CONTRACTUAL SHIFTING OF DEFENSE COSTS IN PRIVATE OFFERING SECURITIES LITIGATION

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It is a folly to expect men to do all that they may reasonably be expected to do.

—R. Whately*

Federal securities regulation exists primarily to reduce fraud in the sale of securities through disclosure of all material facts in a manner least disruptive to capital formation.[1] This purpose is implemented through the disclosure,[2] registration,[3] and antifraud[4] provisions of the Securities Act of 1933,[5] the Securities and Exchange Act of 1934,[6] and the rules and regulations promulgated by the Securities and Exchange Commission ("SEC"). To enforce the 1933 and 1934 Acts, Congress and the judiciary have created express[7] and implied[8] civil causes of action to penalize those who sell securities with materially false or misleading statements or omissions.

Congress, however, also recognized that varying degrees of investor knowledge existed[9] and that the costs to issuers of compliance with the

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[1] *See* President's Message to the Senate Concerning Regulation of Securities Issues, 77 CONG. REC. 937 (1933) [hereinafter President's Message]; H.R. REP. No. 85, 73d Cong., 1st Sess. 1-4 (1933); Preamble to the Securities Act of 1933, ch. 38, 48 Stat. 74; R. JENNINGS & H. MARSH, SECURITIES REGULATION 38 (6th ed. 1987); L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 35-38 (1983) [hereinafter L. LOSS, FUNDAMENTALS]; 1 L. LOSS, SECURITIES REGULATION 123 (2d ed. 1961); Gadsby, *Historical Development of the S.E.C.—The Government View,* 28 GEO. WASH. L. REV. 6, 9 (1959).

[2] Securities Act of 1933 §§ 6-8, 10, 15 U.S.C. §§ 77f-h, j (1982) [hereinafter 1933 Act].

[3] *See* 1933 Act § 5, 15 U.S.C. § 77e (1982); *see also* R. JENNINGS & H. MARSH, *supra* note 1, at 39-40.

[4] See 1933 Act §§ 11-12, 17, 15 U.S.C. §§ 77k, *l,* q (1982); Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1982) [hereinafter 1934 Act].

[5] 1933 Act, 15 U.S.C. §§ 77a-aa (1982 & Supp. III 1985).

[6] 1934 Act, 15 U.S.C. §§ 78a-hh (1982 & Supp. III 1985 & West Supp. 1987).

[7] *See* 1933 Act §§ 11-12, 15 U.S.C. §§ 77k, *l* (1982).

[8] 1934 Act § 10(b), 15 U.S.C. § 78j(b) (1982); Rule 10b-5, 17 C.F.R. § 240.10b-5 (1987) [hereinafter Rule 10b-5], *see also infra* notes 112-20 and accompanying text.

[9] *See* H.R. REP. No. 85, 73d Cong., 1st Sess. 8-9 (1933); Landis, *The Legislative History of the Securities Act of 1933,* 28 GEO. WASH. L. REV. 29, 37-38 (1959); *see*

registration provisions of the securities laws were high.[10] Consequently, it carefully drafted a scheme of exemptions from the registration requirements. Through the private offering exemption, section 4(1) of the 1933 Act,[11] and the civil liability provisions of section 12 of the 1933 Act,[12] Congress achieved a balance between the rights of knowledgeable purchasers and those of private offering issuers.[13]

The SEC, in response to the exhortations of Congress and securities law commentators,[14] developed Regulation D as a "safe harbor" for issuers claiming an exemption from registration.[15] Under Regulation D, the issuer obtains certain representations from the potential purchaser, or "offeree," to fulfill the requirements of the safe harbor. An issuer shields itself from potentially strict liability, imposed by section 12(1) of the 1933 Act,[16] by obtaining warranties from the offeree covering her "suitability" for the offering and representations that she has read and understands the disclosure with which she was provided. To reduce the costs of potential section 12(1) actions instituted by purchasers, the issuer enters into an indemnity agreement with each purchaser to protect itself from the costs of defending a lawsuit that fails to establish a securities law violation.[17] The indemnity agreement is designed to hold the private offering investor to her representations. It also notifies the investor of the potential for a breach of warranty counterclaim should she initiate a fraud action and then expressly repudiate her warranties.

This Comment argues that the development of the private offering exemption and the statutory structure of the antifraud provisions of the federal securities laws permit an issuer to enforce such an indemnification agreement in limited circumstances. The indemnification may be structured to provide reimbursement by contract for the costs of defending a fraud action that fails to establish a violation of securities law by

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also infra notes 37-48 and accompanying text (varying degrees of sophistication among investors is the basis for exempting certain securities).

[10] *See* L. LOSS, FUNDAMENTALS, *supra* note 1, at 337-40; *see also* W. PRIFTI, SECURITIES: PUBLIC AND PRIVATE OFFERINGS § 4:02 (rev. ed. 1983) ("A private offering under the federal rules can be handled . . . with less expense" than a public offering.).

[11] 1933 Act § 4(1), 15 U.S.C. § 77d(1) (1982).

[12] 1933 Act § 12, 15 U.S.C. § 77*l* (1982).

[13] *See* Landis, *supra* note 9, at 37-38.

[14] *See infra* notes 67-74 and accompanying text.

[15] Regulation D is the common name for a series of rules promulgated by the SEC in 1982 and is designed to provide a uniform private offering exemption. 17 C.F.R. §§ 230.501-.506 (1987); *see also* Securities Act Release No. 6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982).

[16] *See infra* text accompanying notes 100-02.

[17] *See* Zissu v. Bear, Stearns & Co., 805 F.2d 75, 76-77 (2d Cir. 1986).

the defendants. The enforcement of such contracts, moreover, furthers the public policies behind the private offering exemption and the antifraud provisions.

Part I of this Comment details the development of the private offering exemption and the sliding scale liability provisions of the 1933 and 1934 Acts. Part II analyzes the attorneys' fee shifting provisions of federal securities law[18] and the problems faced by a private offering issuer in a modern strike suit when a court applies a "bad faith—frivolous claim" standard to determine if a plaintiff should pay the fees of the issuer's attorneys.[19] Part III then argues that a properly drafted indemnification provision should be enforced in limited circumstances to further the design and policies of federal securities law.

I. THE DEVELOPMENT AND SCHEME OF THE PRIVATE OFFERING EXEMPTION AND THE ANTIFRAUD STATUTES

Although calls for federal regulation of corporations date back to 1885,[20] regulation by individual states of corporate securities, in the guise of "blue sky" laws "with teeth," first appeared as early as 1911.[21] Comprehensive attempts to regulate the issuance and sale of securities by the federal government were not successfully enacted until after the Great Crash of 1929, amidst the ensuing Great Depression.[22] In the tradition of blue sky regulation,[23] the first proposals for federal regula-

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[18] *See* 1933 Act § 11(e), 15 U.S.C. § 77k(e) (1982); 1934 Act §§ 9(e), 18(a), 15 U.S.C. §§ 78i(e), r(a) (1982).

[19] *See Zissu,* 805 F.2d at 80 (plaintiff's failure to support his claims, contradictory testimony, jury findings of credibility, and plaintiff's concededly sophisticated background support finding of frivolous claim, meritless suit, and bad faith conduct of litigation); Weil v. Investment/Indicators, Research & Management, Inc., 647 F.2d 18, 22 (9th Cir. 1981) (undertaking need not be based on formal finding that claim or defense is obviously without merit or asserted in bad faith; only required that court, in view of evidence before it, reaches "an eventual finding" of bad faith or lack of merit); Jackson v. Oppenheim, 533 F.2d 826, 831 (2d Cir. 1976) (record on appeal must support fee award when securities law claims were frivolous or brought in bad faith); LeMaster v. Bull, 581 F. Supp. 1170, 1173 (E.D. Pa. 1984) (fees only available when court finds claim or defense was "without merit" and court must make "specific finding that the suit or the defense was meritless or otherwise frivolous"); Straus v. Holiday Inns, Inc., 460 F. Supp. 729, 732-34 & n.2 (S.D.N.Y. 1978) (award of attorneys' fees may be based on either finding of bad faith in commencement of action or determination that plaintiff's claim "borders on frivolous").

[20] *See* UTILITY CORPORATIONS, S. DOC. NO. 92, pt. 69-A, 70th Cong., 1st Sess. 3 (1934); L. LOSS, FUNDAMENTALS, *supra* note 1, at 31.

[21] L. LOSS, FUNDAMENTALS, *supra* note 1, at 8 (Kansas was the first state to pass such laws.); *see also* Mulvey, *Blue Sky Law,* 36 CAN. L. TIMES 37 (1916) (describing and sharply criticizing American blue sky laws).

[22] *See* L. LOSS, FUNDAMENTALS, *supra* note 1, at 29; Landis, *supra* note 9, at 30.

[23] "[T]he term 'blue sky law' first came into general use to describe legislation

tion evolved around determinations of the true "merit" of the securities offered to the investing public.[24] However, the underlying rationale of the regulatory proposal which led to the 1933 Act was based on an alternative philosophy: comprehensive disclosure.[25]

President Franklin Roosevelt articulated his view of the full disclosure rationale in his Message to Congress accompanying what was to become the Securities Act of 1933:

> Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.
>
> This proposal . . . puts the burden of telling the whole truth on the seller. . . .
>
> The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.[26]

This overriding policy articulated by President Roosevelt is embodied in the two principal objectives of the 1933 Act. The first is "to protect investors by requiring adequate and accurate disclosure regard-

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aimed at promoters who 'would sell building lots in the blue sky in fee simple.'" L. LOSS, FUNDAMENTALS, *supra* note 1, at 8 (footnote omitted).

[24] Such legislation was proposed initially by Huston Thompson, a former member of the Federal Trade Commission ("FTC"). *See* Landis, *supra* note 9, at 30-31. Thompson's proposal called for the FTC to "revoke the registration of any security . . . if upon examination . . . it shall appear . . . that its affairs are in unsound condition . . . or that the enterprise or business of the issuer . . . is not based upon sound principles, and that the revocation is in the interest of the public welfare." H.R. 4314, 73d Cong., 1st Sess. § 6 (1933). Merit regulation proposals were criticized sharply. *See, e.g.*, Landis, *supra* note 9, at 30-33; *id.* at 32-33 ("[T]he Thompson bill . . . provided no basis for sound federal securities legislation."). For a discussion concerning how the "merit" of a security permeated state blue sky regulation, see generally Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899 (1982). For an overview and discussion of recent developments concerning state merit blue sky laws, see Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986).

[25] *See* H.R. REP. NO. 85, 73d Cong., 1st Sess. 3 (1933); L. LOSS, FUNDAMENTALS, *supra* note 1, at 35; 1 L. LOSS, SECURITIES REGULATION, *supra* note 1, at 121-29.

[26] President's Message, *supra* note 1, at 937.

ing securities distributed to the public . . . ."[27] This objective is achieved primarily through the registration provisions of section 5,[28] which require that new issues of securities be registered with the Securities and Exchange Commission[29] and be accompanied by a disclosure document if sold in interstate commerce. The second objective is "to outlaw fraud in the sale of all securities whether or not newly issued."[30] This "antifraud" objective is enforced via private civil actions pursuant to sections 11[31] and 12,[32] in conjunction with other enforce-

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[27] Gadsby, *supra* note 1, at 9.

