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Ted J. Fiflis

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Liability for Misleading Statements under Section 11

TED J. FIFLIS, *Professor of Law, University of
Colorado School of Law, Boulder, Colorado*

Speaking generally, §11 of the Securities Act of 1933 (hereafter the "Act"), 15 U.S.C. §77K (1970), gives purchasers of registered securities a cause of action against several participants in a registered offering for an untrue statement or omission of a material fact in the final, effective registration statement.

A particular registered offering may be subject as well to other liability provisions, such as §10b-5 of the Securities Exchange Act of 1934.

The leading cases on §11 have been *Escott v. Bar Chris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), and *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971). Another case (in two opinions) which presumably will be of importance is *Beecher v. Able*, [1973-1974

Transfer Binder] CCH FED. SEC. L. REP. ¶94,450 (S.D.N.Y. 1974), and [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶95,016 (S.D.N.Y. 1975).

SCOPE

The incidence of §11 was recently extended as a result of the adoption of Rule 145, which repealed Rule 133, the "no-sale rule," and made securities transactions in certain previously exempted reclassifications, mergers, and purchases of assets for stock subject to the registration requirements. Since adoption of Rule 145, a registration statement will be required in a statutory merger unless an exemption is available, and misrepresentations or omissions in the registration statement will be subject to §11 exposure. However, on a purchase of assets for securities, Rule 145(3) requires regis-

tration only if the transfer of assets is part of a pre-existing plan for distribution of the securities, or the asset seller is dissolved or distributes the securities received or adopts resolutions for dissolution or distribution within a year of the vote of its shareholders on the asset sale.

Section 11 therefore relates to all the various types of registered offerings—direct offerings by issuers, including corporate combinations, reorganizations, and share for share exchanges, and registered secondary offerings by persons in a control relationship with the issuer, including a parent corporation's use of its subsidiary's securities in a corporate combination, and vice versa.

Non-registered primary or secondary offerings, including "Reg. A" offerings, are not covered by §11 but may be subject to other liability provisions of the securities acts.

Even if accompanied by a prospectus, oral misrepresentations are not covered by §11, although an action may be available under §12(2) or §17(a) of the 1933 Act, Rule 10b-5 promulgated under the 1934 Act, and, in certain circumstances, §§9, 14, and 15 under the 1934 Act.

PURPOSES

The general assumption is that §11 liability is not punitive in na-

ture, though its exclusive purpose does not seem to be to make the investor whole. Rather, it appears to be aimed at effectuating the two expressed policies stated in the preamble to the Act: "To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes."

One other matter that may throw light on §11 is the fact that the original version of the section, enacted at the nadir of business prestige in early 1933, was amended in 1934 as the result of a concerted campaign to weaken its provisions. Numerous changes which seem incompatible with the major thrust of §11 were adopted at that time. Hence, these clauses are the product of ultimate compromise by two antagonistic factions.

PLAINTIFFS

Linear Privity

Section 11(a), a victim of poor grammar, states:

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring *such security* (unless it is proved that at the time of such

acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue . . . (italics supplied).

Because the phrase, "such security," is an appositive without a referent, the issue is posed whether only persons who acquired a security in the chain of title from the registered offering—linear privity—may sue, or whether anyone who acquired a security of the same class as those registered may also sue.

Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967), and *Colonial Realty Corp. v. Brunswick Corp.*, 257 F. Supp. 875 (S.D.N.Y. 1966), held that a plaintiff must prove linear privity. See also *Rudnick v. Franchard Corp.*, 237 F. Supp. 871 (S.D.N.Y. 1965), where an underwriter in the first of two registered offerings was not liable to buyers in the second offering. Hence if the registered offering is of a class previously outstanding, or if additional offerings are made, a plaintiff may be unable to recover if he cannot sustain his burden of proving linear privity.

The proposed American Law Institute Federal Securities Code (hereafter "ALI Code") §§1403 and 1409 (T.D. No. 2, 1973), would permit recovery by all persons purchasing subsequent to the offering statement, the functional

equivalent of the prospectus, but it would prorate the recovery among all claimants.

Class Actions

Because the misrepresentations and omissions actionable under §11 are all contained in or omitted from a single registration statement, one important characteristic facilitating class actions is established. As a result, class suits are common under the section and are well suited. See H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATION LAW 8-98* (Clark Boardman, New York, 1975).

Actions by Underwriters

Professor Loss has suggested that an underwriter, being one who "acquired" the securities in a registered offering, may himself have an action under §11 although he is also one of the class of defendants. 3 L. LOSS, *SECURITIES REGULATION 1723-24*, n. 129 (Little Brown, Boston, 2d ed. 1961). (This set and the 1969 Supplement, volumes 4, 5, and 6, will hereafter be cited "Loss.") But he recognizes the disruption that this right to sue would cause in the operation of §11(f), providing for contribution among the defendants. 6 Loss at 3844.

