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AMENDING THE SECURITIES ACT—THE AMERICAN BAR ASSOCIATION COMMITTEE'S PROPOSALS

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THE question whether and to what extent the federal Securities Act ought to be amended has been recently brought to the fore by the recommendations of the Special Committee of the American Bar Association on Amendments to the Securities Act of 1933 which were adopted by the Association at its fifty-eighth Annual Meeting. To a minor extent the questions with which those recommendations deal are questions of draftsmanship—whether certain portions of the act fail to express the legislative intent or to express such intent with sufficient clarity, and whether these alleged defects are sufficiently important to make amendment desirable. In the main, however, the committee's report deals with the policy rather than with the draftsmanship of the existing Act. It raises the broad questions of the appropriateness of the present provisions of the Act for the protection of investors in corporate securities and the extent, if any, to which those provisions burden distributors of securities with undue expense, unreasonably curb their activities, or subject them to undue risks.

It is the purpose of the present article to set forth the considerations which have led the writer to conclude that most of the committee's more important proposals would be so detrimental to the interests of investors that they ought not to be adopted. In order to make these considerations intelligible, it is necessary, before discussing the committee's recommendations, to consider first of all the general character of our existing system of security distribution and the dangers to the investor which are likely to result from it. In so doing we may disregard such dangers as are inherent in any system based on the assumption that investors ought to be permitted to risk their money in speculative ventures, provided only that the material facts relating to such ventures are adequately disclosed to them, for that assumption is the underlying principle of the Act.

Although American methods of security distribution differ widely according to the size of the corporation, the character of its securities and

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the special circumstances under which they are issued, there are certain general features common to the distribution of most of the securities of enterprises which are of sufficient size to cause them to make use of the channels of interstate commerce in the selling process and thereby to bring themselves within the purview of the federal Securities Act.

Such securities are sold chiefly to persons who are not in a position to make any independent investigation of the facts on which the value of the securities depend, but must rely for the most part on information furnished to them, directly or indirectly, by the issuing corporation or by other participants in the distribution process. This is not, indeed, true of such facts as are external to the particular enterprise, such as the condition of the woolen industry or of industry in general, but it is almost wholly true of the internal facts with respect to a new enterprise and very largely true of the internal facts with respect to any enterprise, however well established. The experienced investor can do little more than subject the statements and figures furnished by the corporation or its bankers to careful scrutiny; the inexperienced investor—and it is the inexperienced investor who furnishes a substantial portion of our modern corporate capital—is incapable of even that limited form of investigation. Furthermore, particularly where the enterprise is large and has been in operation for some time, the facts with regard to it are necessarily so complicated that chances of serious error in any statement about them are very great unless those who are responsible for making the statements exercise a high degree of care.

Such being the case, legal protection against fraud alone is wholly inadequate to fit the investor's needs. Being unable to ascertain the facts for himself, he needs reasonable assurance that those who are in a position to ascertain them shall, on the one hand, exercise care in discovering and accuracy in stating the facts, and, on the other hand, give him a statement so full as to furnish no opportunity for concealment of facts that may be vital to a correct appraisal of the present value and future prospects of the security which he is asked to buy. Although the information furnished by the corporation or by the banking house which originates the issue reaches only part of the investing public in the form in which it is orginally given out, this information, being read by a substantial number of buyers and sellers of the security, affects investors generally either by causing someone who has read it to advise them to purchase, or more indirectly still, by producing a favorable public impression of the security and creating a market price at which the investor must buy if he buys at all. Disclosures which may be too complicated and technical for the average investor to understand will nevertheless benefit him through being understood by investors of greater experience. For the inexperienced investor normally pays no more for the security

than does his more experienced neighbor, it being the general practice to have a uniform offering price.[1]

The orthodox common law doctrine which requires reliance on misrepresentations is ill adapted to meet the investor's needs unless reliance be given a meaning wholly different from that which it has traditionally had. In many cases all that the investor will be able to show is that an important false statement was given wide currency at the time when the securities were being offered to the public, and that, although neither he nor the person from whom he bought had any knowledge of the specific statement, he paid the current market price in a market which could scarcely fail to have been influenced by the importance of the statement and the wide publicity which had been given to it. Unless investors are able to base a cause of action on a showing of this sort, many who have suffered serious injury by reason of false or misleading statements will be left without remedy.

Finally, the nature of corporate securities and the manner of their distribution create peculiar problems with respect to damages. Subject to certain minor exceptions, it is our common law tradition to measure damages in cases of misrepresentation as of the date when the plaintiff acted upon the misrepresentation, and, where the misrepresentation induced a sale, to measure these damages by deducting the actual value of the thing bought either from the price actually paid or from an estimate of the value which the thing bought would have had if the representations had been true.[2] In most cases in which sales of readily marketable property have been induced by misrepresentation, the market value of the thing sold furnishes us with satisfactory evidence of its actual value. In the sale of securities, however, the misrepresentations for which it is particularly important to give redress are those which are made so generally that they affect the entire market and establish a market price which has little or no relation to actual value. If, therefore, our rule of damages compels us to ascertain the actual value of the securities on the date of purchase, we must in so doing use evidence other than market value. The difficulty of ascertaining in litigation which may arise several years after the purchase, what the actual as distinct from the market value of the security was at that time is likely to be well-nigh insuperable. Accordingly, even where the problem has arisen at common law, the courts have frequently abandoned the attempt to determine values as of the date of purchase, and have sought to measure the investor's loss by taking into consideration subsequent declines in the market value of the

1. There may, of course, be a group of insiders who are "let in on the ground floor" and permitted to buy at a special bargain price.

2. The latter measure of damages is that generally adopted where the action is for breach of warranty; each of the two measures has substantial support where the action is for deceit. See WILLISTON, SALES (2d ed. 1924) §§ 613, 614.

security.[3] Although there seems to be no other practicable way of dealing with the damage problem in a manner which will furnish adequate protection to the investor, nevertheless this attempt to focus attention upon subsequent events is subject to the objection that it will normally be very difficult, if not impossible, to separate a fall in market value, due to the public discovery of the erroneous character of a representation, from a fall in market value due to other causes. Any rule of law which would put on the investor the burden of establishing the extent to which a fall in price was due to the original making and subsequent discovery of the material false statement would, therefore, make it impossible for many investors to prove a case where they have indubitably suffered some loss as a result of the defendant's falsehood.[4]

We have been considering the problem thus far solely from the standpoint of the needs of the investor. Obviously this is only one side of the picture. Rules of law which may be necessary if all deserving investors are to obtain a chance of legal redress may be unjust to distributors of securities or unwise when considered from the broader viewpoint of the welfare of the community as a whole. Rules which may be needed to allow deserving plaintiffs to recover may open the door to recovery by a host of undeserving plaintiffs as well. Even where this is not the case, such rules may subject honest distributors of securities to unreasonable expense and to unfair risks. By so doing they may increase the cost of marketing securities to an extent which is not only disadvantageous to the investor but injurious to the entire economic system of the country, in that investment of capital in new industry may thus be hampered. If carried to extremes, such rules may even make the business of selling new securities so unattractive that long-term corporate financing will become impossible.

The security distributors' side of the argument has, however, received so much attention from writers who have dealt with the Securities Act,[5]

3. Whiting v. Price, 172 Mass. 240, 51 N. E. 1084 (1898); Hotaling v. A. B. Leach & Co., Inc., 247 N. Y. 84, 159 N. E. 870 (1928).

