RESURRECTING INDEMNIFICATION: CONTRIBUTION CLAUSES IN UNDERWRITING AGREEMENTS

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Focusing on the special role of underwriters as protectors of the public under the Securities Act of 1933, Professor Helen Scott examines contractual contribution clauses purporting to allocate section 11 liability between underwriters and issuers. Professor Scott notes that while section 11 allows contribution between negligent parties, it does not specifically permit contractual allocation of contribution. She shows that private allocation of contribution can resemble issuer indemnification of underwriters, which courts have rejected as contrary to the policies of the securities acts, and argues that courts must remain free to allocate liability in ways consistent with the Acts' goals. Examining possible contribution formulas, Professor Scott concludes that a per capita formula best combines administrative ease with fairness and is appropriate for most cases.

INTRODUCTION

Virtually every public offering of a security that is actively traded on a public market must be registered under the Securities Act of 1933 (1933 Act).¹ When a company sells its securities to the public, it ordinarily uses an intermediary, known as the underwriter. The underwriter determines the price at which the company's securities can be sold and has access to a sales network through which the securities can be distributed. The mere association of an offering with the name of an underwriter that has previously participated in successful public offerings may help ensure the issue's success. This is due at least in part to the fact that members of the public often rely heavily on a well-known underwriter's evaluation and pricing of the security when making an investment decision.

Unfortunately, not all public offerings are successful, and not all securities which are successfully offered to the public remain successful in the subsequent trading market. Section 11 of the 1933 Act may provide relief when a dissatisfied purchaser of securities seeks recovery from an


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underwriter in connection with a registered public offering by imposing
civil liability on parties on account of a materially false or incorrect regis-
tration statement. Liability under section 11 may extend to six groups
participating in the issuance of the securities, including the underwriter,
and is joint and several among them.

As a result of potential liability under section 11, underwriters in-
clude a clause in contracts they enter into with issuers of securities which
provides for sharing any liability from the transaction between them.
Specifically, such contractual “contribution clauses” provide that if the
underwriters and the issuer are found jointly liable for a violation of the
federal securities acts, damages are allocated away from the underwriters
to the issuer. Although contribution among liable parties is expressly
sanctioned by subsection 11(f), neither the 1933 Act nor its legislative
history provides any guidance as to how the contribution shares are to be

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2 15 U.S.C. § 77k; see R. Jennings & H. Marsh, Securities Regulation: Cases and Materi-

Section 11 is central to the entire federal scheme of securities regulation, and issues arising
under it have tended to have significance beyond the section itself. See, e.g., Sanders v. John
Nuveen & Co., 619 F.2d 1222, 1227-28 (7th Cir. 1980) (application of diligence concepts de-
veloped under § 11 to case brought under § 12 of the 1933 Act), cert. denied, 450 U.S. 1005
(1981); Folk, Civil Liabilities Under the Federal Securities Acts: The BarChris Case (pt. 2), 55
Va. L. Rev. 199, 237-56 (1969) (discussing impact of § 11 case on other liability provisions of
the federal securities acts).

While actions under § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1982), and Rule 10b-5
thereunder, 17 C.F.R. § 240.10b-5 (1986), have provided the bulk of the spectacular growth of
securities litigation, the elements of the implied cause of action under Rule 10b-5 are drawn
from the express remedies of §§ 11-12 of the 1933 Act, 15 U.S.C. §§ 77k, 77l, and § 9 and § 18
of the 1934 Act, 15 U.S.C. §§ 78i, 78r (1982). This is increasingly true as the scope of Rule
10b-5 has been restricted. See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206-11 (1976)
(discussing elements and procedural limitations of § 11 actions in the context of a § 10(b)
action).

3 Under § 11(a) of the 1933 Act, civil liability extends to:
   (1) every person who signed the registration statement;
   (2) every person who was a director of (or person performing similar functions) or part-
       ner in the issuer at the time of the filing of the part of the registration statement with
       respect to which his liability is asserted;
   (3) 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;
   (4) every accountant, engineer, or appraiser, or any person whose profession gives au-
       thority 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;
   (5) every underwriter with respect to such security.


5 Most initial public offerings involve syndicates composed of numerous underwriters
formed to distribute issued securities. See note 10 infra.

6 1933 Act § 11(f), 15 U.S.C. § 77k(f). Contribution among jointly liable parties is also
allocated. In addition, no court has ruled on the enforceability of an underwriter-drafted contribution clause.

Contractual risk shifting by both contribution and indemnification is a common practice, and indemnification arrangements that shift liability entirely away from one party may be permissible in some areas. With respect to liability under federal securities acts, however, courts have struck down issuer indemnification of underwriters as contrary to the laws' underlying policies because it undermines the underwriter's role as an investigator and public advocate. However, the distinction between contribution and indemnification for purposes of the federal securities acts has never been clearly articulated.

This Article clarifies the boundary between indemnification and contribution, and examines its significance under the securities laws. This Article provides a basis for making contribution doctrine under securities law more articulate and analyzes contribution clauses currently in use. This analysis examines contribution clauses in the context of what may be termed a straightforward section 11 case: where the initial registration statement of a never-before-public corporation, underwritten on a “firm commitment” basis, contains false or misleading information and consequently results in liability on the part of both the issuer and the underwriters.

Part I sets forth the issue of whether contribution clauses in underwriting agreements are compatible with the legal prohibition against indemnification. Part II examines the legislative history and case law development of section 11 of the 1933 Act that provide the context for assessing the validity of contribution clauses. Part III develops an analysis for distinguishing between indemnification and contribution and examines the various possible contribution formulas in light of this analysis. While the two principal methods of allocating contribution, per capita and relative fault, have different advantages and drawbacks, the per capita formula is generally more appropriate in light of the policies of the federal securities acts. A third method, a modified per capita

specifically provided for in § 9(e) and § 18(b) of the 1934 Act, 15 U.S.C. §§ 78i(e), 78r(b) (1982). The operative language of those sections is almost identical to that of § 11(f).

The prohibition of indemnification is clear as a matter of judicial interpretation. See text accompanying notes 96-125 infra. While the Securities and Exchange Commission has not ruled directly on the question, it has spoken in analogous areas and expressed strong opposition to indemnification for federal securities acts liabilities. See text accompanying notes 65-67 infra.

The simplest § 11 case provides the clearest setting for examination of questions of allocation of loss and indemnification versus contribution. The effect of abbreviated forms of registration and the doctrine of incorporation by reference, see note 27 infra, on liability concepts under the securities acts is beyond the scope of this Article.
formula, is also considered and found to be useful under some circumstances. Part IV considers the effect of applying various contribution formulas on the underwriting business and assesses the effectiveness of the clauses when placed in the business context.

I

STATEMENT OF THE PROBLEM

Issuers retain underwriters as intermediaries in order to facilitate the sale of their securities pursuant to a registered public offering. Underwriters may be engaged by issuers under several types of arrangements. In the most customary and significant arrangement, the “firm commitment underwriting,” the underwriters agree to purchase all of the securities to be offered by the issuer at a stated price. The underwriters assume the risk that they cannot resell the securities and may incur a substantial loss on the transaction. However, current industry practice is to refrain from executing the underwriting agreement until the morning the registration statement is declared effective, thus not fixing the underwriters’ obligations until two or three hours before they are legally permitted to sell the securities. The underwriters are permitted to “feel out” the market in advance and minimize the risk of loss. In addition,
the price at which the securities will be sold to the public is usually determined by the underwriters after the close of the market on the day before the registration statement is to be declared effective, thereby placing the costs of an unattractive issue on the issuer.

The underwriters' compensation, expressed in terms of the underwriting discount or "spread," is computed on the basis of a certain amount for each unit sold and is charged against the proceeds of the sale. For example, in a stock offering where the price to the public is ten dollars per share, an underwriter whose spread is five percent would receive fifty cents per share. The issuer would receive nine dollars and fifty cents per share as the proceeds of the sale.\(^\text{16}\) The underwriter may split its spread with dealers, who are not in privity with the issuer, through whom the stock may flow on its way to the public if the underwriting agreement permits.\(^\text{17}\)

The underwriters participate in drafting the registration statement and prospectus.\(^\text{18}\) If these documents are to withstand judicial scrutiny under the federal securities laws, the underwriters must undertake considerable research into the issuer and the industries in which it operates. This requires extensive financial analysis as well as visits to principal underwriters are permitted to "offer" and solicit indications of interest from potential purchasers of the securities, but no sales may be consummated until the effective date. 1933 Act § 5, 15 U.S.C. § 77e (1982).

\(^{15}\) Failure to feel out the market in advance can result in great losses for underwriters. In the recent European issuance of $2.1 billion of Fiat S.p.A. stock, underwriters who were not permitted to develop pre-sale interest in the securities were forced to assume losses of $100 million to $200 million. See Syndicate in Fiat Sale Faces Loss, N.Y. Times, Sept. 30, 1986, at D1, col. 6. Recent developments facilitating the offering of large amounts of securities in transactions which may take only hours from start to finish have put some teeth back into the underwriters' risk. See note 27 infra. For a discussion of the kind of large well-known issuers involved in those transactions, see Ehrbar, Upheaval in Investment Banking, Fortune, Aug. 23, 1982, at 90. Many underwriters have not been pleased with these changes. They have complained that while the standards of behavior required to escape liability under § 11 have not changed, they are under greater pressure to take risks in an increasingly competitive market. See Adoption of Integrated Disclosure System, Securities Act Release No. 33-6383, 47 Fed. Reg. 11,380 (1982). It should be noted that risk of loss is completely absent in a "best efforts" underwriting, in which the underwriters only commit to buy those securities they have been able to presell through the use of their best efforts.

\(^{16}\) The proceeds to the issuer would also be reduced by expenses of registration, which are typically the costs of printing, legal fees, accounting fees, and expenses associated with qualifying the offering under the various state securities laws.

\(^{17}\) Dooley, The Effect of Civil Liability on Investment Banking and the New Issues Market, 58 Va. L. Rev. 776, 785 (1972); Folk, supra note 12, at 55.

\(^{18}\) The registration statement filed in connection with a public offering contains the prospectus. The preliminary prospectus (i.e., the prospectus included in a registration statement which has been filed, but has not yet become effective) may be used by the underwriters to feel out the market for the securities, but not to complete sales. 1933 Act § 5(b), 15 U.S.C. § 77e(b) (1982). As a consequence, the prospectus has two sometimes opposing functions: marketing and disclosure.
company locations.\textsuperscript{19}

Section 11 of the 1933 Act provides a basis for liability for those who reviewed or should have reviewed a registration statement used in the public sale of securities if the statement contains a material misstatement or omission.\textsuperscript{20} Where sales were achieved through the use of a faulty registration statement, all purchasers of securities traceable to the statement may recover from the defendant groups specified in subsection 11(a), including the issuer, its directors, certain officers of the issuer, any experts whose opinions were contained in the registration statement, and “every underwriter with respect to such security.”\textsuperscript{21}

Where liability is found under section 11, damages are available pursuant to a statutory formula. Subsection 11(e) provides that, in general, damages are measured by the difference between the amount the plaintiff paid for a security, up to the public offering price, and its value at the time of the suit.\textsuperscript{22} This formula contemplates the case where the corrected disclosure causes a substantial drop in the market price of the


\textsuperscript{20} Subsection 11(a) provides in part:

\begin{quote}
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... may, either at law or in equity, in any court of competent jurisdiction, sue... 1933 Act § 11(a), 15 U.S.C. § 77k(a).
\end{quote}

\textsuperscript{21} Id. The phrase “any person acquiring such security” contained in § 11(a) includes purchasers in the aftermarket, if such purchasers can show that the securities they purchased were among those whose offering was covered by the faulty registration statement. Thus, there may be multiple plaintiffs for each share registered. Tracing securities to the registration statement is a simple matter where the litigation concerns an initial public offering, since all securities then publicly tradeable (with minor exceptions generally involving officers, directors, or controlling shareholders who would be unlikely plaintiffs in any event) will be in the public markets by virtue of the registered offering.

\textsuperscript{22} Subsection 11(e) states in relevant part:

\begin{quote}
The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: provided that if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable.
\end{quote}

1933 Act § 11(e), 15 U.S.C. § 77k(e).
issuer's securities. But it is in those situations where the provable damages are greatest that the issuing corporation is most likely to be unable to satisfy the judgment against it. As a substantive and tactical matter, naming all potential defendant groups listed in subsection 11(a) can be particularly important for a plaintiff if the issuer is or may become insolvent.