Priorities on Insolvency

If the issuer is insolvent, there may be claims against the insol-

vent estate both by equity security purchasers suing under §11 and other non-equity creditors, suggesting a question whether the §11 equity holding plaintiffs should share on a par with other creditors or should be subordinated. This problem arises with other provisions of the securities acts as well. See Slain & Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Security Holders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261 (1973).

The uniform answer so far has been that securities act claimants are creditors regardless of whether their claims derive from some equity security, and will share on a par with other unsecured creditors on insolvency. *Four Seasons Nursing Centers of America, Inc.*, 472 F.2d 747 (10th Cir. 1973); *In Re Los Angeles Land & Investments, Ltd.*, 282 F. Supp. 448 (D. Hawaii 1968); *SEC v. Insurance Investors Trust Co.*, [1971-72 Transfer Binder] CCH FED. SEC. L. REP. ¶93,259 (W.D. Ky. 1971); *Carpenter v. Hall*, 311 F. Supp. 1099 (S.D. Tex. 1970), *petition for writ of mandamus denied in part and granted in part sub. nom. Ernst & Ernst v. U.S. Dist. Ct.*, 457 F.2d 1399 (5th Cir. 1972). *Cf. Oppenheimer v. Harri-man Nat. Bank & Trust Co.*, 301 U.S. 206 (1937).

The rule has been criticized by Slain & Kripke, *supra*, who recommend subordination where an equity holder claims rescission. The proposed Bankruptcy Act of 1973 §4-406, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), introduced as H.R. 10792 and S.2565, would subordinate not only rescission claimants but even those whose claims are based on a tort by non-selling defendants. The ALI Code §1602(d), T.D. No. 3 (1974), will follow whatever provisions the Bankruptcy Act contains.

DEFENDANTS

Section 11 also presents some difficult problems of interpretation as to who are proper defendants, although it seems to identify very specifically several categories. The questions arise in determining who belongs in each category.

Section 11(a) lists as possible defendants:

- Signers of the registration statement;
- Directors, partners, or near directors and partners of the issuer;
- Experts who are named as having prepared or certified a part of the registration statement; and
- Underwriters of the security.

Signers

Section 6(a) of the Act, 15

U.S.C. §77f(a), specifies those who are required to sign a registration statement:

[E]ach issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of its board of directors or persons performing similar functions (or if there is no board of directors or persons performing similar functions, by the majority of the persons or board having the power of management of the issuer), and in case the issuer is a foreign or territorial person, by its duly authorized representative in the United States.

Since §11(a) seems to be unambiguous in holding every person who "signed," any ambiguities of §6(a) presumably will have been resolved at the time of filing the registration statement. Those who signed will be liable, but not those who did not. But see Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L. J. 171, 194 (1933).

Directors and Near Directors

§11(a)(2) and (3) add to the list of possible defendants:

(2) [E]very person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted.

(3) [E]very person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner.

Does a "person performing similar functions" to those performed by directors include a person who controls dummy directors? The dictum in *Mersay v. First Republic Corp. of America*, 43 F.R.D. 465, 469 (S.D.N.Y. 1968), indicates so. More likely, only persons who direct non-corporate issuers, like general partners, trustees, and associates, are covered. See 3 Loss at 1724, n.130. The legislative history of §15 of the Act, dealing with vicarious liability, indicates that it is that section that is aimed specifically at the principal of a dummy director. S. Rep. No. 47, 73d Cong. 1st Sess. 5 (1933); H.R. Conf. Rep. No. 152, 73d Cong. 1st Sess. 27 (1933).

Experts

§11(a)(4) makes liable:

[E]very accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation,

which purports to have been prepared or certified by him.

Although ordinarily the phrase "whose profession gives authority to a statement made by him" might be ambiguous, the practical administration of the registration process removes any doubt, since the Securities and Exchange Commission (hereafter "Commission") requires that manually signed consents to be named an expert be filed with it before the registration statement will be made effective. See 3 Loss 1740-41.

It would seem that, as with "signers," one who signs a consent will be considered an expert.

Unlike any of the other persons liable under §11, experts are liable only if the portion of the registration statement purporting to be made on their authority is misleading. §11(a)(4).

Underwriters

§11(a) concludes the list of those liable with "every underwriter with respect to such security."

Because the term "underwriter" is a word of art, not only are the managing and participating underwriters held but so too are the so-called "statutory underwriters" as defined in §2(11), as well as the "last moment underwriter" under §11(d). SEC Securities Act Release No. 5275 (June 26, 1972), CCH FED. SEC. L. REP. ¶4506B at pp. 4056-57; Folk,

Civil Liabilities Under the Federal Securities Acts: The Bar Chris Case (Part II), 5 VA. L. REV. 199, 227-34 (1969).

