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## li. Conflicting Standards Of Liability In Short Form Registration: The Underwriter'S Dilemma

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expected solely from the efforts of others, but since its resolution of this issue was merely dicta,<sup>155</sup> lower courts need not follow the Court's analysis. Moreover, the Court's decision can be read narrowly to leave the lower courts with the recurring task of defining a security.<sup>156</sup>

JOHN J. EKLUND

## II. CONFLICTING STANDARDS OF LIABILITY IN SHORT FORM REGISTRATION: THE UNDERWRITER'S DILEMMA

As a result of administrative action by the Securities and Exchange Commission (SEC), the reporting requirements of the Securities Act of 1933<sup>1</sup> ('33 Act) and the Securities Exchange Act of 1934<sup>2</sup> ('34 Act) constitute a continuous disclosure system of corporate, financial and managerial information.<sup>3</sup> Form S-16 integrates the registration provisions of the '33

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<sup>155</sup> See note 151 *supra*.

<sup>156</sup> By analyzing SEC interpretations of the Securities Acts and past actions of Congress, see text accompanying notes 56-75 *supra*, the Court implied that if either had indicated the propriety of applying the Acts in the *Daniel* context, it may have deferred to congressional or administrative judgment. 99 S. Ct. at 798-801. The Court also held that adequate regulation of pension plans under ERISA obviates the need for additional federal controls. See text accompanying notes 78-81 *supra*. Courts therefore may be justified in extending the provisions of the Securities Acts to transactions that are not subject to more detailed federal regulation. In addition, the Court specifically limited its holding in *Daniel* to the applicability of the Acts to compulsory, noncontributory pension plans. 99 S. Ct. at 802. Courts addressing other financial schemes in future cases might avoid resolving the conflicts between *Daniel* and the Court's prior decisions by finding factual distinctions that justify a departure from *Daniel's* analysis. See, e.g., *Tanuggi v. Grolier, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,880 (S.D.N.Y. 1979). In *Tanuggi*, the Court held that a voluntary contributory pension plan was not a security. Noting the myriad questions *Daniel* left unanswered, *id.* at 95,607, the court concluded that the Grolier Plan did not meet *Howey's* "expectation of profit" element. *Id.* at 95,608. Unlike the plan addressed in *Daniel*, see text accompanying note 17 *supra*, an employee's pension benefits under the Grolier Plan varied according to his number of years of service and his highest average salary over a five year period. *Id.* at 95,607. Moreover, the Grolier Plan provided that employer contributions would compensate for amounts by which the Plan's current assets fell short of the level necessary to meet fixed benefit payments. *Id.* at 95,608. Since qualified participants received the same level of benefits whether or not the Plan's Trustees invested assets successfully, the Grolier Plan did not create an expectation of profit from the Trustees' efforts. *Id.* Notwithstanding the *Tanuggi* court's pronouncements to the contrary, its analysis of the Grolier Plan under *Howey's* "expectation of profit" element differs significantly from that employed by the *Daniel* Court. In *Daniel*, the Court recognized that the pension benefits in question may have had security characteristics, see text accompanying note 39 *supra*, but held that the non-security elements of *Daniel's* compensation package characterized his relationship with his employers. See text accompanying notes 38-42 *supra*.

<sup>1</sup> 15 U.S.C. §§ 77a-77aa (1976).

<sup>2</sup> 15 U.S.C. §§ 78a-78kk (1976).

<sup>3</sup> See Bialkin, *The Issuer Registration and Distribution Provisions of the Proposed Federal Securities Code*, 30 VAND. L. REV. 327, 331 (1977) [hereinafter cited as Bialkin]. Since

Act with the reporting requirements of the '34 Act by incorporating by reference '34 Act documents into a registration statement.<sup>4</sup> Recently, the extension of Form S-16 to primary offerings has rekindled underwriters' concerns as to their civil liability under section 11 of the '33 Act.<sup>5</sup> These concerns originate from an uncertainty regarding the extent of investigation underwriters must undertake to verify information in '34 Act documents which have been incorporated by reference into registration statements on Form S-16.<sup>6</sup> Under the present Acts, individuals preparing '34 Act documents are subject to a lesser standard of liability than persons preparing a '33 Act registration statement.<sup>7</sup> Many underwriters object to the application of the more stringent liability of the '33 Act to documents incorporated by reference on Form S-16.<sup>8</sup> Thus, the SEC's endeavor to reduce registration time and costs by the use of a short form for the registration of securities on Form S-16 creates a practical dilemma for underwriters attempting to avoid section 11 liability.<sup>9</sup>

Exemption from full registration under the '33 Act is based on the assumption that '34 Act materials filed by an issuer can adequately furnish disclosure information required by both acts.<sup>10</sup> As a result of the 1964 amendments to the '34 Act, corporations are subject to continuous reporting provisions either through an initial public distribution of securities or by compliance with the requirements of shareholder participation and asset size specified in the '34 Act.<sup>11</sup> Form S-16 is premised on the availabil-

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the enactment of § 12(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 781(g) (1976), the SEC has adopted numerous amendments to Exchange Act forms to integrate their disclosure requirements with the disclosure provisions of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976). 1 REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 425-26 (November 3, 1977) [hereinafter cited as ADVISORY REPORT].

<sup>4</sup> 43 Fed. Reg. 16,672, 16,677 (1978) (to be codified in 17 C.F.R. § 239.27) [hereinafter cited as Form S-16]; see text accompanying notes 12-20 *infra*.

<sup>5</sup> 15 U.S.C. § 77k (1976); see text accompanying notes 35-39 *infra*. Effective May 30, 1978, the SEC extended the availability of the short form for registration, Form S-16, *supra* note 4, to primary offerings of certain issuers. SEC Securities Act Release No. 33-5923 (April 11, 1978), reprinted in [Current] FED. SEC. L. REP. (CCH) ¶ 81,561, at 80,243 [hereinafter cited as Release 33-5923]. A summary of underwriters' concerns and the response of the SEC may be found in SEC Securities Act Release No. 33-5998 (Nov. 17, 1978), reprinted in [Current] FED. SEC. L. REP. (CCH) ¶ 81,761, at 81,056 [hereinafter cited as Release 33-5998]. See text accompanying notes 49-64 *infra*.

<sup>6</sup> See text accompanying notes 49-64 *infra*.

<sup>7</sup> Compare '34 Act § 18, 15 U.S.C. § 78r (1976) with '33 Act § 11, 15 U.S.C. § 77k (1976). See text accompanying notes 21-27 *infra*.

<sup>8</sup> See text accompanying notes 49-60 *infra*.

<sup>9</sup> See ALI FEDERAL SECURITIES CODE, comment 10(a) at 104 (Tent. Draft No. 2, 1973); text accompanying notes 49-64 *infra*.