When a section 11 action is brought against a party other than the issuer, the only realistic defense against liability in a timely filed lawsuit is the "due diligence" defense set out in subsection 11(b). The due dili-

23 In Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971), one of the few cases brought under § 11 litigated to judgment, Judge Weinstein determined that a registration statement issued by Leasco Data Processing Equipment Corp. (Leasco), in connection with the securities it was offering the shareholders of Reliance Insurance Company (Reliance) in its acquisition of Reliance, contained a material omission. The market price of the Leasco securities, however, was barely affected by the disclosure of the omitted information. Judge Weinstein therefore concluded that under § 11, despite the statutory violation, damages were nominal, or, in some cases, not available at all. Id. at 586.

24 This is particularly true in light of the potentially large number of plaintiffs in a § 11 suit. See note 3 and accompanying text supra.

25 The possibility of insolvency would be more likely in connection with an initial public offering, since such transactions generally involve younger and less established companies.

26 Of course, if the circumstances so provide, the defendant may assert that the action is barred by the running of the statute of limitations. Section 13 of the 1933 Act, which contains the statute of limitations applicable to § 11 actions, provides in part:

No action shall be maintained to enforce any liability created under [section II of the 1933 Act] ... unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence ... In no event shall any such action be brought to enforce a liability created under section [11] ... more than three years after the security was bona fide offered to the public ....


Although three years is the maximum period theoretically available to plaintiffs, it is rarely feasible to file suit more than one year after the offering because the statute places the burden of proving reliance on the plaintiff after a subsequent disclosure document is filed. 1933 Act § 11(a), 15 U.S.C. § 77k(a).

27 Subsection 11(b)(3) contains the due diligence defense, the basic principle of which is:

(b) Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof -

.....

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading ....

1933 Act § 11(b)(3), 15 U.S.C. § 77k(b)(3). The due diligence defense has been attacked as outmoded, particularly in offerings involving companies which have been publicly traded for several years. This is because seasoned companies may now use abbreviated forms of registra-
gence defense is available to all parties specified in subsection 11(a) except the issuer of the securities.\textsuperscript{28} It has its conceptual basis in tort theories of negligence\textsuperscript{29} and provides that a defendant can avoid section 11 liability by proving that, under the circumstances, it acted "reasonably" in the discharge of its statutory obligation to "believe, after reasonable investigation" that the registration statement was true and complete. "Reasonable" conduct is "that required of a prudent man in the management of his own property."\textsuperscript{30} But since different people manage their own property differently, reasonable behavior to one defendant may be unreasonable to another.

Liability under section 11 is joint and several.\textsuperscript{31} The defendants, however, have a statutory right of contribution against each other.\textsuperscript{32} This

\textsuperscript{28} 1933 Act § 11(b), 15 U.S.C. § 77k(b).


\textsuperscript{30} 1933 Act §11(c), 15 U.S.C. § 77k(c).

\textsuperscript{31} 1933 Act § 11(f), 15 U.S.C. § 77k(f).

\textsuperscript{32} The right of contribution may be enforced either by bringing the potential contributors into the main action by way of a third-party complaint or in a separate action after judgment in the main action has been rendered. Compare Gould v. American-Hawaiian Steamship Co., 387 F. Supp. 163 (D. Del. 1974), vacated on other grounds, 535 F.2d 761 (3d Cir. 1976), with Smith v. Mulvaney, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,084 (S.D. Cal. June 5, 1985). Procedural questions regarding the method of enforcing the right to contribution are beyond the scope of this Article. For a discussion of such questions, see Adamski, Contribution and Settlement in Multiparty Actions Under Rule 10b-5, 66 Iowa L. Rev. 533 (1981).
right is provided in subsection 11(f):

[E]very person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.33

Underwriters have also attempted to obtain complete indemnification from the issuer for federal securities acts liability. In fact, contribution clauses rose from the ashes of indemnification agreements, and began to appear in underwriting agreements only after it was first held that an underwriter could not seek complete indemnification from the issuer.34 However, despite the near unanimity of the federal courts in voiding them,35 indemnification clauses have not completely disappeared from underwriting agreements. In most agreements, the indemnification clause immediately precedes the contribution clause.36

Unfortunately for underwriters, it is not clear that subsection 11(f)

33 1933 Act § 11(f), 15 U.S.C. § 77k(f). Fraud has been defined under the securities acts as encompassing only acts that involve some degree of scienter, i.e., willful, knowing, or purposeful conduct, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), as distinguished from the merely negligent acts for which liability may follow under § 11. Subsection 11(f) therefore excludes a defendant that intentionally violated § 11 from obtaining contribution from someone who was reckless or merely negligent in violating § 11. A negligent violator may, however, recover contribution from other violators.


36 The persistence of indemnification provisions in the face of virtually unanimous judicial opposition may be attributable either to the stubborn optimism of investment banking houses or to the utility of such clauses to an underwriter seeking to force a recalcitrant issuer into settlement negotiations. See note 191 infra. Would such leverage have much effect in dealing with a sophisticated issuer? One underwriter's counsel has suggested that indemnification clauses will cause the issuer to "at least . . . pay attorneys' fees as they are incurred." McLaughlin, Stapleton & Harman, supra note 34, at 258.
permits ex ante private contractual arrangements to implement its contribution provisions. Congress might have intended that subsection 11(f) occupy the field and thus preclude rather than authorize contribution clauses. Yet until there is a judicial determination of this question, the clauses will continue to appear. If the practice with respect to indemnification clauses is any guide, contribution clauses will probably continue to appear even if they receive a hostile reception from the judiciary.

Even if contribution clauses are authorized by the 1933 Act, subsection 11(f) provides no guidance in dividing liability. Contribution clauses in underwriting agreements generally take one of two forms. In the first, a “relative benefit” clause, contribution shares are based on the difference in benefits received by the various parties in the transaction. An example of a clause based on the relative benefit theory is the following:

If the indemnification provided in this section is unavailable or insufficient to hold harmless an indemnified party in respect of any losses, claims, damages or liabilities (or actions in respect thereof), then each indemnifying party shall contribute to the amount paid or payable by such indemnified party as a result of such losses, claims, damages or liabilities (or actions in respect thereof) in such proportion as is appropriate to reflect the relative benefits received by the Company on the one hand and the Underwriters on the other from the offering of the Shares. The relative benefits received by the Company on the one hand and the Underwriters on the other shall be deemed to be in the same proportions as the total net proceeds from the offering (before deducting expenses) received by the Company bear to the total underwriting discounts and commissions received by the Underwriters, in each case as set forth in the table on the cover page of the Prospectus.

In the second, a “relative fault-relative benefit” clause, contribution shares are based on a consideration of the relative benefits received by the parties as well as the relative fault of the parties in connection with the subject transaction. For example:

If the indemnification provided for in this section is unavailable to or insufficient to hold harmless an indemnified party in respect of any losses, claims, damages or liabilities (or actions in respect thereof), then each indemnifying party shall contribute to the amount paid or payable by such indemnified party as a result of such losses, claims, damages or liabilities (or actions in respect thereof) in such proportion as is appropriate to reflect the relative benefits received by the Company on the one hand and the Underwriters on the other from the offering of the Shares. If, however, the allocation provided by the im-

37 See text accompanying notes 171-78 infra.
Immediately preceding sentence is not permitted by applicable law or if the indemnified party failed to give notice to the indemnifying party, then each indemnifying party shall contribute to such amount paid or payable by such indemnified party in such proportion as is appropriate to reflect not only such relative benefits but also the relative fault of the Company on the one hand and the Underwriters on the other in connection with the statements or omissions which resulted in such losses, claims, damages or liabilities (or actions in respect thereof), as well as any other relevant equitable considerations. The relative benefits received by the Company on the one hand and the Underwriters on the other shall be deemed to be in the same proportions as the total net proceeds from the offering (before deducting expenses) received by the Company bear to the total underwriting discounts and commissions received by the Underwriters, in each case as set forth in the table on the cover page of the Prospectus. The relative fault shall be determined by reference to, among other things, whether the untrue or alleged untrue statement of a material fact or the omission or alleged omission to state a material fact relates to information supplied by the Company on the one hand or the Underwriters on the other and the parties' relative intent, knowledge, access to information and opportunity to correct such statement or omission.

Interestingly, contribution clauses which apportion liability by relative fault alone do not appear. Their absence is possibly explained by an assumption by underwriters and their counsel that such clauses would provide no protection to underwriters beyond what a court might afford in the absence of prior agreement by the parties. In other words, relative fault-based clauses will not limit the underwriters' liability since a court could still allocate a full range of fault to the underwriters.

The relative benefit concept is very important to underwriters because it enables them to plan for an upper limit of potential exposure. Since the compensation received by the underwriter is its most obvious and easily quantifiable benefit from the transaction, the relative benefit

38 A less quantifiable form of economic benefit which may accrue to underwriters is the enhancement of an underwriter's reputation, either generally, for completing a large number of deals, or specifically, for expertise in a particular industry or type of offering. This can in turn be readily marketed and translated into higher earnings. Each year, for example, the Wall Street Journal reports the winner of the "underwriter sweepstakes." See, e.g., Monroe, Salomon Brothers Was Lead Manager of 25% of Public Securities Issues in '84, Wall St. J., Jan. 2, 1985, at 23, col. 3. Immediately following such reports, investment banks advertise their expertise in the underwriting of securities. Following the announcement that they were number one for 1984, Salomon Brothers took out a full page ad, entitled "Congratulations, Salomon Brothers," in the Wall Street Journal telling the world of their achievement. Wall St. J., Jan. 10, 1985, at 25. Other investment banking houses also advertise the work they did in the preceding year at this time. For an example, see the advertisement entitled "Vision . . . Commitment: Shearson Lehman/American Express," which occupied eight full pages in the Wall Street Journal. Wall St. J., Jan. 10, 1985, at 35-42. For an example of an investment banking firm advertising its expertise in a particular industry, see the advertisement entitled
factor is actually an attempt to limit the underwriters' damages to a disgorgement measure by defining "benefits" as the underwriting spread.

Do either relative fault or relative benefit as set forth in these clauses provide an appropriate method for allocation? Is there a point at which a contractual allocation of contribution shares presents the same problems for the policies of the federal securities acts as would complete indemnification? Are the components of fault for tort purposes the same as the components of culpability for securities acts purposes? Are there important policy differences between the roles of issuer and underwriter which are not adequately expressed in traditional tort-based analysis? Resolution of policy dilemmas such as these is traditionally accomplished by recourse to the statutory provision's legislative history. Unfortunately, in this case the legislative history of section 11 is not particularly illuminating.

II
SECTION 11, INDEMNIFICATION, AND CONTRIBUTION

A. The Legislative History of Section 11

The legislative history of subsection 11(f) of the Securities Act of 1933 is sparse. The hearings and debates on the entire 1933 Act are more evocative of the time, place, and attitude following the 1929 stock market crash than elucidative of particular sections of the statute. However, the emphasis Congress placed on the special status of underwriters is apparent from the legislative record. It is clear that Congress intended underwriters to be responsible for injuries suffered by purchasers in connection with public offerings of securities.

Subsection 11(f) first appeared, in substantially the same form Congress ultimately enacted, in a memorandum submitted by the Investment Bankers Association of America to the House Committee on Interstate and Foreign Commerce. The text of section 11, including subsection

"A growing number of health care companies recognize the expertise of a particular investment bank," Wall St. J., Sept. 23, 1985, at 55.


came from an English law, the Companies Act 1929, with one significant difference: section 11 provides for underwriters' liability and the English version does not.

This reflects Congress's belief that underwriters of securities were among the central contributors to the tragedy resulting from the stock market crash of 1929. This opinion is clearly set forth in the House Report:

During the post-[World War I] decade some 50 billions of new securities were floated in the United States. Fully half or $25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises.

As the report shows, Congress recognized the significance of the dual function of the underwriters, as both evaluators and marketers, in the enterprise of securities distribution. It also realized that the reliance of the public upon the underwriter as the guarantor of the soundness of an issuer is substantial.

Thus, Congress imposed section 11 liability on underwriters as a

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41 Companies Act, 1929, 19 & 20 Geo. 5, ch. 23. Subsection 37(3) of the Companies Act, 1929 reads:

Every person who, by reason of his having been a director or named as a director or as having agreed to become a director or of his having authorized the issue of the prospectus, becomes liable to make any payment under this section may recover contribution, as in cases of contract, from any other person who, if sued separately, would have been liable to make the same payment, unless the person who has become so liable was, and the other was not, guilty of fraudulent misrepresentation.

§ 37(3). Excluding the last clause, the language of the Companies Act 1929 comes in turn from the Directors Liability Act, 1890, 53 & 54 Vict. ch. 64, § 5.