Statutory underwriters may include, for example, controlling persons as well as lenders who take shares from controlling persons as pledges, although the term does not include selling group brokers unless they receive special treatment from the underwriters.

Controlling Persons

In addition to the persons named in §11(a), liability under §11 may be imposed by §15 of the Act on certain others. Section 15, 15 U.S.C. §770, reads:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in conjunction with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Because the "unless" clause, added by the 1934 amendments,

gives a special defense to control persons, it will often be important to determine whether one is liable under §15 or §11(a).

Vicarious Liability

Further, vicarious liability may be imposed on persons other than those specified by §§11(a) and 15 by operation of common law rules of agency or aiding and abetting. See especially *In re Caesar's Palace Securities Litigation*, 360 F. Supp. 366, 383 (S.D.N.Y. 1973) (aiding and abetting a §11 violation); *SEC v. Management Dynamics, Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶95,017 (2d Cir. 1975) (SEC enforcement proceeding, principal held liable for agent's fraud under the analogue to §15 and §20(a) of the Securities Exchange Act of 1934, and Rule 10b-5; §20a held to supplement and not restrict vicarious liability.)

There may be some question whether persons who control dummy directors are covered, not by §15, but by §11(a)(2) and (3), which imposes the same liability that directors face upon "persons performing similar functions" as directors.

Security Holders in Control Relationship

Conspicuous by their absence from §11(a) as potential defendants are security holders in a "control relationship" with the issuer,

whose offerings may have to be registered under §5.

Control persons are not exempted from the registration requirements of §5 if they use a §2(11) statutory underwriter to make a distribution, as those terms are defined by the Act and Rule 144. If the sale is but a "link in a chain of transactions through which securities move from an issuer to the public," it must be registered. Preliminary Note to Rule 144. A person is in a "control relationship," as defined in the last sentence of §2(11), if he controls an issuer, is controlled by an issuer, or is under common control with the issuer, as in a brother-sister corporation relationship.

Therefore a person in a "control relationship" whose shares must be registered under §5 will not be subject to §11 liability unless he is in that one type of "control relationship" whereby he is the one who is in control, because §11 itself does not list control persons as defendants and §15 includes only the "controlling person" who controls someone.

ELEMENTS OF PLAINTIFF'S CLAIM Misrepresentations and Omissions

Misrepresentations of fact, half-truths, and omissions of facts required in the registration statement, if material, are actionable when contained in or omitted from

the effective registration statement. However, misrepresentations and omissions from other documents, such as the "red herring" prospectus, are not actionable under §11.

What are "facts" and what are "material facts" are questions of no small moment. See Schneider, *Nits, Grits and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254 (1972); Kripke, *Rule 10b-5 Liability and "Material" "Facts,"* 46 N.Y.U. L. REV. 1061 (1971). Literal-mindedness as to what constitutes a fact is not in consonance with recent decisions, which have held that estimates of an insurance company's excess reserves are facts, *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971), as are projections of profits, *Beecher v. Able* [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶94,450 (S.D.N.Y. 1974). But see Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 BUS. LAWYER 300, 307-08 (1961), protesting that such information is not "facts."

The common law recognized that an utterance was actionable if misleading even though it was an opinion, and the emphasis was on "material," not on "fact." While projections were not facts under early common law cases, an attorney's opinion of law could be misleading if, under the circumstances,

it was reasonable to rely upon it. W. PROSSER, *TORTS* 725 (West Publishing, St. Paul, 4th ed. 1971). Accountants still urge in their pleas for a "better understanding" of accounting by lawyers that auditors' reports are merely "opinions." The misunderstanding is on the other side.

Subsequently Discovered Facts and Updating

Because §11(a) speaks of misrepresentations and omissions when the registration statement became effective, two quite similar situations receive differing treatment. The draftsmen, apparently concerned in §11 with maximizing the possibilities for an honest registration statement, required only that it be true when made—i.e., when effective.

Thus, representations that were true when made, but which subsequently become false because circumstances changed, are neither actionable under §11 nor require post-effective amendments to the registration statement. See 1 *Loss* 293.

On the other hand, representations that were false when made, although the falsity is not discovered until later, are actionable under §11, and require "post-effective" amendments to the registration statement. See 1 *Loss* 219.

