NOTES

SECTION 11 IN THE EXCHANGE OFFER SETTING: AN ANALYSIS OF *FEIT* v. *LEASCO DATA PROCESSING EQUIPMENT CORP.*

For four decades the issuance and trading of securities have been guided by the single goal of "full and fair disclosure." This objective, supplemented by proscriptions against fraud, rests on twin underpinnings: the effective operation of a free market for securities demands equal access by buyers and sellers to all information material to an intelligent investment decision; and the degree of exposure to the "electric light" of publicity is directly proportional to the deterrence of fraudulent or manipulative practices. The essence of the securities disclosure scheme, though, is the elusive concept of "materiality"; that which is not essential to an informed investor decision need not be disclosed. The task of determining what information is material (and in what contexts it is material) has fallen to several actors in the securities scheme; their independent efforts have superimposed upon the skeletal framework of the Securities Act of 1933 a voluminous, and at times discordant, body of federal securities law. Congress, by enactment of subsequent legislation, has both broadened


3. Brandeis emphasized the deterrent effect of the disclosure policy in his famous statement: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." *L. BRANDEIS, OTHER PEOPLE'S MONEY* 62 (1933).

4. See, e.g., Securities Act of 1933 § 11, 15 U.S.C. § 77k (1970), prescribing civil liability if any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . .

The statute also authorizes suit by buyers of such securities against certain parties who are afforded limited defenses based upon the degree of care exercised in their involvement in the registration process.

the scope of the original Act and granted to the Securities and Exchange Commission authority to build upon the statutory framework through its rule-making powers, its administration of the registration system, and its active participation in the enforcement process. Paralleling this expansion has been the often volatile judicial construction of the statutes and rules promulgated thereunder, spurred forward by the increasing ingenuity of the securities plaintiffs' bar. This multiplicity of input has rendered extremely difficult the realization of what must be a goal of any legislative system embodying regulatory and judicial sanctions—that of predictability and uniformity of result.

A notable example of judicial expansion of the securities laws was Judge McLean's exhaustive opinion in Escott v. BarChris Construction Corp. BarChris Construction Corporation, engaged primarily in the construction of bowling centers, was swept forward in the rapid expansion of bowling as a leisure sport in the 1950's. The company publicly offered its common stock in 1959, and in 1961 sold $3,500,000 in subordinated convertible debentures. However, overexpansion in the industry caused defaults by its customers, forcing BarChris into bankruptcy in October, 1962 and subsequently into default on its debenture obligations. Purchasers of the BarChris de-


9. Id. at 653. As time passed, BarChris became increasingly active in the operation of repossessed bowling centers. Id. at 670, 676.

10. Actually, BarChris installed only three percent of the lanes built, with two larger companies dominating the industry. Nonetheless, in the five years ending in 1960, annual net sales skyrocketed from $800,000 to $9,165,000. Id. at 653.

11. A third attempt to issue additional common stock in 1962 fell through. Id. at 654.
bentures brought a class action, alleging numerous misrepresentations and omissions of material facts in the registration statement in violation of section 11 of the 1933 Act. Judge McLean concluded that a number of alleged misstatements and omissions had in fact violated the statute and thus imposed liability upon Bar Chris and its directors, the underwriters, and the auditor.

Most commentators agree that the most significant aspect of the *BarChris* holding is its extensive analysis of the section 11 "due diligence" defenses, which are available to all defendants other than the issuer. The statutory defenses are two pronged, requiring a more stringent standard for non-expertised portions of the registration statement as opposed to those purported to be made on the authority of an expert. In order to avoid liability as to the former, the defendant must have made a "reasonable investigation" upon which his reasonable grounds for belief in the accuracy of the document are based. It is here that Judge McLean's construction of the statute is most telling, particularly his designation of only the auditors as experts, excluding underwriters and attorneys; his functional delinea-

13. 283 F. Supp. at 654-703. Five directors were also officers and therefore "insiders," while four were "outsiders": an attorney in the company's law firm, a partner of the lead underwriter, a banker, and an engineer. The ill-fated latter three were all elected to the BarChris board one month before the registration statement became effective. 283 F. Supp. at 652.
17. Section 11(c) defines the reasonable investigation standard as "that required of a prudent man in the management of his own property." *Id.* § 77k(c).
18. Judge McLean held unreasonable the defendants' assertion that "the entire registration statement is expertised because some lawyer prepared it. . . . " 283 F. Supp. at 683. *See also* Folk 58; Comment, 68 COLUM. L. REV., *supra* note 15, at 1414. Especially significant is Judge McLean's incorporation of the standards of the American Institute of Certified Public Accountants, Folk 60-61, into the "due diligence" standard as applicable to the auditor-expert. Since the Peat, Marwick accountant's S-I review failed to "come up to that standard," the defense was not available. 283 F. Supp. at 703.
tion of the duty of investigation as applied to insiders, outsiders, and specialist directors; and, indirectly, his unavoidable consideration of the degree to which the duties of reasonable investigation and belief may be met by delegation or reliance.