<sup>10</sup> See Knauss, *Disclosure Requirements—Changing Concepts of Liability*, 24 BUS. LAW. 43, 47 (1968). One commentator has suggested that the larger reservoir of continuously updated information accumulated under the '34 Act might be substituted for the sporadic and often duplicative information disclosed in '33 Act registration statements. See Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340 (1966) [hereinafter cited as Cohen].

<sup>11</sup> See Bialkin, *supra* note 3, at 331. Section 12(g) of the '34 Act extended the continuous

ity of a significant body of disclosure material provided under the '34 Act, which need not be repeated in a '33 Act registration statement.<sup>12</sup> A prospectus<sup>13</sup> prepared pursuant to Form S-16 is required to contain only limited information concerning the identity of the issuer, the description of the securities to be offered, the plan of distribution, and the use of the proceeds.<sup>14</sup> Basic disclosure of information about the business, management and financial operations of the issuer is included through incorporation by reference of '34 Act reports in the registration statement.<sup>15</sup> In addition, the prospectus must describe any material changes in the issuer's affairs which have occurred since the end of the latest fiscal year and which have not been previously reported.<sup>16</sup> The abbreviated registration form of S-16 may be used for certain offerings of securities by companies which meet the requirements for use of Form S-7.<sup>17</sup> Initially available only for secondary

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reporting provisions of the Act to issuers not listed on any major exchange whose total assets exceeded \$1 million and who had a class of equity securities held of record by at least five hundred persons. 15 U.S.C. § 781(g)(1) (1976).

<sup>12</sup> ADVISORY REPORT, *supra* note 3, at 424-25.

<sup>13</sup> A prospectus is defined as "any prospectus, notice, circular, advertisement, letter or communication . . . which offers any security for sale or confirms the sale of any security." '33 Act § 2(10), 15 U.S.C. § 77b(10) (1976).

<sup>14</sup> SEC Securities Act Release No. 33-5879 (Nov. 9, 1977), *reprinted in* [1977] SEC. REG. & L. REP. (BNA), No. 427, at H-1; Form S-16 (Part I - Information Required in Prospectus), *supra* note 4.

<sup>15</sup> In light of the experience of S-7 short form registration, the Wheat Report recommended that the scope of the prospectus be reduced for certain companies to cover only essential disclosures that relate to the plan of distribution. The Report suggested that the prospectus should contain an appropriate legend referring to the issuer's reports and proxy statements filed under the '34 Act and informing the reader how to obtain them. DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 68 (1969) [hereinafter cited as THE WHEAT REPORT].

The SEC adopted the Wheat Report recommendations in Form S-16. The issuer must incorporate by reference into the Form S-16 prospectus its latest annual report filed pursuant to the '34 Act or its latest prospectus filed under the '33 Act, all other reports filed pursuant to the Exchange Act since the end of the most recent fiscal year, its proxy statement for the most recent annual meeting, and any subsequent proxy statement. *See* Form S-16 (Item 7), *supra* note 4.

<sup>16</sup> *See* Form S-16 (Item 8), *supra* note 4.

<sup>17</sup> *See* Form S-16 (Rule as to use of Form S-16), *supra* note 4. Generally, a registrant may utilize Form S-7 if: (1) the registrant has a class of securities registered pursuant to § 12 of the '34 Act, 15 U.S.C. § 781 (1976), or is required to file reports pursuant to § 15(d) of the '34 Act, 15 U.S.C. § 780(d) (1976); (2) the registrant has been subject to the requirements of §§ 12 or 15(d), and has filed all applicable reports for thirty-six calendar months prior to the filing of the registration statement; (3) the registrant has not defaulted in payments on preferred stock, indebtedness for borrowed money or long term leases during the past thirty-six months; and (4) the registrant has a consolidated net income of at least \$250,000 for three of the last four fiscal years, including the most recent year. 17 C.F.R. § 239.26 (1978) (Rule as to use of Form S-7).

Form S-7 entitles an issuer with a substantial history of reporting under the '34 Act to omit certain information required in a Form S-1 registration statement since such information already is available to the investing public. ADVISORY REPORT, *supra* note 3, at 423-24. A Form S-7 registrant is not required to describe its business history or properties or to provide

offerings of securities, the SEC in 1978 extended the availability of Form S-16 to the registration of primary offerings of debt and equity.<sup>18</sup> To use S-16 for primary offerings, the issuer must have outstanding voting securities with a minimum market value of \$50 million<sup>19</sup> and a firm commitment underwriting of not less than ninety percent of the securities offered.<sup>20</sup>

The basic effect of incorporation by reference is to subject '34 Act filings to the disclosure standards of the '33 Act.<sup>21</sup> Disclosure in '34 Act documents, however, generally has been less complete and less accurate than disclosure in '33 Act prospectuses.<sup>22</sup> In addition, substantive review by the SEC of '34 Act filings is less thorough and prompt than the processing of registration statements under the '33 Act and proxy statements under the '34 Act.<sup>23</sup> Moreover, the liability provisions of the '34 Act do not have the *in terrorem* effect of the severe sanctions of the '33 Act which demand care and responsibility in the preparation of registration statements.<sup>24</sup> Under section 18 of the '34 Act,<sup>25</sup> liability is imposed upon persons who make or

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information about its management. The SEC reasoned that adequate disclosure in these specific areas could be assumed to have been made in reports and proxy statements filed over the years pursuant to the '34 Act by the class of companies eligible to use the new form. THE WHEAT REPORT, *supra* note 15, at 74-75.

<sup>18</sup> See Release 33-5923, *supra* note 5. The SEC maintains that Form S-16 should be available for the primary offerings of a "small top tier of companies . . . which usually provide high quality corporate communication documents, including 1934 Act reports, and whose corporate information is widely disseminated" because "members of this class of registrants are widely followed by debt and equity analysts." *Id.* at 80,246; ADVISORY REPORT, *supra* note 3, at 433-34. In addition, the availability of Form S-16 has been extended to the registration of offerings to certain existing security holders, and to offerings under certain conditions to holders of outstanding convertible securities or outstanding transferable warrants. See Release 33-5923, *supra* note 5.

<sup>19</sup> Form S-16 (Rule as to use of Form S-16), *supra* note 4. In addition to the wide dissemination of information concerning companies of the required size, the SEC believes that the \$50 million market capitalization standard adds assurance that securities analysts will follow such companies. See Release 33-5923, *supra* note 5, at 80,246.

<sup>20</sup> Form S-16 (Rule as to the use of Form S-16), *supra* note 4; see Release 33-5923, *supra* note 5, at 80,247. In a firm commitment underwriting, an underwriter agrees to purchase the proposed public issue regardless of whether or not it can sell the entire issue to the public. Such an agreement involves the greatest risk to an underwriter. See G. ROBINSON & K. EPPLER, GOING PUBLIC: SUCCESSFUL SECURITIES UNDERWRITING § 22 (1976) [hereinafter cited as G. ROBINSON & K. EPPLER].