4. It may be that there are other practicable methods of control of security marketing which would in the long run be of even more importance to the investor than a method which seeks to compel disclosure and to give a remedy where damages have been suffered by reason of misrepresentations or concealments. See Douglas & Bates, *The Federal Securities Act of 1933* (1933) 43 YALE L. J. 171. However this may be, the importance of requiring full information and of damage provisions which will both tend to induce compliance with this requirement and give an effective remedy for non-compliance is indisputable.

5. For articles written wholly or chiefly from the distributor's point of view see Ballantine, *Amending the Federal Securities Act* (1934) 20 A. B. A. J. 247; Dean, *The Federal Securities Act* (Aug. 1933) 8 FORTUNE 50; Dean, *The Amended Securities Act* (Sept. 1934) 10 FORTUNE 80. The act in its orginal form was so severe that even writers whose point of view was much more detached tended to emphasize its harshness towards directors and underwriters. See Douglas & Bates, *supra* note 4. But cf. Shulman, *Civil Liability and the Securities Act* (1933) 43 YALE L. J. 227.

and is so clearly implicit in the recommendations of the Bar Association's committee as to need but little further elaboration. The reasons why the security buyer needs a special type of protection different from that given to other buyers, and the precise character of those needs have been less emphasized in the literature of the subject, but need to be understood thoroughly in order that one may form an intelligent judgment as to the desirability of the recommended changes in the Act.

The committee's recommendations are grouped under the various sections of the Act to which they relate, and a similar grouping will be adopted in this article. We shall deal however, only with those suggested amendments which appear to be of substantial importance.

Amendments to Section Two

Section 2 of the Securities Act is a definitional section. The committee's first recommendation is that that section be changed to give a more limited meaning to the term "underwriter." It suggests that "underwriter" as used in the Act be redefined so as to exempt from the burdens now imposed upon underwriters those "true" underwriters who "confine themselves merely to agreements to purchase outright such portions of security issues as are not distributed to the public or other security holders, and who do not participate in the actual distribution of the issue in question." The committee further suggests that underwriters so exempted be required to retain the securities underwritten for some such period as six months.

The general purpose of the Securities Act is to render all persons whose position makes them, or should make them closely associated with the issue of a security, responsible for the correctness of the registration statement and of a prospectus based thereon, and to subject to much less severe burdens other persons who participate in the sale of securities to the public, but are less closely connected with the issuing corporation. It has long been customary in this country, particularly in the case of the larger corporations, for prospectuses to be issued by investment bankers, commonly known as originating houses, rather than by the corporations themselves, and for the public to rely to a large extent upon the reputation of these bankers rather than upon that of the corporate management in purchasing securities. The relations between such bankers and the issuing corporations make it entirely practicable for the former to obtain full information about the enterprises which they are sponsoring. For these reasons, the Act seeks to subject persons who are substantially in the position of such bankers to responsibility for the registration statement and the prospectus. The basis for this responsibility is threefold: that such bankers participate as wholesale and frequently as retail security merchants in the distribution process; that they are normally in close contact with the corporation and able through

their direct dealings with it to obtain information, if not, indeed, actually controlling its security-issuing activities; and finally that they are the sort of persons whose names the public expects to find on prospectuses.

The method adopted in the act for bringing such bankers within the scope of its registration and prospectus provisions is to make all underwriters responsible for the registration statement and then to give, in Section 2 (11), a very broad definition of the term "underwriter." Under the definition as it now stands, "any person who has purchased from an issuer with a view to . . . the distribution of any security or participates or has a direct or indirect participation in any such undertaking" is included within the term "underwriter." As the committee indicates, this definition would appear to include "true" or "English type" underwriters, who agree to purchase such portion of the issue as is not sold to the public. These underwriters do not participate directly in the selling process unless some portion of the issue remains unsold to others, in which event they are themselves obliged to purchase that unsold portion and may resell it. If such underwriters disassociate themselves completely from the selling process, do not permit their names to be used on a prospectus or otherwise as sponsoring the issue, and do not even permit a public announcement to be made that they are underwriting it, there is force in the argument that they should not, merely because of their underwriting agreement, be treated as parties to the registration statement. If the public takes all the securities which are being marketed, these underwriters have not dealt with the public at all, but have merely earned a commission for acting as insurers.

On the other hand, if the underwriters are obliged to take some of the securities themselves, they are likely to seek to resell these securities to the public. If exempted altogether from the liabilities imposed upon underwriters, they could under these circumstances resell their securities with no legal responsibilities under the Act except those imposed upon ordinary dealers by Section 12. That section imposes upon them no duty of disclosure and no liability for misrepresentations except liability to persons purchasing directly from them by means of the mails or some instrumentalities of interstate commerce. To enable an investment banker whose business relations with the issuing corporation may be very close and whose sponsorship of an issue may carry great weight with the public to reduce his liabilities to those of an ordinary retail dealer, merely because the issuing corporation has made an abortive attempt to market the issue through other channels, would be so inconsistent with the purposes of the Act that substantial safeguards must be provided if the committee's recommendation is to be adopted. The committee suggests that in order to obviate the employment of "true" underwriters as a device to evade the Act, such underwriters should be required to retain, for some such period as six months, the securities which they have been com-

pelled to purchase as a result of their underwriting. This suggestion, if coupled with a very broad definition of what is meant by "participation," would eliminate much of the objection to exempting "true" underwriters from responsibility for the registration statement. It may be doubted, however, whether the risk of thereby encouraging evasion would not still be substantial. Furthermore, although underwriting is a socially useful activity, it may be questioned whether encouragement of this particular type of underwriting is of sufficient importance to the community to justify the complications which it would introduce into the administration and enforcement of the Act.[6]

The committee also suggests the insertion in Section 2 of a definition of the phrase "public offering." Although Section 4 of the Act exempts from most of its provisions "transactions by an issuer not involving any public offering," the Act nowhere states what is meant by a public offering. The Federal Trade Commission, which was charged with the administration of the Act previous to the time the Securities and Exchange Commission took over that function, has ruled that an offer need not be made to the public generally in order that it be public, an offer to a particular group such as the corporation's own employees being public within the meaning of the Act if the class is large.[7] The Securities and Exchange Commission has made no change in this ruling.

The committee dissents vehemently from the ruling and suggests a definition of "public offering" which would eliminate issues "confined solely to the holders of the issuer's securities or to the employees of the issuer or to the creditors of the issuer." The committee urges in support of its view that members of these classes either have full information or facilities for obtaining such information with respect to the issuer and the security, and that the filing of a registration statement is accordingly unnecessary.

Stockholders do, of course, have a theoretical legal right to examine the books of the corporation. But no one knows better than the eminent corporation lawyers who are members of the committee that, at least in corporations of substantial size, the expense of exercising this right is so great that it is utterly impracticable for the average stockholder, when

6. The position is taken below that offers to special classes, such as stockholders and employees, require registration under the Act if the class is large. There is, however, frequently a real business need of an underwriting agreement in connection with such offers, and this agreement must necessarily be of the true or English type. Even to one who is, like the writer, strongly impressed with the wide gulf which, in the modern publicly-financed corporation, separates the individual stockholder from the management, a rule which makes an underwriter responsible for what the management tells the stockholders when it offers them rights to subscribe to new issues seems unreasonable. As applied to this particular situation, the committee's plea for exempting true underwriters is persuasive.