[28] 1933 Act § 5, 15 U.S.C. § 77e (1982).

[29] Although the 1933 Act was originally administered by the FTC, the SEC was created by the 1934 Act to regulate the sale of securities under the 1933 and 1934 Acts, not the securities themselves. *See* 1934 Act § 4, 15 U.S.C. § 78d (1982 & Supp. III 1985); *see also* Gadsby, *supra* note 1, at 9-11 (discussing the role of the SEC).

[30] Gadsby, *supra* note 1, at 9; *see* Preamble to the Securities Act of 1933, ch. 38, 48 Stat. 74.

[31] 1933 Act § 11(a), 15 U.S.C. § 77k(a) (1982), provides:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue -
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> (1) every person who signed the registration statement;
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> (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
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> (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
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> (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
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> (5) every underwriter with respect to such security.

[32] 1933 Act § 12, 15 U.S.C. § 77*l* (1982), provides:

> Any person who -
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> (l) offers or sells a security in violation of section 77e of this title, or
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> (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, 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 not knowing of such untruth or omis-

ment provisions. These sections are supplemented by section 14, which invalidates "any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision"[33] of federal securities laws. As discussed below, these antifraud provisions are further supplemented by sections 10(b) and 17(a) of the Securities and Exchange Act of 1934[34] and subsequent judicial interpretation.[35]

A. *The Private Offering Exemption*

The registration and disclosure provisions of the 1933 Act were designed to provide adequate truthful disclosure to prevent issuers from misleading the investor.[36] Specifically, disclosure was designed to "place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller."[37] At the same time the drafters were cognizant of the impediments that the registration provisions placed on "honest business."

> The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government. That bureaucracy, untrained in these matters as it was, could hardly

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> sion), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
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> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

[33] 1933 Act § 14, 15 U.S.C. § 77n (1982).

[34] 1934 Act § 10(b), 15 U.S.C. § 78j (1982); *id.* § 17(a), 15 U.S.C. § 789 (1982). Section 10 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[35] *See infra* notes 119-20 and accompanying text.

[36] *See* 1 L. LOSS, SECURITIES REGULATION, *supra* note 1, at 128 & n.21 ("Congress did not take away from the citizen 'his inalienable right to make a fool of himself.' It simply attempted to prevent others from making a fool of him.").

[37] 77 CONG. REC. H2918 (1933) (statement of Rep. Rayburn).

> equal these investors for sophistication, provided only it was their money that they were spending.[38]

In recognition of the "parity" which may exist between some buyers and sellers of certain types of securities, sections 3 and 4[39] created exemptions for certain issues and transactions. Over the past fifty years, the Securities and Exchange Commission, pursuant to its statutory authority,[40] has developed rules and regulations delineating "safe harbors" for exemption under these sections.[41]

Among the statutory exemptions included in section 4 are "transactions by an issuer not involving any public offering."[42] Although the legislative history addressing this provision provides little guidance,[43] it does shed some light on the general direction the drafters believed this exemption should take.[44] The exemption included "an issuer [making] a specific or an isolated sale of its securities to a particular person"[45] and such transactions in which "there is no practical need for [the Act's] application or where the public benefits are too remote."[46] Transactions, however, were not to be exempted "unless [purchasers

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[38] Landis, *supra* note 9, at 37.

[39] 1933 Act § 3, 15 U.S.C. § 77c (1982), exempts certain classes of securities, such as government, bank, or insurance company issues, from the registration requirements of § 5, while 1933 Act § 4, 15 U.S.C. § 77d (1982), exempts certain transactions.

[40] 1933 Act, § 3(b), 15 U.S.C. § 77c(b) (1982), provides:

> The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000.

[41] Such exemptions include Regulation D, 17 C.F.R. §§ 230.501-.506 (1987), which regulates new issues of private offerings, and Regulation A, 17 C.F.R. § 230.144 (1987), which exempts certain transactions in the secondary market. This Comment focuses solely on transactions by issuers in new issues.

Although the SEC has authority to promulgate rules exempting certain issues of $5 million or less under 1933 Act § 3(b), 15 U.S.C. § 77c(b) (1982), it has created Rule 506 as part of Regulation D. This rule exempts offerings without regard as to the dollar amount of the offering. *See infra* notes 77-88 and accompanying text. *But see* L. LOSS, FUNDAMENTALS, *supra* note 1, at 375 (Professor Loss questions the SEC's authority to adopt Rule 506.).

[42] 1933 Act § 4(2), U.S.C. § 77d(2) (1982). Section 4(2) was embodied originally in § 4(1) of the 1933 Act and became § 4(2) in 1964. *See* Act of Aug. 20, 1964, Pub. L. No. 88-467, 78 Stat. 565.

[43] *See* L. LOSS, FUNDAMENTALS, *supra* note 1, at 349.

[44] *See id.*

[45] H.R. REP. NO. 85, 73d Cong., 1st Sess. 16 (1933).

[46] *Id.* at 5.

are] so small in number that the sale to them does not constitute a public offering."[47]

Until 1962, interpretation of the private offering exemption was based on a 1935 opinion of the SEC's General Counsel.[48] The opinion focused primarily on the factors to be considered in determining the availability of the exemption.[49] The SEC, alluding to a previous discussion of the Office of the General Counsel, stated that an offering to twenty-five or fewer persons does not involve a public offering and, hence, is an exempted transaction.[50] The release also highlighted other factors such as 1) the relationship of offerees to each other and the issuer; 2) the number of units offered; 3) the size of the offering in dollar terms; and 4) the manner of the offering.[51]

The SEC release implied that members of certain classes of offerees, whose membership "may be determined by the application of some pre-existing standard," would not constitute members of the general public, and thus did not require the full protections theoretically afforded by the disclosure and registration requirements.[52] These classes consist primarily of investors with special knowledge of the issuer, such as "insiders," and those with "economic bargaining power."[53] Subsequent statutory and administrative pronouncements concerning the private offering exemption continue to follow this classification scheme.

The Supreme Court, however, suggested that the private offering exemption was based on criteria other than the number of offerees. In 1953, the Court held in *SEC v. Ralston Purina Co.*[54] that the availability of the exemption depended upon the extent to which the offerees needed the protections of the Act. In *Ralston Purina,* an employer distributed its unissued common stock through a private offering to select employees who were willing to "take the initiative and [were] interested

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[47] ABA Position Paper, *Section 4(2) and Statutory Law,* 31 BUS. LAW. 485, 486 (1975) [hereinafter ABA Position Paper] (citing H.R. REP. No. 85, 73d Cong., 1st Sess. 5-7, 15-16 (1933); H.R. REP. No. 152, 73d Cong., 1st Sess. 1-29 (1933)).

[48] *See* Letter of General Counsel Discussing the Factors to Be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 33-285 (Jan. 24, 1935) (available on Westlaw) [hereinafter Securities Act Release No. 33-285]; ABA Position Paper, *supra* note 47, at 486-87 (describing the "interpretative stage" set by Securities Act Release No. 33-285, *supra*).

[49] *See* Securities Act Release No. 33-285, *supra* note 48.

[50] *See id.*

[51] *See id.*

[52] *Id.*

[53] *See id.* ("[A]n offering to the members of a class who have special knowledge of the issuer is less likely to be a public offering than is an offering to the members of a class of the same size who do not have this advantage.").

[54] 346 U.S. 119 (1953).

in buying stock at present market prices."[55] The company willingly conceded that a similar offering to all its employees would have constituted a public offering but contended that because the employees allowed to purchase the stock were chosen at management's discretion, the offering was private.[56] In holding that "corporate employees, as a class," could not be deprived of the protections of the registration and disclosure provisions through such an offering,[57] the Court stated:

> [T]he exemption question turns on the knowledge of the offerees . . . . The focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with section 5.[58]

Despite *Ralston Purina,* subsequent SEC interpretations of the exemption continued to emphasize the relevance of "counting noses."[59] Judicial decisions subsequent to *Ralston Purina* frequently denied the exemption and found the registration provisions violated, often in egregious cases.[60] In the face of conflicting and confusing interpretations by

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[55] *Id.* at 121.

[56] *See id.* at 121-22.

[57] *Id.* at 125.

[58] *Id.* at 126-27.

[59] *See, e.g.,* Great N. Management Co., Inc., 44 S.E.C. 266, 268 (1970).

[60] *See, e.g.,* SEC v. Continental Tobacco Co., Inc. 463 F.2d 137, 160-61 (5th Cir. 1972) (letters from investors asserting knowledge of the investment held insufficient to justify exemption without proof that all offerees had contact with Continental officers and access to any additional information); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 691 (5th Cir. 1971) (no exemption allowed because offerees received inaccurate and insufficient information); Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971) (evidence of private offering cannot be based on conclusory statements); United States v. Custer Channel Wing Corp., 376 F.2d 675, 679 (4th Cir.) (none of the purchasers possessed required knowledge that would have been available in a registration statement), *cert. denied,* 389 U.S. 850 (1967). *But see, e.g.,* Gilbert v. Nixon, 429 F.2d 348, 358 (10th Cir. 1970) (allowing private offering exemption because seller not required to state every fact which might influence a purchaser's decision); Garfield v. Strain, 320 F.2d 116, 119 (10th Cir. 1963) (small number of offerees, small size of transactions, small number of units sold, and the knowledge of the offerees held sufficient to establish a private offering); Woodward v. Wrights, 266 F.2d 108, 115 (10th Cir. 1959) (arrangement made between close friends and acquaintances on a personal basis constituted a private offering); Livens v. William D. Witter, Inc., 374 F. Supp. 1104, 1112 (D. Mass. 1974) (although offerees did not sign investment letters or possess all information required by registration, surrounding circumstances, such as close relationships and business expertise of offerees, provided sufficient basis for allowing the private offering exemption); Bowers v. Columbia Gen. Corp., 336 F. Supp. 609, 624 (D. Del. 1971) (access to relevant data, rather than all that a registration statement would have revealed, constitutes basis for private offering if the transaction involves offerees with business expertise; however, this result did not follow as a matter of law

the SEC and the judiciary, soon-to-be SEC Chairman Garrett espoused his view that the combined body of law concerning the private offering exemption was a "kind of mishmash . . . [where t]he saving recipe is kept secret, a moving target which [the issuer] can never be sure he has hit."[61] Furthermore, some commentators thought the exemption was destroyed by two Fifth Circuit cases.[62]

In the face of the uncertainties surrounding the private offering exemption, the SEC proposed a safe harbor in Rule 146.[63] The Rule specified conditions that, if observed, would ensure that a particular transaction would qualify for a section 4(2) exemption.[64]

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but depended on factual analysis); Vicioso v. Watson, 325 F. Supp. 1071, 1078 (C.D. Cal. 1971) (transaction constituted a private offering because only two investors were involved and deal was made through direct negotiations); Fuller v. Dilbert, 244 F. Supp. 196, 212 (S.D.N.Y. 1965) (no public offering found because investors were few in number, sophisticated businessmen, and had access to all information which registration would disclose), *aff'd,* 358 F.2d 305 (2d Cir. 1966); Value Line Fund v. Marcus, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,523, at 94,970 (S.D.N.Y. Mar. 31, 1965) (few offerees with sophisticated knowledge and access to relevant information clearly make the transaction a private offering); Collier v. Mikel Drilling Co., 183 F. Supp. 104, 112 (D. Minn. 1958) (no public offering found because investors could protect themselves, and transactions involved were few and distinct from each other); Campbell v. Degenther, 97 F. Supp. 975, 977 (W.D. Pa. 1951) (no public offering existed because of the small number of investors and their close relationship to each other).