BarChris unleashed shock waves of self-examination motivated, at least from the cynic's point of view, by a desire not to be caught making the same mistake. Presumably, practice among issuers, underwriters, accountants and their supportive legal personnel has been tailored to comply with the BarChris mandate; however, as with many precedent-shattering pronouncements in the law, the BarChris opinion left important questions unanswered.

Because the alleged misrepresentations and omissions in BarChris were so egregious, Judge McLean had no cause to refine the definition of "materiality." The need for a more precise definition is acute, however. Unless he knows which facts are so essential to a particular investment decision that omission of a single one will trigger liability, a potential defendant cannot act with confidence that his disclosures are adequate. His confusion is compounded by the explicit disclosure requirements of some sections of the federal securities

19. The five inside directors in BarChris were also all officers and, with one exception, members of the executive committee; all but one failed completely to meet the due diligence defense. It should be noted that insiders apart from directors are potentially, but not automatically, liable. Folk 25.

20. Professor Folk defines "outsiders" as "directors who are not also officers of the corporation or who otherwise have no specific and intimate relationship to the corporation which would afford them either actual knowledge of corporate affairs or such ready access thereto to confer a right to such information." Id. at 26. See also Comment, 117 U. PA. L. Rev., supra note 15, at 739-41; Comment, 68 COLUM. L. Rev., supra note 15, at 1411-14.

21. Professor Folk uses the term "specialist director" to designate one upon whom the court's judgment may fall harder "because of his particular function in the corporation . . . his professional knowledge or skill . . . or the fact that he participates in the registration process not only as a director but also in some additional capacity." Folk 33. Such a classification could encompass the attorney, underwriter, or section 11 "expert" himself, Id. at 33-42.

22. The facts of BarChris force this consideration, though not expressly. For example, attention is directed to reliance by directors on corporate documents or reports. Professor Folk expands upon this problem. Id. at 64-72. See also Comment, 1969 DUKE L.J., supra note 15, at 1209-16.

23. The commentary on BarChris is legion. See, e.g., authorities cited at note 15 supra.

24. The concerned commentary of the securities bar certainly indicates increased diligence as a result of BarChris. See, e.g., Israels, Preparation of Registration Statement: Issuer's Counsel—Advice to My Client, 24 Bus. Law. 537 (1969).

25. The "average prudent investor" standard of the SEC, 17 C.F.R. § 230.405(l) (1972), was sufficient when viewed in light of the overstatement of gross profit, sales, orders on hand, understatement of contingent liabilities, and failure to disclose facts as to officer loans, customers' delinquencies, application of proceeds, and impending default by customers. 283 F. Supp. at 681.
exchange offers, as well as by the knowledge that he is as likely to be penalized for saying too much as for saying too little.  

Another issue not considered in BarChris was the proper measure of damages to be awarded when the fraud occurred in a falling market. In such a situation it is clear that the plaintiff would have suffered some losses on his investments which could not be attributed to the misdeeds of the defendant. Although section 11 denies recovery for losses not resulting from misrepresentation or omission, the defendant's burden of proof in such cases has been described by commentators as "impossible."

The remainder of this Note will discuss the questions unanswered in BarChris. Particular emphasis will be placed on the recent district court holding in Feit v. Leasco Data Processing Equipment Corp., a decision notable for its thorough—and frequently novel—analysis of materiality and the measure of damages, as well as for its refinement of the BarChris treatment of section 11 defenses.

Feit v. Leasco: Facts and Holding

Any discussion of the Leasco case must be prefaced by reference to the dynamic ascendancy in the financial community of the "growth cult." From the mid-1950's through the 1960's, investors "paid more and more attention to the fundamental competitive position of industries and companies, to changing processes and technologies, and to earnings projections over an extended time horizon." This passion for performance was epitomized by the conglomerate movement, fueled by the use in takeover bids of convertible securities, which leveraged the earnings potential of the conqueror by absorption of the immediate earnings performance of the target while postponing a proportionate expansion of the parent's equity base. The investment community and acquisition-minded management would find extremely lucrative, for example, the potential leverage accruing from

27. See text accompanying notes 77-80 infra.
the combination of an aggressive parent in the electronic data processing field with a fire and casualty company whose estimated $100,000,000 in liquid assets could be stripped away for more productive utilization by a holding company manipulated by the parent.

One such combination was inspired by two studies of the fire and casualty insurance industry which were made available to Leasco Data Processing Equipment Corporation. One study envisioned a broad-based, financial services holding company making use of the tremendous capital resources of the subsidiary insurance company.\(^2\) The second report, prepared internally by Leasco,\(^3\) analyzed the advantages of such an acquisition, using Reliance Insurance Company\(^4\) as a model. Crucial to such an acquisition was the desire of Leasco to control the tremendous surplus capital reserves of Reliance known in the industry as "surplus surplus." Essentially, surplus surplus consists of "the highly liquid assets of an insurance company which can be utilized in non-regulated enterprises."\(^5\) To be of such use, however, surplus surplus must be segregated from the insurance assets subject to state regulation; therefore, the holding company concept or a viable alternative was critical to Leasco's plans.\(^6\)

---


33. The Gibbs Report, prepared by Leasco's Vice President for Corporate Planning, expanded upon the Netter Report's holding company concept. In Gibbs's opinion, the principal advantages to Leasco of such an acquisition included: (1) great increase in earnings per share, (2) tremendous growth potential of the financial services holding company, (3) larger capital input for Leasco's computer leasing, (4) aggressive acquisition and investment on the part of the holding company and (5) a foothold in the financial services industry of the future. Plain-tiff's Exhibit 3 at 1-2, Felt v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971).