7. See Fed. Trade Comm. Release, No. 97, Dec. 28, 1933, taking the view that a proposed offering of stock to 2450 employees of a corporation is a public offering.

offered a new issue of securities of his corporation, to examine the books in order to determine whether it would be wise for him to subscribe. Apart from this right to examine the books, and from the right given by the corporation laws of a few states to insist upon receiving an annual report, generally of a rather meagre character, a stockholder who has no close relations with the management has no sources of information other than those available to the general public.

Theoretically, it might seem that any excessive price which stockholders may be induced, by misrepresentation or non-disclosure, to pay will enrich the corporation and hence come back to the stockholders in the long run, but practically there will be many situations in which this will not be true.[8] Furthermore, although the fiduciary obligations which the directors owe to the corporation, and to a lesser extent to the stockholders, may furnish a stockholder who has been induced by misrepresentation to purchase additional securities some remedies not available to an outside buyer, nevertheless, what the stockholder needs is not a chance to purchase a lawsuit but opportunity to obtain sufficient information in advance to enable him to determine whether it is wise for him to purchase anything.

The fact is that our state corporation laws and the legal and equitable principles which our courts have developed in connection with them do not give the stockholders in our large corporations, in which control and ownership are almost completely divorced, adequate means of obtaining reliable information with respect to corporate affairs. Effective reform through state legislation is unlikely so long as the states are bidding against one another for the favor of corporate promoters and so long as our corporation statutes are drafted on the theory that there is no legal distinction between an enterprise with five stockholders and one with five hundred thousand. Federal statutes have given the stockholders of many of our corporations as well as the general public new opportunities for obtaining information by authorizing the Interstate Commerce Commission to require periodic public reports from railroads, and the Securities and Exchange Commission to require such reports from all corporations whose securities are listed on an exchange.[9] There are, however, many important corporations which are immune from regulation under those statutes but which come within the purview of the Securities Act whenever they are issuing additional securities. The stockholder's need of information, acute at all times, is peculiarly so when he

8. The purpose of the issue may be to provide funds for expenditures which may be unlikely to benefit the stockholders; insiders may be given extravagant underwriting or other commissions in connection with the issue; it may be offered to one class of stockholders on terms which are unfair to some other class.

9. See § 20 of the INTERSTATE COMMERCE ACT, 34 STAT. 593 (1906), 49 U. S. C. A. § 20 (1929), and § 13 of the SECURITIES EXCHANGE ACT, 48 STAT. 894, 15 U. S. C. A. § 78m (1934).

is being asked to invest additional funds in the corporate enterprise. To give him a right to information at that stage, through the Securities Act, is not only beneficial in compelling disclosure to him, but may be even more beneficial indirectly in tending to destroy the vicious notion which has generally prevailed that much which is going on behind the scenes in our large, publicly-owned corporations—the payment of huge managerial bonuses, for example—may with propriety be concealed even from those members of the public who are the owners of the enterprise.

Creditors do not, as such, have any special legal rights to information. No doubt those large creditors who are in a position to threaten the corporation with inconvenient demands for payment, or with equally inconvenient withholding of further credits, are generally able to obtain a great deal of information. This is not true of most small creditors, however, and any assumption that large creditors will look out for the interests of the entire class is certainly unwarranted.[10]

As for employees, those occupying the higher salaried positions doubtless have special means of information, but offers of securities to employees are frequently made to those whose position in the organization is so humble that they would not dare to ask for any information other than that which the management chose to give them. Such employees may not only be asked to subscribe without being told the relevant facts; they may be, and sometimes are, practically forced to subscribe for fear of losing their positions or incurring the ill will of the management if they refuse. Where the management's desire not to antagonize its employees by forcing them to buy undesirable securities is outweighed by its eagerness to obtain funds for a corporation whose securities are difficult to market, the employees' need of legal protection is very great. That such cases are rare ought not lightly to be assumed.

It is true that where an issue is made to a limited class such as stockholders, creditors, or employees, a registration statement will not have the effect which it normally has of establishing a general market price.[11] To require that a management which attempts to make such an issue shall place on file with the Commission a public statement of the important facts concerning the enterprise and shall incorporate the substance thereof in a prospectus issued to the class in question, will nevertheless act as a very effective deterrent against fraud and over-reaching. The construction which the Federal Trade Commission has placed upon

10. In suggesting a definition of "public offering" which would exclude offers to creditors, the committee presumably did not have in mind offers made to creditors in the course of a reorganization in equity or under Section 77B of the Bankruptcy Act, a matter it has dealt with elsewhere.

11. Public disclosure made in connection with an issue to stockholders will indirectly tend to establish a general market price where, as is usually the case with corporations of substantial size, the stockholders are given transferable rights which are traded in on the exchanges.

the words "public offering" may be undesirably vague and may result in making some useful transactions unduly expensive, but to insert in the Securities Act a definition of "public offering" which would exclude all offers to stockholders, creditors, or employees, however numerous or ill-informed, would not be to reform the existing vagueness but largely to defeat the purpose of the Act.

Amendments to Section Three

The committee recommends that subclause (9) of Section 3a, which exempts certain exchanges of securities, be broadened so as clearly to exempt securities issued to existing security holders in connection with a statutory merger or consolidation, and also to exempt securities of a buying corporation issued to security holders of a selling corporation in connection with a sale of the assets of the latter. Since the date of the committee's report, the Commission has issued a ruling to the effect that, under ordinary circumstances, such issues do not constitute "sales" within the meaning of the Securities Act and accordingly do not require registration.[12] Without questioning the correctness of this ruling as a construction of the existing Act,[13] it may well be doubted whether the result thus achieved is a desirable one. The law reports are unhappily full of cases in which mergers, consolidations, and sales of assets, grossly unfair in their terms to one of the corporations concerned or to some class of its security holders, have been attempted. Our law relating to sales of assets, which is in most states a much more common method of combination than statutory merger or consolidation, is based on the assumption that the managements of the buying and of the selling corpora-

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12. See Securities and Exchange Commission Release, No. 493, Sept. 20, 1935, relating to use of form E-1.

13. If such transactions were held to involve sales to stockholders which could not lawfully be made without prior registration of the securities, it would be necessary to determine when such sales take place. Where one corporation sells its assets to another for stock of the buyer which is issued to the seller and subsequently distributed by it to its stockholders, it would seem that the only part of the transaction which could with any show of reason be deemed a sale to the stockholders would be the final act of distribution. The issue to the selling corporation, although probably constituting a sale to it, would be an exempt transaction under § 4 of the Act unless the fact that subsequent distribution to the seller's stockholders was contemplated would make the transaction one involving a public offering. It would also be exempt under § 5 unless the mails or instrumentalities of interstate commerce were used. It would be difficult, therefore, to construe the Act as requiring registration and disclosure prior to the transaction between the two corporations. Conceivably the subsequent distribution by the seller of the buyer's stock might constitute a sale, but it would be of little value to the stockholder to require disclosure at that stage of the proceedings. It seems reasonably clear that, whatever construction be put upon it, the Securities Act in its present form does not furnish a workable method of requiring disclosure to stockholders who are asked to vote on a merger, consolidation, or sale of assets.

tions, trading at arm's length, make a tentative deal for the purchase by the buyer of the seller's assets, generally for shares of the buyer's stock to be distributed to the seller's stockholders.[14] This tentative proposition is then submitted to the seller's stockholders, who must approve it by vote of a majority or some larger percentage of outstanding shares. In the negotiations between managements, neither side has any right to information, but each has the trader's power of refusing to deal unless given a full statement of facts about the other's enterprise. When the matter has reached the stage where it is ripe for a vote by the seller's stockholders, these stockholders have, apart from their right to examine the books of their own corporation, no right to be informed of anything except the terms of the sale agreement, but they can in theory protect themselves by refusing to vote in favor of the sale unless their directors furnish them satisfactory data with respect to both corporations.