For other fraud sections of the

securities acts, both types of cases are treated as misleading. *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967); Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 128-30 (1975). Both types of cases would seem to invoke the doctrine of *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096-97 (2d Cir. 1972), which held that a prospectus true when made, but which later became false, is not a prospectus for purposes of §5 requiring delivery of a prospectus on sale of a security. The case would clearly apply where the prospectus was false from the start but the falsity was discovered belatedly. See Folk, *Civil Liabilities under the Federal Securities Acts: The Bar Chris Case (Part II)*, 5 VA. L. REV. 199, 256-266 (1969).

Unfulfilled Projections

Projections frequently appear in prospectuses. Although projections were specifically prohibited only in proxy solicitations under the Note to Rule 14a-9, the Commission had a basic policy against any projections in prospectuses until two years ago. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973); *Thomas Bond, Inc.*, 5 S.E.C. 61, 71 (1939); T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS 472 (West Publishing, St. Paul, 1971). They are now permitted but not re-

quired. SEC Securities Exchange Act Release No. 9844 (Nov. 1, 1972 [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶79,075; *Beecher v. Able* (1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶94,450, at p. 95,561 (S.D.N.Y. 1974) (by stipulation of parties). See also the "hot issues" releases and other items cited in Ruder, *Disclosure of Financial Projections*, FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 5, 9-10 (Practising Law Institute, New York City, 1974).

If projections are false when made because without foundation, they will result in liability only when damages occur. Hence, most often suits probably will not be brought unless the projections do not eventuate or some other factors cause a decline in values. In the latter event, the "comparative causation" concept of §11(e) may apply. On the other hand, a projection may not be false even though it later fails to occur.

One important case involving projections was a §11 case, only recently completed at the trial level. *Beecher v. Able* [1973-1974, Transfer Binder] CCH FED. SEC. L. REP. ¶94,450 (S.D.N.Y. 1974), and [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶95,016 (S.D.N.Y. 1975). In the first opinion, the Court held that predictions in a prospectus that

Douglas Aircraft would break even for a particular year were materially false because of a failure to disclose some uncertain assumptions underlying the forecast and the fact that prior projections had been quite inaccurate. In the second opinion, the Court considered damages under §11(e).

On the other hand, in *Dolgow v. Andersen*, 53 F.R.D. 664 (E.D.N.Y. 1971), *aff'd*, 464 F.2d 437 (2d Cir. 1972), where the Court held merely that the action could not proceed as a class action, it said that an unmet projection was probably not a misrepresentation even though the underlying assumptions were not stated. Perhaps the cases can be reconciled on the basis of the reasonableness of the assumptions under the circumstances. See generally, Comment, 16 B.C. IND. & COMM. L. REV. 115 (1974).

Pleading

The pleading of misrepresentations or omissions under §11 is not regulated by Rule 9(b) of the Federal Rules of Civil Procedure, which requires pleading of fraud with particularity. *Schoenfeld v. Giant Stores Corp.*, [1973-1974, Transfer Binder] CCH FED. SEC. L. REP. ¶94,460 (S.D.N.Y. 1974).

Materiality

The formal definitions of materiality tend to use synonyms in a

circular way—e.g., a fact is material to a reasonable man if an ordinary person would, or might, consider it important, or if it is a matter as to which an average prudent investor ought reasonably to be informed before purchasing. These definitions are not useful except to begin the inquiry, which seems to boil down to whether the trier of fact believes that an investor justifiably relied.

The determination of the court is not always convincing. In *Escott v. Bar Chris Construction Co.*, 283 F. Supp. 643 (S.D.N.Y. 1968), the Court found a misstatement of the current ratio at 1.9 to 1 rather than 1.6 to 1 to be material, while an earnings overstatement of 16 per cent was not material where actual earnings had increased from \$441,103 for 1959 to \$1,496,196 for 1960, instead of the misrepresented increase to \$1,742,801.

The most interesting treatment of materiality was in *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971), where Judge Weinstein articulated several features of the concept. Among other things, he pointed out that materiality in a formal document such as a prospectus is more readily established than when the same words are used informally, and that it differed with the various antifraud provisions of the securities acts and with the nature of the com-

munication as an affirmative statement or omission.

Defendants' Culpability

A plaintiff need not establish the defendant's knowledge of, or negligence concerning, the untruth, or the foreseeability of the harm or an intent to cause it, although a defendant other than the issuer will have certain due diligence defenses.

Causation

A plaintiff need not show that the purchase was caused by the misrepresentation, unless he acquired the security after an earnings statement for a 12 month period after the effective date of the registration statement was made generally available to the issuer's security holders. Even then, reliance may be established without proof of the reading of the registration statement. §11(a).