[61] PRACTICING LAW INSTITUTE, FOURTH ANNUAL INSTITUTE ON SECURITIES REGULATION 10-11 (1973).

[62] *See* 2 S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES § 2.16(a) (Release No. 14, Nov. 1982); R. JENNINGS & H. MARSH, *supra* note 1, at 307; L. LOSS, FUNDAMENTALS, *supra* note 1, at 371; Kripke, *Wrap-up,* 29 BUS. LAW. 185, 187 (Special Issue, Mar. 1974). The two cases were *Continental Tobacco,* 463 F.2d at 161 (issuers failed to establish that offerees had a "privileged" relationship with Continental Tobacco), and Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972) (defendants failed to meet burden of proof to establish a private offering because they presented no evidence of the number of offerees, the relationships between offerees and issuer, the offerees' knowledge of each other, or the manner of the offering). Some commentators believed that these cases narrowed the exemption by requiring "insider" status of the offerees. *See, e.g.,* Marsh, *Who Killed the Private Offering Exemption?,* 71 NW. U.L. REV. 470, 476 (1977) (*Continental Tobacco* has been "read by some as indicating . . . that only 'insiders' were eligible as buyers pursuant to the private offering exemption.") The Fifth Circuit, however, later gave a different interpretation. *See* Doran v. Petroleum Management Corp., 545 F.2d 893, 908 (5th Cir. 1977) ("[W]e do not read *Continental* as requiring insider status . . . [because] [s]uch requirements would constrict the scope of the private offering exemption more narrowly than does Rule 146 . . . ."). The most alarming issue for issuers was the strict liability imposed by § 12(1) for § 5 violations when the issuer failed to hit the "moving target." *See infra* text accompanying notes 100-02.

[63] Notice of Revision of Proposed Rule 146 Under the Securities Act, Securities Act Release No. 5430, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,529 (Oct. 10, 1973).

[64] *Id.*; *see also* PRACTICING LAW INSTITUTE, FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 357 (1974) [hereinafter FIFTH ANNUAL INSTITUTE] (Rule 146 sets forth conditions necessary to qualify for a § 4(2) exemption.).

While the courts heralded Rule 146 as a "serotine development,"[65] practitioners[66] and academics[67] greeted it with criticism. The Rule proved problematic because it was essentially a codification of the vagueness of preexisting law.[68] It created the possibility that a minor infraction of one "condition," such as the failure to file a form, could render an issuer strictly liable under section 12(1) for rescission of an entire offering, regardless of the significance of the violation. In addition, implementation of the Rule became difficult and costly almost immediately.[69]

By 1978, the prophecies of the early critics of the rule had become reality. Indeed, SEC Chairman Harold Williams himself recognized the shortcomings of Rule 146. He acknowledged that modifications to Rule 146 were necessary to "benefit . . . small businesses seeking to raise capital. Compliance with the rule was . . . unduly complex, costly, and subjective, with an unacceptable level of risk that the exemption may be lost inadvertently."[70]

Moreover, the procedures required by judicial interpretation[71] of Rule 146 were only economical for issuers raising large amounts of capital. While the SEC[72] and Congress[73] took steps in other areas to

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[65] *Doran,* 545 F.2d at 908.

[66] *See* FIFTH ANNUAL INSTITUTE, *supra* note 64, at 385-93; Practicing Law Institute, *Letters of Comment on Proposed Rule 146: Securities Act Release No. 5430,* in RULE 146 219-329 (1974).

[67] *See, e.g.,* Benton & Gunderson, *Venture Capital Financings and Exemptions from Registration Under the Securities Act of 1933: Section 4(2), Rule 146, and Rule 242,* 21 SANTA CLARA L. REV. 23, 44 (1981) (issuers rarely depend on Rule 146 in venture capital transactions); Campbell, *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market,* 1977 DUKE L.J. 1139, 1143-47 (ambiguities of the Rule devastate small issuers); Kessler, *Private Placement Rules 146 and 240—Safe Harbor?,* 44 FORDHAM L. REV. 37, 38 (1975) (vagueness of rule can increase dangers for small issuers); Kinderman, *The Private Offering Exemption: An Examination of Its Availability Under and Outside Rule 146,* 30 BUS. LAW. 921, 921 (1976) (imprecise standards and unclear obligations of Rule 146 lead to practical problems; additionally, compliance with the Rule's requirements is unduly burdensome for small businesses).

[68] Transactions by an Issuer Deemed Not to Involve Any Public Offering, Securities Act Release No. 33-5487, 39 Fed. Reg. 15,261 (1974).

[69] *See* R. JENNINGS & H. MARSH, *supra* note 1, at 319.

[70] *Hearings on Capital Formation Before the Senate Select Comm. on Small Business,* 95th Cong., 2d Sess., pt. 3, at 584 (1978) (statement of Harold Williams, Chairman, SEC).

[71] The Fifth Circuit in Mary S. Krech Trust v. Lakes Apartments, 642 F.2d 98, 103 (5th Cir. 1981), held that the seller's use of offeree questionnaires, project fact sheets, and a list of all brokers and offerees was sufficient evidence of a private offering exemption. *See* R. JENNINGS & H. MARSH, *supra* note 1, at 319 (such "due diligence" procedures important to fulfill burden of proof that conditions of Rule have been met).

[72] The SEC's power to exempt small offerings, under § 3(b) of the 1933 Act, was increased to $5 million in 1980. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, tit. 3, § 301, 94 Stat. 2275, 2291 (codified as amended at 15 U.S.C.

aid small businesses in raising capital apart from the section 4(2) exemption, the use of that exemption more frequently occurred in real estate and oil and gas syndications.[74]

In response to these problems, the SEC adopted Regulation D[75] in 1982. It provides a comprehensive safe harbor to remove "disproportionate restraints on small issuers" and to develop a uniform exemption from registration "in order to facilitate capital formation consistent with the protection of investors."[76] The three exemptions provided by Regulation D are found in Rules 504, 505, and 506.[77] Rules 504 and 505 provide exemptions under section 3(b) based on aggregate offering price.[78] Rule 504 is designed primarily for small issuers engaged in intrastate offerings.[79] Rule 505 offerings are limited to $5 million and sales may be made to accredited investors and up to thirty-five "purchasers that are not accredited investors."[80] Rule 506 provides an exemption for offerings without regard to aggregate offering price pursu-

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§ 77c(b) (1982)).

[73] *See* Omnibus Small Business Capital Formation Act of 1980, Pub. L. No. 96-477, tit. 5, § 505, 94 Stat. 2291, 2292-93 (codified as amended at 15 U.S.C. § 77s(c)(1) (1982)), which added subsection 19(c) to the 1933 Act. Subsection 19(c) authorized the SEC to coordinate federal securities matters with state securities associations, primarily the North American Securities Administrators Association ("NASAA"). *See* R. JENNINGS & H. MARSH, *supra* note 1, at 328.

[74] *See* Business and Corporations Law Section, Los Angeles County Bar Association, *Recent Developments in Corporate and Securities Laws,* 14 LOY. L.A.L. REV. 79, 120-21 (1980) (comments of Neal Brockmeyer, member, Executive Committee, Business and Corporations Law Section, Los Angeles County Bar Ass'n). For a comparison of the relative cost of private, Regulation A, and intrastate offerings, see W. PRIFTI, *supra* note 10, at §§ 1:11-:12.

[75] 17 C.F.R. §§ 230.501-.506 (1987). On January 16, 1987, the SEC published for comment proposed amendments to several of the rules comprising Regulation D. "The revisions involve additions to the 'accredited investor' definition in the regulation, an increase in the ceiling on the total offering price permitted under Rule 504 for certain offerings, and the revision of the general solicitation restrictions under Rule 504." Regulation D Revisions, Securities Act Release No. 6683, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,054, at 88,399 (Jan. 16, 1987) [hereinafter Proposed Revisions].

[76] Regulation D—Revision of Certain Exemptions From Registration Under the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106, at 84,908 (Mar. 8, 1982) [hereinafter Revised Exemptions Under the Securities Act of 1933].

[77] *Id.* at 84,907-09.

[78] *See id.* at 84,918.

[79] *See id.* at 84,909 ("The [SEC] is proposing to expand the availability of Rule 504 as a capital-raising device."). *See* Proposed Revisions, *supra* note 75, at 88,402. Under the proposed revisions, "the aggregate offering price that could be offered under Rule 504 would be raised to $1 million . . . ." *Id.*

[80] *See* Revised Exemptions Under the Securities Act of 1933, *supra* note 76, at 84,909.

ant to section 4(2).[81] Rule 506 is limited to thirty-five "sophisticated" purchasers, and, as in Rule 505, "[a]ccredited investors . . . do not count towards that limit."[82]

The provisions of Rule 506 are consistent with legislative history and subsequent judicial and administrative interpretations of the section 4(2) exemption. The criteria for accredited investor status embody the economic bargaining power or specialized knowledge standards of previous interpretations. Exemptions are provided for those investors with "knowledge," such as institutions or executive officers,[83] and those with economic bargaining power, such as high-income or high-net worth individuals.[84] In addition, Rule 506 requires that "unaccredited" pur-

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[81] *See id.*

[82] *Id.*

[83] Rule 501(a)(1)-(4) provides:

> As used in Regulation D [§§ 230.501-.506], the following terms shall have the meaning indicated:
>
> (a) *Accredited Investor.* "Accredited investor" shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:
>
> (1) Any bank as defined in section 3(a)(2) of the Act whether acting in its individual or fiduciary capacity; insurance company as defined in section 2(13) of the Act; investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; Small Business Investment Company licensed by the U.S. Small Business Administration under section 301 (c) or (d) of the Small Business Investment Act of 1958; employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000;
>
> (2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;
>
> (3) Any organization described in section 501(c)(3) of the Internal Revenue Code with total assets in excess of $5,000,000;
>
> (4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer . . . .

17 C.F.R. § 230.501(a)(1)-(4) (1987).

The proposed revisions to Regulation D would "extend the definition of accredited investor to include various institutional investors, such [as] savings and loan associations and broker-dealers, certain trusts, partnerships and corporations, and to permit a joint as well as an individual income test . . . ." *See* Proposed Revisions, *supra* note 75, at 88,400 (footnote omitted).

[84] Rule 501(a)(5)-(8) classifies the following as accredited investors:

> (5) Any person who purchases at least $150,000 of the securities being offered, where the purchaser's total purchase price does not exceed 20 percent of the purchaser's net worth at the time of sale, or joint net worth with that person's spouse, for one or any combination of the following: (i) Cash, (ii) securities for which market quotations are readily available, (iii)

chasers be sophisticated, i.e., that they have "knowledge and experience" to assess the risks and merits of the offering[85] without regard to the purchaser's ability to withstand the economic risk of the offering.[86]

These terms of Regulation D represent a combined legislative, judicial, and administrative acknowledgment that certain investors do not need the protections afforded by the registration requirements when they have the requisite knowledge, economic or bargaining power, or expertise to protect themselves.