<sup>21</sup> See ADVISORY REPORT, *supra* note 3, at 451; Release 33-5998, *supra* note 5, at 81,058.

<sup>22</sup> ADVISORY REPORT, *supra* note 3, at 426. See generally Cohen, *supra* note 9, at 1353-72. Various commentators, as well as the SEC, have recognized that integration by short form registration procedures, which permit incorporation by reference of '34 Act reports, must be conditioned on the improved quality and dissemination of disclosures in periodic reports. See, e.g., ADVISORY REPORT, *supra* note 3, at 425-26; THE WHEAT REPORT, *supra* note 15, at 67; BarChris: *A Dialogue on a Bad Case Making Hard Law*, 57 GEO. L.J. 221, 248 (1968) (remarks of D. Schwartz) [hereinafter cited as BarChris *Dialogue*].

<sup>23</sup> See Cohen, *supra* note 10, at 1362, 1368-72. See also ADVISORY REPORT, *supra* note 3, at 426-27.

<sup>24</sup> See, e.g., Cohen, *supra* note 10, at 1355, 1361; ADVISORY REPORT, *supra* note 3, at 426; text accompanying notes 35-39 *infra*.

<sup>25</sup> 15 U.S.C. § 78r (1976).

cause to be made a misstatement in a document filed under the '34 Act and who act in bad faith or have knowledge of the misrepresentations.<sup>26</sup> In contrast, the '33 Act establishes, without regard to knowledge or bad faith, an obligation of inquiry upon all participants in the registration process.<sup>27</sup> Accordingly, the SEC has reasoned that incorporation by reference of '34 Act documents into registration statements on Form S-16 should improve the quality of disclosure in '34 Act filings.<sup>28</sup> Concern about liability under the '33 Act for the content of incorporated '34 Act filings would demand increased care in preparation of these reports by underwriters.<sup>29</sup> In addition, the underwriters' financial interest in a firm commitment offering helps assure adequate inquiry into '34 Act documents incorporated by reference.<sup>30</sup>

Underwriters have asserted that the intermixing of the securities registration requirements of the '33 Act with the periodic reporting requirements of the '34 Act in Form S-16 creates inherently different responsibilities in the preparation of a registration statement.<sup>31</sup> As a result, they contend that the measure of underwriter liability in the use of Form S-16 should reflect the changed circumstances.<sup>32</sup> Underwriters have requested that the SEC delineate the steps necessary to fulfill the underwriters' '33 Act obligations and to avoid section 11 liability for material misstatements or omissions in the information contained in the S-16 and the documents incorporated by reference.<sup>33</sup>

The primary function of section 11 of the '33 Act<sup>34</sup> is to promote enforcement of the '33 Act and to deter negligence through the *in terrorem* nature of the liabilities.<sup>35</sup> Section 11 holds various participants in the registration

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<sup>26</sup> *Id.* A person seeking civil remedy under § 18 must establish that he did not know that the statement in question was false or misleading. Further, he must prove that in reliance upon such statement he purchased or sold a security at a price which was affected by such statement. *Id.*

<sup>27</sup> See text accompanying notes 35-39 *infra*.

<sup>28</sup> See Release 33-5998, *supra* note 5, at 81,058; Release 33-5923, *supra* note 5, at 80,246.

<sup>29</sup> See Release 33-5998, *supra* note 5, at 81,058; Release 33-5923, *supra* note 5, at 80,246.

<sup>30</sup> See Release 33-5923, *supra* note 5, at 80,247; text accompanying notes 40-48 *infra*.

<sup>31</sup> See, e.g., Letter from Securities Industry Association to SEC (Jan. 24, 1979) (SEC File No. S7-763)[hereinafter cited as SIA]; text accompanying notes 49-59 *infra*.

<sup>32</sup> *Id.*

<sup>33</sup> See generally Release 33-5998, *supra* note 5, at 81,059.

<sup>34</sup> 15 U.S.C. § 77k (1976).

<sup>35</sup> See *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); SEC Securities Act Release No. 33-5275 (July 26, 1972), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 4506B, at 4055 [hereinafter cited as Release 33-5275]. The purpose of the '33 Act is to protect the investor by requiring "full disclosure of every important element attending the issue of a new security." H.R. REP. No. 85, 73d Cong., 1st Sess. 3 [hereinafter cited as HOUSE REPORT]. Theoretically, disclosure may deter questionable business practices and, concomitantly, have the prophylactic effect of promoting business integrity. The primary purpose of disclosure is to enable investors to arrive at independent decisions based upon access to adequate information. See THE WHEAT REPORT, *supra* note 15, at 10, 52-53. See also *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 563-64 (E.D.N.Y. 1971). Although an investor rarely will be able to assimilate the mass of informa-

process, including officers, directors, and underwriters, responsible for an untrue statement of a material fact or an omission of a material fact in the registration statement.<sup>36</sup> The participants are liable to a purchaser "not only if they cannot prove that they did not know of the flaw in the information offered the public but also if they cannot prove that they could not have found the flaw 'after reasonable investigation' and that they 'had reasonable ground to believe and did believe'" the adequacy and accuracy of the statements at the time the registration statement became effective.<sup>37</sup> Underwriters, however, are not required to guarantee the absolute accuracy of every statement.<sup>38</sup> Instead, an underwriter must prove that he has conducted a due diligence investigation. If an underwriter can establish that he had exercised reasonable care in verifying the statements contained in the prospectus, the underwriter can avoid section 11 liability.<sup>39</sup> An underwriter, however, derives little guidance from the '33 Act as to the extent and intensity of review or inspection necessary to perform a reasonable investigation which will avoid liability for misstatements or omissions.

The consideration and development of relevant factors in determining

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tion in the registration statement, he will be influenced by experts such as brokers, bankers and investment advisers whose judgment will be reflected in the market price. In addition, the need to report complicated business facts must be balanced with the need to inform average investors of special factors, such as the speculative nature of the securities. See Douglas, *Protecting the Investors*, 23 YALE REV. 508, 523-24 (1933); THE WHEAT REPORT, *supra* note 15, at 52-53. The obligation to make full and accurate disclosure is enforced by the imposition of the standards of trusteeship: "all those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary." HOUSE REPORT, *supra*, at 9.

<sup>36</sup> 15 U.S.C. § 77k(a). Section 11(a) of the '33 Act provides in part:

[i]n 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 truth or omission) may . . . sue . . . .

