup> See note 77 *supra*.

ticular underwriters end up selling securities in excess of their underwriting commitments.<sup>142</sup> It would not be unwarranted to increase their share of the burden proportionately, with particular justification in the case of the manager, since his is usually the primary fault.

Nevertheless, our preference is to base liability on the purely underwriting (or risk-taking) aspect of the transaction. In viewing the three components of underwriting compensation — the management fee, the underwriting commission, and the selling concession — it is clear that the one most directly related to the risk-taking function is the underwriting commission. The management fee is normally allocated to the managing underwriter's corporate finance department for its efforts in finding clients and preparing the offering. The selling concession is credited to a firm's sales offices for placing the securities and compensating the salesman. The underwriting commission, however, is retained by the syndicate department as a fee for the use of the firm's capital, and the risks to which it is put, of which liability from potential litigation is certainly a major constituent.

### C. Claims Covered

The rationale underlying the scope of coverage of the provision is to limit risk-sharing principles to those violations based on activities which are undertaken on behalf of the syndicate as a whole, while leaving the underwriters, including the manager, responsible for their individual errors and wrongs. To do otherwise would be to subject manager and participants alike to risks not comprehended by the syndicate concept of limited joint effort. The alternative of listing the specific types of claims to be covered seemed less practicable, particularly since courts may in the future judicially impose new liabilities for underwriters after the fact.<sup>143</sup>

Basing the manager's right of contribution on his conduct properly focuses attention on a determination of how the manager discharged his obligations in the underwriting, and avoids to a large degree the fortuitous aspects of whether or not the plaintiff chooses to bring an action under section 11 or rule 10b-5 or any other provision of law. While it does not solve the question of whether negligent behavior is actionable under rule 10b-5,<sup>144</sup> it does mitigate some of the more draconian effects of a large potential loss for the manager by assuring

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<sup>142</sup> See notes 34-37 and accompanying text *supra*.

<sup>143</sup> A case in point has been the expansion of rule 10b-5 liability into this area. See notes 47-52 and accompanying text *supra*.

<sup>144</sup> See note 49 *supra*.

for him a right of contribution under rule 10b-5 so long as his conduct was no worse than negligent.

#### D. Minimize Distinctions

One of the troublesome possibilities under the current state of affairs is that, in a lawsuit concerning the underwriting generally, a managing underwriter could potentially be forced to shoulder the burden of an entire judgment for no reason other than the fact that he was the only underwriter to be sued. The clause's operative provisions provide for uniformity of economic outcome, irrespective of who among the underwriters gets sued.<sup>145</sup>

#### E. Public Policy

We take our cue here from court decisions with respect to due diligence and indemnification.<sup>146</sup> The holding of the *BarChris* case can be viewed as a strong expression of public concern that underwriters adhere to high standards in connection with the public offering of securities. Each underwriter has an obligation to investigate, within the limits of reasonableness, the veracity and completeness of the statements made about the issuer, its business and the details of the offering. And, although this obligation may properly be delegated to another party, each underwriter must still bear liability if he has not fulfilled his obligation.

The corollary to the *BarChris* axiom was enunciated in the *Globus I* case — namely, that careful scrutiny must be given to any device which may tend to make underwriters less likely to fulfill, or be less careful in carrying out, their obligations; and that, if necessary, such device should be condemned as contrary to the public good.

Does the contribution scheme enunciated in the provision contravene these public policy objectives — does it encourage underwriters to be lax in their necessary due diligence obligations? The argument can be made that the contractual right to contribution might tend to make the manager less careful in his due diligence, because of his anticipation of partial reimbursement by the participants for any losses he might suffer. However, as contrasted with indemnification, the manager who can count on contribution still retains a substantial exposure to financial loss, as well as damages to reputation. Since the 1933 Act

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<sup>145</sup> This also applies to the highly unlikely situation where, in an action by a third party, the manager is not sued, but some of the participants are. The participants could then, under appropriate circumstances, invoke the right of contribution against the manager or other participants for their proportionate share.