B. *The Fraud Liability Provisions*

In response to the President's Message[87] and to the "tragedy in the lives of thousands of individuals who invested their life savings"[88] in $25 billion of worthless securities,[89] Congress included in the 1933 Act provisions to remove the common law obstacles to fraud recovery and to penalize the sellers of fraudulent securities.[90] These provisions included express civil remedies for defrauded purchasers of securities,[91] a general antifraud provision for SEC enforcement,[92] and criminal sanctions for

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an unconditional obligation to pay cash or securities for which market quotations are readily available which obligation is to be discharged within five years of the sale of the securities to the purchaser, or (iv) the cancellation of any indebtedness owed by the issuer to the purchaser;

(6) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;

(7) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years and who reasonably expects an income in excess of $200,000 in the current year; and

(8) Any entity in which all of the equity owners are accredited investors under paragraphs (a) (1), (2), (3), (4), (6), or (7) of this section.

17 C.F.R. § 501(a)(5)-(8) (1987).

[85] *See* 17 C.F.R. § 230.506(b)(2)(ii) (1987). Rule 506 modifies the purchaser qualification principles of its predecessor, Rule 146, in two ways. First, whereas Rule 146 drew no distinction between "accredited investors" and "unaccredited purchasers," *see* 17 C.F.R. § 230.146(d)(1) (1982), "Rule 506 requires that only [unaccredited] purchasers meet the sophistication standard." Revised Exemptions Under the Securities Act of 1933, *supra* note 76, at 84,919. Second, Rule 506 gives no consideration to the purchaser's ability to withstand the economic risk of the offering. *See id.*

[86] *See* Revised Exemptions Under the Securities Act of 1933, *supra* note 76, at 84,919.

[87] *See* President's Message, *supra* note 1.

[88] H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933).

[89] *See id.*

[90] *See* L. LOSS, FUNDAMENTALS, *supra* note 1, at 808-817; 3 L. LOSS, SECURITIES REGULATION, *supra* note 1, 1430-44.

[91] 1933 Act § 12 (codified as amended at 15 U.S.C. § 77*l* (1982)).

[92] 1933 Act § 17(a) (codified as amended at 15 U.S.C. § 77q(a) (1982)). Whether a private cause of action can be implied under section 17 is an open question. The Supreme Court has reserved the question on several occasions. *See* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 304 n.9 (1985); Herman & MacLean

willful violations of the Act,[93] as well as other sections delineating various procedural limitations.[94]

1. The Express Remedies of the 1933 Act

Section 11 provides for civil liability on the part of the issuer and

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v. Huddleston, 459 U.S. 375, 378 n.2 (1983); International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 557 n.9 (1979); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 n.6 (1975). The circuits currently are split over this issue. *Compare* Mosher v. Kane, 784 F.2d 1385, 1390-91 & n.9 (9th Cir. 1986) (recognizing an implied right of action under § 17(a)) *and* Stephenson v. Calpine Conifers II, Ltd., 652 F.2d 808, 815 (9th Cir. 1981) (holding that "a private right of action exists under § 17(a)") *and* Kirshner v. United States, 603 F.2d 234, 241 (2d Cir. 1978)) (holding that § 17 is "broad enough to imply a private right of action"), *cert. denied,* 442 U.S. 909 (1979) *and* Newman v. Prior, 518 F.2d 97, 99 (4th Cir. 1975) (holding that "§ 17(a) supports a private damage claim") *with In re* Wash. Pub. Power Supply Sys. Sec. Litig., [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,330, at 96,669 (9th Cir. July 30, 1987) (en banc) (finding "no indication, explicit or implicit, of legislative intent to create a private right of action under section 17(a)") *and* Corwin v. Marney, Orton Invs., 788 F.2d 1063, 1066 (5th Cir. 1986) (no private cause of action exists under § 17 (a)) *and* Keys v. Wolfe, 709 F.2d 413, 416 (5th Cir. 1983) (refusing to find error in lower court's ruling that no private right of action existed under § 17(a)) *and* Landry v. All Am. Assurance Co., 688 F.2d 381, 384-91 (5th Cir. 1982) (rejecting an implied private cause of action under § 17(a)) *and* Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 155 (8th Cir. 1977) (restating prior holding that "the private remedy of a purchaser must be found in § 12(2) and not in § 17(a)"), *cert. denied,* 434 U.S. 1086 (1978) *and* Anderson v. Lowrey, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,372, at 96,927 (S.D.N.Y. Aug. 15, 1987) (no recognition of private cause of action under § 17(a)) *and In re* Storage Technology Corp. Sec. Litig., [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,716, at 93,480 (E.D. Colo. Mar. 16, 1986) (refusing to imply a private cause of action under § 17(a)). The grounds cited for not recognizing an implied § 17(a) action are based on a fear that the creation of a remedy under § 17(a) would undermine the liability scheme of §§ 11 and 12(2) of the 1933 Act. *See* Kimmel v. Peterson, 565 F. Supp. 476, 488 (E.D. Pa. 1983).

[93] 1933 Act § 24 (codified as amended at 15 U.S.C. § 77x (1982)) (Willful violations are punishable by up to five years of imprisonment or up to a $10 thousand fine, or both.).

[94] 1933 Act § 13 (codified as amended at 15 U.S.C. § 77m (1982)), provides a statute of limitations of one year from discovery of the false or misleading statements in actions under §§ 11 or 12(2), and one year after a violation of § 12(1), and in no event more than three years after sale for actions under § 12(2) or after offered to the public for actions under §§ 11 or 12(1). *See* SEC v. Seaboard Corp., 677 F.2d 1301, 1308 (9th Cir. 1982); Summer v. Land & Leisure Inc., 664 F.2d 965, 968 (5th Cir. 1981). *But see In re* Home-Stake Prod. Co. Sec. Litig., 76 F.R.D. 337, 344-45 (N.D. Okla. 1975) (fraudulent concealment tolls three-year limitation period). Section 14 voids any stipulations waiving compliance with federal securities laws. 1933 Act § 14, 15 U.S.C. § 77n (1982). Section 15 creates liability for a person who controls, through stock ownership or otherwise, another person who fails to comply. 1933 Act § 15, 15 U.S.C. § 77o (1982). "Control" is the "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities . . . or otherwise." 17 C.F.R. § 240.12b-2 (1987). Finally, § 16 makes the remedial provisions of the 1933 Act nonexclusive. 1933 Act § 16, 15 U.S.C. § 77p (1982).

various other classes of persons such as directors, experts, and underwriters. Liability is incurred when the registration statement or any part thereof contains "an untrue statement of a material fact or [omission of] a material fact required to be stated therein or necessary to make the statements therein not misleading."[95] Section 11, however, does not impose absolute liability on all participants involved in formulating the registration statements;[96] indeed, there are some statutory defenses.[97] By its express terms, section 11 covers liability for registration statements and, therefore, is not generally relevant to offerings claiming an exemption from registration requirements.

Section 12 contains two provisions. Section 12(1)[98] imposes liability for rescission for violations of the registration requirements in section 5. In order to deter noncompliance with the registration requirements,[99] liability under section 12(1) is "virtually absolute."[100] If an issuer misses the target of a section 4(2) exemption and has not complied with the registration requirements under section 12(1), she then becomes strictly liable for rescission.[101] The only defense to a section

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[95] 1933 Act § 11(a), 15 U.S.C § 77k(a) (1982).

[96] *See* H.R. REP. No. 85, 73d Cong., 1st Sess. 22 (1933). A § 11 plaintiff must demonstrate first that the securities she bought were issued under the complained of registration statement. *See* Barnes v. Osofsky, 373 F.2d 269, 271-73 (2d Cir. 1967); Turner v. First Wis. Mortgage Trust, 454 F. Supp. 899, 911 (E.D. Wis. 1978). She also must show that the misstatement or omission was material. *See* Greenapple v. Detroit Edison Co., 468 F. Supp. 702, 708 (S.D.N.Y. 1979), *aff'd,* 618 F.2d 198 (2d Cir. 1980). *But see In re* Gap Stores Sec. Litig., 79 F.R.D. 283, 297 (N.D. Cal. 1978) (plaintiff need not prove privity, reliance, causation, or scienter in § 11 action).

[97] Underwriters and certain other enumerated classes are provided with a "due diligence" defense if they can show that they did not know and could not reasonably have discovered an untrue or misleading material statement or the existence of a material omission. 1933 Act § 11(b)(3), 15 U.S.C. § 77k(b)(3) (1982). Furthermore, underwriters and others are not responsible for material misstatements in "expertised" portions of registration statements. *See, e.g.,* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 682-84 (S.D.N.Y. 1968). Insiders, such as officers and directors, must satisfy a high burden to establish a due diligence defense; alternatively, they may engage in "whistle blowing" by resigning and notifying the Securities and Exchange Commission. *See* 1933 Act § 11(b)2, 15 U.S.C. § 77k(b)(2) (1982).

[98] 1933 Act § 12(l), 15 U.S.C. § 771(1) (1982).

[99] *See* R. JENNINGS & H. MARSH, *supra* note 1, at 776; L. LOSS, FUNDAMENTALS, *supra* note 1, at 832-33, 1026; 3 L. LOSS, SECURITIES REGULATION, *supra* note 1, at 1692-98.

[100] L. LOSS, FUNDAMENTALS, *supra* note 1, at 1017.

[101] *See, e.g.,* Dahl v. Pinter, 787 F.2d 985, 988 (5th Cir 1986), *cert. granted,* 107 S. Ct. 1885 (1987); Western Fed. Corp. v. Erickson, 739 F.2d 1439, 1442-43 (9th Cir. 1984); SEC v. Murphy, 626 F.2d 633, 640-41 (9th Cir. 1980); Chapman v. Dunn, 414 F.2d 153, 158-60 (6th Cir. 1969); Anastasi v. American Petroleum, Inc., 579 F. Supp. 273, 274-75 (D. Colo. 1984). The Supreme Court has granted certiorari in *Pinter* to review the scope of the term "seller" under § 12(1) and to determine if the common law defense of in pari delicto is available in a § 12(1) action. *See* Federal Securities Law Reports, No. 1226, pt. 1, Fed. Sec. L. Rep. (CCH) 2 (April 22, 1987). The Supreme Court's decision in *Pinter* will effect the "absoluteness" of liability under

12(1) claim is to show that the sale did not violate section 5.[102]

For private civil plaintiffs, section 12(2) serves as a broad antifraud provision unrelated to the registration requirements.[103] Section 12(2) applies to any sale of a security regardless of exemptions[104] and, in addition, covers all false or misleading statements, whether oral or written.[105] Section 12(2) reaches a broad class of sellers by requiring privity between the seller and the person purchasing such security.[106] Furthermore, if "a purchaser *is* in privity with the defendant [seller], but the defendant is not named in section 11 (e.g., a dealer in a selling group), the purchaser could sue him *only* under section 12(2)."[107] Section 12(2) places the burden on the plaintiff to prove her lack of knowledge. This contrasts with section 11 under which the burden rests on the defendant to prove that a plaintiff had knowledge.[108] Section 12(2) also does not contain the defenses to liability, such as "expertising," included in section 11. Finally, proof of reliance on the false or misleading statement is unnecessary under section 12(2).[109]

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§ 12(1).