The possibility of reliance on an unread registration statement has puzzled many. Doubtless, this language in §11(a), being one of the 1934 amendments, was the result of some pushing and shoving by the antagonists and is not completely clear. However, one of the draftsmen explains it by suggesting that the seller's claims, communicated to the buyer, will be based on the registration statement. See letter of James M. Landis to Felix Frankfurter dated December 4,

1933, quoted extensively in R. CHATOV, *THE COLLAPSE OF CORPORATE FINANCIAL STANDARDS REGULATION: A STUDY OF SEC-ACCOUNTANT INTERACTION* 150 (Ph.D. Dissertation, U. Cal., Berkeley, 1973).

Furthermore, reliance by an investor on the unread untruth could also be the result of an investment advisor's recommendations based on the registration statement, *Rudnick v. Franchard Corp.*, 237 F. Supp. 871, 873 (S.D.N.Y. 1965), as well as reliance on the market price as being based on legal disclosure. *Cf. Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶95,090 (2d Cir. 1975); *Reeder v. Mastercraft Electronics Corp.*, 363 F. Supp. 574 (S.D.N.Y. 1973).

THE MEASURE OF DAMAGES

A contract measure of damages would give a plaintiff the difference between what he paid and the value, at that time, of what he received. Section 11(e), however, uses a different measure, complicated with variables, resulting in eight different possible combinations. In addition, it establishes a special measure for underwriters, and provides all defendants with a "comparative causation" defense.

Because of the various combinations, it is impossible to state the

general measure in a simple sentence. The statute uses three clauses in a compound sentence, which, when paraphrased, say:

The general measure of damages for all except underwriters is the amount paid by the plaintiff, or the public offering price, whichever is less, minus:

- The value at the time of suit, if the securities have not been resold before judgment;
- The sale price received, if the securities have been resold in the market before suit; or
- The higher of value at time of suit or price received on resale, if the securities have been resold after suit but before judgment.

In a recovering market, a plaintiff's attorney must be careful to tell the client that he may recover less if he resells the security than if he holds it.

Numerous complex questions may arise, making the formula even more difficult. For example, the "value" even of publicly traded securities unsold at the time of suit may not be trading price. *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971). Cf. *Beecher v. Able*, [1974—1975 Transfer Binder] CCH FED. SEC. L. REP. ¶95,016 (S.D.N.Y. 1975). And what is the value of a security sold before suit if the sale is a distress

sale rather than "in the market?"

If the defendant is an underwriter, his liability is further limited unless he received some special benefit from the issuer. The outside limit for an underwriter is the total offering price of the securities underwritten by him and actually distributed to the public. This outside limit is based on the price of the securities sold, not on the damages incurred, and should be contrasted with the underwriter's liability under §10b-5. *Chrysler Industries, Inc. v. Piper Aircraft Corporation*, [1974—1975 Transfer Binder] CCH FED. SEC. L. REP. ¶95,058 (2d Cir. 1975).

Regarding the measure of damages generally, see *Cherner v. Transitron Electronic Corp.*, 221 F. Supp. 48 (D. Mass. 1963); *Fox v. Glickman Corp.*, 253 F. Supp. 1005 (S.D.N.Y. 1966); *Beecher v. Able*, [1974—1975 Transfer Binder] CCH FED. SEC. L. REP. ¶95,016 (S.D.N.Y. 1975).

Under the ALI Code, §1403(h), Reporter's Revision of Text of T.D.'s Nos. 1-3 (1974), there would be a general \$100,000 per defendant limit of liability for negligence on all but underwriters and issuers, except that for defendants whose gross revenues exceed \$10,000,000, the limit is 1 per cent of their gross revenues, to a maximum of \$1,000,000. See T.D. No. 2 Comment e, p. 106.

Concomitantly, recovery is to be prorated among all the potential claimants. ALI Code §1409.

Comparative Causation

As a result of the 1934 amendments, §11(e) was altered to permit a defendant to prove that any portion of the damages did not result from the untruths in the part of the registration statement upon which his liability is asserted.

The opponents of this amendment probably comforted themselves with the thought that, as a practical matter, it could never be effectively invoked. That was the view held by two able commentators. R. JENNINGS & H. MARSH, *SECURITIES REGULATION, CASES AND MATERIALS* 810 (Foundation Press, Mineola, N.Y., 2d ed. 1968). But *Feit vs. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 586-587 (E.D.N.Y. 1971), has given the words a powerful effect.

In that decision, Judge Weinstein reasoned that the share values would have declined proportionately to the Standard & Poor's Daily Stock Price Index, and he therefore diminished the measure of damages in the same proportion. In *Beecher v. Able* [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶95,016, at p. 97,560 (S.D.N.Y. 1975), Judge Motley endorsed the *Leasco* technique but

found that the defendants there had failed in their burden of proof, offering numerous items of evidence to show that the security's value probably would not have dropped. However, even in this case, the plaintiffs had made a concession based on the concept of §11(e).