43 The stock market crash spurred Congress into passing the 1933 Act. Dooley, supra note 17, at 794.


45 Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev. 29, 30 (1959); Dooley, supra note 17, at 794.
matter of public policy as well as one of marketing reality. By the enactment of section 11, Congress charged underwriters with the duty of furthering the statutory goals of fraud prevention and investor protection.\textsuperscript{46} As intermediaries between the issuers and the market, underwriters must represent the public in investigating issuers and prevent the fraudulent issuance of securities, where appropriate, by refusing to handle such offerings.\textsuperscript{47} By lending their names to an issue, underwriters will also be held, in law as well as in fact, to have conveyed the assurance that reasonable inquiry has been made into the soundness of an investment.\textsuperscript{48} Given the nature and extent of the disclosures required in the registration statement, a reasonable investigation entails a review by the underwriter of all of the business, operations, and finances of the issuer. Such an examination by the underwriter fulfills the public advocate function Congress imposed by putting the underwriter on notice of any facts that might necessitate the halting of an offering.\textsuperscript{49}

Original drafts of the 1933 Act in both houses of Congress contained no “outs” for the parties listed in subsection 11(a).\textsuperscript{50} The drafters of the 1933 Act, however, while generally in favor of heightened liability for participants in public securities sales, recognized that liability could chill legitimate business if it were too easily imposed. The drafters sought to make the “penalties . . . so severe as to make it improvident not to tell [the truth]” while ensuring “minimum interference” with legitimate business.\textsuperscript{51} Accordingly, Congress introduced various modifications, including the due diligence defense and the addition of subsection (f), to section 11 in order to meet this concern.\textsuperscript{52}


\textsuperscript{47} While recent developments have increased competition among underwriters for business, see note 15 supra, the SEC has been notably unsympathetic to underwriters’ pleas for relief from some of their statutory obligations. See text accompanying notes 70-71 infra.


\textsuperscript{49} The provisions of the Companies Act 1929 regarding directors liability, on which § 11 is based, reflected a concern shared by the 73d Congress about “dummy” directors and other persons who lend their names and credibility to an issue of securities about which they know nothing. Note, supra note 42, at 1264-67.

\textsuperscript{50} The legislative history does not show a clear differentiation in the minds of the members of Congress between the roles played by directors of corporations and by underwriters of securities of those corporations. In light of the fact that many underwriters sat as directors of the corporations whose securities they underwrote, and since underwriters controlled access to the markets by the issuer, this was not an unreasonable confusion.


\textsuperscript{52} The disquiet of various members of Congress could be attributed to a concern that massive liability would be imposed on individuals who had acted in good faith or made honest mistakes. The drafters of the bill responded to this complaint as follows: “Let us assume that a
Furthermore, Congress established a standard of reasonable care rather than one of strict liability in the due diligence defense for all parties except the issuer. The House Report made clear, however, that evidence sufficient to support the defense would vary, not only with the skill and knowledge of the defendant, but also with the defendant's participation in the marketing process and the degree to which purchasers are likely to rely on that defendant.

Even though the investment banks' counsel initially proposed the language of subsection 11(f), the financial community still feared potentially enormous liability exposure resulting from the enactment of section 11. Congress responded by including in the Securities Exchange Act of 1934, amendments to the 33 Act making additional modifications to section 11 which further limited underwriters' liability. First, Congress changed the fiduciary standard underlying subsection 11(c) from that of "a person occupying a fiduciary relationship" to that of "a prudent director makes an innocent mistake, but that, as a result of the mistake, an innocent investor suffers. Who should bear the loss of the mistake, the man who set the machinery in motion which resulted in the loss or the man who suffered the loss?" Senate Hearings, supra note 46, at 204, 2 Legislative History of the Securities Act of 1933 and Securities Act of 1934, at 204 (1973) (testimony of the Hon. Alexander Holtzoff, special assistant to the Attorney General). The attitude of the drafters largely prevailed in the statutory provisions, with some significant limitations. See text accompanying notes 56-61 infra.

54 "The duty of care to discover 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." House Report, supra note 44, at 9, 1 Federal Securities Laws, Legislative History 1933-1982, at 146 (1983).
55 "The Senate manager [of the 1934 Act] noted that the original standards [for underwriters' liability] had been 'terrifyingly portrayed' and implied that the change [that was ultimately made in subsection 11(f)] was made largely for psychological purposes." Folk, supra note 12, at 19 n.117; see also Dooley, supra note 17, at 804-05 ("Instead of retiring from the field, the investment banking community brought considerable pressure to modify the Act . . . .").
56 The House Report states:

[The] essential characteristic [of the civil liabilities imposed by this bill] consists of a requirement that all those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary. Honesty, care, and competence are the demands of trusteeship. These demands are made by the bill on the directors of the issuers, its experts, and the underwriters who sponsor the issue. If it be said that this imposition of such responsibilities upon these persons will be to alter corporate organization and corporate practice in this country, such a result is only what your committee expects.

House Report, supra note 44, at 5, 1 Federal Securities Laws, Legislative History 1933-1982, at 142 (1983). This theme is further elaborated in the discussion of civil liabilities in the same report:

For those whose moral responsibility to the public is particularly heavy, there is a correspondingly heavier legal liability . . . [citing the listed defendants, including underwriters, and the due diligence standard of investigation]. This throws upon originators of securities a duty of competence as well as innocence which the history of recent spectacular failures overwhelmingly justifies . . . .

man in the management of his own property.”57 Next, Congress revised subsection 11(a) to require proof of a limited form of reliance as an element of a plaintiff’s case.58 In the original subsection 11(a), as long as a case could be brought, liability could be imposed on an underwriter whether or not the plaintiff actually relied on any of the underwriter’s acts to his detriment. Third, Congress amended the damage formula of subsection 11(e) by placing a specific cap on the liability of underwriters (but not of any other defendants).59 Finally, Congress amended section 13 to shorten the period of the applicable statute of limitations from ten years to three years.60 Despite these amendments, it remained clear that Congress intended underwriters to be responsible for injuries suffered by purchasers in connection with public offerings of securities.61

B. Judicial and Administrative Development of Section 11

Congress’s emphasis on the special status of underwriters under the 1933 Act62 has significantly influenced federal court treatment of securities acts liability, including the interpretation of indemnification and contribution concepts. Courts generally have adopted the position that the

   If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.
   Underwriting agreements typically include a covenant by the issuer that it will release an earnings statement 12 months from the date of the offering for that intervening period, thereby triggering the reliance requirement.
   In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public.
1933 Act § 11(e), 15 U.S.C. § 77k(e).
nature of the underwriters' function in the public issuance of securities is that of "devil's advocate" on the public's behalf with respect to the issuer. This stress on the underwriter as an adversary to the issuer is well-founded, given the policy expressed in section 11 and the consequent need for the underwriter to avoid concentrating its energies solely on pleasing its client-issuer.

On the other hand, the SEC, which, as the agency charged with administering the federal securities acts, might be expected to take positions on indemnification and contribution questions, has not made a definitive statement on the indemnification of underwriters and has remained silent regarding the nature of the contribution permitted by the statutes. However, the SEC has issued interpretive statements that address section 11 liability questions, and has spoken strongly against indemnification when it concerns officers, directors, and controlling persons. The Commission's position is that indemnification of these parties is "against public policy as expressed in the [1933] Act and is, therefore, unenforceable." Similarly, the SEC has condemned indemnification of independent accountants. The thrust of the Commission's position on accountants is that indemnification would have a debilitating effect on the accountant's obligation to "appraise with professional acumen the information disclosed by the examination" of the issuer's financial affairs. Since underwriters have a similar obligation in connection with an offering of securities, the SEC's analysis should by analogy be applicable to underwriters as well.

Additionally, the SEC requires disclosure of the existence and terms of contractual arrangements providing for indemnification of underwriters. Moreover, the SEC has on several occasions spoken of the special and heightened burden that underwriters bear as intermediaries between the issuer and the public. For example, in the early 1950s, the Commission spoke of the underwriters' obligation to go beyond reliance on "the issuer's obviously self-serving statements" and engage in verification. More recently, in the face of pressure from underwriters to reduce the

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64 Underwriters are hired and paid by the issuer. Virtually all dealings between the issuer and the underwriters are through the managing underwriter, to whom the issuer is a client. Remuneration is both through the payment of expenses and through the sharing of the offering proceeds by way of the underwriting discount (or commission) per unit. See text accompanying note 16 supra.
67 Id. at 10,923.
68 This disclosure requirement appears in Item 508(g) of Regulation S-K, 17 C.F.R. § 229.508(g) (1986).
standards of the due diligence requirement, the SEC's position has consistently been that the investigation requirement is particularly important for underwriters\textsuperscript{70} and that competitive pressures on underwriters are not a sufficient basis for modification of their statutory responsibilities.\textsuperscript{71} Even in the context of the integrated disclosure system and abbreviated forms of registration,\textsuperscript{72} the SEC has preferred to rely on the "continued flexible application" of the due diligence standard by the courts to provide "assurance to subject persons that they will not incur unreasonable investigative burdens."\textsuperscript{73}

The absence of express SEC objection to the indemnification of underwriters by issuers remains a mystery. Commentators have said that while the Commission is perceived to harbor "apparent hostility" toward such indemnification,\textsuperscript{74} its silence is "unjustifiable"\textsuperscript{75} and "unpersuasive for want of justification consistent with the deterrent policy of the [1933] Act."\textsuperscript{76} The most likely explanation for the silence is timing. During the period shortly after the 1933 Act was passed, the SEC probably avoided statements that would exacerbate the fear of liability being expressed by the underwriters.\textsuperscript{77} By more recent times, the courts had already taken the lead in pronouncements in the area.

The federal courts' analysis of underwriters' liability under the federal securities acts began with \textit{Escott v. BarChris Construction Corp.},\textsuperscript{78} the first reported case to explore the due diligence defense.\textsuperscript{79} In arriving at its decision, the \textit{BarChris} court took several positions regarding the liability of the underwriters which are significant to later developments regarding indemnity and contribution questions. \textit{BarChris} involved the registered public offering of debentures by a bowling alley construction company. The registration statement for the debentures was declared effective on May 16, 1961. The industry found itself with enormous excess capacity, however, as the public turned to other leisure-time activities. BarChris, in progressively deeper financial trouble, filed for

\textsuperscript{72} See note 27 supra.
\textsuperscript{74} Freund & Hacker, Cutting Up the Humble Pie: A Practical Approach to Apportioning Litigation Risks Among Underwriters, 48 St. John's L. Rev. 461, 473 (1973).
\textsuperscript{75} Note, supra note 61, at 411.
\textsuperscript{78} 283 F. Supp. 643 (S.D.N.Y. 1968).
\textsuperscript{79} 6 L. Loss, supra note 77, at 3849; Folk, supra note 12, at 4. BarChris remains one of the few cases brought under § 11 to be litigated to a judgment on the merits.
bankruptcy and, in November 1962, defaulted on the interest due on the debentures it had issued.  

The plaintiffs, owners of the BarChris debentures, sued the full panoply of available defendants under section 11, alleging various misstatements and omissions in both the narrative text and in the audited financial statements of the registration statement for the debentures. All of the defendants asserted the due diligence defense under subsection 11(b) except the issuer, to whom the defense is not available. All defendants were found liable.

The court's analysis shows that the due diligence defense actually comprises several different defenses having different elements. Only two of these are significant for the purposes of this discussion. The first arises when the due diligence defense is asserted by a nonexpert defendant with respect to portions of a registration statement not prepared or certified by an expert. In this case, the defendant must establish that his behavior conformed to the statutory standard. Specifically, the defendant has the affirmative burden of showing that he made a reasonable investigation which led to his actual and reasonable belief that the registration statement was true and complete. The second arises when the due diligence defense is asserted as to the so-called expertised portion of the registration statement. Here, the defendant need only show that he had no reasonable ground to believe, and had no actual belief, that the expertised portion contained a defect.

In BarChris, the managing underwriter, Drexel & Co., had conducted a general investigation of the issuing company. The court, how-

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80 283 F. Supp. at 654.
81 Id. at 652. Among the defendants were the persons signing the registration statement (including the company and all its directors), the underwriters, and the auditors.
82 Id. at 683.
83 See note 28 and accompanying text supra.
85 Nonexpert defendants include the issuer, its directors, its officers who signed the registration statement, and the underwriters.
87 An expert is someone "whose profession gives authority to a statement made by him, who has with his consent been named" as such in the registration statement. 1933 Act § 11(a)(4), 15 U.S.C. § 77k(a)(4). Accountants who certify financial statements are expressly considered experts. Id.
88 1933 Act § 11(b)(3)(C), 15 U.S.C. § 77k(b)(3)(C). The BarChris court rejected the defense's contention that an entire registration statement is expertised by virtue of the fact that the statement is drafted by lawyers. 283 F. Supp. at 683. Such a finding would have relieved all parties, except the issuer and the lawyers—who are not named in § 11(a) as possible defendants—from any affirmative burden of reasonable care, a result which would have been clearly at odds with congressional intent.
89 The court found that the participating underwriters delegated their statutory obligations to investigate and therefore held them liable due to Drexel's failure to investigate adequately. 283 F. Supp. at 697.
ever, found the underwriters’ specific investigation of the information contained in the registration statement insufficient to meet the due diligence standard because the underwriters neglected to attempt to verify information supplied by the company and its counsel.\(^9\) The underwriters were not permitted to rely on reports received from the company’s officers despite the fact that Coleman, a member of Drexel, was a director of BarChris.\(^9\) Thus, underwriters are subject to a higher standard than even the directors of a company, who may ordinarily rely on the reports of their subordinates. Indeed, underwriters must take a position “adverse” to the company.