<sup>146</sup> See generally text accompanying notes 54-61 & 66-70 *supra*.



itself contains provisions which generally limit each underwriter's liability,<sup>147</sup> it would appear the retention of a considerable risk of loss is sufficient to avoid contravening policy.<sup>148</sup>

The inclusion of a right of contribution in the 1933 Act, to reverse the common law rule of no contribution among joint tortfeasors, was a means of insuring that all persons involved in an offering would be exposed to the sanction of potential liability. The provision simply carries this rationale one step further.<sup>149</sup>

#### F. Settlement

In the absence of an express agreement on the subject, if the manager (or a participant) desires to settle a lawsuit or claim, and seeks proportionate contribution to the settlement, each defendant has the individual right to refuse to participate in the settlement. To the extent that the settlement is consummated without the participation of certain defendants, they will probably receive the benefit of the suit being dropped against them without having to foot their share of the bill. One of the more desirable aspects of a contractual provision is to enable the underwriters acting as a group to effectuate a fair and expeditious settlement, binding on all. The issue of settlement is, of course, particularly important to the manager as a means of saving considerable expense (both in terms of dollars and time) and of avoiding unnecessary damage to his reputation.

We have attempted to avoid the possible extremes in designing this part of the provision. The solution utilized by others<sup>150</sup> — allowing the manager alone to control completely the decision of whether or not to compromise a claim and requiring contribution from all participants — was deemed unwise, since it might well have the effect of encouraging the manager to settle at too handsome a premium, especially in difficult cases where the manager's conduct has been seriously called into question. On the other hand, to require virtual unanimity among the underwriters for any settlement could seriously jeopardize the manager's ability to receive contribution to a reasonable settlement.

Our resolution of this matter concededly represents a compromise position. By requiring the consent of underwriters representing 66-2/3

<sup>147</sup> Each underwriter's liability is limited to the dollar amount of securities actually underwritten by him. See notes 51-52 and accompanying text *supra*.

<sup>148</sup> This view is supported by the draftsmen of the Model Federal Securities Code. See text accompanying note 114 *supra*.

<sup>149</sup> Furthermore, in spreading the risk and avoiding the impact of large adverse judgments on one investment banker, the clause assists in the preservation of a viable capital market, which is in the general interests of all investors.

<sup>150</sup> See text accompanying note 103 *supra*.

percent of the total underwriting commitment and making it then binding on all, the parties are saying, in effect, that when this substantial majority of the group feels it is appropriate to terminate the lawsuit, there should be an end. The manager, with his presumably large underwriting share, retains a very influential position, but is unable to force settlement without consent of a substantial number of the participants. Thus, in order for the settlement to be approved, the manager must present a convincing case of its propriety to the participants — but he need not be concerned that a small number of recalcitrant participants can block the compromise.

We recognize that, since the manager's right of contribution is denied to him in cases where he alone is adjudged to have been guilty of gross negligence or worse conduct, he might be overly anxious to settle in instances where he has been severely remiss in the discharge of his duties, rather than risk an adverse court determination. However, the safeguard of partial participant consent to the settlement should work here; if the participants believe the manager to have been grossly negligent or worse, they can and should withhold their consent to settlement, thus forcing him either to settle with his own money or face the consequences of a trial.

#### G. Counsel and Expenses

The clause provides for the manager to select counsel of his choice to handle the defense of a lawsuit related to the underwriting. This does not appear to be an inappropriate grant of authority, since the participating underwriters have already given their tacit consent for the manager to select the counsel who will represent the underwriters in handling the offering itself. Such counsel's fees and other litigation expenses are to be shared in the same proportion as a judgment or settlement amount would be shared, with provision for periodic payments (so that the manager will not have to carry the load unilaterally) which are reimbursable by the manager if contribution is ultimately not warranted.

Since there may be potential conflicting interests between the manager and the participants, there is no prohibition on any participant's retaining counsel of his own.<sup>151</sup> Ethical considerations would mandate that the manager's counsel disclose to the participants the potential conflicts and the consequences thereof, before accepting any multiple representation.<sup>152</sup> And, at least in some instances, the safest course might

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<sup>151</sup> See generally ABA CODE OF PROFESSIONAL RESPONSIBILITY, EC 5-16.

<sup>152</sup> *Id.*

be for the participants as a whole to retain their own counsel at the outset, at least for the purpose of independent advice as to contribution.