The ALI Code has adopted this proviso for all kinds of cases, not limiting it to §11 type situations. The comments refer to the concept as "comparative causation." See §1402(f)(2)(A) and comments thereto in T.D. No. 2 (1973).

Rescission

The 1934 amendments introduced some enigmatic language concerning the relief available to the plaintiff.

The words of §11(a) permitting suits "at law or in equity" and of §11(e) that the suits authorized under §11(a) "may be to recover such damages" leave open the question whether the plaintiff is limited exclusively to the defined damage liability of §11(e) or whether he may obtain equitable relief such as rescission.

In certain circumstances, rescission may be more favorable to a plaintiff than damages and may invoke equity practices and procedures not otherwise applicable. Still, the infirmities of a common law rescission action, described in Shulman, *Civil Liability and the Securities Act*, 43 YALE L. J. 227,

231-33 (1933), would perhaps be applicable to an action for rescission based on §11.

A consideration of the history of the 1934 amendments repealing, inter alia, an express rescission remedy, is relevant. Section 11(e) had originally read: "The suit authorized under subsection (a) may be either (1) to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security or (2) for damages if the person suing no longer owns the security."

Section 12(2), which now reads as the original §11(e) had read, allows, according to *Independence Shares Corporation v. Deckert*, 108 F.2d 51 (3d Cir. 1939), an action merely for money damages and not for equitable relief. But the Supreme Court, reversing in *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 287-88 (1940), held that although the ultimate recovery under §12(2) must be limited to what is permitted thereunder, the form of action or the procedure employed may include a claim for equitable relief under the "Act as a whole" and §22(a), which permits enforcement in equity or law of all liabilities under the Act.

Both of the same grounds apply equally under §11(e) as it now reads. Furthermore, the plaintiff

should be able to add a count under §12(2) and seek rescission or other equitable relief, following the Supreme Court's decision in *Deckert. J. I. Case Co. v. Borak*, 377 U.S. 426 (1964), and *Mills v. The Electric Auto-Lite Co.*, 396 U.S. 375 (1970), further strengthen this view. But see *Gerity v. Cable Funding Corp.* [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶94,205, at n.4, p. 94,874 (D. Del. 1973), where the court left unresolved the question whether liquidation and dissolution could be decreed under §11.

Under the original act, "rescission" presumably could be had against all the defendants. Rescission under the amended act might seem to be available only against the petitioner's immediate seller—perhaps an underwriter or dealer. But see the recent case allowing rescission against a non-seller under Rule 10b-5. *Gordon v. Burr*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶94,874 (2d Cir. 1974).

DEFENSES

The Issuer

The only substantive defense of the issuer under §11 is that the plaintiff knew of the untruth or omission at the time of his acquisition. Of course, any defendant will seek to refute the affirmative elements of the plaintiff's case or to introduce facts that require the

plaintiff to go forward with evidence. Thus, the issuer may show that it had issued a 12 month earning statement and force the plaintiff to prove reliance on the misleading facts in the registration statement.

Furthermore, the comparative causation defense of §11(e) may be established by the issuer. Perhaps if rescission or other equitable relief is applicable, equity doctrines of laches and unclean hands will also be available, although there are no cases on these matters.

The issuer has no "due diligence" defense of the type available to all other defendants.

Non-experts

In addition to the defenses and opportunities to shift the burden of going forward available to the issuer, all other defendants have certain additional defenses under §11(b).

Withdrawal

Any defendant may prove that he withdrew from the office and relationship described in the registration statement, and notified the Commission and the issuer in writing before the effective date. §11(b)(1).

Due Diligence

Of more significance are the due diligence defenses of §11(b)(3). Although non-experts are responsible for the entire registration

statement, their duties of diligence are diminished for the expertised portions, and need merely negative belief and any reasonable ground for believing the statements in the expertised parts were untrue. §11(b)(3)(C).

As to the remainder of the registration statement, they have a duty to investigate the facts to establish an affirmative belief and reason to believe in the truthfulness of the statements. §11(b)(3)(A). The standard of reasonableness is that of the "prudent man in the management of his own property." §11(c).

The facts that will establish these defenses and the right to delegate these duties will vary with circumstances.

Experts

Due Diligence

Experts are responsible only for the expertised portions. §11(a). They have a duty to investigate the facts to establish an affirmative belief and reason to believe in the truthfulness of these portions. §11(b)(3)(B).

Somewhat incongruously, the same standard of reasonableness—that of "a prudent man in the management of his own property"—applies to experts and non-experts. Does this mean that an auditor must audit as though he were working for himself? Prob-

ably not. See the *Bar Chris* opinion requiring auditors to follow the standards of their profession. But the statutory language arguably may permit a court to hold an expert to a higher standard than that of his profession when the custom is not supported by learned reason. See Fiffis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 83 (1975).