According to the BarChris court, underwriters carry an extra heavy burden in due diligence relative to other parties. Like the issuer, they bear general responsibility for the registration statement. However, the court noted, “prospective investors rely upon the reputation of the underwriters,” not just upon the disclosed information, “in deciding whether to purchase the securities.”\(^9\) Inclusion of the underwriters as subsection 11(a) defendants is thus meant to provide protection to investors beyond that provided by the issuer, which may have what it considers good reasons to withhold or color information.

The BarChris court further noted that underwriters are not engaged in “mere accurate reporting”\(^9\) but are charged with protecting the public.\(^9\) This task is one for which they are entirely suited. Underwriters bring professional financial expertise, staff, and resources to a proposed public offering, and they are compensated for those resources. Further, an issuer gains prestige by associating with an important investment banking house. The sum of these elements gives the underwriter unrivaled leverage over the issuer, and thus places the underwriter in an ideal position to meet its section 11 obligations.\(^9\)

C. Limitations of Underwriters’ Liability Through Indemnification and Contribution

Given the Escott v. BarChris Construction Corp.\(^9\) view of underwriters’ duties,\(^9\) it is not surprising that courts have carefully scrutinized devices which attempt to limit underwriters’ liability under the federal securities acts. The rationale of BarChris and the standards it established

\(^9\) Id. at 696.

\(^9\) Id. at 693.

\(^9\) Id. at 696; see also Folk, supra note 12, at 54.

\(^9\) 283 F. Supp. at 697.

\(^9\) Id.

\(^9\) See Folk, supra note 12, at 54-56, 79.


\(^9\) See text accompanying notes 92-95 supra.
for the due diligence defense remain undiluted. Therefore, when the question arose of indemnification of underwriters by issuers for securities acts liability, the conclusion that such indemnification was prohibited as against public policy should have flowed smoothly into the river of the law. However, underwriters, using their leverage over issuers, were accustomed to obtaining contractual indemnification from issuers to protect themselves against potential liability for securities law violations and assumed that indemnification agreements were enforceable. For this reason, *Globus v. Law Research Service, Inc.* (*Globus I*) 98 landed on the securities industry like a rock on a quiet pool.

The *Globus* cases 99 arose out of a Regulation A 100 public offering of the common stock of Law Research Service, Inc., a computerized research service company. The offering materials failed to mention an important dispute between the company and its computer supplier and servicer. Various defendants were found liable for this omission, but since the underwriting agreement between the underwriters, Blair & Co., and the issuing company contained an indemnification clause, 101 Blair cross-claimed against the issuer to enforce the agreement. The *Globus I* court denied the cross-claim, and Judge Mansfield was forthright about the need to void the indemnification agreement. First, he found that Blair had acted with "wanton indifference to its obligations and the rights of others." 102 Second, he reasoned that enforcing the indemnification provision would deny the public the "benefit of a thorough investigation of the facts" by the underwriter, an investigation found less likely to occur if the underwriter "were to be permitted to escape liability for its own misconduct by obtaining indemnity." 103

While the Second Circuit's affirmance carefully limited the effect of its ruling to "the case where the underwriter has committed a sin graver than ordinary negligence," 104 Judge Kaufman's opinion mentioned the statutory equation of underwriters with directors and others named in

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100 A Regulation A offering is made in compliance with Rules 251-262 under the 1933 Act, 17 C.F.R. §§ 230.251-.262 (1986). Regulation A offerings are exempt from the registration requirements of the 1933 Act pursuant to § 3(b), 15 U.S.C. § 77c(b). Thus, no effective registration statement was filed. In the absence of such a statement, § 11 does not apply. 1933 Act § 11(a), 15 U.S.C. § 77k(a) (1982).
102 Id. at 199.
103 Id.
subsection 11(a), even though section 11 was not at issue. Moreover, the court was troubled by the notion that permitting issuer indemnification of the underwriter would have the ultimate consequence of shifting the economic burden of liability to the stockholders of the issuer, many of whom may have been "the very purchasers to whom the underwriter should have been initially liable."106

A trend against indemnification emerged after Globus I. Initially, courts began to expand the scope of Globus I, applying its policy against indemnification of underwriters to cases involving liability based solely on negligence.107 In Gould v. American-Hawaiian Steamship Co.,108 the court held that a party who negligently breaches responsibilities imposed by subsection 14(a) of the 1934 Act109 has no right to indemnification. "Only a realistic possibility of liability for damages will encourage due diligence . . . and will protect the interest of informed corporate suffrage."110

More recently, the court in Kennedy v. Josephthal & Co.111 recognized that "it is the purpose of the federal securities laws to deter conduct that is merely negligent, as well as conduct that is willful, knowing or reckless. This is particularly important when the acts in question are those of an underwriter . . ."112 The court reiterated the point that indemnification of underwriters against securities acts liabilities is generally conceded to be impermissible as against public policy.113

105 Id.
106 Id. at 1289.
107 See, e.g., Heizer Corp. v. Ross, 601 F.2d 330 (7th Cir. 1979) (no indemnification for Rule 10b-5 violations); Maryville Academy v. Loeb Rhodes & Co., 530 F. Supp. 1061 (N.D. Ill. 1981) (indemnification disallowed for securities acts liabilities, regardless of whether indemnity is sought through a contractual provision or through the common law).
112 Id. at 95,821-22.
113 Id; see also Seiler v. E.F. Hutton & Co., [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,632, at 99,203 (D.N.J. Aug. 15, 1984) ("The law is settled that no right to indemnity exists under the securities laws."). Occasional opinions acknowledge the possibility that where the underwriter is significantly less culpable than the issuer, an indemnification agreement might be enforced. See, e.g., Steinberg v. Pargas, Inc., [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,979, at 90,882 (S.D.N.Y. Mar. 18, 1985) ("It is unnecessary for this Court to decide whether the indemnification provision in the instant case would ultimately be enforceable if defendants were found liable. The court need only find that the making of the agreement
It is clear that courts refuse to enforce indemnity provisions because a rule allowing indemnification would nullify the liability of the indemnified party and, in the case of issuer indemnification of an underwriter, could irreparably damage the statutory scheme by eliminating the underwriter's incentive to fulfill its investigative obligation under section 11. The statute would fail to serve the prophylactic purpose that, at least since BarChris, has required an independent investigation as a separate element of the due diligence defense, thus ensuring that underwriters "make some reasonable attempt to verify the data submitted to them."

In contrast to the judicial hostility towards enforceability of indemnification agreements, courts generally have warmly received defendants seeking contribution from others who are or would be jointly liable. The reappearance of the Globus case in Globus v. Law Research Service, Inc. (Globus II) established the policy differences between indemnification and contribution. Globus II arose when the underwriter, Blair & Co., having lost its bid for indemnification in Globus I, paid the entire judgment and sought contribution from the issuer, Law Research, and its president. In Globus II, Judge Frankel permitted, and indeed endorsed, contribution, explaining that contribution promotes the same policy interests indemnification thwarts.

A central ground for the ruling on indemnity [in Globus I] was the judgment that allowing such means of absolution would dilute the deterrent impact of the securities laws . . . . The shoe is now on the other foot. If not identical, the mode of escape [avoidance of contribution] sought by [Law Research and its president] is objectionable on substantially similar grounds. They may not effectively nullify their "liability for compensatory damages" by leaving the whole of the burden to the more prompt and diligent party with which they have been cast in joint and several liability.

Globus II endorsed the contribution doctrine and expanded its scope under the federal securities acts because it was brought under subsection 12(2) of the 1933 Act and subsection 10(b) of the 1934 Act rather than under section 11 or either of the two federal securities acts provisions.
that expressly authorize contribution among jointly liable parties. Judge Frankel's opinion is particularly important because it rests on concepts which pervade all civil liability under the federal securities acts.

Other courts have endorsed the view that contribution furthers the policies of the federal securities acts. For example, in Laventhol, Krekstein, Horwath & Horwath v. Horwitch, a section 11 case, the court allowed contribution for an underwriter found liable, noting that "contribution strengthens the policy underlying the securities laws. As between the culpable parties, contribution reinforces the deterrent effect of the statute by preventing one wrongdoer from unjustly escaping loss by shifting its responsibility to another wrongdoer liable for the same payment." The common analytical thread running through these opinions is that contribution prevents wrongdoers from escaping liability through the fortuitous circumstance of not being sued in a particular action. Knowing this, underwriters will undertake the required diligent investigation necessary to avoid liability, furthering the prophylactic purpose of section 11. This belief that the deterrent function of the securities laws is best served by a rule of contribution, coupled with the express provision for contribution in three statutory provisions, has led courts to imply a right of contribution into sections of the securities laws where none is provided by statute. Furthermore, in dramatic contrast to the

119 The Globus cases alleged violations of § 12(2) and § 17(a) of the 1933 Act, 15 U.S.C. §§ 77l(2), 77q(a) (1982), and § 10(b) and § 15(c) of the 1934 Act, 15 U.S.C. §§ 78j(b), 78o(c) (1982). Section 9 and § 18 of the 1934 Act, 15 U.S.C. §§ 78i, 78r (1982), in addition to § 11 of the 1933 Act, are the only sections which expressly authorize contribution among jointly liable parties.
120 637 F.2d 672 (9th Cir. 1980), cert. denied, 452 U.S. 963 (1981).
121 Id. at 672, 675.
122 This argument has some detractors. See, e.g., Adamski, supra note 32, at 540 (rule allowing contribution has no deterrent effect since it is unlikely that potential wrongdoers would be aware of the rule).
123 See note 119 and accompanying text supra.
124 E.g., Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981) (right of contribution implied under Rule 10b-5), rev'd in part on other grounds, 459 U.S. 375 (1983); Odette v. Shearson, Hammill & Co., 394 F. Supp. 946 (S.D.N.Y. 1975) (right of contribution implied under § 12(2) of the 1933 Act). Cf. Texas Industries v. Radcliffe Materials, Inc., 451 U.S. 630 (1981) (right to contribution not implied under the federal antitrust statutes). Of particular interest in Texas Industries, id., are the Court's focus on the absence of any evidence of legislative intent to authorize contribution in the antitrust laws, and its determination that the availability of treble damages evinced a primarily punitive purpose to liability there, supporting its holding that liability for joint tortfeasors should be left where it falls. The federal securities acts are markedly different on both points. The right of contribution is explicit in several sections of the securities law, and treble damages are not available to private plaintiffs. Treble damages have been available to the government only since 1984, upon the enactment of the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified at 15 U.S.C. §§ 78c, 78o, 78t, 78u, 78ff (Supp. II 1984)).
common law principle that contribution is not available to intentional wrongdoers, one court has gone so far as to find that "[i]f the securities laws are to serve their intended purpose, contribution among tortfeasors, including intentional tortfeasors, is essential."125

III
CONTRIBUTION VS. INDEMNIFICATION:
ARE THEY REALLY DIFFERENT?

The Globus v. Law Research Service, Inc. cases, Globus I126 and Globus II,127 and subsequent cases rejected indemnification while they welcomed contribution. In practice, however, the difference between contribution and indemnification is not clear. In many respects they are closely related, and there is no clear division between them. Indeed, contribution and indemnification are simply two points along a single continuous line.128 Consequently, there may be "contribution" arrangements which, while not effecting a complete shift of expense, actually result in de facto indemnification. Such allocations of loss through such forms of contribution greatly dilute the deterrent impact of the securities laws and should be treated with the same hostility directed toward indemnification agreements.129 This Part investigates the reasons favoring contribution over indemnification under the securities acts and discusses the types of contribution arrangements which are consistent with these rationales.

A. The Preference for Contribution

The theory under which courts favor contribution over indemnification is simply that indemnification against federal securities acts liabilities could discourage performance of the underwriters' statutory functions, while contribution could encourage the desired performance. The reasons for this differential treatment lie in the conceptual bases for indemnification and contribution.