The actual situation is usually quite different from the theoretical one. In many, perhaps in most cases,[15] the prospective buyer acquires a working control over the prospective seller before the negotiations begin, which means that the officers and directors of the seller cannot be relied upon to safeguard its interests in those negotiations. If this control is carried far enough to give the buying corporation the necessary statutory majority in the selling corporation, no disclosure of any kind to stockholders is necessary. Even where this is not the case, the trouble and expense which stockholders would incur in an attempt to obtain adequate information is so great that they are generally obliged to vote on the transaction with only such data as the management of their corporation chooses to give them. Those stockholders who vote in favor of the sale are then bound by their assent, and, in the absence of an appraisal right which in many states does not exist,[16] those who dissent are also bound unless they can establish fraud in a suit in equity.

In cases in which the buying corporation was not in complete control of the seller, compulsory disclosure of the facts relating to both buying

14. Under most state laws, the proper practice would seem to be for the buyer's stock to be issued to the selling corporation, and for the latter corporation, after acquiring this stock, to hold a second stockholders' meeting to determine whether that corporation should be dissolved and the stock which it has acquired distributed to its stockholders. Finch v. Warrior Cement Corp., 16 Del. Ch. 44, 141 Atl. 54 (1928); Geiger v. American Seeding Machine Co., 124 Ohio St. 222, 177 N. E. 594 (1931). But cf. OHIO CODE ANN. (Throckmorton, 1934) §§ 8623-65. It is, however, a very common practice to issue the stock of the buying corporation directly to the stockholders of the selling corporation.

15. See Stone, J., dissenting, in Arrow-Hart & Hegeman Electric Co. v. Federal Trade Commission, 291 U. S. 587, 600 (1934).

16. In such important corporation states as Delaware and Michigan, for example, there is no right of appraisal where corporations are combined by sale of the assets of one for stock of the other rather than by statutory merger or consolidation. See Delaware Laws, 1929, p. 397, § 64A; MICH. COMP. LAWS (1929) §§ 10135-57.

and selling corporations would make it more difficult to obtain the necessary majority vote in favor of a sale where the terms were unfair. Even where the buyer owned or controlled the necessary majority of the seller's shares, such disclosure would still tend to prevent consummation of the deal by furnishing the minority with adequate data on which to base successful lawsuits. The states have thus far shown no tendency to enact legislation which is at all adequate to assure stockholders of the information which they need in connection with sales of assets or statutory mergers and consolidations. If it is legitimate for the federal government through the Securities Act to remedy the defects of state laws which cover other types of stock issues and to require disclosure in connection therewith, it would seem equally legitimate for it, either through amendment of the Securities Act or enactment of a separate statute, to remedy the defects in our state laws governing sales of assets, mergers, and consolidations by requiring similar disclosures in connection with such transactions. Incidentally, the effect of such a requirement of public disclosure might be to discourage many of such transactions which, although not injurious to the interests of existing shareholders in either corporation, are in other ways detrimental to the public interests.[17]

The committee also proposes an amendment of subclause (10) of Section 3a which would, if adopted, exempt from registration certificates of deposit issued in connection with a corporate reorganization carried out either through equity receivership or under Section 77B of the Bankruptcy Act. The present form of the clause exempts securities issued in exchange for those which are already outstanding where the terms and conditions of the exchange are approved by court or commission after a hearing.[18] In the case of equity and bankruptcy reorganizations, there is a court hearing with respect to the reorganization plan and the securities to be issued under it, but there is not ordinarily any court hearing with respect to certificates of deposit, which are issued as part of the machinery for mobilizing majority support in favor of a plan.

The committee's proposal to exempt such certificates from registration is based on the assumption that court approval of reorganizations in equity and under Section 77B furnishes an adequate safeguard for investors. Since it seems probable that most future reorganizations of corporations, other than railroads, banks, and insurance companies, will

17. Mergers, consolidations, and sales are frequently made the occasion for marking up assets and watering of stock. If this watered stock is distributed fairly among existing shareholders, the result may be to increase the market value of their shares, benefiting them temporarily at least, at the expense of subsequent purchasers and possibly, if the enterprise is a public utility operating or holding company, at the expense of consumers.

18. A somewhat ambiguous provision in subdivision (h) of Section 77B has been construed by the Securities and Exchange Commission in a manner which leaves this situation unchanged. Securities & Exchange Comm. Release, No. 296, Feb. 14, 1935.

be effected under Section 77B, the practical problem is one of the effectiveness of the judicial procedure under that section to safeguard security holders and creditors participating in a reorganization if the present requirement of registration of certificates of deposit were eliminated.

Section 77B gives the courts powers of a very broad character in connection with reorganizations. Although it is expressly provided in subdivision (b) that a creditor may act through a duly authorized agent or committee, the judge may

> "disregard any limitations or provisions of any depositary agreements, trust indentures, committee or other authorizations affecting any creditor acting under this Section and may enforce an accounting thereunder or restrain the exercise of any power which he finds to be unfair or not consistent with public policy, and may limit any claims filed by such committee member or agent to the actual consideration paid therefor."

Furthermore, although a duly authorized committee may assent to a reorganization plan on behalf of the stockholders or creditors whom the committee represents, the plan cannot be carried out unless the judge has found, after hearing such objections as may be made, that the plan is fair, equitable, non-discriminatory, and feasible. Subdivision (c) provides that any creditor or stockholder is entitled to be heard "on the proposed confirmation of any reorganization plan." This provision may conceivably be broad enough to entitle a creditor, who has previously become a party to a deposit agreement purporting to confer upon a committee an irrevocable power to assent to the plan on his behalf, to appear in opposition to the plan at the hearing. Subdivision (f) provides that the plan shall not be confirmed unless the judge finds that "all amounts to be paid to committees or reorganization managers . . . have been fully disclosed and are reasonable or are to be subject to the approval of the judge," and subdivision (c) (9) provides that the judge "may allow reasonable compensation for the services rendered and reimbursement for the actual and necessary expenses incurred in connection with the proceeding and the plan by officers, parties in interest, depositaries, reorganization managers and committees, or other representatives of creditors or stockholders, and the attorneys or agents of any of the foregoing and of the debtor." A recent amendment to subdivision (e) (1) empowers the judge to require the filing of information with respect to speculation in securities by committees and others who accept a reorganization plan.[19]

Although these powers appear on their face to be broad enough to give the judge a far-reaching control over the whole process of reorganization, they are limited in actual operation by the unavoidable tendency

19. See 49 STAT. 809 (1935).

of judges to assume that deposit agreements are fair, that committees are devoting themselves single-mindedly to protect the interests of their depositors, that fees are reasonable, and that reorganization plans are equitable, unless some security holder or creditor appears in court and directly challenges one or more of these assumptions. The judge has no administrative machinery which he can use for investigating questions of this sort, and the trustee, even when one is appointed, is ordinarily so absorbed in operating the business that any attempt to use him as the eyes of the court for looking into the activities of committees would be impracticable. Experience with equity receiverships strongly indicates that the ordinary security holder and creditor has such a feeling of helplessness and so great an unwillingness to throw good money after bad by making expensive investigations or indulging in expensive litigation that he will normally do whatever a committee with a reasonably impressive-sounding list of members asks him to do. Protests are made, if at all, only by small minorities who thus appear to the judge to be in the position of attacking what the majority want.