*Id.* If the registration statement is defective, under § 11 a purchaser need not establish reliance upon the misstatement or omission. Liability is imposed substantially without regard to the registrants' intention or knowledge of the misstatement or omission. See *id.*

<sup>37</sup> HOUSE REPORT, *supra* note 35, at 9. A participant may establish a defense under § 11(b)(3)(A) only if

he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . .

15 U.S.C. § 77k(b)(3)(A) (1976).

<sup>38</sup> HOUSE REPORT, *supra* note 35, at 9; see Release 33-5275, *supra* note 35, at 4055.

<sup>39</sup> See text accompanying notes 34-37 *supra*; Release 33-5275, *supra* note 35, at 4054. Although there is no express provision requiring an underwriter to conduct a due diligence investigation, the underwriter's desire to avoid liability theoretically creates the incentive to exercise the "honesty, care and competence" necessary to assure the accuracy of statements in the registration statement. See HOUSE REPORT, *supra* note 35, at 9; Release 33-5275, *supra* note 35, at 4055.

what constitutes a reasonable investigation and a reasonable ground for belief regarding information contained in a registration statement has been left to the courts.<sup>40</sup> The courts have emphasized the public's expectation that an underwriter will conduct an independent investigation of the issuer and the issue.<sup>41</sup> Furthermore, because of its importance in the preparation of an issue for market, the underwriter is the only participant, excepting accountants, who can assume an adverse position to the company for the

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<sup>40</sup> See, e.g., *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). Although the SEC has been requested to establish factors to be considered in connection with the reasonableness of an underwriter's inquiry, the Commission has refused to do so in abstract terms. See, e.g., Release 33-5998, *supra* note 5, at 81,060-61; cf. Release 33-5375, *supra* note 35 (underwriters requested by SEC to establish standards). Noting the failure of previous attempts to standardize the elements of underwriters' due diligence obligations, the SEC has chosen to leave such development and refinement to the courts. See Release 33-5998, *supra* note 5, at 81,060 & 81,061 n.19; see, e.g., *Proposed Article III, Section 35 of Rules of Fair Practice Concerning Underwriter Inquiry and Investigation Standards Respecting Distribution of Issues of Securities to the Public*, reprinted in Messer, *Roles and Reasonable Expectations of the Underwriter, Lawyer and Independent Securities Auditor in the Efficient Provision of Verified Information: 'Truth in Securities' Reinforced*, 52 NEB. L. REV. 429, 473 (1973) [hereinafter cited as Messer]; Israels, *Checklist for Underwriter's Investigation*, reprinted in H. WANDER & W. GRIENENBERGER, *SELECTED ARTICLES ON FEDERAL SECURITIES LAW* 65 (1968).

<sup>41</sup> See, e.g., *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 370 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); *In re The Richmond Corp.*, 41 S.E.C. 398, 406 (1963). The duty of care imposed by § 11 upon participants in a securities distribution is determined by their importance in the distribution scheme and by the degree of protection that the public has the right to expect because of the particular registrant's participation. See HOUSE REPORT, *supra* note 35, at 9.

By associating itself with a proposed offering, an underwriter impliedly represents to the investment community that the issuer meets the firm's standards, that the underwriter has exercised diligence and care in examining the issuer's business, and that the offered securities are suitable for public ownership. See *In re The Richmond Corp.*, 41 S.E.C. 398, 406 (1963). In *Richmond*, the issuer's prospectus failed to disclose the company's investment plans which materially altered the nature of the investment opportunity and the attendant risks. *Id.* at 400-02. Furthermore, the underwriter's inexperience, a material factor bearing on the success of the offering, was not disclosed. *Id.* at 403. The SEC ruled that in light of investor reliance, failure to disclose these facts constituted material omissions. *Id.* The underwriter's investigation, consisting of a visit to the issuer's property, examination of the registrant's list of stockholders and the obtaining of a credit report on the company, failed to meet the investors' expectation of diligence and care in examining the issuer's business and accuracy of the prospectus. *Id.* at 405-06; see 1 REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION 493, 496, 513 (1963) [hereinafter cited as SPECIAL REPORT].

According to the general industry view, underwriters vouch for the quality of the issuer. A firm's reputation is risked, in some measure, on each issue it underwrites. See Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case* (pt. 1), 55 VA. L. REV. 1, 54 (1969) [hereinafter cited as Folk]. Furthermore, reputable underwriting firms are expected to underwrite only issues of well-established companies with substantial earnings records. See SPECIAL REPORT at 496, 512. Other firms, however, may be willing to underwrite a company solely on the basis of potential profit regardless of the issuer's quality. As a result, many investors regard the character of the underwriter as indicative of the character of the issue. See G. ROBINSON & K. EPPLER, *supra* note 20, at § 21.



purposes of the due diligence investigation.<sup>42</sup> Under the current standard, an underwriter must satisfy itself as to the accuracy and adequacy of the representations contained in the registration statement.<sup>43</sup> Thus, if underwriters were allowed to fulfill their responsibilities by mere reliance on the representations of the issuer's management, section 11 would provide the investor no additional protection.<sup>44</sup> In order to fulfill its responsibilities to

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<sup>42</sup> See Release 33-5275, *supra* note 35, at 4055; *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 696 (S.D.N.Y. 1968). In an action brought under § 11 of the '33 Act, 15 U.S.C. § 77k (1976), the plaintiffs alleged that the BarChris registration statement contained material misstatements and omissions. 283 F. Supp. at 652. After consideration of the misstatements and omissions in the prospectus, *see id.* at 679-80, the district court declared that disclosure of the inaccuracies relating to the company's state of affairs immediately prior to the effective date of the registration statement would have deterred the average prudent investor from purchasing the offered securities. *Id.* at 681-82. The court held that the registrants and underwriters had not established their affirmative defense of due diligence and, therefore, were liable to the purchasers under § 11. *Id.* at 684-97. In particular, the court suggested that the underwriters and the company's officers were in adverse positions because of the underwriters' due diligence obligations under § 11. *Id.* at 696. Since no fiduciary relationship existed, the underwriter could not rely on the officers' statements. *Id.* The misleading statements may have been made in a self-serving attempt to induce the underwriter to underwrite the offering. Therefore, the court found that such statements may be unduly enthusiastic or deliberately false. *See id.* at 696-97.

Since the underwriter usually is not contractually committed to the underwriting until immediately prior to the effective date of the registration statement, he should have the leverage to demand access to records or data verifying the information contained in the registration statement. *See* Release 33-5275, *supra* note 35, at 4055; *Folk*, *supra* note 41, at 54-55.