[102] *See* R. JENNINGS & H. MARSH, *supra* note 1, at 833.

[103] *See id.* at 834.

[104] *See id.* at 833. Sales of bank and government securities are exempted from § 12(2) liability under 1933 Act § 3(a), 15 U.S.C. § 77c(a) (1982).

[105] *See id.*; Stoppelman v. Owens, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,511, at 98,570 (D.D.C. June 7, 1984).

[106] *See* R. JENNINGS & H. MARSH, *supra* note 1, at 834. The definition of who may be sued typically includes such terms as sellers, those in privity, substantial factors, substantial participants, coconspirators, and aiders and abettors. The terminology varies from circuit to circuit and even within a circuit. *See, e.g.,* Collins v. Signetics Corp., 605 F.2d 110, 112 (3d Cir. 1979) (those in privity or with "some special relationship"); Cady v. Murphy, 113 F.2d 988, 990 (1st Cir.) (sellers), *cert. denied,* 311 U.S. 705 (1940); Van Boeckel v. Weiss, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,648, at 97,589 (N.D. Cal. Sept. 12, 1983) (substantial factor); Frankel v. Wyllie & Thornhill, Inc., 537 F. Supp. 730, 744 (W.D. Va. 1982) (aiders and abettors); *In re* Caesars Palace Sec. Litig., 360 F. Supp. 366, 380 (S.D.N.Y. 1973) ("some indica" of participation or solicitation).

[107] R. JENNINGS & H. MARSH, *supra* note 1, at 834.

[108] *See id.*; *see also In re* Itel Sec. Litig., 89 F.R.D. 104, 115 (N.D. Cal. 1981) (plaintiffs have burden of proving that they were unaware of untrue statements or omissions when they purchased the securities).

[109] *See* R. JENNINGS & H. MARSH, *supra* note 1, at 1278; *see also* Alton Box Board Co. v. Goldman, Sachs & Co., 560 F.2d 916, 924 (8th Cir. 1977) (plaintiff need not prove reliance to recover; instead, must show causal relationship between the misleading representations and the sale); Jackson v. Oppenheim, 533 F.2d 826, 830 n.8 (2d Cir. 1976) (when liability is based on a sale, § 12(2) requires a causal relationship between the challenged communication and the sale, even if not decisive); Gilbert v. Nixon, 429 F.2d 348, 356 (10th Cir. 1970) (purchaser reliance is not a prerequisite to seller liability under the statute); John Hopkins Univ. v. Hutton, 422 F.2d 1124, 1129 (4th Cir. 1970) (causation did not present a material issue of fact because buyer need not show that she relied on a misstatement or omission); Brooks v. Land Drilling Co., 574 F. Supp. 1050, 1054 (D. Colo. 1983) (plaintiff need only show causal connection between the challenged communication and the sale, not reliance).

In its report accompanying these provisions, the House Committee stated that "the duty of care to discover [fraud] varies in its demands upon participants in security distribution with the importance of their place in the scheme of distribution and with the degree of protection that the public has a right to expect."[110] Viewed with regard to liability under sections 11 and 12, this statement illuminates the sliding scale of liability that those sections create. First, the importance of the participant/defendant's role conditions the procedural and substantive aspects of her liability and defenses. Second, "the degree of protection" that the purchasers may expect suggests a legislative intent to facilitate recovery for violations of registration requirements and to impede recovery for purchasers of exempt securities relative to purchasers of registered securities. Taken together, these explanations reflect a legislative judgment that the purchaser of an exempt security should not receive the same general litigation advantages from the express liability provisions as those provided to purchasers of registered securities.[111]

2. Implied Actions Under the 1934 Act

The 1933 Act regulated the issuance of new securities. To remedy the "purely speculative operations" of the various exchanges,[112] however, Congress enacted the Securities and Exchange Act of 1934. Section 10(b) of the 1934 Act was enacted to supplement the antifraud provisions of the 1933 Act by creating an enforcement vehicle for the new Securities and Exchange Commission.[113] Under its broad rulemaking power, the Securities and Exchange Commission hurriedly[114] added the present heart of the civil antifraud provisions, Rule 10b-5,[115] in

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Furthermore, the plaintiff need never have received the information containing the misleading statement nor even seen a prospectus. *See, e.g.,* Sanders v. John Nuveen & Co., 619 F.2d 1222, 1225-26 (7th Cir. 1980), *cert. denied,* 450 U.S. 1005 (1981); DeMarco v. Edens, 390 F.2d 836, 841 (2d Cir. 1968).

[110] H.R. REP. NO. 85, 73d. Cong., 1st Sess. 9 (1933).

[111] *Cf.* Quintel Corp., N.V. v. Citibank, N.A., 596 F. Supp. 797, 801-802 (S.D.N.Y. 1984) (investor's sophistication is relevant to adequacy of disclosure).

[112] *See* Message of the President to Congress on the Regulation of Securities Exchanges, 78 CONG. REC. S2264 (Feb. 9, 1934).

[113] *See supra* note 34 and accompanying text.

[114] The circumstances surrounding the SEC's adoption of Rule 10b-5 have been described aptly by a former SEC staff attorney. *See* ABA, *Conference on Codification of the Federal Securities Laws,* 22 BUS. LAW. 793, 922 (1967). The total discussion by the Commissioners about the proposed rule consisted of " 'Well, we are against fraud, aren't we?' " *Id.* (Milton Freeman, one of the rule's codrafters, quoting Sumner Pike).

[115] 17 C.F.R. § 240.10b-5 (1987) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

1941. This Rule originally was added to close "a loophole in the protections against fraud" and to grant the SEC a vehicle for attacking fraudulent sellers of securities.[116]

Unlike sections 11 and 12 of the 1933 Act, neither Rule 10b-5 nor section 10(b) provides express civil remedies for private purchasers or sellers of securities.[117] The federal courts, nevertheless, implied a private remedy in 1946 in *Kardon v. National Gypsum Co.*[118] In recent years the Supreme Court has imposed various restrictions on the very broad potential reach of Rule 10b-5.[119] Currently, "[t]he existence of this implied [private] remedy simply is beyond peradventure."[120]

II. THE EMERGENCE AND FAILINGS OF "BAD FAITH" IN THE PRIVATE OFFERING CONTEXT

Commentators greeted the broad civil liability provisions of sections 11 and 12 with criticism of the in terrorem effect such sweeping

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(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
in connection with the purchase or sale of any security.

[116] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-13 n.32 (1976) (quoting SEC Release No. 3230 (May 21, 1942)).

[117] The 1934 Act did create certain express civil liability provisions, none of which is applicable specifically to a new issue of securities claiming a private offering exemption. Section 9(e) of the 1934 Act provides an express civil remedy for a person who purchases or sells a registered security on a national exchange at a price affected by unlawful manipulation. 1934 Act § 9(e), 15 U.S.C. § 78i (1982). Section 18 grants a cause of action to a person who purchases or sells a security in reliance on a false or misleading statement made in a document filed with the SEC. 1934 Act § 18, 15 U.S.C. § 78r (1982). The practical impact of these provisions is limited. *See* 11A E. GADSBY & A. SOMMER, BUSINESS ORGANIZATIONS, FEDERAL SECURITIES EXCHANGE ACT OF 1934, pt. 1, § 5.04 (1986).

[118] 69 F. Supp. 512 (E.D. Pa. 1946). *See generally* E. GADSBY & A. SOMMER, *supra* note 117, § 5.04 (tracing the development of implied civil remedies under the federal securities acts).

[119] The Supreme Court first recognized an implied private right of action in Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971). Since then, the Court has decided numerous other cases highlighting the existence of this implied right. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980) (silence is actionable only with a duty to disclose); Santa Fe Indus. v. Green, 430 U.S. 462, 473 (1977) (action requires misrepresentation or nondisclosure); TSC Indus. v. Northway, Inc., 426 U.S. 438, 444 (1976) (action requires material omission or misstatement); *Ernst & Ernst,* 425 U.S. at 212-14 (action requires allegation and proof of scienter); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 n.5 (1975) (action requires actual purchase or sale of a security); Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-53 (1972) (in an action for omission, reliance is presumed).

[120] Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983).

liability would impose on legitimate securities issuers.[121] As part of the Securities and Exchange Act of 1934, Congress enacted the "Fletcher Amendments" to the 1933 Act.[122] Aimed specifically at sections 11 and 12, these amendments were intended to "give assurance to every honest man who is an official of a corporation that he need have no fear of the Securities Act of 1933 . . . ."[123]

Congress believed that honest corporate officials feared strike suits[124] made possible by the civil liability provisions of the 1933 Act. In order to alleviate these fears,[125] Congress amended section 11(e)[126] to provide, in part:

> In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant such costs may be assessed in favor of such party litigant . . . if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him . . . .[127]

Congressional shifting of attorneys' fees found in section 11(e) is thought to be one of the exceptions to the general "American Rule" concerning payment of legal fees in litigation.[128]

Under the American Rule each party litigant bears his own attorneys' fees regardless of the outcome of the litigation.[129] Fees also may be shifted under the "common benefit" rule which spreads the cost of litigation among those who are benefited by the action[130] or when liti-

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[121] *See, e.g.*, Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 210-16 (1933).

[122] Amendments to Securities Act of 1933, Pub. L. No. 73-291, 48 Stat. 907 (1934) (codified at 15 U.S.C. § 77k(e) (1982)).

[123] 78 CONG. REC. 10,186 (1934) (statement of Sen. Brynes).

[124] *See id.* at 10,185.

[125] *See id.* at 10,186.

[126] Amendments to Securities Act of 1933, Pub. L. No. 73-291, 48 Stat. 907 (1934) (codified at 15 U.S.C. § 77k(e) (1982)).

[127] *Id.* at 908.

[128] *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975); *see also* Civil Rights Attorneys' Fees Award Act of 1976, Pub. L. No. 94-559, 90 Stat. 2641 (codified at 42 U.S.C. § 1988 (1982)). For a comprehensive collection of attorneys' fee statutes, see Marek v. Chesney, 473 U.S. 1, 7-9 (1985); *Alyeska*, 421 U.S. at 260-69.

[129] *See Alyeska*, 421 U.S. at 247.