The definitions usually used to distinguish indemnification from contribution are that the former "means a shifting of the entire loss to another who, for equitable reasons, should pay alone," while the latter "means a sharing of the loss."130 This distinction may help explain why

129 Id.
130 Note, supra note 42, at 1261. The author states:
courts are reluctant to permit the indemnification of underwriters while they welcome contribution: the issue of contribution does not arise at all until there has been a finding of liability, while indemnification settles the distribution of risks up front. Since under section 11 a finding of liability means that the underwriter's behavior did not meet the statutorily mandated minimum, there are few compelling equitable reasons for shifting the entire loss elsewhere by indemnification. Contribution, on the other hand, unlike indemnification, does not dilute the statute's deterrent effect because it ensures that everyone failing to meet the standard of care will bear some of the loss. In fact, in *Globus v. Law Research Service, Inc. (Globus II)*, Judge Frankel opined that refusing to permit contribution might produce the same undesirable effect as allowing indemnification, which is to insulate a joint tortfeasor from the liability imposed by the statute.

The history of the development of indemnification and contribution at common law also sheds light on the nature of the right to contribution set forth in the 1933 Act. At the time the statute was drafted, the majority common law rule, traceable to the 1799 English case of *Merryweather v. Nixan*, denied a right of contribution between joint tortfeasors. Although historical research suggests that the *Merryweather* holding was limited to intentional tortfeasors, American courts broadly interpreted the case to prohibit contribution among negligent tortfeasors as well.

Although the rule against contribution was firmly entrenched in American common law, a growing discontent with the rule emerged at

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132 Id. at 958.
134 Restatement of Restitution § 102 (1936). While this was the majority rule at the time, the rule had been more liberal in some jurisdictions. Eleven states by legislative action and four states by judicial decree recognized the right to contribution between negligent tortfeasors. Comment, Legislative Efforts to Distribute Loss Between Joint Tortfeasors, 45 Harv. L. Rev. 369, 370 n.8 (1931).
135 See Ruder, supra note 39, at 648 n.226 (however, in 1799, when the *Merryweather* opinion was handed down, a "tort" was willful or intentional wrongdoing and a "tortfeasor" was a willful or intentional wrongdoer).
136 See generally, Prosser & Keeton, supra note 130, § 50, at 305-06; Davis, Indemnity Between Negligent Tortfeasors, 37 Iowa L. Rev. 517 (1952).
137 Restatement (Second) of Torts § 886A(I) comment a (1982).
the turn of the twentieth century.\textsuperscript{138} It was generally perceived that the rule was inequitable, permitting one tortfeasor to escape liability simply because he was fortunate enough not to have been chosen as a defendant, while saddling the other wrongdoer with the entire liability for a jointly committed wrong.\textsuperscript{139}

This inequity compelled some jurisdictions to change the rule by legislative or judicial action.\textsuperscript{140} Other jurisdictions turned to the doctrine of indemnification as a method for allocating liability among tortfeasors.\textsuperscript{141} Under common law the right to indemnification originally depended upon a contractual arrangement,\textsuperscript{142} typically in the form of either an express contract between the parties or an implied contract to indemnify arising from the particular relationships the parties shared.\textsuperscript{143} These jurisdictions therefore developed an additional basis for indemnification to circumvent the inflexible nature of the no-contribution rule.\textsuperscript{144} This form of relief, called tort-indemnity,\textsuperscript{145} is based upon differences in the degree of negligence of the respective tortfeasors,\textsuperscript{146} and employs court-developed distinctions such as active/passive and primary/secondary in order to assess the varying degrees of negligence among jointly liable parties.\textsuperscript{147} Courts using the tort-indemnity doctrine of indemnification were able to shift liability on the basis of relative degrees of fault notwithstanding the lack of a contractual agreement between the parties and the rule prohibiting contribution.

Tort-indemnity did not provide a fully equitable division of liability among tortfeasors in every case. However, it did allow courts to prevent the most egregious situation where the least culpable tortfeasor was burdened with the entire liability. Consequently, courts were able to miti-

\textsuperscript{138} This discontent may have resulted in § 11(f)'s provision for contribution "as in cases of contract." See text accompanying notes 171-80 infra.


\textsuperscript{141} See Restatement (Second) of Torts § 886B comment a (1982).

\textsuperscript{142} See 2 S. Williston, Contracts § 345 (3d ed. 1959).

\textsuperscript{143} See, e.g., Zapico v. Bucyrus-Erie Co., 579 F.2d 714, 719 (2d Cir. 1978).

\textsuperscript{144} "The law of indemnity developed at an earlier time when contribution was not available. Its all-or-nothing remedy was thus the only relief available to a joint tortfeasor who had paid the full amount of the injury. Courts therefore were inclined to be ready to expand the list of situations in which indemnity might be granted." Restatement (Second) of Torts § 886B comment a (1982).

\textsuperscript{145} See Zapico, 579 F.2d at 718.

\textsuperscript{146} Id.

gate the harshness of the no-contribution rule under the guise of indemnification. Judge Learned Hand explained:

Such cases may perhaps be accounted for as lenient exceptions to the doctrine that there can be no contribution between joint tortfeasors, for indemnity is only an extreme form of contribution. When both are liable to the same person for a single joint wrong, and contribution . . . is impossible, the temptation is strong if the faults differ greatly in gravity, to throw the whole loss upon the more guilty of the two.\textsuperscript{148}

During the twentieth century, a majority of the states discarded the no-contribution rule\textsuperscript{149} and the doctrine of comparative negligence arose. As a result, the apportionment of liability no longer depended on artificial extensions of the doctrine of indemnification such as tort-indemnity. Concepts from tort-indemnity, however, would later appear as part of contribution doctrine.\textsuperscript{150}

Another source for the rejection of indemnification and the acceptance of contribution may be found in notions regarding the purpose of civil liability under the federal securities acts. In order to safeguard the public from fraud, section 11 functions primarily to modify behavior at the investigation phase.\textsuperscript{151} By making private causes of action available, Congress intended primarily to promote this deterrence goal and only secondarily to compensate investors for their losses. As one court explained, "Civil liability under section 11 and similar provisions was designed not so much to compensate the defrauded purchaser as to promote enforcement of the [1933] Act and to deter negligence by providing a penalty for those who fail in their duties."\textsuperscript{152}

The development of the 1933 Act reveals the drafters' focus on deterrence rather than on compensation. The original Senate version of the Act, unlike the House version,\textsuperscript{153} did not provide for a due diligence defense.\textsuperscript{154} Rather, the Senate version treated defendants as insurers, rendering them liable for a materially defective registration statement even if reasonable care was exercised.\textsuperscript{155} The imposition of such strict liability would have stopped all but the best and worst transactions from going forward at all.\textsuperscript{156} Further, such a scheme would serve to compensate in-


\textsuperscript{149} Restatement (Second) of Torts § 866A (1982).

\textsuperscript{150} See text accompanying notes 188-92 infra; note 191 infra.

\textsuperscript{151} See, e.g., Globus v. Law Research Serv., Inc. (Globus I), 418 F.2d 1276, 1288 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970).

\textsuperscript{152} Id.

\textsuperscript{153} H.R. 5480, 73d Cong., 1st Sess., 77 Cong. Rec. 2916 (1933).

\textsuperscript{154} S. 875, 73d Cong., 1st Sess., 77 Cong. Rec. 2979 (1933).

\textsuperscript{155} Id. at 50, 77 Cong. Rec. 2981.

\textsuperscript{156} In the best transactions, there would be no basis for liability, while in the worst transac-
jured investors at the expense of securing a certain standard of behavior in the implementation of transactions. If due care would not protect one from liability, there would be no incentive to incur costs. Congress concurred with this reasoning, and in passing the House version of the due diligence defense, the conference committee stated that it did so "because it was believed that the insurance concept of liability in the Senate version would not materially aid investor protection but might interfere with the efficient operation of business."157

By so eliminating insurer's liability, Congress intended to strike the balance between maximizing protection to investors and chilling legitimate transactions. However, Congress still sought to ensure that high fiduciary standards would be met primarily "through the imposition of adequate civil liabilities."158 The statutory scheme thus protects investors by coercing parties to behave properly through the in terrorem nature of potential liabilities rather than by guaranteeing compensation for loss.159

The low priority of the compensatory function of section 11 relative to its protective function is also evident from the statute itself. First, subsection 11(a) limits the availability of the cause of action to purchasers of the specific securities issued under the defective registration statement.160 Open market purchasers of securities cannot recover under section 11 if they cannot trace their specific securities to the defective registration statement. Purchasers from other sources have no standing to recover under section 11 regardless of damages they may have suffered due to reliance on even intentionally defective registration statements. Second, the total damages recoverable by a plaintiff under section 11 are limited to the "price at which the security was offered to the public" even if the plaintiff actually paid a higher price for the security.161 Third, a defendant may always reduce or eliminate damages entirely by proving that all or part of such damages resulted from a cause other than his misbehavior.162 Finally, as to each underwriter, damages are limited to "the total price at which the securities underwritten by him and distrib-

158 Landis, supra note 45, at 35.
161 1933 Act § 11(g), 15 U.S.C. § 77k(g).
162 1933 Act § 11(e), 15 U.S.C. § 77k(e). "While the elements of the plaintiff's case may be easy to satisfy, the limitations on damages in section 11 make the statute no bonanza for defrauded purchasers." In re Gap Stores Securities Litigation, 79 F.R.D. 283, 298 (N.D. Cal. 1978).
uted to the public were offered to the public.”

Moreover, the statutory policy makes “the question of who pays the damages to the plaintiff . . . of as great concern as the issue of whether the plaintiffs are compensated at all.” If the scheme were merely compensatory in nature, the identity of the payor would be irrelevant since no public policy concerns would be implicated by a defendant seeking to shift its loss, as long as the plaintiff was paid. However, since the purpose of the scheme is deterrence, making a liable party bear real economic loss as a consequence of its misconduct is an integral part of the scheme.

As between indemnification and contribution, it appears that contribution better serves the policy behind the securities acts by assuring “that the deterrent effect of the judgment will be felt by all culpable parties.”

Indemnification, on the other hand, shifts the payment of the judgment away from the indemnitees, and by shifting the risk of loss, changes the incentive structure which the statute is intended to create. While indemnification may guarantee that damaged parties will be compensated by someone, unlike contribution it does not deter misconduct by controlling which party will be responsible for the compensation.

Another way to state this position is that “spreading liability over section 11 wrongdoers is necessary to avoid de facto indemnification.”

De facto indemnification results in undermining the economic penalty associated with liability so as to eliminate liability as a deterrent to the proscribed behavior. As such, contribution agreements, whether or not denominated as such, should not be enforceable to the extent that they give rise to indemnification by providing for a similar dilution of the deterrence the statute seeks to impose.

B. The Different Types of Contribution Arrangements

The enforceability of contractual contribution provisions should depend on how closely such provisions conform to a damage allocation method consistent with the securities acts’ deterrence policies. This depends on whether the contribution reallocation destroys an underwriter’s incentive to adequately investigate the issuer’s disclosures. There are

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165 See Dooley, supra note 17, at 797 n.109.
167 Note, supra note 76, at 92.
168 “The first and controlling factor in judicial scrutiny of contribution claims must be the effect of the proposed reallocation of liability on incentives to comply with the requirements of investigation and disclosure.” Id. at 97.
essentially two types\textsuperscript{169} of contribution formulas that courts have thus far used: a per capita arrangement in which each culpable defendant bears an equal share of the liability, and a relative fault arrangement in which liability is allocated among the liable parties according to a determination of the relative culpability of the parties.\textsuperscript{170} Whether these provisions further the purpose and policies of the securities act will be explored in this section.

As a threshold matter, it is not clear that private contractual contribution arrangements are permissible. Subsection 11(f) authorizes contribution “as in cases of contract.”\textsuperscript{171} This phrase was imported from the Companies Act 1929 provision on contribution, which itself was adopted from the Director’s Liability Act of 1890,\textsuperscript{172} and was meant to overcome the then prevailing view that contribution was not available among joint tortfeasors.\textsuperscript{173} However, the legislative history of the 1933 Act provides no adequate explanation of whether Congress intended the phrase to provide for private contractual contribution arrangements or was merely anticipating further development of the right to contribution by the courts.\textsuperscript{174}

Commentators discuss the validity of private arrangements only summarily. In 1933, then-Professor Douglas and Professor Bates suggested that existing American common law and decisions arising under the Companies Act 1929 made it “probable, though not certain, that the parties liable on the registration statement may by contract allocate inter

\textsuperscript{169} There is a third contribution scheme known as disgorgement, whereby a party’s total liability is limited to the proceeds it received from the offering. Disgorgement can result in de facto indemnification because a party who participates in a fraud but receives little or no proceeds from the offering pays no damages, thus escaping liability. Consequently, it defeats the statutory deterrence policy. Gould v. American-Hawaiian Steamship Co., 387 F. Supp. 163, 171 (D. Del. 1974), vacated on other grounds, 535 F.2d 761 (3d Cir. 1976). But disgorgement based solely on benefits obtained has received very little attention from courts and commentators; the one court that has considered it rejected it. Id.; Note, supra note 76, at 99. Benefits received, however, remain a factor which courts have taken into account even when apportioning loss primarily on some other basis. See, e.g., Smith v. Mulvaney, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,084 (S.D. Cal. June 5, 1985).