An expert is any accountant, engineer, appraiser, or person whose profession gives authority to a statement made by him. §11(a)(4).

An expertised portion of a registration statement is any part of the registration statement which was prepared or certified or which is copied from or extracted from a report or valuation which was prepared or certified by an expert whose name is mentioned with his consent.

Because of the holding in *Bar Chris*, *supra*, it has generally been assumed that an accountant is an expert only with respect to audited statements. While that is, at least in part, a factual question, under the typical existing practices, admittedly only the audited statements are expertised.

Because what is "expertised" is a question of fact to some extent, the diligence duty of non-experts is not as strong for the expertised portions, and experts are liable

only with respect to their expertised portions, there may be a conflict of interest between experts who would seek to minimize the extent of expertised portions and the non-experts who would want to maximize it. An attorney should be careful to note the conflict when the registration statement is being prepared.

Withdrawal

An expert has the same defense of withdrawal and notification as a non-expert.

Controlling Persons

Controlling persons who are liable vicariously would seem to have the benefits of defenses established by their subordinates, although this is not entirely clear. They have a further defense under §15 if they show they "had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."

Does this clause require the controlling person to make an investigation? Does it merely mean that if he knows of suspicious circumstances he must inquire further? Is mere absence of evidence of falsity a defense? Will his duty be higher when the sale is his own secondary offering? Does he have a duty to supervise the controlled

person so as to become aware of facts which would have put him on notice? Will the duty vary as the persons controlled vary from the issuer to underwriter to accounting firm? See Folk, *Civil Liabilities under the Federal Securities Acts: The Bar Chris Case (Part II)*, 5 VA. L. REV. 199, 218-223 (1969).

MULTIPLE PARTY LIABILITY

The liability of all the defendants, with the possible exception of controlling persons, is joint and several. §11(f). Thus, a plaintiff need not sue all the potential defendants, and, for example, if the issuer is solvent, he may consider suing only the issuer to avoid establishing an array of defense attorneys against him and because the issuer has no due diligence defense.

Whenever more than one person is liable, problems of contribution and indemnification arise. The problems are exacerbated under the securities laws for several reasons:

- Section 11(f) and other sections provide express rights of contribution, thereby altering the normal common law rules concerning contribution among joint tortfeasors;
- Often contracts for indemnity are in existence, especially between issuers and underwriters and issuers and their officers and directors;
- Each of the defendants is likely to have varying degrees of relationship to the wrong, with the result that those less closely related will believe they should not bear the ultimate loss;
- At times the parties may have been misled one by the other, thus invoking many calls for indemnification; and
- Huge sums are often at stake, making the pressure to seek indemnity or contribution great.

As a result, attorneys involved in securities litigation face difficult problems in this area in virtually every case.

Since §11(f) permits contribution "as in cases of contract," it has been said that contribution should be pro rata without regard to fault, though it should not be available on behalf of or against controlling persons liable under §15, and experts may not be entitled to contribution against non-experts who establish their own diligence as to expertised portions. Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L. J. 171, 179, 196 (1933). *But see Gould v. American-Hawaiian SS Co.*, 387 F. Supp. 163, 169-72 (D. Del. 1974).

Some other specific problems under §11(f) seem worth raising:

- Given the express grant of a contribution right, is indemnity to

be denied? In a case under Rule 10b-5, but following §11(f) by analogy, contribution was allowed and indemnity denied, at least where both parties were guilty of the fraud. *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2d Cir. 1969) (indemnity denied); 318 F. Supp. 955 (S.D.N.Y. 1970) (contribution permitted on remand). Indemnification would seem to work contrary to the policy of the Act to deter misrepresentation.

- Since most issuers are corporations that can perpetrate acts only through directors and officers, should a corporation be entitled to indemnity from its directors and other servant-agents liable under §11? See the analogy in *deHaas v. Empire Petroleum Company*, 286 F. Supp. 809 (D. Colo. 1968).
- Section 11(f) specifies that if the first person held "liable was, and the other was not, guilty of fraudulent misrepresentation," there should be no contribution. Aside from the difficulties suggested in this language in the case of corporations that are issuers, and the problems of defining terms, what if the only person initially sued was guilty of mere neglect and another is guilty of fraudulent misrepresentation? Will this fortuitous order of events mean that the first person held is stuck with

part of the liability or should the fact that had he not been sued by the victim he would have no liability to make contribution entitle him to sue for full indemnity?