[130] *See* Hall v. Cole, 412 U.S. 1, 5-9 (1973); Mills v. Electric Auto-Lite Co., 396 U.S. 375, 391-92 (1970); Sprague v. Ticonic Nat'l Bank, 307 U.S. 161, 164-67 (1939); Trustees v. Greenough, 105 U.S. 527, 532-37 (1882).

gation is commenced or conducted by either party "in bad faith, vexatiously, wantonly, or for oppressive reasons . . . ."[131]

In securities fraud cases involving section 11(e), courts apply different standards to determine the meaning of "without merit."[132] Most courts, however, have included the concept of "bad faith" in their decisionmaking process.[133] Further clouding the meaning of "without merit" is the fact that the courts are split as to the meaning of bad faith and its applicability to "colorable" claims.[134]

Although the specific term "bad faith" does appear in the Senate Committee Report accompanying the Fletcher Amendments, Professor Loss points out that the imputation of a bad faith requirement to a meritless claim is dubious.[135] A better interpretation suggests that Congress really intended to create two separate situations in which fees could be shifted: strike suits and bad faith litigation. This reading is further supported by a Conference Committee report accompanying the amendment to section 11(e) of the 1933 Act:

> It provides, as a defense against blackmail suits *as well as* a defense against purely contentious litigation on the part of

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[131] F.D. Rich Co. v. United States *ex rel.* Indus. Lumber Co., 417 U.S. 116, 129 (1974); *accord* Browning Debenture Holders' Comm. v. DASA Corp., 560 F.2d 1078, 1088 (2d Cir. 1977).

[132] *Compare* Nemeroff v. Abelson, 620 F.2d 339, 348 (2d Cir. 1980) (award of attorneys' fees for bad faith only proper when "clear evidence" shows that a claim is entirely without color and made for reasons of harassment and delay) *and* Homburger v. Venture Minerals, Inc., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,205, at 91,563 (S.D.N.Y. Apr. 24, 1985) ("without merit" requires showing that claim does not simply lack merit but also borders on frivolous) *and* Robert Alan Ins. Agency v. Girard Bank, No. 83-2370 (E.D. Pa. July 29, 1987) (LEXIS, Genfed library, Dist file) ("failure of a party to present sufficient evidence at trial . . . does not, standing alone, support a determination . . . that attorney's fees should be awarded") *with* Western Fed. Corp. v. Erikson, 739 F.2d 1439, 1444 (9th Cir. 1984) ("without merit" standard includes claims and defenses that "*either* are brought in bad faith *or* border on the frivolous"); *accord* Straus v. Holiday Inns, Inc., 460 F. Supp. 729, 732-33 (S.D.N.Y. 1978).

[133] *See* L. LOSS, FUNDAMENTALS, *supra* note 1, at 1214; *see also* cases cited *supra* note 19 (discussing the application of the "bad faith-frivolous claim" standard).

[134] *See* L. LOSS, FUNDAMENTALS, *supra* note 1, at 1212. *Compare DASA Corp.*, 560 F.2d at 1088 (award of attorneys' fees not supported by trial court finding that litigation was conducted in bad faith to force reduction in conversion price of stock because legal claim was based on "colorable" theory) *with In re* National Student Mktg. Litig., 78 F.R.D. 726, 728 (D.D.C. 1978) (litigation motivated by vindictiveness supports "bad faith" award of attorney's fees despite presentation of colorable legal claim), *aff'd sub. nom.* Lipsig v. National Student Mktg. Corp., 663 F.2d 178, 182 (D.C. Cir. 1980).

[135] *See* L. LOSS, FUNDAMENTALS, *supra* note 1, at 1213. "In order to give protection against 'strike' suits, or litigation brought in bad faith, the court is authorized to assess reasonable costs, including attorney's fees against either party to the suit . . . ." S. REP. No. 792, 73d Cong., 2d Sess. 18 (1934). The section of the report from which this was taken later became § 9(e) of the 1934 Act.

> the defendant, that a court can require a bond for costs and can assess costs against the plaintiff if his suit had no merit or against the defendant if his defense had none. The suggested amendments seem equitable.[136]

The modern Supreme Court's interpretation of attorneys' fees provisions in securities fraud cases further supports reading the bad faith standard out of certain strike suit situations. In *Mills v. Electric Auto-Lite Co.*,[137] the Court liberally construed similar fee-shifting provisions in the securities context. *Mills* involved the use of a misleading statement in proxy solicitation material,[138] a possible violation of section 14(a) of the 1934 Act.[139] After concluding a private right of action did exist under section 14(a),[140] the Court fashioned a remedy for a consummated complex merger that was "fair" on its term.[141] The Court concluded that in the absence of an express statutory authorization for the award of attorneys' fees under section 14(a), the express provisions in sections 9(e) and 18(a) "should not be read as denying to the courts the power to award fees in suits under other sections of the Act when circumstances make such an award appropriate . . . ."[142]

In determining when circumstances were appropriate, the Court reasoned that the clear remedial provisions of other statutes may foreclose implying a right to a fee award; however, the broad remedial purposes of the 1934 Act did not prevent courts from granting appropriate remedies.[143] Similar to the implied right of action reasoning of *J.I. Case Co. v. Borak*,[144] "[t]he courts must . . . determine whether the special circumstances exist that would justify an award of attorneys' fees . . . ."[145] Justice Black, dissenting from this part of the opinion, indicated that contractual arrangements to shift attorney's fees may be valid. "I do not agree . . . that stockholders who hire lawyers to prose-

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[136] H.R. REP. NO. 1838, 73d Cong., 2d Sess. 42 (1934) (emphasis added).

[137] 396 U.S. 375 (1969).

[138] *See id.* at 377.

[139] 1934 Act § 14(a), 15 U.S.C. § 78n(a) (1982).

[140] *See Mills*, 396 U.S. at 381-83.

[141] *See id.* at 386-89.

[142] *Id.* at 390-91.

[143] *See id.* at 391.

[144] 377 U.S. 426, 432 (1964) ("While [§ 14(a)] . . . makes no specific reference to a private right of action . . . [, it] certainly implies the availability of judicial relief where necessary . . . ."); *see also* Touche Ross & Co. v. Redington, 442 U.S. 560, 569 (1978) (limiting *J.I. Case Co.* to statutes that prohibit certain conduct and create federal rights for private parties).

[145] *Mills*, 396 U.S. at 391. The remainder of the opinion, which held that attorneys' fee awards were appropriate for the bestowal of a "common benefit" for private enforcement of a statutory law, was limited by Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 257-69 (1975).

cute their claims in such a case can recover attorneys' fees in the absence of a valid contractual agreement so providing or an explicit statute creating such a right of recovery."[146]

Mills may well have been the high point for securities laws "implied" actions and remedies. During the 1970s and early 1980s, the Supreme Court imposed a series of substantive requirements in Rule 10b-5 fraud actions.[147] In *Ernst & Ernst v. Hochfelder*,[148] the Court held that plaintiffs in Rule 10b-5 actions must allege and prove "scienter," i.e., an intent to deceive, manipulate, or defraud, on the part of the defendant.[149] As part of its rationale, the Court noted that "the express civil remedies in the 1933 Act . . . [including] § 11, . . . [were] subject to significant procedural restrictions not applicable under § 10(b)."[150] This would include § 11(e)'s security-for-costs provision.[151] The Court articulated in a footnote that "one of . . . [the] purposes [of section 11(e)] was to deter actions brought solely for their potential settlement value."[152]

In a more recent decision, *Herman & MacLean v. Huddleston*,[153] the Supreme Court interpreted how the remedial provisions of the 1933 and 1934 Acts should be construed: "[S]ecurities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.' "[154] Applying this flexible interpretation to the combined purposes of the registration exemptions, antifraud provisions, and section 11(e) leads to this possible conclusion: Congress did intend for certain potential plaintiffs—those who were not to receive the same protections afforded the general public under the Acts[155]—to be deterred more from bringing suits for their settlement value. Such an interpretation also implies a different standard for fee-shifting under section 11(e).

The concept of "settlement value," moreover, is much different for the plaintiff involved in a private offering than one involved in a public offering. Offerings exempted from the registration requirements also

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[146] *Mills*, 396 U.S. at 397 (Black, J., concurring in part and dissenting in part).
[147] *See supra* note 119.
[148] 425 U.S. 185 (1976).
[149] *Id.* at 193.
[150] *Id.* at 208-09.
[151] *Id.* at 209-10.
[152] *Id.* at 211 n.30.
[153] 459 U.S. 375 (1983).
[154] *Id.* at 386-87 (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963)); *accord* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971).
[155] *See supra* notes 83-97 and accompanying text.

are exempted from the margin requirements of the 1934 Act.[156] Exempt offerings, therefore, may be purchased with any combination of cash and installment or demand debt. In the tax shelter area, for example, the security is purchased often with a relatively small initial cash investment and a full recourse loan for the balance of the offering price.[157] By instituting a fraud action under sections 10(b) and 12(2) for a failed investment,[158] the investor may be seeking release from her

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[156] 1934 Act § 7(a), 15 U.S.C. § 78g(a) (1982), requires the Federal Reserve Board to "prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security)." The Board's primary regulations in this area are as follows: Regulation G, 12 C.F.R. §§ 207.1-.7 (1987) (governing lending by other persons who engage in the business of making loans for purchasing or carrying margin securities); Regulation T, 12 C.F.R. §§ 220.1-.18 (1987) (governing lending on securities by broker-dealers); Regulation U, 12 C.F.R. §§ 221.1-.8 (1987) (governing loans made by banks for purchasing or carrying margin stock or that are secured by margin stock); Regulation X, 12 C.F.R. §§ 224.1-.3 (1987) (governing borrowing by persons in the U.S. from domestic or foreign lenders for the purpose of purchasing or carrying securities). For a general discussion of lending on securities by broker-dealers and banks, see REPORT ON SPECIAL STUDY OF THE SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 4, at 15-25 (1963).

Under Regulation T, private placements and small business offerings are explicitly exempted. 12 C.F.R. § 220.12 (1987). In addition, the Federal Reserve Board has taken the position that offerings made under Rules 505 and 506 of Regulation D, 17 C.F.R. §§ 230.505-.506 (1987), are exempt from the operation of Regulation T, *supra*. *See* Interpretative Release on Regulation D, Securities Act Release No. 33-6455, 48 Fed. Reg. 10,045, 10,054 (1983). For a detailed discussion of Regulation T, see 4 R. HAFT & P. FASS, TAX SHELTERED INVESTMENTS § 2.05[2] (1986).

[157] *See* Kashner, *Financing Limited Partnerships and Their Partners: Caveat Creditor,* 37 BUS. LAW. 171, 171-72 (1981) (describing the structure of many private offerings). The Internal Revenue Code effectively requires that an investor be "at risk" in certain tax shelter investments by allowing the investor to claim losses "only to the extent of the aggregate amount with respect to which [she] is at risk." I.R.C. § 465(a)(1) (1982). The amount she has at risk is comprised essentially of her cash investment plus recourse debt. *See* 4 R. HAFT & P. FASS, *supra* note 156, § 1.05; Klehm & Ward, *Common Elements of Tax Advantaged Investments,* J. COM. & FIN., Spring 1983, at 43, 44-45.