\textsuperscript{170} Incorporation of some notion of relative culpability may be used only as a modification of the per capita allocation, see text accompanying notes 224-45 infra, or as an original basis for distinguishing among the parties.


\textsuperscript{172} See notes 41-42 and accompanying text supra; Annotations to Companies Act, 1929, 53 & 54 Vict., ch. 49, § 37(3), reprinted in 2 Complete Statutes of England 797 (1929) (the “contract” language provides “an exception to the general law that there can be no right of contribution between joint tortfeasors”). The same interpretation was made in the case law under the Director’s Liability Act of 1890. Gerson v. Simpson, [1903] 2 K.B. 197.

\textsuperscript{173} See note 134 and accompanying text supra. The civil liabilities under the securities acts sound in tort rather than contract.

\textsuperscript{174} E.g., Ruder, supra note 39, at 650.
se their liability." But since the right to contribution under then existing common law arose "not from any express or implied contract but from the 'relations of the parties as persons liable for the same debt,'" this analysis is not illuminating. The American Law Institute's proposed Federal Securities Code (the Code) seems to support preliability contribution contracts, stating in a comment that ex ante contracting for the allocation of liability can be implied under subsection 11(f). The drafters of the Code, however, cite Douglas and Bates as the sole support for this contention, and thus the matter remains open.

Assuming contractual contribution provisions are generally enforceable, the issue of whether the per capita or the relative fault forms of contribution are specifically sanctioned by subsection 11(f) must be addressed. Under common law, contribution in contract cases resulted in per capita allocations of liability. The phrase "as in cases of contract" in subsection 11(f) may therefore indicate legislative intent to limit contribution to per capita allocations as provided under the common law. Since all litigation to date regarding contribution has involved the allocation of liability in the absence of contractual provisions, however, ex ante contribution provisions in underwriting agreements have not been subjected to judicial scrutiny; thus, the phrase "as in cases of contract" provides little guidance to this inquiry.

Examination of per capita and relative fault allocations in light of the policies behind the securities acts also provides little guidance. Neither method fully assures that the due care and diligence requirements in obtaining and disclosing information will be met. On the other hand, there are limitations on the extent to which any deterrent mechanism will produce conduct that conforms to the statutory standard. Consequently, the inquiry as to which method is preferred is reduced to

175 Douglas & Bates, supra note 51, at 178-79.


177 Subsection 1724(f)(1) reads: "[T]wo or more persons liable in an action created by or based on a violation of this Code . . . may allocate liability among themselves by contract made either before or after liability is imposed." Source provisions for this section are § 11(f) of the 1933 Act, 15 U.S.C. § 77k(f), and § 9(e) and § 18(b) of the 1934 Act, 15 U.S.C. §§ 78i(e), 78r(b) (1982). Comment (2) to this section reads in its entirety: "This [the ability to allocate liability by contract] is probably so under the source provisions." 2 Federal Securities Code § 1724(f)(1) (1980) (adopted by American Law Institute 1978). See Douglas & Bates, supra note 51, at 178.

178 The problem of allocating liability under § 11(f) is not a problem confined to underwriters. "Most lawsuits relating to an underwriting will have a full cast of characters, including the issuer, its officers and directors—and perhaps its accountant, as well as the underwriters—among whom contribution must be shared." Freund & Hacker, supra note 74, at 474 n.78. Lawyers may also share in the payment of liability. However, indemnification clauses commonly appear only in the underwriters' contracts with the issuers.

179 Douglas & Bates, supra note 51, at 178-80 & n.30; Ruder, supra note 39, at 650 n.239.
one of degree. For example, even an underwriter who has been completely indemnified has an incentive to investigate issues since he is not protected against an issuer who becomes insolvent before satisfying the judgment. However, courts have considered an indemnified underwriter's incentive to be insufficient to satisfy the securities acts.\textsuperscript{180}

Subsection 11(f) prohibits contribution to a party guilty of fraudulent misrepresentation from a party who is not so guilty.\textsuperscript{181} Some commentators argue that this distinction within the contribution provision, based on differences in culpability, can be read to sanction other gradations of liability based on levels of culpability.\textsuperscript{182} Given the silence of the legislative history on this point, however, it is equally plausible that the statute contains within it all the relative fault allocation permissible under the law.

1. \textit{Per Capita v. Relative Fault Contribution}

The securities acts and the relevant legislative history clearly are not helpful in determining whether the per capita or the relative fault scheme better serves public policy. Designers and proponents of the schemes, however, do provide good arguments for the implementation of each.

Advocates of per capita contribution\textsuperscript{183} point to several advantages. A per capita formula is easy to apply. It is enormously burdensome in complex securities litigation, where the structure of a transaction and the relationships among the parties may be extremely complicated, to require a court that has already found the defendants liable to go further and untangle the web of circumstances tying the defendants together often in ways unrelated to their original liability.\textsuperscript{184} Under the per capita scheme, a court need only find each defendant negligent to invoke contribution, unlike in the relative fault scheme, where in order to determine the relative degrees of culpability among the defendants, a court may be required to make additional factual inquiries. Relative fault may be too difficult to measure with any precision where the differences between the parties' degrees of participation in the preparation of the registration statement are not substantial.\textsuperscript{185} In many ways, a per capita rule "is probably as

\textsuperscript{180} See text accompanying notes 96-125 supra.
\textsuperscript{182} See, e.g., Ruder, supra note 39, at 646.
\textsuperscript{183} Courts sometimes use the phrase "pro rata" interchangeably with the phrase "per capita." "Pro rata" is defined as "proportionately according to an exactly calculable factor," Webster's Ninth New Collegiate Dictionary 994 (1983), which generally has meant that each party bears an equal share, Note, supra note 42, at 1303.
\textsuperscript{184} Douglas & Bates, supra note 51, at 180.
simple and satisfactory a way to handle the matter as any."\textsuperscript{186} Moreover, the per capita scheme may have a greater deterrent effect because it provides certainty: each liable party bears an equal share of the damages. Such a rule may also encourage early settlements.\textsuperscript{187}

The proponents of the relative fault scheme argue that the per capita scheme fails to distinguish more culpable actors from less culpable ones and is therefore unfair and inequitable.\textsuperscript{188} These proponents contend that the relative fault rule is "consistent with the fault structure inherent in the securities laws."\textsuperscript{189} The appeal of the relative fault approach is simply that it appears to distribute the costs of a wrong equitably among various parties according to their respective degrees of blameworthiness. This appeal is strongest in cases arising under those sections of the securities acts, such as section 11 of the 1933 Act, which impose liability for negligence.\textsuperscript{190} Behavior subject to liability under such provisions may range from the merely negligent to the wholly willful. Where proof of scienter (i.e., recklessness or mens rea) is required, the appeal of a relative fault standard is diminished.

Several different fact patterns illustrate why relative fault schemes may be viewed as more equitable than per capita ones. In the first scenario, the underwriter engages in intentional fraud while the issuer is innocent. The underwriter ought not be relieved of substantial liability merely by a per capita formulaic shift to an issuer whose liability only stems from the statutory provisions for strict issuer liability. In the second scenario, the underwriter is negligent while the issuer remains innocent. This case could arise when a relatively unsophisticated issuer relies on the advice of its underwriter and counsel. The underwriter's negligence could give rise to liability for both. It is difficult to see why the contribution formula should have the effect of favoring the underwriter in such a case.

In the third scenario, both the underwriter and the issuer are negligent. It is irrelevant for purposes of this analysis whether the issuer is more negligent than the underwriter or vice versa, as long as neither acts with recklessness or intent to defraud. Here, there is no justification for

\textsuperscript{186} Douglas & Bates, supra note 51, at 179-80.

\textsuperscript{187} Note, supra note 76, at 97-98.

\textsuperscript{188} See United States v. Reliable Transfer Co., 421 U.S. 397, 404-67 (1975) (recognition of unfairness of per capita "divided damages" rule in admiralty cases). The per capita rule has been said to produce results "characterized by more mathematical than judicial integrity." McLean v. Alexander, 449 F. Supp. 1251, 1273 (D. Del. 1978), rev'd, 599 F.2d 1190 (3d Cir. 1979).

\textsuperscript{189} Note, supra note 185, at 246.

\textsuperscript{190} Few such causes of action remain after the Supreme Court's holding in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), that scienter is a necessary element of the general cause of action for fraud under § 10(b) of the 1934 Act and Rule 10b-5.
shifting liability either away from the underwriter and toward the issuer or vice versa. In the final case, the issuer has actively concealed material facts from the underwriter. If the underwriter has failed to demonstrate its due diligence defense, on a per capita scheme, it will face costs greatly disproportionate to the consequences its conduct appears to deserve.\footnote{191}

It is unfair to allocate liability equally to parties acting with grossly different degrees of scienter, especially if liability turns entirely or even largely on notions of culpability in the sense of mens rea. However, tort law doctrines are not transferable into federal securities law doctrine without some adjustment. The primary policy of section 11 is to induce the investigative conduct that leads to the desired disclosures, and it is in that context that the deterrent effect of liability and damage allocation must be assessed. If liability under the federal securities acts did not involve notions of structural responsibility or market power but only mens rea, the underwriters would clearly have the better argument. However, if this were true, public policy would permit indemnification of underwriters by issuers as well, at least in those cases where the underwriter acted with less scienter than did the issuer. Of course, a result much like indemnification would occur if a contribution formula that yielded only nominal payments from the underwriter were applied.

Judicial analysis of the choice of contribution theories remains uncertain. \textit{Gould v. American-Hawaiian Steamship Co.}\footnote{192} was brought under subsection 14(a) of the 1934 Act\footnote{193} for violations of the proxy rules which, like section 11, impose liability for negligent behavior.\footnote{194} The court denied indemnification as being inappropriate for loss shifting

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\footnote{191}{The inclusion of contribution clauses in underwriting contracts is driven by two factors. First, litigation is costly, and the more leverage an underwriter has to force an issuer into settlement negotiations, the more likely it is that litigation can be avoided altogether. Issuers are faced with far fewer of these lawsuits than are underwriters because they are not in the business of making public offerings and thus would be more likely to fight a single case. The clauses, however, present the issuer with the possibility of having to pay virtually all the costs and damages, and may therefore incline it to enter negotiations when it otherwise would not.

Second, these clauses reflect the underwriters' belief that courts have neither a general understanding of the underwriting business nor sensitivity to the specific difficulty of wresting from an issuer the kind of adverse information most likely to be both material and omitted. As a result, underwriters fear that liability will result more often from the ignorance or incorrectness of the court's position than from their own substandard behavior. It is difficult to confront this fear rationally. The cases which have been litigated do not confirm it; underwriters are not always found liable. 17 Sec. Reg. & L. Rep. (BNA) No. 20, at 880 (1984).


194 The private cause of action for damages under § 14(a) is implied, not express. J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964). However, the availability of a right to contribution under the implied causes of action had already become accepted doctrine in some § 10(b) and Rule 10b-5 cases, see, e.g., deHaas v. Empire Petroleum Co., 286 F. Supp. 809 (D. Col. 1968), aff'd in part and vacated in part, 435 F.2d 1223 (10th Cir. 1970); Globus v. Law Research Serv., Inc. (\textit{Globus II}), 318 F. Supp. 955, 958 (S.D.N.Y. 1970), aff'd, 442 F.2d 1356 (2d Cir.),}
in a negligence scheme. It held that even in the absence of intentional fraud, the total shifting of loss from one party to another is impermissible.\(^{195}\) When it came to contribution, however, the court approached the various defendants on a case-by-case basis. One group of defendants argued for a per capita allocation, while another group advocated a benefit disgorgement\(^{196}\) formula. The court attempted to reach an equitable solution while promoting the regulatory rather than the compensatory purpose of the statute.\(^{197}\) It rejected the per capita allocation for those defendants that had already disgorged the benefits they had received in settlement and were now seeking to reduce their settlement by the retrospective application of a per capita rule. The court found that disgorgement was appropriate for them, as any other solution would be "inequitable."\(^{198}\) As to those defendants seeking to subscribe to the disgorgement theory, however, the court refused to apply it, since those defendants received no benefit from the violative transaction. Disgorgement "would [have] amount[ed] in principle to full indemnity"\(^{199}\) and was therefore impermissible. The court’s exercise demonstrates the difficulties that the various formulas can pose.