<sup>43</sup> *See generally* *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 692-97 (S.D.N.Y. 1968); notes 44 and 45 *infra*. In a practical context, the primary responsibility for preparation of the registration statement rests with the issuer. The offering company is in the best position to know fully and present adequately the facts concerning its business and operations. *See* Freund & Hacker, *Cutting Up the Humble Pie: A Practical Approach to Apportioning Litigation Risks Among Underwriters*, 48 ST. JOHN'S L. REV. 461, 471-72 (1974). The underwriter, however, remains responsible under § 11 for the facts contained in the registration statement and prospectus. *See, e.g., In re Charles E. Bailey & Co.*, 35 S.E.C. 33 (1953). In *Bailey*, the defendant contended that a preliminary investigation of the issuer's affairs was sufficient to comply with his duty as an underwriter. Furthermore, the underwriter disclaimed responsibility for the contents of the prospectus because the contents were based upon information furnished by the issuer. *Id.* at 41. Bailey was aware, however, that the issuer was in bad financial straits, that the company was attempting to finance an untried venture, and that funds from the public offering would be consumed by overhead expenses unless the venture was immediately successful. *Id.* at 41-42. The SEC ruled that such reliance on the information furnished by the issuer did not discharge the underwriter from the duty to exercise reasonable care to assure the substantial accuracy of representations made in the prospectus and sales literature. *Id.* at 42.

<sup>44</sup> *See* *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968). In *BarChris*, the underwriters regarded the prospectus as being the company's responsibility. *Id.* at 696. The underwriters cited *Litwin v. Allen*, 25 N.Y.S.2d 667 (1940), as establishing an analogous standard of reasonableness entitling a director of a corporation to rely upon information furnished him by the officers without independently verifying the information. 283 F. Supp. at 696. The court rejected this standard, indicating that the '33 Act makes no distinction between the underwriters' and directors' duty under § 11 to verify information.

the investing public, an underwriter's due diligence investigation must go beyond and behind the representations of management in a reasonable attempt to verify the data submitted in the registration statement.<sup>45</sup> The underwriter's investigation must focus especially on updating information and the trends and present status of the company between the last audited financial report and the effective date of the registration statement.<sup>46</sup> If the

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*Id.* If the prospectus contained false statements, the underwriters failed to fulfill the same responsibility as the directors. *Id.*

In addition, underwriters may not avoid their responsibility to prospective investors by increasing the issuer's liability through an indemnity agreement. See *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969). Although the underwriter in *Globus* was guilty of more than mere negligence, the court's reasoning is applicable to civil liability for any breach of the § 11 standard. See *id.* at 1288. The court feared that an indemnified underwriter would tend to lessen the vigor of its independent investigation. *Id.* Whether or not such consequences would occur, the court emphasized that the purpose of the '33 Act is to encourage diligence, investigation and compliance with the statutory requirements by exposing issuers and underwriters to joint liability. An exemption from such liability would be tantamount to avoiding such responsibilities. *Id.* at 1289.

<sup>45</sup> See *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968); *In re The Richmond Corp.*, 41 S.E.C. 398, 406 (1963); *In re Charles E. Bailey & Co.*, 35 S.E.C. 33, 42 (1953). In *BarChris*, the counsel for the lead underwriter conducting the due diligence investigation of *BarChris* was aware of the importance of inspecting corporate records. *Id.* at 696. An inspection of the executive committee minutes would have revealed many of the discrepancies and deficiencies in the *BarChris* prospectus. *Id.* at 695. However, counsel chose not to investigate the composition of backlog orders, although he earlier had raised an issue about the certainty of the figure given. Further, counsel made no investigation into the company's cash position, despite notice of unusual conditions placed on officers' loans to the company. The counsel chose to rely, instead, on the information received from various directors without further verification. *Id.* The court ruled that the underwriters must meet the same standards of due diligence as the directors involved, *id.* at 696-97, and held that it is not sufficient to ask questions and obtain answers thought to be satisfactory without seeking to verify such answers from the corporate records. *Id.* at 696. Cross-examination of the issuer's officers by the underwriter or belief in their truthfulness and reliability does not constitute a reasonable investigation. See *id.* at 697. The court recognized that the limits of verification are a matter of judgment to be determined in each case. *Id.* at 697; see *Competitive Assocs., Inc. v. International Health Sciences, Inc.*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,966 (S.D.N.Y. 1975) (despite failure to discover conspiracy, underwriters performed necessary procedures to justify findings of due diligence). In *BarChris*, since the underwriter's counsel made no attempt to verify the management's representations, the underwriter did not establish a defense of due diligence. 283 F. Supp. at 697.

<sup>46</sup> See 283 F. Supp. at 681-82, 694-97; *BarChris Dialogue*, *supra* note 22, at 236 (remarks of C. Israel). Section 11 imposes liability for misstatements or omissions as of the effective date of the registration statement. 15 U.S.C. § 77k(a); (b)(3)(A). Therefore, the underwriter bears the responsibility of updating the registration documents if material changes occur. *But see Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971). In *Leasco*, the issuer's prospectus did not indicate the significance of nor include a specific figure for nonregulated funds the issuer would be receiving upon gaining control of an insurance company. *Id.* at 549, 551-52. Although the failure to include the figure constituted a material omission known to the underwriter, the court held that the underwriter had established a due diligence defense. *Id.* at 582. The court reasoned that the underwriter's duty to investigate should be considered in light of his more limited access to information. However, the *Leasco* underwriter made no further inquiries to ascertain subsequent developments during the three

underwriter becomes aware of facts which strongly suggest that the registration materials are deceptive, it must conduct a further investigation.<sup>47</sup> In addition, because of its strategic position in the distribution of the offering, the underwriter is expected to use its influence to correct misstatements and omissions in the registration statement before it goes to the public.<sup>48</sup>

Recently, underwriters have become concerned with the extension of the section 11 standard of diligence to '34 Act documents incorporated by reference into Form S-16. Previously, underwriters were not responsible for information contained in '34 Act documents and argue that they are not in a position to meet their usual standard of care with respect to such information.<sup>49</sup> Underwriters do not participate in the preparation of the annual, quarterly and current reports, and proxy material filed pursuant to the '34 Act and which may be incorporated by reference.<sup>50</sup> Unlike other registrants who are subject to potential liability for misstatements or omissions on a Form S-16 registration statement, the underwriter cannot control the procedures for preparing these filings. Nor does the underwriter have the opportunity to review the '34 Act documents prior to filing.<sup>51</sup> Since the difficult disclosure issues usually are discovered and resolved in conducting due diligence inquiries during the preparation of a registration statement,<sup>52</sup> various underwriters claim that they should not be expected to take equivalent responsibility for the '34 Act filing.<sup>53</sup> A subsequent review of the incorporated '34 Act documents made in conjunction with the preparation of a Form S-16 registration statement would not enable an underwriter to pursue the due diligence procedures normally performed

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weeks before the registration statement became effective. *Id.* at 582-83. Despite the *Leasco* court's acknowledgment of the *BarChris* standards, the *BarChris* court's emphasis upon the updating process renders *Leasco* difficult to reconcile with *BarChris*. See H. BLOOMENTHAL, 3A SECURITIES AND FEDERAL CORPORATE LAW § 8.15(4)(a) (1978).