[158] *See, e.g.,* Luce v. Edelstein, 802 F.2d 49, 55 (2d Cir. 1986) (allegation of materially misleading claims); Warner v. Central Trust Co., 715 F.2d 1121, 1122 (6th Cir. 1983) (fraud in initial transaction); DuPont v. Brady, 646 F. Supp. 1067, 1072 (S.D.N.Y. 1986) (materiality of scienter omissions); Hill v. Equitable Bank, N.A., 642 F. Supp 1013, 1016 (D. Del. 1986) (connection to RICO violations); Greenberg v. RRI XX Management Corp., No. 85-1262 (E.D. Pa. Aug. 1, 1985) (LEXIS, Genfed library, Dist file) (gross misrepresentation of limited partnership tax shelter); Leslie v. Minson, No. 84 Civ. 8674 (S.D.N.Y. Dec. 12, 1984) (LEXIS, Genfed library, Dist file) (fraud in the transaction solicitations); Westland Energy 1981-1 Ltd. v. Bank of Commerce & Trust Co., 603 F. Supp. 698, 704 (N.D. Okla. 1984) (direct causality between knowing material misrepresentation and harm suffered); Cromwell v. Commerce & Energy Bank, 464 So. 2d 721, 729 (La. 1985) (applicability to letters of credit); Shaffer v. Brooklyn Park Garden Apartments, 311 Minn. 452, 465, 250 N.W.2d 172, 178 (1977) (recognition of honesty in intent defense); Brown v. United States Nat'l Bank, 220 Neb. 684, 690, 371 N.W.2d 692, 695 (1985) (disclaimers may limit misrepresentation of bank letters of credit).

recourse obligation. One commentator, discussing this type of suit from the perspective of the lender, summarized the problem as follows:

> [T]he lender seeking to collect on . . . investor notes may face a series of rather formidable hurdles to overcome if the business of the venture fails . . . . For in those circumstances, investors will not be particularly eager . . . to permit realization on the collateral security . . . and may be expected to invoke any and all possible claims and defenses, however spurious.[159]

In these circumstances, defendants are tempted to trade off collection of the recourse debt against the potential costs of defending a fraud suit.[160] Thus, the private offering investor may receive value in a suit without merit. It is these types of actions which typify "modern" strike

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[159] Kashner, *supra* note 157, at 172. Among the claims a participant in a failed private offering may expect are security fraud claims. *See id.* at 189-201. Lenders in private offerings frequently require investors to post letters of credit as collateral for loans in private offerings. Such lenders can expect investors to seek injunctions against collecting on investor letters of credit should the lender be forced to call upon the letter. *See, e.g., Warner,* 715 F.2d at 1122-23 (plaintiff sought to enjoin letter of credit he provided as part of purchase price of investment in limited partnership on grounds of fraud). For a discussion of the law surrounding such injunctions, see Farrar, *Judicial Intervention,* in LETTERS OF CREDIT AND BANKERS' ACCEPTANCES 1986, at 651, 657 (Commercial Law & Practice Course Handbook Series No. 399, C. Mooney & R. Ryan eds. 1986); Harfield, *Enjoining Letter of Credit Transactions,* 95 BANKING L.J. 596 (1978).

[160] The cost of defending securities fraud suits is significant in relation to the amount of the investor's initial investment. For example, defense costs in Zissu v. Bear, Stearns & Co., 627 F. Supp. 687 (S.D.N.Y.), *aff'd,* 805 F.2d 75 (2d Cir. 1986), discussed *infra* at text accompanying notes 162-73, were claimed to be $555,000 for the issuer and the underwriter, while Zissu's investment totalled only $1.5 million. *See Zissu,* 627 F. Supp. at 689, 690-91. Defendants also often face the prospect of litigating investor claims in different jurisdictions at the same time. *Cf.* Kashner, *supra* note 157, at 172 (lenders seeking to collect on investor notes face task of collecting from a number of individuals who may reside in different jurisdictions).

The possibility of liability under RICO, 18 U.S.C. §§ 1961-68 (1982), in the context of securities fraud may increase the temptation for abuse. *See* Sedima, S.P.R.L. v. Imrex Co., 741 F.2d 482, 487-88 (2d Cir. 1984), *rev'd,* 473 U.S. 479 (1985). RICO provides a number of advantages to the securities plaintiff including treble damages, attorneys' fees, a broad scope of discovery, broad venue choices, and an opportunity to avoid the substantive restrictions of securities laws by bringing a RICO claim based on mail or wire fraud rather than a § 12(2) or a § 10(b) claim. In fact, "RICO claims are now being routinely added to complaints based on alleged securities law violations . . . ." Kleinberg & Morris, *An Introduction to Civil RICO for Securities Law Litigators,* in RECENT DEVELOPMENTS IN SECURITIES LITIGATION 243, 247 (Litigation and Administration Practice Series No. 276, B. Vanyo & E. Yodowitz eds. 1984).

At least one court granted judgment for the plaintiff on a recourse obligation owed to him by a defendant despite the court's conclusion that securities laws were not violated by the defendants. *See* Eriksson v. Galvin, 484 F. Supp. 1108, 1129 & n.8 (S.D.N.Y. 1980) (describing judgment based on long-overdue note as "merely a pyrrhic victory").

suits.

III. The Use of Indemnification Contracts as an Alternative to Establishing Bad Faith

The modern strike suit in the private offering context subverts the purposes of securities laws to provide "sliding scale" antifraud remedies and to aid the capital formation goals embodied in the private offering exemption. Additionally, the imputed "bad faith-frivolous claim" standard of section 11(e) does not achieve its deterrent purposes when the private offering investor has an expected settlement value lower than the defendants' costs of first establishing compliance with the securities law and thereafter prevailing on a bad faith claim. Under these circumstances the issuer who qualifies for the private offering exemption may protect himself via a contractual agreement such as Justice Black suggested in *Mills v. Electric Auto-Lite Co.*[161] In certain limited circumstances, the contract would not violate federal securities laws; moreover, the contract actually can be structured to further the purposes of the disclosure requirements in the private offering context.

The case of *Zissu v. Bear, Stearns & Co.*[162] is illustrative of the modern strike suit and a contractual agreement which, with some modification, should survive judicial scrutiny. The plaintiff, Frederick Zissu, purchased $1.5 million of a private offering oil and gas limited partnership as a tax shelter.[163] Zissu, as related by the District Court, signed a document with the following provision in the course of purchasing:

> I understand the meaning and legal consequences of the representations and warranties contained . . . [herein] and I agree to indemnify and hold harmless the Partnership and each general and limited partner thereof from and against any and all loss, damage or liability due to or arising out of a breach of any representation or warranty of mine, whether contained in the Partnership Agreement or this Subscription Agreement. Notwithstanding any of the representations, warranties, acknowledgments or agreements made herein by me, I do not thereby or in any other manner waive any rights granted to me under federal or state securities laws.[164]

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[161] 396 U.S. 375, 397 (1970) (Black, J., concurring in part and dissenting in part).

[162] 627 F. Supp. 687 (S.D.N.Y.), *aff'd*, 805 F.2d 75 (2d Cir. 1986).

[163] *See Zissu*, 805 F.2d at 76.

[164] *Zissu*, 627 F. Supp. at 691.

In conformity with Rule 146 requirements,[165] the plaintiff had represented that he was a wealthy, sophisticated investor and that he not only had read and understood the investment literature but also was able to bear the financial risks of the offering.[166] When the venture proved "less successful . . . than [Zissu] had . . . hoped,"[167] he instituted a fraud action under sections 10(b) and 12(2). The defendants[168] counterclaimed based on the above provision and the plaintiff's breach of his express warranties.[169] At trial the jury found no violations of securities laws and granted the defendants' breach of warranty counterclaim.[170] On appeal the Second Circuit upheld the award of fees based on bad faith but avoided determining the validity of the counterclaim, finding the drafting of the indemnity clause "not sufficiently specific" to hold Zissu liable for the costs of defending the suit.[171] Had the damage provision been more specific, the contractual counterclaim would not violate federal securities laws or their underlying policies.

Two provisions, section 14 of the 1933 Act[172] and section 29 of the 1934 Act,[173] delineate when a contract or stipulation is void under federal securities law. A brief review of the judicial interpretations of these provisions indicates that the *Zissu* indemnity clause was not void under these statutes. First, section 14 (and its counterpart in section 29(a) of the 1934 Act) void "any condition, stipulation or provision binding any person acquiring security to waive compliance with [federal securities laws]."[174] The Supreme Court appeared to construe the purposes of

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[165] 17 C.F.R. § 230.146 (1974).

[166] *See Zissu,* 805 F.2d at 76-77.

[167] *Zissu,* 627 F. Supp. at 694.

[168] The defendants in *Zissu* were the issuer, a limited partnership, and the seller, Bear Stearns. Bear Stearns was also a "special limited partner" and, therefore, included in the indemnification agreement. *See* 805 F.2d at 76.

[169] *See id.* at 77. It is important to note that Zissu's rights under federal securities law were preserved. By bringing the claim alleging oral and written misstatements, he admitted that the representations and warranties were made to him outside the private offering memorandum. It was this breach of his own acknowledgement that no representations or warranties had been made to him outside the memorandum which gave rise to the defendants' counterclaim. *See id.*

[170] *See id.*

[171] *Id.* at 78. The court found that the "any and all damages" clause in the subscription agreement was used to maintain the private offering exemption and was insufficiently specific to put Zissu on notice of his potential responsibility for the defendants' legal costs. *See id.* at 79. As the Second Circuit left open the possibility that, with a sufficiently specific clause, the securities fraud plaintiff may be assessed the defendants' legal fees for breach of warranty, *see id.* at 79-80, this Comment sets forth a framework for determining when a counterclaim based on a contract would not deter meritorious suits and, therefore, should be granted.

[172] 1933 Act § 14, 15 U.S.C. § 77n (1982).

[173] 1934 Act § 29, 15 U.S.C. § 78cc (1982).

[174] 1933 Act § 14, 15 U.S.C. § 77n (1982); 1934 Act § 29(a), 15 U.S.C.

section 14 to provide the purchasers of securities with the procedural benefits of the 1933 Act in *Wilko v. Swan.*[175] The Court did not preclude the possibility that "a buyer and seller of securities, under some circumstances, may deal at arm's length on equal terms . . . ."[176] Furthermore, in *Shearson/American Express, Inc. v. McMahon,*[177] the Court held that section "29(a) only prohibits waiver of the substantive obligations imposed by the Exchange Act."[178] An indemnity clause merely holds the buyer to her warranties; it does not waive any substantive rights.

If an issuer has complied with the terms of Regulation D, particularly its "accredited investor" or "sophisticated purchaser" requirements, then the buyer and seller are in parity. Under these circumstances, the investor does not need the full protections available under the registration provisions. Exempting the issuer from registration requirements, therefore, is consistent with the views expressed by the SEC,[179] Congress,[180] and the Court.[181] Because the law finds that the buyer and seller are on "equal footing" when the requirements of Regulation D are satisfied, indemnification contracts from the investor to the issuer would not constitute contracts of adhesion.

The purpose of the contractual indemnification provision is to hold a wealthy and sophisticated investor to her warranties and to ensure that she has read and understands the precise disclosures with which the law requires she be provided. To hold that such a provision is "contrary to the Act" makes disclosure the futile and expensive exercise many fear.[182] After all, who is better situated to understand the man-

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§ 78cc(a) (1982).