It is this situation rather than any lack of power on the part of equity courts that is responsible for many of the evils which have arisen in connection with equity reorganizations. Although our experience with reorganization under Section 77B has been short, there is reason to believe that the situation has been only slightly changed by the enactment of that section. It is true that dissenters can no longer be left out of a reorganization so that the pressure upon the individual claimant to deposit with a particular committee and thus join the majority has been considerably relaxed. It is true also that under the new procedure the judge is not as likely as he was under the old to wait until a majority of each class have deposited with a particular committee before passing on the merits of a reorganization plan, since subdivision (d) of Section 77B authorizes him to consider a plan approved by a certain percentage of creditors or stockholders, or proposed by the debtor, although the plan has not yet been accepted by a majority of any class. It still remains true, however, that the judge is not usually in a position to act for the protection of the security holders unless someone is objecting, and that where there are committees whose membership is such as to give them considerable prestige, the objections to anything which they have done will normally be made by relatively small minorities, if made at all. Furthermore, they will be made by minorities who, in the absence of legal requirements such as those now contained in the Securities Act for public disclosure by committees, will have great difficulty in finding out the facts.

The kinds of harm which may come to security holders and creditors from non-disclosure by committees who are soliciting deposit of securities are many and various. The members of the committee may, unkown

to the security holders, have such present or past connections with other parties concerned in the reorganization as to make them unfit representatives of the particular class of claimants whose claims they are seeking to have deposited with them. Unknown to the intending depositors, the committee may have prevented them from getting impartial advice as to the desirability of depositing by offering a commission on deposits obtained to such persons as brokers and local security dealers, to whom the investor is likely to turn for advice. The deposit agreement may contain provisions not easily detected or understood by the ordinary investor which may confer upon the committee unreasonable powers, unfair immunities, and excessive remuneration.[20]

The Securities Act, and the form for registration of certificates of deposit which the Securities and Exchange Commission has evolved pursuant to the provisions of the Act[21] attack this problem directly by requiring disclosure of facts which the investor may need to know about the committee, the deposit agreement, the progress of the reorganization, and the corporation to be reorganized. If certificates of deposit were exempted from the requirements of the Securities Act, the dangers resulting from misrepresentation and non-disclosure by committees could be dealt with only indirectly. Subject only to the ordinary law of fraud, committees would be able to say what they please, and to conceal as much as they please from the security holders whom they seek to represent. Judges would then be expected to exercise their powers in such a way as to prevent committees who had secured deposits by unfair means from abusing their powers and from injuring the security holders either by misconduct or lack of zeal.

Even if efficient administrative machinery for investigating the facts relating to reorganizations should be provided and courts thus no longer be compelled to rely almost entirely on such facts as may be brought to light by a few militant dissenters, the exemption suggested would be unjustified. Investors would still have much reason to contend that they are entitled to know enough facts to enable them to determine intelligently for themselves whether or not to authorize a committee to represent them by means of a deposit of securities with it, and that the paternalistic efforts of a court or an administrative body to see that their deposits,

20. Lowenthal, *The Stock Exchange and Protective Committee Securities* (1933) 33 Col. L. Rev. 1923; cf. Dodd, *Reorganization through Bankruptcy: A Remedy for What?* (1935) 48 Harv. L. Rev. 1100.

21. Form 14. The Interstate Commerce Commission, acting under the broad powers conferred upon it by the amended Railroad Reorganization Act, 48 Stat. 912, 11 U. S. C. A. § 205p (1934), has recently issued regulations requiring protective committees and others who solicit proxies or deposits in connection with railroad reorganizations to file with the Commission detailed information somewhat similar to that called for by Form 14. See N. Y. Times, Oct. 29, 1935, p. 34.

made in ignorance of many important facts, should do them no harm, are an unsatisfactory substitute for their own opportunity to make an intelligent decision.[22] Under the present state of things, protection of the investor's interests even more clearly requires that the law insist upon adequate disclosures by committees. Careful scrutiny of the form which the Commission has adopted for registration of certificates of deposit does not, to the writer at least, indicate that the disclosures required are unduly burdensome or expensive, or unreasonably inquisitorial. A desire to make reorganizations quick, easy, and inexpensive is a laudable one, but there is little reason to believe that these objects are seriously interfered with by requiring the present form of registration statement from committees soliciting deposits.[23]

In fact one may go further and insist that the real objection to the Securities Act as applied to reorganizations is not that it gives the Commission too much control over certificates of deposits and other similar instruments, but too little. As the Act now stands, certificates of deposit are exempt from registration where there has been a judicial hearing at which the terms and conditions on which the certificates are to be issued have been found to be fair. Furthermore, such documents as powers of attorney or proxies which accomplish much the same purpose as certificates of deposit but are not technically securities are also exempt from registration. The dangers to investors which result from such exemptions have been discussed elsewhere.[24]

Amendments to Section Eleven

The next important group of recommendations made by the committee relate to Section 11, which deals with civil liabilty for errors and

22. There are those who would go even further in the direction of governmental paternalism than is here suggested and would abolish committees altogether and vest plenary powers over reorganizations in some federal administrative agency, with provisions for judicial review. The assumption that the interests of security holders and creditors would receive better protection from a bureaucracy, probably underpaid and politically appointed, than from committees whose members may be, and often are, substantial holders of the class of claims which they represent, seems to the writer to be wholly unwarranted. Cf. Douglas, *Protective Committees in Railroad Reorganizations* (1934) 47 HARV. L. REV. 565, 583. Nor is the argument that the general public, as well as existing creditors and stockholders, has interests in reorganizations which deserve protection particularly persuasive in the case of the smaller enterprises whose existence could be terminated without serious public inconvenience.

23. Section 211 of the Securities Exchange Act, 48 STAT. 909, 15 U. S. C. A. § 78jj (1934), directs the Commission to make a study of protective and reorganization committees and report the results of its studies and its recommendations to Congress on or before January 3, 1936. Clearly, no amendment of the Securities Act which would exempt certificates of deposit issued by such committees should be adopted until the Commission has made its report.

24. See Dodd, *supra* note 20, at 1120 et seq.

omissions in the registration statement. The section in its present form imposes liability if 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." The Act is thus aimed at three kinds of statements, those which are directly false, those which are incomplete by reason of the fact that they omit something which the Securities Act requires to be stated, and those which are incomplete in the sense that the omission of certain facts renders the statements actually made misleading, although literally true. In any case, however, there is no liability unless the statement or omission was sufficiently important to be material.

The committee suggests the substitution of language found in Section 18*a* of the Securities Exchange Act imposing liability for a statement which "was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact." The change suggested would apparently have three consequences. In the first place it would make it clearer than it is at present, that the materiality and the misleading character of statements should be judged as of the time when they were made. This date would apparently be either the date when the registration was filed or the date when it became effective. In the second place it would apparently limit the liability, which now exists for omission of material facts required to be stated, to cases in which such omissions rendered misleading the statements actually made. Finally, it would change the form and possibly slightly change the substance of the provision relating to omissions of facts which are not expressly required to be stated, but are necessary in order to prevent the statements from being misleading. These three points require separate treatment.