<sup>47</sup> See *Chris-Craft Indus. Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 370-73 (2d Cir. 1973). Although the underwriter in *Chris-Craft* was not subject to § 11 liability, the court reasoned that public reliance on the underwriter created obligations similar to due diligence. *Id.* at 370. The *Chris-Craft* registration statement contained no mention of the potential sale of a major corporate asset. The underwriter, aware that a possible sale had been mentioned in the corporate minutes, performed no further investigation after questioning company officials about the possible sale. *Id.* at 372. The court stated that such notice of deception in the registration materials required the underwriter to seek further verification either by a careful search of the records or contacting the prospective buyer. *Id.* at 371, 373. Thus, failure to do so went beyond mere negligence and amounted to an abdication of the underwriter's responsibility to protect potential investors. *Id.* at 373-74.

<sup>48</sup> See *Folk*, *supra* note 41, at 55-56; note 42 *supra*.

<sup>49</sup> See, e.g., *SIA*, *supra* note 31.

<sup>50</sup> See Release 33-5998, *supra* note 5; Letter from Sullivan & Cromwell to SEC (Jan. 24, 1979) (SEC File No. S7-763) [hereinafter cited as Sullivan & Cromwell].

<sup>51</sup> See *SIA*, *supra* note 31.

<sup>52</sup> See Letter from Goldman, Sachs to SEC (Feb. 9, 1979) (SEC File No. S7-763) [hereinafter cited as Goldman, Sachs].

<sup>53</sup> See, e.g., *SIA* *supra* note 31; Sullivan & Cromwell, *supra* note 50; Letter from Morgan Stanley & Co. (Jan. 22, 1979) (SEC File No. S7-763) [hereinafter cited as Morgan Stanley].

during the preparation of a Form S-1 or Form S-7 registration statement.<sup>54</sup>

In addition to the practical problems of '34 Act disclosures, issuers may be more reluctant to cooperate with underwriters in preparation of a Form S-16 registration statement. An underwriter's ability to conduct an adequate due diligence investigation may be hampered by the issuer's expectation that the short form registration procedure will greatly reduce the complexity, cost and time required for a public offering.<sup>55</sup> In order to protect themselves against the uncertain liability for incorporated documents, many underwriters contend they would be forced to insist upon costly and time consuming procedures which would eliminate these economies which Form S-16 registration is intended to achieve.<sup>56</sup> Besides the addition of difficult investigative duties, underwriters contend that these duties will be further complicated by issuers' reluctance to correct, clarify or modify earlier disclosures in '34 Act documents incorporated by reference.<sup>57</sup> This reluctance appears to be attributable to the issuer's concern that the subsequent disclosure may be viewed as an admission that the prior document was materially false or misleading. Therefore, the issuer might subject himself to '34 Act liability.<sup>58</sup> Since amendment in the Form S-16 prospectus of incorporated documents might have a misleading significance, the issuer's concept of an adequate disclosure may vary markedly from the underwriter's opinion about the materiality of a misstatement or omission.<sup>59</sup> As a result, many underwriters doubt that their participation in the preparation of Form S-16 registration statements will result in improved filings of subsequent '34 Act documents.<sup>60</sup>

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<sup>54</sup> See *Current Issues and Developments in the Duties and Liabilities of Underwriters and Securities Dealers*, 33 BUS. LAW. 335, 356 (1977) [hereinafter cited as *Current Issues*]; Sullivan & Cromwell, *supra* note 50.

<sup>55</sup> See Sullivan & Cromwell, *supra* note 50. Since the adoption of the short form registration statement, the SEC has emphasized that the primary goals of the integration of the '33 Act and '34 Act are the reduction of registration costs, the ability to reach markets more quickly, and the elimination of duplicative disclosure. See, e.g., Release 33-5923, *supra* note 5. Various underwriters fear that, in light of these expectations, registrants will become increasingly reluctant to delay their offering to await an underwriter's due diligence investigation. See *Current Issues*, *supra* note 54, at 348-58; Sullivan & Cromwell, *supra* note 50. Concurrently, normal competitive forces within the securities industry may encourage use of Form S-16 by companies whose disclosure has been of lesser caliber. See Letter from Blyth, Eastman Dillon & Co. to SEC (SEC File No. S7-763).

<sup>56</sup> See Letter from ABA Federal Regulation of Securities Committee to SEC (Feb. 22, 1979) (SEC File No. S7-763); Sullivan & Cromwell, *supra* note 50.

<sup>57</sup> See Johnson, *Expanded Use of Form S-16*, PLI TENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 65, 67 (1978) [hereinafter cited as Johnson]; Release 33-5998, *supra* note 5, at 81,059.

<sup>58</sup> See Release 33-5998, *supra* note 5, at 81,059.

<sup>59</sup> See Johnson, *supra* note 57, at 67; Goldman, Sachs, *supra* note 52.

<sup>60</sup> See SIA, *supra* note 31. In contrast to the ongoing relationship with the registrant during the preparation of a Form S-1 or S-7 registration statement, an underwriter preparing a registration statement on Form S-16 does not have the same opportunity to improve the form, content and format of disclosure to serve as a model in subsequent filings. *Id.* Furthermore, underwriters state that their participation in the preparation of '34 Act filings of clients would not be practical or economically feasible. *Id.*

Various underwriters contend that their potential liability for possible material misstatements or omissions in documents not prepared and presented for purposes of the offerings warrants adoption by the SEC of a safe harbor rule.<sup>61</sup> An underwriters' petition for rulemaking has requested the SEC to limit underwriter liability in the S-16 context by establishing relevant factors to be considered in determining the reasonableness of an underwriter's investigation of documents incorporated by reference.<sup>62</sup> Furthermore, underwriters argue that the section 11 standard of due diligence is flexible because the investigation of a reasonable and prudent man should vary according to the circumstances.<sup>63</sup> Since the short form contains little financial disclosure and the underwriter has less influence with the issuer, underwriters argue that a reasonable investor would not expect a prudent underwriter to verify incorporated documents with the kind of painstaking detail customary in traditional underwriting.<sup>64</sup>

The SEC has addressed the underwriters' concerns by proposing amendments to Form S-16 which deal narrowly with specific issues raised by the underwriters. The SEC proposes that for the purposes of section 11 liability documents incorporated by reference shall be deemed effective as of the date of each document's filing with the Commission, rather than the effective date of the registration statement.<sup>65</sup> This amendment would protect the issuer and underwriter from liability for an incorporated '34 Act document which, although accurate at the time of filing, became misleading due to subsequent events. The SEC has stated, however, that an underwriter would still be liable under section 11 of the '33 Act if the disclosures in the document contained false or misleading statements at the time of filing which were not superseded or modified in the subsequent Form S-16 registration statement.<sup>66</sup>

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<sup>61</sup> See Morgan Stanley, *supra* note 53; SIA, *supra* note 31.