The court in \textit{McLean v. Alexander}\(^{200}\) carried \textit{Gould} a step further and, "keeping in mind that equity is the cornerstone of remedial relief,"\(^{201}\) felt constrained to consider the differing degrees of fault which were "painfully evident" in the case.\(^{202}\) It effected an equitable allocation of fault by grouping the defendants into two entities, finding one entity ninety percent responsible and the other entity ten percent responsible for the plaintiff’s loss.\(^{203}\) Thus, the court hybridized the per capita and relative fault schemes.

Support for the relative fault method of allocation is also found in a recent admiralty case decided by the Supreme Court. The Court said, "A rule that divides damages by degree of fault would seem better designed to induce care than the rule of equally divided damages, because it imposes the strongest deterrent upon the wrongful behavior that
is most likely to harm others.”

The deterrent effect of a relative fault rule lies in the fact that the varying of damages by culpability removes “the hope or expectation that someone less culpable will foot the bill.”

The arguments in favor of per capita and relative fault under the securities laws are in equipoise. The incremental deterrent effect of one over the other does not seem amenable to empirical verification. While the courts strain for equitable solutions, they have been perfectly willing to impose a per capita allocation, in some cases without discussion. Where the courts use relative fault concepts, they do so with little analysis. Both methods are accepted mechanisms to encourage performance of the due diligence required under the federal securities acts. The principal advantage of a per capita rule is its ease of administration. The principal advantage of a relative fault rule is its promotion of notions of fairness.

2. Fairness-Based Allocation Schemes

As between the interests of administrative efficiency and fairness, fairness should prevail. Ease of administration is a straightforward notion, but it cannot justify an “archaic rule” or one that “produces unjust results.” A first consideration is that set forth above by the Supreme Court: the most wrongful behavior is that which is the most likely to cause harm to others. Fairness dictates that a person behaving in such a fashion should suffer more than a person whose behavior is less harmful.

One possible allocation scheme based on fairness would make fault-based wrongfulness correspond to the defendant’s degree of culpability or scienter. However useful this may be in cases of common law torts, it misses an important point in federal securities law cases. Wrongful behavior limited to the reckless or intentional inclusion of misstatements or omissions in public documents is not the behavior most likely directly to harm others. Injury to investors results from misstatements or omissions which when corrected cause the security’s price to drop. Whether the

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205 McLean, 449 F. Supp. at 1275.
207 See, e.g., Herzfeld, 378 F. Supp. at 135.
208 Reliable Transfer Co., 421 U.S. at 408. In Reliable Transfer Co., the Supreme Court eradicated the admiralty rule of “divided damages,” which is similar to the per capita rule, and replaced it with a relative fault formula. The court further stated that damages should be allocated equally between liable parties “only when the parties are equally at fault or when it is not possible fairly to measure the comparative degree of their fault.” Id. at 411.
209 See text accompanying note 204 supra.
loss is traceable to recklessness or to mere negligence is not significant to the occurrence of the loss. In light of the role of underwriters in the scheme of securities distribution, and their function as intermediaries between the public and the issuer, negligent lapses by underwriters are at least equally as harmful as the issuer's intentionally self-serving misstatements.210

Fault must, for securities law purposes, include consideration of the function of the parties. In light of an underwriter's responsibility to the public, its leverage over the issuer, and its specialized knowledge,211 once liability is found, the "fault" of the underwriter is as much a question of status violation as mental state.212

There are practical problems as well as analytical ones in equating fault with scienter under the securities acts. In denying indemnification in Globus v. Law Research Service, Inc. (Globus I),213 the Second Circuit noted that "showing that the issuer was 'more liable' " than the underwriters is "a process not too difficult when the issuer is inevitably closer to the facts."214 The issuer has the greatest incentive to deceive or cast its disclosures in the rosiest possible light because it receives the bulk of the proceeds of the security's issuance. Thus, the issuer will almost always be more at "fault" than the underwriter, but these factors may already have been accounted for by the statute's imposition of strict liability on the issuer.215

The other aspect of fairness which, while discredited as the sole basis of allocation,216 is certainly important to the underwriters, is the comparative benefits received by the issuer and the underwriters. Per capita allocation "would clearly be inappropriate based upon a comparison of the issuer's proceeds with the underwriting commissions."217 This aspect of the fairness issue poses two different questions: one, whether benefit disgorgement is an appropriate measure of damages; and two, whether departing from the benefit analysis results in an improper windfall to the issuer. The former has already been discussed.218

The specter of a windfall to the issuer has two interesting aspects.

210 See text accompanying notes 39-49. "The average investor probably assumes that some issuers will lie, but he probably has somewhat more confidence in the average level of morality of an underwriter who has established a reputation for fair dealing." Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 581 (E.D.N.Y. 1971).
211 See text accompanying notes 18-19 supra.
212 See Ruder, supra note 39, at 646-47.
214 Id. at 1288.
216 See note 169 supra.
217 McLaughlin, Stapleton & Harman, supra note 34, at 260.
218 See note 169 supra.
First, the windfall argument assumes that economic benefit to the issuer is separate and distinct from economic benefit to the issuer's shareholders. That is, in an initial public offering, the issuer's shareholders are the persons who are harmed by a violation of section 11. Payment of damages, while not intended primarily to be compensatory under section 11, will in fact compensate injured security holders. To the extent that those persons remain holders of the issuer's securities, the retention of proceeds in the issuer benefits them. The windfall argument ignores the identity of economic interest between the issuer and its shareholders in favor of the juridical distinction between the two.\(^\text{219}\) By the time the contribution question arises, it has already been decided that the underwriter is liable to the shareholders.

In the case of an initial public offering of equity securities, the case against contribution based on comparative fault is easily illustrated. The likely case would result in the shareholders competing with the underwriter for assets of the insolvent issuer. Thus, the shareholders would bear the costs associated with an indemnifying form of contribution because the underwriter would get assets the shareholders would otherwise receive. This would be true even in the case in which the underwriters' violations were reckless while the issuer's were negligent, although its behavior did fall below the statutory norm. Since the shareholders include persons who purchased stock on the basis of a registration statement defective at least in part due to the misfeasance of the underwriter, it seems inequitable to impose costs of an indemnifying form of contribution on the shareholders.\(^\text{220}\)

Second, the windfall argument ignores the special importance of deterrence with respect to underwriters. An issuer, however frequently it goes to the public market, is involved with far fewer registration statements than an underwriter. In that regard, any windfall to the issuer, namely, the potential for a gain to the issuer through a reduction of its  

\(^{219}\) This is particularly odd in light of the use of economic realities to argue in favor of apportionment based on relative benefits received. McLaughlin, Stapleton & Harman, supra note 34, at 260.

\(^{220}\) If the faulty offering was of debt securities and the issuer is insolvent, the debt holders will have more protection in terms of securing the remaining assets than will the underwriter. This still leaves the underwriter in competition with the shareholders for the rest. Again the choice involves an equitable balancing between the claims of the two groups. On the one hand, the shareholders in this case (where the defect was in an offering of debt securities) may have benefitted from the issuer's receipt of proceeds more then they suffered from the faulty offering. Nonetheless, the underwriter has still engaged in unacceptable behavior. While the claims are more nearly in equipoise, given the choice between rewarding the underwriter by eliminating its cost through enforcement of an indemnifying form of contribution, and relieving the shareholders of the cost of such contribution, it makes sense to opt for the latter in light of the intended deterrence effect of the liability provisions.
damages, may be outweighed in the deterrent scheme by the importance of assuring that the underwriters have a downside risk.

Courts should also be free to take account of equitable factors in their allocations, and contribution is an equitable doctrine. However, an equitable decision requires consideration of the underlying concepts embodied in the statute. Arguments can be made to support both a per capita and a comparative fault rule. A comparative fault rule should be applied where it yields an equitable resolution that is consistent with the policies of the statute, the effect of which clearly outweighs the ease of administration of a per capita allocation.

The principal objection to a per capita rule is “the unfairness inherent in automatically apportioning damages equally.” The principal objection to the comparative fault rule is that it may be “too difficult or impossible to measure each party’s comparative fault” however fault is defined. Precise measurement of damages in order to maximize deterrence is extremely difficult, while abandonment of any attempt at precision may be unpalatable. An ideal solution would thus be a method that combined the convenience of a per capita rule with the more precise deterrent allocation yield by a comparative fault rule. Therefore, a middle ground is most desirable.

New solutions have emerged from the case law. One such solution, which is sometimes called the “entity theory,” is really a form of modified per capita allocation. This formula was first hinted at in *Feit v. Leasco Data Processing Equipment Corp.* Although it is not entirely clear from the report of the case, it appears that, of the defendants found liable, the three director defendants were grouped into one entity, and the per capita rule was then applied. Since the creation of the entity left only two defendants, the entity and the issuer, each bore one-half of the liability.

The modified per capita theory was used by the court in *Wassel v. Eglowsky* to “relax the harshness of the pro rata rule in a manner which reflected to some degree the parties’ relative culpability.” The *Wassel* court grouped two of the three defendants into one entity on the

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222 Adamski, supra note 32, at 557.
223 Note, supra note 185, at 245.
224 See text accompanying notes 201-03 supra.
228 Adamski, supra note 32, at 562-63.
ground that within the entity, one party's liability was "largely derivative" of the other.\textsuperscript{229} The court then applied a per capita rule to the two entities, one of which was composed of two defendants, and the other of one defendant. In the absence of these entities, each defendant would have borne one-third of the damages. The grouping of the defendants appeared to reflect the court's determination that the single defendant entity was as culpable alone as the other two defendants were together.\textsuperscript{230}

The court in \textit{McLean v. Alexander}\textsuperscript{231} employed the entity theory of allocation. Although the court considered the creation of defendant groups "highly appropriate,"\textsuperscript{232} it found that action insufficient to account for the "vast difference between the defendants in the degrees of their wrongdoing, thus, the damages ought to reflect that fact."\textsuperscript{233} Complicating the case was the settlement by some of the defendants who still had to be accounted for in the entities. The court found that contribution was available only to a defendant who had paid an amount in excess of his per capita share. However, after subtracting the settlement amount from plaintiff's damages, there would have been insufficient liability remaining using a per capita rule to reach the parties whom the court felt were the most culpable.\textsuperscript{234} As a consequence, the court applied a comparative fault rule to the entities it had formed. This enabled the court, in the face of a settlement reduction in total damages, to impose the vast majority of the balance on the parties it felt were most at fault.

The entity theory was further modified by the court in \textit{Smith v. Mulvaney},\textsuperscript{235} in which its use gave the court the flexibility it was seeking to fashion an appropriate remedy. In \textit{Smith}, all defendants, except the Smiths, had settled under the careful supervision of a magistrate. After a trial, a jury verdict was rendered against the Smiths.\textsuperscript{236} In the contribution action by Mrs. Smith against the other defendants, the treatment by the magistrate of the directors (other than Mr. Smith) as a single entity was favored because it is "not only an approved practice for effecting settlement, it is also an appropriate vehicle for apportioning loss under contribution."\textsuperscript{237} Since settlement is not a bar to a subsequent contribution action under the securities laws,\textsuperscript{238} the court was faced with intrud-

\begin{footnotes}
\textsuperscript{229} \textit{Wassel}, 399 F. Supp. at 1370.

\textsuperscript{230} Id.

\textsuperscript{231} \textit{449 F. Supp. 1251 (D. Del. 1978), rev'd, 599 F.2d 1190 (3d Cir. 1979).}

\textsuperscript{232} Id. at 1272.

\textsuperscript{233} Id.

\textsuperscript{234} Id. at 1273.


\textsuperscript{236} Id. at 91,424.

\textsuperscript{237} Id.

\end{footnotes}
ing on the settlement if it were to require per capita contribution. Citing Gould v. American-Hawaiian Steamship Co. and McLean, the court left the settlement intact, in the interest of "retain[ing] flexibility in measuring contribution," and left Mrs. Smith to pay the judgment. This holding was based on the court's previous findings after the trial as to Mrs. Smith's "apparent enhanced culpability and the profits she reaped" from the violations.

There are two differences between the posture in which Feit and Wassel arose, on the one hand, and the posture of McLean and Smith, on the other, which are significant to the choice of contribution theory. First, in the former cases, the contribution question was part of the main judgment in the trial on the merits, while in the latter cases, the contribution claim was asserted in an action brought subsequent to the action in which liability was found. When a court decides all the relief in a single action, the process of fault finding in the liability trial eases the court's task considerably in the contribution decision. Second, in McLean and Smith some of the defendants had settled out of the main action. While interference with settlements is not prohibited, courts are not inclined to disturb them and will use the flexibility of the contribution doctrine to leave a settlement intact.