With respect to the first point, it may be assumed that no liability ought to be imposed on anyone for a misrepresentation in a registration statement about a fact which no reasonable man would have regarded as important at the date on which the particular plaintiff purchased his securities. Even if the representation was fraudulently made and subsequent events made the misstated fact unexpectedly important, the statement could hardly have been, even indirectly, the inducing cause of the plaintiff's purchase. To impose liability would, therefore, be punitive, not compensatory. It is less obvious that there should be no liability where the misstatement, apparently unimportant when made, becomes important by reason of events which occur between the making of the registration statement and the plaintiff's purchase of securities. Persons who know that their statements are false might well be held to run the risk that they may become material before they are acted on. However, since the Act imposes liability for negligence as well as for fraud, places

the burden on the defendants to prove due care, and does not require reliance by the plaintiff, it may be unduly harsh in both situations to permit recovery for misstatements which were unimportant when made. But to assume that the Act will be construed in such a manner as to determine materiality as of some later date, although it expressly creates liability only where some part of a registration statement contained a material untruth "when such part became effective,"[25] is to assume a perverse desire on the part of judges to distort the normal meaning of words in order to reach an unreasonable result.

With respect to the second point, it should be noted that Congress has made it the statutory duty of issuers of securities and persons associated with them to give investors, through the registration statement and the prospectus,[26] the specific information called for by Schedule A of the Act. Thus, except in cases in which the Securities and Exchange Commission requires the inclusion in the registration statement of additional information not contained in Schedule A,[27] the omission of any fact required to be stated means the omission of some fact which Congress has specifically declared to be one about which investors are entitled to be informed. Section 11 in its present form provides that, if the fact so omitted is material, any investor who has suffered damage may recover in the absence of proof that the omission was not the cause of his injury. Liability is thus imposed for a material breach of a clearly defined statutory duty resulting in damage.

Under the committee's suggested amendment, on the other hand, there could be no recovery even where such an omission related to a material fact unless it could be further shown that the omission made the statement false or misleading. Obviously, such a change would substantially weaken the protection given to investors. To take a single illustration, one of the requirements of Schedule A is that the names of all persons

25. As a general rule, a registration statement becomes effective on the twentieth day after filing. See Section 8 of the Securities Act.

26. Under Section 5b of the Act, registered securities cannot be sent through the mails or in interstate commerce for purposes of sale unless accompanied or preceded by a statutory prospectus. Under Section 10 of the Act, such prospectus must in general contain all the statements made in the registration statement, although the Commission has some power to expand or contract the prospectus.

27. Section 7 provides that the registration statement shall contain such other information, not contained in Schedule A, "as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors." Schedule A requires so much information that it is unlikely that the Commission will ever require more, except where the security is of such a peculiar type that the provisions of Schedule A are not well suited to it.

Section 7 also authorizes the Commission by rule or regulation to authorize the omission from the registration statement of any information if it finds, with respect to any class of issuers or security, that such information is inapplicable to such class and that adequate disclosure may be made without it.

owning more than ten percent of the issuer's stock be given. One can readily conceive of a case in which stock control of the issuer might be in a person whose reputation was such that no prudent investor would risk funds in any enterprise dominated by him. Under these circumstances omission to state the stock holdings of such person would plainly be material, and yet it could hardly be said that such an omission would make the remainder of the registration statement—which is composed largely of such matters as balance sheets and income statements—false or misleading.

It is true, as the committee points out, that the phraseology which it suggests has been adopted in the civil liability section of the Securities Exchange Act. That is no reason for incorporating it into the Securities Act, however, unless it can be shown that, as applied to the particular problem involved in the latter act, the much weaker rule of liability established by the Securities Exchange Act is more just than the rule now embodied in the Securities Act. Whether the Securities Exchange Act rule is a sound one as applied to the quite different situation presented by that Act is another question which need not be dealt with here.[28]

The third point concerns the other type of omission—omission of facts not specifically required to be stated but necessary to prevent the statements made from being misleading. Such omissions are dealt with in the Securities Exchange Act by imposing liability for misleading statements, and in the Securities Act by imposing liability for omissions which make statements misleading. The two provisions are very similar. The committee may be right in thinking that the language of the Securities Act gives a shade more encouragement than that of the other act to a court which might desire to give the Act a broad interpretation. If so, one's choice between the two forms of words will naturally be determined by whether one feels that the judicial tendency is likely to be to extend

28. The section in question, Section 18 of the Securities Exchange Act, 48 STAT. 897, 15 U. S. C. A. § 78r (1934), imposes liability for misrepresentations "in any application, report, or document filed pursuant to this chapter." This would seem to include registration statements filed by security exchanges under § 6, applications for registration of securities on an exchange under § 12, periodical reports of issuers under § 13, solicitations of proxies under § 14, statements of stock ownership by directors and others under § 16, and reports by brokers and others under § 17. The scope of these various statements is left largely to the judgment of the Commission so that no one has a statutory right to any particular form of statement. Under such circumstances, it may not be unreasonable for Congress to prescribe a milder form of liability than that provided where, as will usually be the case under the Securities Act, the omission relates to information which Congress has specifically determined ought to have been given to the investors. In any case the point at issue is whether the existing provision in the Securities Act is too severe, not whether the existing provision of the Securities Exchange Act is too lenient.

liability for literally true but misleading statements too far or to contract it unduly.

A more important recommendation by the committee is its advocacy of the proposition vigorously but unsuccessfully pressed on Congress at the time of the amendment of Section 11 in 1934, that liability for unintentional false statements should be limited to cases in which the plaintiff can prove reliance. The present section does not require reliance on the registration statement, regardless of whether the misstatement therein was fraudulent or merely negligent, with the exception that such reliance must be proved if, prior to the plaintiff's acquisition of the security, the issuer had made generally available to its security holders an earning statement covering a period of one year beginning after the effective date of registration.

The committee suggests that reliance be required except in cases of actual fraud, but that reliance be defined "in such manner as to protect one who indirectly relies upon false and misleading statements, as, for example, one who relies upon the advice of another who has actually relied upon a false or misleading statement contained in the registration statement, or one who relies upon false or misleading statements contained in a prospectus, which false or misleading statements were also contained in substance in the registration statement."

As indicated at the beginning of this article, however, a large and important class of security holders which the law ought to protect, if it can do so without undue hardship to security distributors, is that class which relies neither on careful perusal of registration statements or prospectuses or on the advice of those who have perused such statements, but rather on the fact that the securities in question are known to be selling readily at a particular market or public offering price. The connection between the effect produced upon a small portion of the public by actual knowledge of particular portions of a registration statement, and a subsequent much more widespread public impression that a certain newly-issued security is a desirable purchase at a certain price, is likely to be substantial and yet practically impossible to prove. Unless, therefore, the law assumes, as Section 11 of the Securities Act does, that such connection exists, a large number of persons who have in fact been injuriously affected by the defendant's untrue statements will be denied recovery, in the absence of proof that the statements were made fraudulently.

On the other hand, it is probably true that, by assuming such connection, the Act will enable some persons to recover for statements which, though substantial enough to be deemed material, have not in fact seriously affected the market in which the plaintiffs bought. Whether the class that will thus be able to recover, even though they have probably not been injured by the defendant's act, will be large or small will depend to some extent upon the interpretation of the word "material."

Vitally important statements inevitably affect the markets; but there is considerable likelihood that some statements which will seem material to a judicial mind have not, in fact, had any appreciable effect upon the market.[29] Nevertheless, it seems safe to predict that the present omission of the requirement of reliance from this section will permit many more deserving than undeserving plaintiffs to recover.