<sup>62</sup> See Release 33-5998, *supra* note 5, at 81,059-60. The Securities Industry Association submitted two proposed rules to the SEC relating to underwriters' liability with respect to registration statements on Form S-16. See SIA, *supra* note 31. The first proposal set forth relevant circumstances which should be considered in determining whether an underwriter has made a reasonable investigation. *Id.* The second proposal deemed an underwriter to have conducted a reasonable investigation if the underwriter had (a) read the registration statement, including the documents incorporated by reference, (b) discussed the registration statement with representatives of the issuer, and (c) as a result does not know of any untrue statement or omission of a material fact. *Id.*

<sup>63</sup> See *Current Issues*, *supra* note 54, at 350.

<sup>64</sup> *Id.*

<sup>65</sup> See Release 33-5998, *supra* note 5, at 81,061. The proposed amendment to Form S-16 clarifying the effective date of documents incorporated by reference (Item 7(e)) states:

- (i) For purposes of determining pursuant to Section 11(a) of the Act only when a document incorporated by reference pursuant to this Item 7 "became effective," the effective date shall be the date of the document's initial filing with the Commission.
- (ii) For all other purposes under the Act, including Section 13, the effective date shall be the effective date of the registration statement.

Form S-16 Proposed Amendment, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7292, at 6433-34.

<sup>66</sup> See Release 33-5998, *supra* note 5, at 81,061.

This amendment should not obscure the fact that section 11 would apply if the disclosure in the registration statement omitted or contained an untrue statement of a material fact when it became effective.<sup>67</sup> Form S-16 requires the disclosure of any material changes in the issuer's affairs occurring after the filing date of the incorporated document and before the effective date of the S-16 registration statement.<sup>68</sup> Thus, although the basic disclosure in Form S-16 is accomplished through the incorporation of specific documents by reference,<sup>69</sup> a court should assess the adequacy and accuracy of the disclosure in the Form S-16 registration statement by considering the prospectus and incorporated documents as a single entity. The SEC proposal supports this view by providing that the Form S-16 prospectus, or a subsequent document which has been incorporated, be deemed to modify or supersede statements in prior documents incorporated by reference.<sup>70</sup> As a practical matter, however, the SEC's distinction between the effective dates should be helpful. During the course of the due diligence investigation, the underwriter must review the adequacy and accuracy of the initial disclosure in the incorporated '34 Act documents to determine whether corrective disclosures are necessary. If such disclosures have been made, however, the underwriter must determine whether the updated information adequately and accurately addresses the untrue statements or omissions of material fact in the incorporated documents. In order to encourage issuers to correct earlier disclosure documents incorporated by reference, the SEC proposes that inclusion of a modifying or superseding statement will not be deemed to be an admission that the superseded or modified statement constituted a violation of the federal securities acts when made.<sup>71</sup>

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<sup>67</sup> See 15 U.S.C. § 77k (1976).

<sup>68</sup> See Form S-16 (Item 8), *supra* note 4.

<sup>69</sup> See text accompanying notes 12-16 *supra*.

<sup>70</sup> The proposed amendment to Form S-16 (Item 7(f)) states:

Any statement contained in a document incorporated or deemed to be incorporated by reference shall be deemed to be modified or superseded for purposes of the prospectus to the extent that a statement contained in the prospectus or in any other subsequently filed document which also is or is deemed to be incorporated by reference modifies or replaces such statement.

The modifying or superseding statement may, but need not state that it has modified or superseded a prior statement or include any other information set forth in the document which is not so modified or superseded.\*\*\*

Form S-16 Proposed Amendment, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7292, at 6433-35.

<sup>71</sup> The proposed amendment to Form S-16 (Item 7(f)) states:

\*\*\* The making of a modifying or superseding statement shall not be deemed an admission that the modified or superseded statement, when made, constituted an untrue statement of a material fact; a statement false or misleading with respect to any material fact; an omission to state a material fact necessary to make a statement not misleading; or the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act, practice, course of business or artifice to defraud\*\*\*

Form S-16 Proposed Amendment, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7292, at 6433-35. Underwriters' comments properly question whether this proposal in the text of a SEC form

Although the amendments to Form S-16 proposed by the SEC address certain problems caused by the incorporation of documents by reference, the underwriters' request for clarification of their due diligence obligations remains unanswered. The SEC remains reluctant to promulgate a rule on underwriters' liability and due diligence obligation which would have unforeseen ramifications on the degree and quality of underwriter investigation.<sup>72</sup> Thus, the SEC has refused to redress the alleged imbalance in the statutory liabilities of the two securities acts which has been created by the integration of the disclosure provisions of the '34 Act with the registration procedures mandated by the '33 Act.<sup>73</sup> Instead, the SEC believes that a court would recognize an underwriter's practical difficulties and consider the circumstances of the underwriter's position with respect to information contained in the documents incorporated by reference into a Form S-16 registration statement.<sup>74</sup>

Despite the underwriters' difficulties with incorporation by reference into Form S-16 of '34 Act information, the underwriters' responsibility to independently verify the information in the registration statement remains undiminished. Historically, the courts and the SEC have placed the burden of policing the disclosure process in the registration of new securities on the underwriter. This policy is a result of unmistakable congressional intent and the underwriter's unique role in the offering of securities.<sup>75</sup> Securities' buyers in an initial distribution do not have the protection of a continuous scrutiny of a security afforded to purchasers in the trading markets.<sup>76</sup> Furthermore, new public offerings have a special economic significance because of their impact on the economy.<sup>77</sup> Short form registration is intended to encourage new securities offerings by facilitating timely access to the capital markets and reducing the costs of raising capital.<sup>78</sup> Form S-16 has been viewed as providing quicker access to the capital

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would be binding on federal or state rules of evidence. *See* SIA, *supra* note 31; ABA, *supra* note 56.

<sup>72</sup> *See* Release 33-5998, *supra* note 5, at 81,060-61.

<sup>73</sup> *See id.* The underwriters contend that the nonstatutory intermixing of the '34 Act with the '33 Act in Form S-16 compels "underwriters to serve a function and subject themselves to substantial risks of liability in a manner which Congress never envisaged." Sullivan & Cromwell, *supra* note 50; *see* Goldman, Sachs, *supra* note 52. Furthermore, the liability for documents incorporated by reference on Form S-16 coerces underwriters to improve the quality of registrants' '34 Act filings. Underwriters argue that they have neither the statutory responsibility nor the realistic means to perform this function. *See* SIA, *supra* note 31.