- If a plaintiff sues only the issuer, will the issuer have a duty to seek contribution or indemnification? If the same persons are directors when the liability arose and when the issuer pays the judgment, they would have a conflict of interest. See the SEC brief in opposition to corporate issuer's petition to allow it to pay the full liability in *Feit v. Leasco*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶93,415.
- If the terms of a settlement whereby the issuer pays more than its share of the liability are not disclosed, is this a failure to disclose a material fact in connection with a purchase or sale of a security so as to be actionable under §10b-5? Perhaps disclosure itself will not avoid the application of §10b-5 under one aspect of *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (en banc).
- If a partial settlement is made, say, with one of two defendants, what will be the liability of the settling defendant to contribute to the non-settling defendant?
- What is the applicable statute of limitations for a contribution action under §11(f) or for contri-

bution or indemnification actions otherwise? When is it initiated and tolled?

- For §11(f) contribution actions, the broad venue and service provisions of §22(a) will apply, but what of actions for contribution or indemnification otherwise? See *Miller v. Hano*, 8 F.R.D. 67, 71 (E.D. Pa. 1947), holding that no independent basis of subject matter jurisdiction is required. The venue would seem to be appropriately identical to venue for the main action. *Lyons v. Marrud, Inc.*, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶92,307 (S.D.N.Y. 1968). But jurisdiction over the person is a different matter, and must be independently established. *U.S. v. Rhoades*, 14 F.R.D. 373 (D. Colo. 1953) (involving the Housing and Rent Act of 1947). See 3 Loss 1739 and 6 Loss 3855 for further treatment.

Many of these questions have been addressed at least in part in several decisions. Many more cases will be required before clear rules can emerge.

THE STATUTE OF LIMITATIONS

The Statute of Limitations, §13 of the Act, will cause the action to expire one year after discovery of the misrepresentation or omission should have been made and not later than three years after a

bona fide offer to the public.

The plaintiff must plead and prove the non-expiration of the limitations period, in accordance with the usual federal rule for periods of limitation that are part of the substantive cause of action. *Rosenberg v. Hano*, 121 F.2d 818 (3d Cir. 1941).

JURISDICTION, VENUE, AND SERVICE

Under §22 of the Act, jurisdiction is concurrent with state and territorial courts and removal is prohibited.

Venue is placed "in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein."

Process may be served in the district of venue, any other district in which the defendant is an inhabitant, or wherever the defendant may be found.

SECURITY FOR COSTS

Under §11(e), a court may require security for costs, including attorney's fees, from any party under any section of the 1933 Act, and if the suit or defense is found to be without merit, it may tax costs after judgment. §11(e) was intended to avert strike suits.

The court's determination is generally not appealable. *Donton Industries, Inc. v. Forte*, 402 F.2d

935 (2d Cir. 1968). See *Klein v. Adams & Peck*, 436 F.2d 337 (2d Cir. 1971) (not appealable since not a final order, and claims of abuse of discretion are so unlikely to succeed as not to justify the expense of appeal).

INTERACTION WITH OTHER SECTIONS

Section 11 may not exhaust the possibilities of recovery for misrepresentations and omissions in securities sales. See *Stewart v. Bennett*, 359 F. Supp. 878 (D. Mass. 1973), for a summary of the varying views. But see *Blue Chip Stamps v. Manor Drug Stores*, 95 S. Ct. 1917, 1933, at n.15 (1975), which may renew the enthusiasm of defense attorneys to argue against the availability of other provisions.

As previously noted, in the Second Circuit, a misleading prospectus is no prospectus at all for the purpose of meeting the requirement of delivery of a prospectus on sale of a security. *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972). Since §12(1) gives a private action for non-delivery of a prospectus, it may be that a plaintiff could obtain rescission or damages under §12(1) for a misleading prospectus.

Much of the law of §11 may have substantial effects on analogous requirements of diligence and

rights of contribution under other sections. See *deHaas v. Empire Petroleum Co.*, 286 F. Supp. 809 (D. Colo. 1968); *Globus v. Law Research Service, Inc.*, 318 F. Supp. 955 (S.D.N.Y. 1970); and especially Folk, *Civil Liabilities under the Federal Securities Acts: The Bar Chris Case (Part II)*, 5 VA. L. REV. 199 (1969).

This overlap is one of the principal targets of the ALI Code project. Avoiding overlaps is generally commendable as a matter of neatness. But given the present availability of numerous remedies for misleading prospectuses, in weighing the fairness of the ALI Code, one cannot merely compare §11 with proposed §1403. It is necessary to also consider the effect of removal of present rights of action under the other fraud provisions of the Act.

CONCLUSION

Close analysis of §11 yields a surprising quantity of difficult questions under this most explicit of the securities acts' civil liability provisions. One must anticipate that the newly perceived potency of the section will yield a greatly increased flow of decisions in the near future. In the meantime, practitioners would be well-advised to take a second look at what at first glance may seem to be a simple provision imposing civil liability for misleading registration statements.