The committee makes two recommendations with respect to the damages recoverable under this section. The first is that the liability of an underwriter should be limited to "damages with respect to a total amount of securities equal to the amount of the portion of such securities underwritten by him and distributed by him to the public." Under the Act as it now stands, the underwriter is not to be held liable "for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public." The suggested change has a double aspect: it would reduce the liability of all underwriters wherever the total damages suffered by investors are less than the total issue price of the security, and it would exempt altogether an underwriter who distributed no securities to the public.

To take up the second point first, unless it be assumed that the committee's phrase "distributed by him to the public" would be construed to include wholesale as well as retail distribution, the suggested change would exempt those large underwriters who sell wholly through other underwriters or dealers—an exemption which is so plainly undesirable that it may be assumed that the committee did not intend to advocate it. Even if the phrase does include wholesale distribution, the effect would still be to exempt English type underwriters wherever such underwriters were not called upon to take up any of the securities underwritten by them. The question whether underwriters of that type should be exempt has already been discussed.

Furthermore, the value of the first part of the suggested change is debatable. Under the Act as it now stands, if ten thousand shares were sold at a public offering price of $100 a share, or $1,000,000 in all, and a particular underwriter sold one tenth of these, the maximum liability

29. In an opinion dated March 21, 1934, relating to the issuance of a stop order against the Bondholders' Protective Committee for Cambridge Apartments, the Federal Trade Commission defined a material fact, in accordance with the view taken in certain English cases cited by it, as "a fact which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question." According to this definition, the Act reaches only misrepresentation or concealment of facts which would, in the opinion of the tribunal, have been calculated to affect the market. This is not quite the same thing as saying that the misrepresentation or concealment did in fact affect the market. It should be noted, however, that, as indicated below, no recovery can be had under § 11 even for a material misstatement if the defendant proves that it was not the cause of the subsequent depreciation in the value of the security.

of such underwriter would be $100,000, and he might be sued for that amount even though the total damages suffered by all those who invested in the shares did not exceed $100,000. The proposed amendment appears to make it legally impossible for the holders of more than one tenth of the total number of securities issued to sue him. In view of other provisions of the Act, these plaintiffs would recover much less than $100,000[30] in any case in which the shares sold had a substantial value in spite of the misrepresentation.

The effect of the existing provision is to limit the liability of any one underwriter to the entire body of investors, to the amount which he would have received if there had been no spread between the price which the underwriter charged the retailer and the price which the public paid to the latter. The fact that the damage suffered by those who were directly or indirectly the underwriter's vendees may have been much less than the amount for which their shares were issued is treated as irrelevant. The rule adopted is thus a compromise between a rule which would treat all underwriters as joint adventurers and make each one liable for the entire loss, and the committee's suggested rule which would seek to limit the liability of each to the damages applicable to the shares which he distributed. In view of the fact that the Act allows persons who become liable to sue one another for contribution (except where the one seeking contribution was fraudulent and the other was not), it is by no means clear that the compromise is an unreasonable one.

The committee recommends a further amendment of Section 11 which would put the burden on the plaintiff of proving that the damages which he has suffered through a decline in the value of the purchased security were caused by a misrepresentation or omission in the registration statement, instead of putting the burden on the defendant to prove that some portion of the damages suffered was due to other causes. As indicated earlier in this article, an attempt to separate that portion of a plaintiff's damages which results from the defendant's misrepresentation from that which results from other causes will in many cases prove extremely difficult, if not absolutely impossible. An enterprise may have a serious inherent weakness which is concealed or misrepresented in the registration statement. This weakness may be one of a number of factors, the combined effect of which is to cause the enterprise to collapse or to operate so unsuccessfully as to bring about very serious depreciation in the market value of its securities. A rule which placed the burden of distinguishing between damage due to the misrepresentation and damage due to other causes upon the plaintiff would, because of his inability

30. Section 11 (g) provides that the amount recoverable shall in no case exceed the public offering price. Where the securities were bought at that price and still have some value, the amount recoverable would be less than that price.

to prove the amount of the first type of damages, inevitably leave remediless some plaintiffs who undoubtedly suffered damage because of the defendant's misrepresentation. On the other hand, the rule now embodied in the section, which places the burden on the defendants, will in some cases enable plaintiffs who are lucky enough to discover material misrepresentations in the registration statement to recover losses which are in all probability due largely to other causes but which cannot definitely be proved to be due to such causes.

It is doubtful whether it will be, as a general rule, any easier for defendants to prove what portion of the damages is due to other causes than it would be for plaintiffs to prove what portion of the damages is due to the misrepresentation, so that the usual basis for placing the burden of proof upon defendants—the fact that the evidence on a particular issue is likely to be more accessible to them than to the plaintiffs—seems inapplicable. It should be borne in mind, however, that the defendants have by hypothesis circulated in the most public manner possible a material misrepresentation, and that even though no proof of reliance thereon by the plaintiff is required, the probability is that this misrepresentation has directly or indirectly been influential in inducing the plaintiff to buy, or at any rate in inducing him to buy at an inflated market price. Plaintiff, on the other hand, is entirely innocent, and if a choice must be made between leaving him without a remedy and allowing him to recover in full for a loss which was probably due only in part to the defendant's act, it seems fairer on the whole to run the risk of some plaintiffs' recovering too much than to make it impossible for many deserving plaintiffs to recover anything. It is not without significance that, even at common law, the New York Court of Appeals has held that where the collapse of a corporation whose bonds the plaintiff had bought was due to the combined effect of an inherent weakness in the enterprise, which was misrepresented by the seller of the bonds, and of other causes, the plaintiff should be allowed to recover for his entire loss.[31]

It should be noted in this connection that even when the failure of the enterprise is due chiefly to causes unconnected with the misrepresentation, the plaintiff's entire loss may in a sense be caused by that misrepresentation, inasmuch as the misrepresentation may have been the primary factor in inducing the plaintiff to buy and to continue to hold the security. In instances in which this can be proved to have been the case, there is a good deal to be said in favor of allowing the plaintiff to recover his entire loss even though the defendant can prove that a definite portion of the shrinkage in value of the securities was due to other causes.[32] Section 11 as now phrased contains a provision "that if the

31. Hotaling v. A. B. Leach & Co., Inc., 247 N. Y. 84, 159 N. E. 870 (1928).

32. For cases allowing full recovery under such circumstances in an action of deceit see Fottler v. Moseley, 179 Mass. 295, 60 N. E. 788 (1901) (misrepresentation inducing

defendant proves that any portion or all of such damage represents other than the depreciation in value of such security resulting from such part of the registration statement, . . . not being true . . . , such portion of or all such damages shall not be recoverable." This language would seem to relieve defendants from a portion of their liability in the case supposed, since part of the plaintiff's damages will have been proved to have been due to causes other than depreciation in value resulting from the untruth. Thus the section in the present form, although imposing a severe burden on defendants, will exempt them from liability under some circumstances in which liability might not unreasonably be imposed.[33]

If the provisions of Section 11 with respect to reliance, burden of proof, and damages in actual operation enable many investors to recover for losses which are not in fact the result of any fraudulent or negligent error or omission in a registration statement, the fault is not likely to be due to any unsoundness of the provisions of the section as abstract legal propositions. It is more likely to be attributable to the inability of judges, and more particularly juries, to administer fairly and intelligently an act which places such heavy burdens of proof on classes of defendants, who in the majority of cases will probably be persons of greater wealth than the plaintiffs. In personal injury cases, defendants who are believed by juries to be rich—and, *a fortiori*, defendants who are believed to be insured—are, despite their superior ability to hire able lawyers, probably on the whole at a disadvantage when sued by relatively unprosperous plaintiffs. It may be that juries will develop undue partisanship in favor of plaintiffs suing under Section 11, but the fact that the latter claim to have suffered in pocketbook alone and not in body makes the analogy to personal injury suits too imperfect to be helpful. In the absence of adequate grounds for predicting that the Act will be unfairly administered, one may reasonably assume that the tribunals which administer it will be impartial, and judge the soundness of its provisions on the basis of that assumption.

plaintiff to cancel order to sell stock—plaintiff entitled to recover for any depreciation in value occurring while the misrepresentation continued to operate as an inducement to holding the stock); Smith v. Duffy, 57 N. J. L. 679, 32 Atl. 371 (Ct. Err. & App. 1895) (misrepresentation inducing purchase of stock—similar result).