At first blush, it may seem unfair that the participants are required to share in the manager's litigation expenses and counsel fees, particularly in a situation where they retain their own attorneys.<sup>153</sup> The premise underlying this concept, however, is that the participants will be performing little, if any, independent due diligence, and thus their success or failure in the litigation will derive from the ability of the manager to sustain his due diligence defense. Thus, it does not seem to us inappropriate, at least in terms of current underwriting practice, for the participants to share in the costs of the defense.

## VI. CONCLUSION

On the basis of the foregoing criteria, the provision appears to be satisfactory. Undoubtedly, other criteria could be established, under which the provision might or might not fare so well. And, to be sure, there still remain some difficult questions.

The basic problem, in our view, comes down to the question of whether a participating underwriter, who has neither been particularly diligent nor negligent on his own, should be forced to share the liabilities of a negligent manager. There will undoubtedly be some underwriters who will prefer to take their chances, on what may be termed the hard-nosed theory, to wit: when they are manager, their due diligence will be sufficiently thorough that no contribution will be needed; and when they are participants, they would like to preserve complete freedom of action in dealing with a negligent manager. Or, to phrase the same thing another way, they are willing to accept market risks but not the hazard of incompetence.

The simple answer to this position is that the participants can't both have their cake and eat it too. If they are going to rely on the manager's due diligence, they should be willing to abide by the results. If the manager descends to the level of gross negligence or fraud, which by its nature is not a reasonably foreseeable risk for the participant, then they should be free to deal with that situation; but short of that, they must sink or swim on the manager's back. And since this seems to be the learning of the few cases on the subject,<sup>154</sup> it is not a situation of imposing a new standard of liability on participants.

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<sup>153</sup> Even with the participants employing separate counsel, however, it is obvious that the efforts of the manager's counsel can be for the ultimate benefit of the participants, since to the extent the manager's due diligence defense is established the participants will likely be absolved.

<sup>154</sup> See text accompanying notes 58-59 *supra*.

However, if this problem proves indigestible, one possibility to minimize its impact would be to make express provision for the participant who wishes to go it alone.<sup>155</sup> To be sure, this runs counter to prevailing syndication practice, and it would certainly be unlikely that any single participant would choose this course of action. However, under extreme circumstances, a group of participants could conceivably band together for this purpose; and it might be thought to provide a useful safety valve for underwriters who are disinclined to assume the risk. To the extent that such a choice encourages increased diligence among the participants, it serves the statutory purpose; to the extent, however, that it fosters duplication of effort and an implicit lack of confidence in the manager, it might be considered counter-productive.

The provision, moreover, is premised on the concept of derivative liability<sup>156</sup> in a legal context in which neither the statutes nor the courts have recognized any distinction between the manager's and the participants' due diligence obligations.<sup>157</sup> Judicial recognition of a lesser standard of due diligence for participants, as has been suggested by the Commission,<sup>158</sup> could have the effect of providing participants with incentives for undertaking some basic due diligence, which occurs only rarely at present. If a lower standard were recognized (and if the participants could reasonably and economically meet it), it would be appropriate to revise the clause, denying the manager contribution from a participant when that participant sustained his defense, as is currently provided in section 11(f).<sup>159</sup>

These are the kind of questions that require full and forthright discussion in the investment banking community. We hope that this article will serve as a stimulus for further study by underwriters and their attorneys, out of which a workable solution to the vexatious issues of relative liability among underwriters will be forged.

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<sup>155</sup> For example, an additional subparagraph could be added to the clause, along the following lines:

"(h) The provisions of this paragraph shall not apply to any Underwriter who (i) at the time such underwriter initially signifies to you his assent to participate in this offering, indicates in writing that he intends to conduct an independent due diligence investigation of the issuer, (ii) conducts such investigation, (iii) within thirty days after receiving notice of the Claim states in writing to you that he is retaining independent counsel to represent him in defending the Claim, and (iv) is so represented. In such event, for purposes of computation under this paragraph, the aggregate of the underwriting obligations hereunder shall be deemed to be reduced by the underwriting obligation of any such Underwriter."

<sup>156</sup> See text accompanying notes 57-61 *supra*.

<sup>157</sup> See notes 60 & 76 *supra*.

<sup>158</sup> See text accompanying note 39 *supra*.

<sup>159</sup> See text accompanying notes 69-70 *supra*.