[175] 346 U.S. 427, 435-36 (1953). *Wilko* is most widely known for its implications concerning the arbitrability of federal and state securities law claims under the United States Arbitration Act, 9 U.S.C. §§ 1-14 (1982). *See* Cantor, *Another Hurdle Remains for Civil RICO Plaintiffs: Will a Predispute Arbitration Agreement Bar RICO Plaintiffs from a Federal Forum?,* 6 J.L. & COM. 283, 292-93 (1986); Schaller & Schaller, *Applying the* Wilko *Doctrine's Anti-Arbitration Policy in Commodities Fraud Cases,* 61 CHI.[-]KENT L. REV. 515, 527-30 (1985); Note, *Arbitrability of Claims Arising Under the Securities Exchange Act of 1934,* 1986 DUKE L.J. 548, 549-60. *Wilko*'s specific holding concerning the arbitrability of securities law claims has been all but overruled by Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332 (1987).

[176] *Wilko,* 346 U.S. at 435.

[177] 107 S.Ct. 2332 (1987).

[178] *Id.* at 2338.

[179] *See supra* notes 75-86 and accompanying text.

[180] *See* H.R. REP. NO. 85, 73rd Cong., lst Sess 3 (1933).

[181] *See supra* notes 54-58 and accompanying text.

[182] *See generally* HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., 1ST SESS., REPORT OF ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SECURITIES & EXCHANGE COMMISSION (Comm. Print 1977) (includes a detailed description of the disclosure system and proposals for change as well as dissenting statement by Committee member Kripke, who felt more attention should have been

dated disclosure than the knowledgeable and experienced investor?[183]

Second, while section 29(b) of the 1934 Act specifically invalidates any contract made in violation of federal securities laws, it does not bar enforcement of a contractual arrangement by an innocent party in the private offering context.[184] This interpretation is consistent with the Second Circuit's decision in *Kaiser-Frazer Corp. v. Otis & Co.*,[185] in which an issuer sought to enforce an underwriting agreement. In voiding the contract, the Second Circuit specifically relied on the fact that the prospectus contained materially misleading information that was part of the contract.[186] "[I]t is clear that a contract which violates the laws of the United States and contravenes the public policy as expressed in those laws is unenforceable."[187]

This view also is consistent with the Supreme Court's interpretation of section 29(b) in *Mills*:

> [The] language [of section 29(b)] establishes that the guilty party is precluded from enforcing the contract against an unwilling innocent party, but it does not compel the conclusion that the contract is a nullity, creating no enforceable rights

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given to the incremental value of a specific disclosure requirement); H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE xvii (1979) (taking the position that as securities regulation is becoming "more and more detailed and pervasive, its effectiveness is rapidly diminishing"); Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 141-49 (1973) (mathematical analysis of the impact of required disclosure on market returns, concluding that disclosure requirements have no measurable positive effect on returns).

[183] Alarmingly, one court appears to have permitted a sophisticated investor to expressly repudiate his representations in the subscription agreement that he read the required disclosure. This court found that the investor's attorney and personal advisor "should have known that [the investor] would not read the placement materials . . . ." DuPont v. Brady, 646 F. Supp. 1067, 1072 (S.D.N.Y. 1986). The court based its finding on the length of the relationship between the investor and his advisors and their knowledge of the manner in which the investor approached his investments. *Id.*

[184] The Supreme Court first interpreted § 29(b) in A.C. Frost & Co. v. Coeur d'Alene Mines Corp., 312 U.S. 38 (1941). *Frost* involved the sale of unregistered stock from an issuer to an underwriter based on an exclusive contract. *See id.* at 39. When the underwriter sued for performance of the contract, the issuer claimed the contract was void because it constituted an unregistered public offering in violation of the securities laws. *See id.* In what Professor Loss described as a hard case that possibly made "bad law," *see* L. LOSS, FUNDAMENTALS, *supra* note 1, at 1048, the Court declined to enforce the contract given the other remedies available to the underwriter under the securities laws: "[T]he clear legislative purpose [of § 29(b) is the] protection of innocent purchasers of securities. They are given definite remedies inconsistent with the idea that every contract having relation to sales of unregistered share is absolutely void . . . ." 312 U.S. at 43.

[185] 195 F.2d 838 (2d Cir. 1952).

[186] *See id.* at 843-44.

[187] *Id.* at 843 (footnote omitted).

> even in a party innocent of the violation. The lower federal courts have read § 29(b) . . . as rendering the contract merely voidable at the option of the innocent party. This interpretation is eminently sensible.[188]

The foregoing discussion demonstrates that the *Zissu* defendants, who were the innocent parties, should not be precluded by federal securities law from enforcing the indemnity contract and, thus, should not be required to meet a "bad faith-frivolous claim" standard to shift defense costs to the plaintiff.

One argument against allowing such counterclaims is the potential "chilling" effect these claims might have on plaintiffs seeking to enforce their rights.[189] Closer examination of the circumstances that constitute a breach of an investor's warranties, however, suggests that the burden of such actions will fall upon investors who breach their express warranties for reasons contrary to the basis for the statutory right on which the investors are suing. After all, the breach is not the filing of the lawsuit, but the express repudiation of the warranties by the investor during the litigation. The *Zissu* clause expressly preserves the investor's right to file the suit. The counterclaim is established when the investor repudiates her warranties. Due to her qualification as an accredited or sophisticated investor, she is deemed to understand her warranties and accept the ramifications stemming therefrom when she purchases the investment.

The private offering plaintiff who legitimately did not know of the indemnification or its effect is not precluded from proving the defendant's liability under sections 12(2) or 10(b) for failing to adequately inform the investor. Because section 12(2) liability also attaches to both oral and written statements, the defendant could not orally repudiate the clause at the time of sale in an effort to induce the investor into the offering and later assert the counterclaim without violating that section. Furthermore, in an action under section 12(2), the plaintiff already bears the burden of proving her lack of knowledge,[190] and the plaintiff need not show reliance on the false or misleading statement or omission in making the investment.[191] Thus, the mere existence of the indemnifi-

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[188] 396 U.S. at 387-88 (citing Greater Iowa Corp. v. McLendon, 378 F.2d 783, 792 (8th Cir. 1967)) (footnote omitted); *see also* Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213 (9th Cir. 1962); Bankers Life & Casualty Co. v. Bellanca Corp., 288 F.2d 784, 787 (7th Cir. 1961); Kaminsky v. Abrams, 281 F. Supp. 501, 507 (S.D.N.Y. 1968); Maher v. J. R. Williston & Beane, Inc., 280 F. Supp. 133, 138-139 (S.D.N.Y 1967).

[189] *See Zissu*, 627 F. Supp. at 692-93.

[190] *See supra* note 108 and accompanying text.

[191] *See supra* note 109 and accompanying text.

cation clause does not impede the investor's fraud action. In terms of who could make the counterclaim and still avoid liability, section 12(2) liability extends to a broad class of sellers. Any defendant, therefore, asserting the breach counterclaim would almost certainly be included should the investor establish a violation.[192] In sum, the private offering plaintiff bears no additional burden in establishing a section 12(2) action when she is held to her express warranties than she does without the indemnification clause.

Finally, if the issuer has failed to comply with securities laws, then, under the above interpretations of sections 14 and 29, it is no longer an innocent party and therefore is barred from establishing its counterclaim.

Limiting the enforceability of such agreements to private offerings that qualify for the exemption from registration under Regulation D reduces a risk to issuers that the SEC implicitly acknowledges exists. The terms of Regulation D reflect the fact that a private offering plaintiff may misrepresent, at times, her eligibility as an accredited investor or sophisticated purchaser status. Indeed, "[t]he definition of 'accredited investor' includes any person who comes within or 'who the issuer reasonably believes' comes within one of the enumerated categories . . . ."[193] While the SEC remains reluctant to define what constitutes a reasonable belief,[194] offeree sophistication continues to play a role in maintaining the Rule 506 exemption.[195] The imposition of section 12(1) liability for violations of section 5 in such circumstances is a needless risk, unduly hindering the capital formation purposes of the private offering exemption.

The effect of enforcement of indemnifications in the private offering context, in terms of the intended legislative policy of section 11(e)[196] and the judicial belief that that section was meant to deter suits brought for settlement value,[197] is merely to deter those actions which inflict unwarranted litigation expense on the issuer. This is consonant with Congress' intent in enacting section 11(e) in 1934.

The public policy implications of the potential chilling effect of

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[192] *See supra* notes 106-07 and accompanying text.

[193] Interpretive Release on Regulation D, Securities Act Release No. 33-6455, 48 Fed. Reg. 10,045 (March 10, 1983).

[194] *See id.* at 10,045-46 (stating that what constitutes "reasonable" belief will depend on the facts of each particular case).

[195] *Cf.* Anastasi v. American Petroleum, Inc., 579 F. Supp. 273 (D. Colo. 1984) (issuer who relies on misrepresentations of investors regarding their financial suitability has no cause of action for damages sustained by loss of exemption against investors).

[196] *See supra* notes 122-27, 136 and accompanying text.

[197] *See supra* notes 148-55 and accompanying text.

private offering indemnification provisions were considered by Judge Edward Weinfeld in *Zissu*:

> Indeed, public policy considerations require that Zissu be held to his express obligations in order to encourage respect for the law and to impress upon him and others that specifically defined commitments and representations are not scraps of paper to be disregarded at will. If the enforcement of this indemnification clause on these facts deters future Frederick Zissus from repudiating expressly stated representations and testifying . . . contrary to the facts warranted, it is fatuous to argue that it is contrary to public policy.[198]

CONCLUSION

Sellers of private offerings claiming an exemption from the registration provisions of federal securities law should be entitled to enforce indemnification clauses included in the subscription documents in the proper circumstances. To be eligible to do so, the seller must have complied fully with federal securities laws, including disclosing the existence and effect of the indemnification clause. In order for the seller's counterclaim to succeed, the investor must have failed to demonstrate a securities law violation and also have repudiated her express warranties. The investor must be sophisticated or misrepresent her suitability for a private offering.

In light of the combined legislative, judicial, and administrative judgments that Regulation D expresses, issuers and purchasers should be viewed as operating on equal footing with regard to disclosure when the offering complies with federal securities laws. For the issuer, this means that the offering has complied with the exemption requirements and that no false or misleading statements or omissions exist. For the purchaser, this means she has received all the protections to which she is entitled under the "sliding scale" provisions of securities laws.

Indemnification contracts in these circumstances should not be considered void as contrary to public policy. In fact, they further the underlying policies of disclosure and capital formation. The indemnity agreement provides an incentive for the sophisticated offeree to read the disclosure mandated by law which she can reasonably be expected to understand. The capital formation policies of the private offering exemption are furthered by reducing the risks of section 12(1) liability and deterring meritless suits against the issuer.

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[198] *Zissu*, 627 F. Supp. at 694.

The deterrent effect of these contracts will manifest itself in those who would conduct a "modern" strike suit as a fishing expedition or who seek to delay or bar the collection of otherwise valid debt obligations. Private offering plaintiffs who legitimately claim they were not informed of the effect or existence of the indemnity contract will bear no greater burdens in establishing a securities law violation than they do without such contracts.

RALPH S. SPRITZER

The editors of the *University of Pennsylvania Law Review* take great pleasure in dedicating this issue to Professor Ralph S. Spritzer, who is currently teaching law at Arizona State University. As the following selections make clear, Professor Spritzer's dedication to teaching, his students, and the legal profession will be missed by the entire Law School community. The *Law Review* wishes him well in his future endeavors.