33. Section 11 is perhaps even more important for the pressure which it puts on corporate executives, directors, and underwriters to be honest and careful in stating facts in a registration statement than for the relief which it gives to purchasers who have suffered by reason of misstatements and omissions. It may be doubted, however, whether the changes which the committee suggests would so weaken the Section that it would no longer operate as an effective deterrent to fraud or negligence. The objection to those changes is rather that stated in the text, that they would deny relief to many plaintiffs who are fairly entitled to it.

Amendments to Section Twelve

The committee's report also suggests several amendments to Section 12. That section imposes liability upon all sellers of securities, including securities exempted from the registration provisions of the Act, in favor of persons purchasing directly from them. No liability exists unless the sale has been made by the use of some instrumentality of interstate commerce or of the mails and has also been made "by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." The purchaser may, under such circumstances, tender the security if he still has it, and recover the consideration paid with interest, or may recover damages if he no longer owns the security.

The most important of the committee's suggestions are that reliance by the purchaser be required, and that the damage provision be modified. The argument in favor of requiring reliance is much more persuasive with respect to this section than with respect to Section 11. A defendant who is sued under Section 12 may be a small local dealer whose misrepresentations have had no effect on the general market but have harmed only those purchasers from him who relied upon them. Under the present form of this section, a plaintiff must indeed prove that he bought from the defendant and that the sale to him was made by means of a prospectus or oral communication which included a material falsehood. It is not altogether clear, however, that he must prove that he bought in reliance upon that falsehood. If he did not do so, there is no adequate ground of policy for permitting him to recover. The committee is right, therefore, in insisting that the Act would be improved by a specific requirement of reliance. However, the courts are accustomed to requiring reliance in cases of misrepresentation, and, although the language of Section 12 is somewhat ambiguous, the prospect that courts will permit recovery in the absence of reliance seems remote.

With regard to the damage provision, the committee suggests that the plaintiff be required to sustain the burden of proof that the damage resulted from the falsehood. The objections to placing this burden of proof upon plaintiffs are substantially the same under this section as under Section 11. Nevertheless, something may be said for confining a rule about burden of proof, which contains a considerable element of harshness on defendants, to those who take part in the original creation of the securities and for exempting mere retail dealers from that burden, at least in cases in which the latter have been guilty of negligence rather than of fraud.

The committee also suggests that maximum damages in cases in which

the plaintiff no longer owns the security be limited to the amount which the plaintiff paid for it. The existing section adopts that limitation where the plaintiff still has the security and is in a position to return it, but lays down no rule for ascertaining damages where the plaintiff has parted with it. If, in the absence of any statutory provision, the analogy of the federal rule in deceit were to be followed in the latter case, damages could rarely, if ever, exceed the amount which the plaintiff had paid.[34] On the other hand, it is probably the law that in an action for breach of warranty a plaintiff who paid $100 for a security which was worth nothing, but which would have been worth $150 if the warranty on which he relied had been true, can recover $150. If this be so, the breach of warranty analogy might in some cases lead to the curious result that a plaintiff could increase his measure of damages under Section 12 by parting with his security. Such a situation would rarely arise, however, and, if it did, it is unlikely that the court would permit the recovery of more than $100 under the section as it now stands.

Amendment to Section Nineteen

The committee suggests that the provision of Section 19a, which exempts from liability persons who rely in good faith on any rule or regulation of the Commission, be broadened so as to give the same protection to persons who rely upon an opinion in writing of counsel for the Commission. As the committee points out, many questions of great importance to security distributors are not covered by any regulation of the Commission but only by opinions of the Commission's counsel. This suggestion of the committee would appear to be a desirable reform.

Amendment to Section Twenty-two

The report also recommends that cases arising under the Act should be subject to removal from state to federal courts in the same manner as most other cases arising under federal laws. Section 22a of the present Act follows the precedent set by the federal Employer's Liability Act in denying removal. The principal objections to permitting removal is that there are a relatively small number of federal trial courts, and that to allow defendants to remove all cases to the federal courts would enable them in many instances to remove the case to a point remote from the plaintiff's home and inconvenient for him. It may be doubted, how-

34. For the federal rule in deceit see Smith v. Bolles, 132 U. S. 125 (1889). There is some tendency to adopt a similar rule in actions for breach of warranty, but perhaps most of the federal courts would agree that in such an action the plaintiff is entitled to measure his damages by the value which the property would have had if the representations had been true and that the price which he paid or agreed to pay is merely evidence of such value. Johnston Mfg. Co. v. Wilson Thread Co., 269 Fed. 555 (C. C. A. 4th, 1920). See WILLISTON, SALES (2d ed. 1924) § 613.

ever, whether a provision for removal of cases arising under the Act would often have the effect of transferring the litigation to a point farther away from the plaintiff's home. Under conditions which prevail in the business of security distribution, most of the persons who will be suable under Section 11 with respect to misrepresentations in the registration statement, and a very large proportion of those who will be suable under Section 12 for misrepresentations in sales of securities made by them, will reside in or near the larger cities and will not, except by accident, be subject to service of process elsewhere. There are few large cities in the United States which do not have a federal district court. It may be doubted, therefore, whether a provision for removal would seriously inconvenience plaintiffs. It would have the indubitable advantage of reducing somewhat the chances of a lack of uniformity in the construction of the Act. Each of the ten Circuit Courts of Appeals could establish substantial uniformity within its circuit, and there is perhaps a stronger tendency on the part of such courts to follow one another's decisions than is the case with state courts of last resort.[35] There is something to be said also for the proposition that, in the country as a whole, the federal district courts are more competent to deal fairly and intelligently with litigation of this type than are the state trial courts. The suggested amendment is therefore probably desirable, but hardly of major importance.

Readers of this criticism of the committee's report will probably feel that the writer has given greater emphasis to the harm which might come to investors through amendment of the Act than to the hardships imposed upon distributors of securities by the severity and vagueness of some of its provisions. Emphasis has, in fact, been designedly put on the investor's side of the case. The committee report, although not wholly ignoring the investor's needs, approaches the problem primarily from the standpoint of persons engaged in the business of security distribution. Where provisions of the Act seem harsh or inconvenient when viewed from the distributor's standpoint, the report recommends that these provisions be modified, with little or no attempt to envisage the possible injury to investors which might result from such modification. Its purpose is to persuade the organized body of American lawyers, and through that body the public at large, that justice to security distributors requires that the Securities Act be radically amended. The primary purpose of the present article is to insist that justice to security purchasers requires that no safeguard which the Act now provides for investors be removed until the possible injury to them which such removal might bring about has been thoroughly canvassed.

35. Regardless of whether cases are tried in the state or in the federal courts, the unifying influence of the Supreme Court of the United States will be limited both by the cost of appeals to Washington and by the unwillingness of that court to grant certiorari except in cases involving what it regards as important questions of law.