<sup>74</sup> *See* Release 33-5998, *supra* note 5, at 81,060. The SEC suggests that a court assessing § 11 liabilities for a Form S-16 registration statement should consider the presence or absence of the underwriter's responsibility for the original filing of material incorporated by reference, as well as other circumstances that might legitimately effect an underwriter's ability to discharge its due diligence obligation under the '33 Act. *Id.*

<sup>75</sup> *See* text accompanying notes 40-42 *supra*.

<sup>76</sup> *See* THE WHEAT REPORT, *supra* note 15, at 58-60.

<sup>77</sup> *Id.* at 60.

<sup>78</sup> *See, e.g.*, Release 33-5923, *supra* note 5, at 81,057-58; ADVISORY REPORT, *supra* note 3, at 425.

market, especially when the issuer believes that time is of the essence.<sup>79</sup> The business judgment of the issuer, however, does not relieve the underwriter of its responsibility to conduct an adequate due diligence investigation. The requirements of the '33 Act were meant to slow up the procedure of selling securities, allowing the financial world the opportunity "to acquaint itself with the basic data underlying a security issue and through that acquaintance to circulate among the buying public some intimation of its quality."<sup>80</sup> Furthermore, as the SEC has recognized, the Form S-16 requirement of a firm commitment underwriting for primary offerings is a basis of the investor's expectation that the underwriter will independently verify the soundness of the offering.<sup>81</sup>

Although the underwriter must perform a due diligence investigation of the documents incorporated by reference in a Form S-16 registration statement, the limits of a reasonable investigation remain unclear. The SEC has suggested that underwriters must carefully review the documents incorporated by reference to assure that these documents, as well as the S-16 prospectus, contain no misstatements or omissions and that the facts disclosed in the documents have not changed materially as of the date of incorporation.<sup>82</sup> The SEC position appears to be proper despite the failure to set forth specific criteria and standards of due diligence.<sup>83</sup>

Despite underwriters' fears that court decisions have established certain procedures and materials for which the underwriters are specifically responsible,<sup>84</sup> the section 11 reasonableness standard of "a prudent man in the management of his own property"<sup>85</sup> suggests that a reasonable investigation should vary according to the circumstances. The flexibility of this standard is limited, however, because neither the public's expectations of protection by the underwriter nor the underwriter's importance in the scheme of distribution are diminished when Form S-16 is used.<sup>86</sup> The underwriter has the duty to investigate regardless of the obstacles that the issuer may put in the way of its access to information.<sup>87</sup> Previous court

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<sup>79</sup> See *Current Issues*, *supra* note 54, at 352-53; Johnson, *supra* note 57, at 67.

<sup>80</sup> Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 35 (1959).

<sup>81</sup> See notes 20 and 41 *supra*. The SEC did not restrict the type or amount of the offering extending the availability of Form S-16 to primary offerings because of the investor protections inherent in a firm commitment underwriting. See Release 33-5923, *supra* note 5, at 80,247. Furthermore, the SEC intended the \$50 million capitalization standard to assure a general market interest in the securities. See *id.*; note 19 *supra*. The need for independent investigation by an underwriter increases for companies whose market capitalization is near the S-16 standard. See note 18 *supra*.

<sup>82</sup> See Release 33-5998, *supra* note 5, at 81,060.

<sup>83</sup> See note 40 *supra*.

<sup>84</sup> See, e.g., BarChris Dialogue, *supra* note 22; Messer, *supra* note 40, at 442-44; Whitney, *Underwriters' Counsel—Advice to My Client: "That Which is Impossible Must Go Away"* in Symposium, *The BarChris Case: Prospectus Liability*, 24 BUS. LAW. 523, 585 (Jan. 1969).

<sup>85</sup> '33 Act § 11(c), 15 U.S.C. § 77k(c)(1976).

<sup>86</sup> See HOUSE REPORT, *supra* note 35, at 9.

<sup>87</sup> See ALI FEDERAL SECURITIES CODE, comment 10(d), at 104 (Tent. Draft No. 2, 1973).



decisions under section 11 have assessed a defendant's defense of due diligence in light of the particular issuer, the issue, and the defendant's role in the preparation of the registration statement.<sup>88</sup> Therefore, judicial consideration of an underwriter's investigation of a document incorporated by reference would take the underwriter's problematic position into account.<sup>89</sup>

While the underwriter's position in a S-16 offering demands the imposition of a due diligence standard, such a standard for investigating incorporated '34 Act documents remains distinct from the due diligence required in the preparation of all the registration materials.<sup>90</sup> Such due diligence requires the underwriter to do more than read and analyze the incorporated documents.<sup>91</sup> The underwriter must independently verify the information contained in these documents and must investigate further any possible discrepancies of which he has been put on notice.<sup>92</sup> Such notice may arise from any facts known to the underwriter, as well as from an examination of corporate records, particularly corporate minutes and major contracts.<sup>93</sup> Furthermore, the issuer has established a managerial and financial history through the reporting of disclosure materials. Since the underwriter usually does not enter into a firm commitment underwriting without an investigation of the issuer,<sup>94</sup> knowledge of circumstances demanding independent verification would be available to the underwriter from sources other than solely the documents incorporated by reference. Finally, courts have emphasized that disclosure in the registration statement must present the current status of the issuer as of the effective date of the registration statement.<sup>95</sup> The problems attributable to documents incorporated by reference in Form S-16 are less consequential since incorporated documents merely form the starting point of an underwriter's investigation of potential material changes in the issuer's affairs.

The underwriters' difficulties caused by the incorporated documents in Form S-16 apparently signify the limits of the SEC's efforts to administratively integrate the disclosure provisions of the '34 Act and '33 Act. The SEC's attempt to achieve economies of time and cost in the registration of securities is limited by the specific statutorily created civil liabilities and defenses of section 11 of the '33 Act. In light of the imperfect integration of the Acts, the underwriters' responsibility to protect the investing public by conducting a due diligence investigation must necessarily over-

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<sup>88</sup> See, e.g., *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

<sup>89</sup> See *Sanders v. John Nuveen & Co.*, 524 F.2d 1064, 1071 (7th Cir. 1975) (nature of investors' interest affects nature of underwriter's investigation), *vacated*, 425 U.S. 929 (1976) (remanded in light of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)).

<sup>90</sup> See text accompanying notes 43-48 *supra*.

<sup>91</sup> See 524 F.2d at 1070-71.

<sup>92</sup> See notes 45 and 47 *supra*.

<sup>93</sup> See, e.g., *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 694-97 (S.D.N.Y. 1968).

<sup>94</sup> See SPECIAL REPORT, *supra* note 41, at 512-13.

<sup>95</sup> See note 46 *supra*.