Where possible, and particularly where the contribution claim is a part of the main proceeding, the use of this modified per capita rule is a solution to the allocation problem. It permits the courts to avail themselves of a rule of both convenience and equity. The modified per capita rule also provides an answer to the equitable arguments of the underwriters in the case where the issuer's violation is willful while the underwriters' violation is negligent. Strict per capita allocation assigns a share of damages to each defendant. In any section 11 litigation, the number of underwriters in the underwriting syndicate is likely to exceed the total number of other defendants. If each is counted as a separate defendant, the lion's share of the damages will be borne by underwriters.

241 Id.
242 The court in Smith found it unjust that Mrs. Smith was seeking a second bite at the apple.

Mrs. Smith, too, had an opportunity to settle for substantially less than that which she has had to pay. She took the risk of going to trial, and she lost. There is something very inequitable about her now approaching the court and seeking compensation from the settling directors for her error of judgment, particularly where the settling directors paid a substantial settlement and assumed the risk that they might not be liable at all.

243 See text accompanying notes 221-23 supra.
244 However, this is not so in new kinds of transactions involving, for example, abbreviated forms of registration and seasoned issuers. See note 27 supra.
The modified per capita theory permits a court to consider the syndicate as a single entity for allocation purposes.245

IV
THE CLAUSES AND THE UNDERWRITING BUSINESS

The primary function of contribution clauses is to allocate risk, rather than loss, just as the purpose of section 11 is deterrence and not compensation.246 As a consequence, contribution clauses are properly analyzed as private liability rules that have their primary impact on the preregistration, due diligence phase of the process. This Part assesses, from a practical standpoint, the effect of contribution clauses on the way underwriters do business. In addition, this Part examines the effectiveness of the clauses given practical and business consideration.

The role of the underwriter differs from that of the issuer. The fact that liability under section 11 is joint and several is not a reason to retrospectively recharacterize these roles. There is no automatic requirement, nor should there be, for identical treatment of underwriters’ and issuers’ independent liabilities. Indeed, the legislative history, administrative rulings, and case law all require different treatment. A registered public offering is an extraordinary event in the life of the issuer, who is rarely exposed to the business of marketing securities.247 By contrast, the underwriter is a repeat performer. The investment firm which underwrites securities offerings is a regular, if not constant, player in the distribution market for securities and probably the trading market as well. Accordingly, underwriters’ and issuers’ incentives differ.

The underwriter calculates that, based on the number and dollar volume of its overall underwritings, only a few issues, if any, that it underwrites in any given year may end up in litigation, much less achieve a final judgment.248 Rationally, then, the underwriter can be less rigorous in meeting its statutory obligations and more willing to take risks.

Moreover, thorough performance of a due diligence investigation, particularly for an initial public offering, is a costly and time-consuming

245 Since due diligence is generally conducted for the syndicate by the managing underwriter alone, this entity notion may have the added attraction of comporting with business reality. In a typical § 11 case, there may be one issuer, several directors, one accounting firm, and the underwriting syndicate with a membership that may go as high as 20 or 30 firms.

246 Globus v. Law Research Serv., Inc. (Globus I), 418 F.2d 1276, 1288 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970); Dooley, supra note 17, at 798; Note, supra note 61, at 410.

247 There are a few large issuers that engage in regular public issuances of securities, usually debt securities, but most issuers rarely go to the market.

248 The 30,000 registration statements filed during the first 35 years of the SEC's history resulted in two adjudicated recoveries and six reported decisions approving settlements of class actions. L. Loss, supra note 2, at 1040.
enterprise. While profits are difficult to estimate, the costs of increased investigation and diligence would surely cut into them. If an underwriter is reasonably certain that a contribution clause will be enforced, it has little incentive to do more than a cursory investigation, the minimum necessary to create a "paper trail." Underwriting is big business, and topping the list in the "underwriting sweepstakes" is an important measure of an underwriter's prestige, profitability, and marketing muscle.

During the year ending September 30, 1983, the Securities and Exchange Commission reported that registration statements for cash sales of securities to the public for the account of the issuer amounting to $179 billion became effective. Total effective registrations during this period amounted to $256 billion. Of the total offerings debt securities amounted to $91 billion; preferred stock, $15 billion; common stock, $150 billion.

For the calendar years 1982 and 1983, respectively, the average gross underwriting spreads were 2.082 and 2.019 for debt issues, 7.280 and 7.300 for common stock, and 3.250 and 3.490 for preferred stock. Applying a weighted average of 2.034 for debt, 7.295 for common stock, and 3.43 for preferred stock to the SEC's figures, gross underwriting spreads for the year ended September 30, 1983 were in the range of $1.85 billion on debt issues, $10.94 billion on common stock issues, and $514 million.

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250 This term is taken from the Institutional Investor, a magazine which produces annual and quarterly reports on underwriting activity.

251 Underwriting firms advertise their expertise by the number and the size of offerings made. See note 38 supra.

252 Securities and Exchange Commission 49th Annual Report 103 (1983) (this represented a 56% increase, from $115 billion, over the previous year). While the registration statement must be signed and filed by the issuer, the proceeds of the offering may go to other parties. For example, a previously private company may sell its own securities to the public and may also register the offering of securities held by some of its original shareholders. This kind of secondary offering may be either separate from an offering for the account of the issuer, or primary offering, or the two may be combined in a single registration statement. This latter method is common in initial public offerings and is a way for early investors, entrepreneurs, and venture capitalists to realize profit on their investments.

253 Id. The difference represents secondary offerings and offers for non-cash consideration, e.g., exchange offers.

254 Id.

255 Corporate Data Department, Securities Data, Inc., Yearly Breakdown of Issue 1 (the report states that "[i]nformation has been obtained from sources believed to be reliable, but its accuracy and completeness are not guaranteed")

256 High and low gross spreads for debt issues were 10.00 and .125 for 1982, and 15.25 and .249 for 1983. For common stock issues, comparable spreads were 18.51 and .390 in 1982, and 17.50 and .530 in 1983. For preferred issues, the numbers are 11.50 and .300 in 1982 and 10.00 and .380 in 1983. Id.
million on preferred stock issues. Each of the top twenty-five firms, acting as lead or co-manager, was credited with underwriting in excess of $300 million worth of offerings based on “all taxable underwritten debt or equity deals of $2 million or more offered during the period January 1, 1983 through December 31, 1983.”257 The top seventeen firms were each credited with offerings in excess of $1 billion, and the top three firms each led or co-managed offerings worth in excess of $10 billion.258

Despite the different roles, experience, and incentives of the underwriter and the issuer, contribution clauses are based on the erroneous concept that these parties are similarly situated parties under the statute.259 In fact, the clauses currently in use are not as equitable as they may appear at first glance. Of the risk allocation methods currently in use, relative benefit is the most suspect. Benefits are expressed solely in dollars received. They do not include intangibles such as the prestige associated with underwriting the offerings of certain companies, or with being the firm with the greatest annual number of dollars underwritten, because these are, at best, difficult to associate with particular transactions, and, at worst, impossible to prove. Similarly, benefits arising from the reduced investigation and other due diligence costs resulting from the certainty of limited liability will be difficult to assess in the adjudication of individual cases, and are thus not part of the underwriters’ “benefit.” Therefore, practical enforcement of the relative benefit clause necessarily undervalues the underwriters’ benefit in any offering.

Moreover, a relative benefit rule crosses the line between indemnity and contribution. On a relative benefit theory, the underwriter essentially has to disgorge its profits. However, a disgorgement theory of damages fails to comport with the statutory deterrent scheme.260 No penalty is exacted: the underwriter had the use of the money for some time before disgorgement and had the benefit of reduced investigation costs in all of its underwritings. Particularly in light of the risk-reward calculation already made by the underwriter, these act as reductions in the amount the underwriter would disgorge, making its “loss” very small, and perhaps nothing at all. The effect of such a relative benefit rule, then, would be to nullify the underwriter’s liability for damages and achieve the indemnification result under the guise of contribution.

Further, constraints that Congress wrote into section 11 liability of underwriters, for example, the due diligence defense and the prudent man standard of care, also suggest that the relative benefits scheme is an

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258 Id.
260 See note 169 supra.

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inappropriate method of allocation. Congress chose to include these limitations to ensure against draconian underwriter liability; further limitations would cut too deeply into the legislative scheme. By contrast, relative fault allocation has great superficial attraction: it rests on equitable notions of fairness and evokes the modern movement in tort law towards contribution and comparative negligence. However, further analysis reveals problems.

"Fault" is defined in these clauses by a list of factors including which party supplied the defective information and "the parties' relative intent, knowledge, access to information and opportunity to correct or prevent" the defective information. These factors ignore the underwriter's special role in the process. First, since the only information that underwriters supply concerns the distribution plan and participating underwriters, the likelihood that the information the underwriter provides contains a material misstatement or omission is quite remote. Under the statute, however, the underwriter's liability is based on its general responsibility to verify the entire registration statement.

Second, the parties' relative intent and knowledge collapse all fault concepts into a scienter standard. Yet, if fault were to be determined solely by scienter, even indemnification would not be prohibited. Scienter need not be ignored, but should be interpreted in light of the underwriter's statutory status, knowledge of its role, and expertise in the business. If, for example, public harm is an element of fault under section 11, the underwriter's negligence may be as "bad" as a higher level of scienter on the part of the issuer.

Third, "the parties' access to the information and opportunity to correct or prevent" the defects are factual questions explored in litigation. If the issuer's denial of access to information or refusal of opportunities to correct is not unreasonable under the circumstances (e.g., it raises no suspicions that a non-negligent underwriter would pursue), then the underwriter should meet its due diligence defense. An underwriter denied access to information it believes necessary to conduct a non-negligent investigation should not be permitted to use such denial as

261 See notes 46-61 supra.
263 See text accompanying notes 37-38 supra.
264 Liability under § 11 does require a finding of negligence. I do not mean to suggest that indemnification should always be unavailable to an underwriter that is absolved of liability, that is, found to have been non-negligent. In such a case, the underwriter's expenses in defending the litigation, particularly its attorneys' fees, might appropriately be indemnifiable by the issuer.
265 See note 210 and accompanying text supra.
266 See text accompanying notes 37-38 supra.
a shield against the liability consequences of its own negligence. Similarly, if the underwriter believes it needs an opportunity to correct the defect, then it faces a clear choice of alternatives: it may either refrain from undertaking the transaction or face the consequences of its failure to insist on the correction.

Questions of access and opportunity are not simple ones. But those questions are bound up in the initial determination of whether the underwriter met its due diligence defense. By the time the litigation has reached the point where contribution shares are being allocated, the factors listed in relative fault clauses seem irrelevant. In almost any imaginable case, these factors would tilt dramatically against the issuer.

Finally, many clauses contain an agreement by the issuer and underwriter to the effect that it would not be just and equitable for contribution to be determined by pro rata allocation. This agreement need not be respected by a court because contribution remains within the courts' discretion.

V
CONCLUSION

Congress drafted section 11 subjecting negligent underwriters to liability to secure the statute's goal of protecting investors. The underwriters' independent statutory obligation, unrelated to that of an issuer or its directors, is to be duly diligent. It does not matter to Congress or a defrauded purchaser that the company may have been reckless, or even dishonest, while the underwriters were merely negligent. Underwriters have an independent status under the securities laws and owe their duties directly to the public.

The 1933 Act is not tort law. In a purposeful extension of the common law, the 1933 Act creates duties that did not previously exist, with new standards of behavior for covered parties. Courts have turned to negligence-based concepts to help define the due diligence defense, but that does not require the wholesale importation of tort theory into the securities laws. Such incorporation is unnecessary in analyzing contribution clauses, where statutory policy provides interpretive principles of sufficient force and clarity.

While it is true that Congress was concerned with undue liability exposure for underwriters under section 11, the statute contains its own safeguards: the due diligence defense, the statute of limitations, and the dollar limitation on underwriters' liability. Permitting private contractual agreements further to limit damages would change the statutory balance of the underwriter-issuer relationship. Where the effect of this
change is to make the underwriter less adversarial to the issuer because it
is less diligent, the scheme of section 11 is adversely affected.

Courts must remain free to apply the contribution formula most ap-
propriate in a given case. No other result provides sufficient incentive for
underwriters, in the full context of their business, to meet their statutory
responsibilities. A per capita rule is straightforward in application, elimi-
nating the need for a court to engage in a second proceeding. Fashioning
an acceptable comparative fault rule would require new interpretations
of "fault" and "fairness" to incorporate the underwriters' special status.
Moreover, in litigation, the liability phase, not the remedial phase or a
subsequent contribution proceeding, is best suited to inquiries into this
statutory fault. If liability is found, very few cases would raise additional
equitable issues sufficient to overcome the ease of applying a per capita
rule. In those rare instances, courts should use the modified per capita
theory to allocate contribution shares, which allows for ease of adminis-
tration with some equitable adjustments.