34. Reliance was a fire and casualty company subject to regulation by the Pennsylvania Insurance Commissioner.

35. 332 F. Supp. at 551. More specifically, surplus surplus is that amount above and beyond the surplus required by regulation. That is, an amount that will be adequate to cover for a reasonable period of time any losses and expenses larger than those predicted and any declines in asset values, including all chance variations in the crucial factors of the operation. Id. at 550-51, quoting N.Y. INS. DEP'T, supra note 32, at 43.

The two reports varied in their estimates of the surplus surplus available. The Netter Report set the figure at $80,000,000 as of the end of 1966, while Gibbs's estimates were $125,000,000 as of June 30, 1967 and $100,000,000 by the end of the year.

36. Since insurance companies are often forbidden to engage in noninsurance business activities, surplus surplus must be separated from the regulated insurance operation with its concomitant restrictions.
The first concrete manifestation of Leasco's interest was its systematic purchases of Reliance stock. Reliance responded defensively in a vaguely-worded letter from its president, Roberts, to the shareholders intended to "forestall a takeover bid." After an unfruitful meeting in early June between representatives of the two companies, Leasco announced an offer to exchange a debenture-warrant package for each two shares of Reliance common. Reliance countered by writing a letter to shareholders counseling deliberation, and by refusing to cooperate with Leasco's numerous requests for assistance and verification in the preparation of the preliminary registration statement. The attitude of the Reliance management remained hostile through the month of July. Reliance filed a deterrent lawsuit against Leasco and, in a letter from Roberts, strongly recommended shareholder rejection of the offer—actions which the court found probative of the Roberts group's preparation "to employ a full panoply of defensive techniques in an attempt to bust the exchange offer." At the end of July, however, the Reliance management was to withdraw its active opposition to the exchange and to assist in establishing a Leasco-controlled holding company which was to be guaranteed access to the surplus surplus but which agreed not to interfere with the insurance aspects of Reliance. This agreement was reduced to writing on

37. By April 3, 1968, Leasco owned 132,000 shares (around 3%) of Reliance's outstanding common, valued at over $4,000,000. 332 F. Supp. at 554.
38. Although the letter made reference to Reliance's own plans to utilize surplus surplus through a holding company, it was admittedly only a "public relations maneuver." Id.
39. Leasco offered one warrant and one convertible debenture having a principal amount of $110 and annual interest of $4.00 in exchange for each two shares of Reliance common. It is crucial to note that during the week immediately prior to this announcement, a partner of White, Weld & Co., the lead underwriter, was named as a director on the Leasco board. See note 120 infra and accompanying text.
40. The registration statement covered the Leasco common into which the debentures were to be converted. 332 F. Supp. at 555.
41. The court found the July 23 shareholder letter significant for its insight into the depth of opposition to the offer. 332 F. Supp. at 556. In addition to enumerating the disadvantages inherent in the Leasco deal, Roberts tacitly suggested that outside interest from a number of sources might produce a more attractive offer if the Leasco exchange fell through. Id.
42. Id. A late July meeting between the two groups was described by Leasco's chief executive officer as "cold." Id. at 555.
43. In return for Reliance's cooperation and announced approval of the exchange, Leasco promised to maintain a majority of the existing board in office for five years. Roberts was personally promised that he could retain his position as a director and chief executive officer
August 1, commencing an "effective working relationship between what was to be parent and subsidiary." Leasco, sensing success, altered the offer package to preferred stock and warrants, while Reliance, in a letter to shareholders, dutifully withdrew its opposition to the takeover, failing to mention that the shift to preferred stock made the offer less beneficial from a tax standpoint than the first offer. On August 19, the registration statement became effective—without express reference either to "surplus surplus" or to Leasco's contemplated use thereof in the holding company context. The offer was overwhelmingly successful; seventy-two percent of the shares were tendered by September 13. Subsequently, the offer was extended four times, with the increasingly enthusiastic cooperation of Roberts, and finally terminated on November 1. A class action suit was brought against Leasco, three directors and the two dealer-managers on behalf of all shareholders of Reliance who had exchanged their shares between August 19 and November 1, 1968. Plaintiffs alleged material misrepresentations and omissions in violation of sections 11, 12(2), and 17(a) of the Securities Act of 1933, sections 10(b) and 14(e) of the Securities Exchange Act of 1934, and rule 10b-5. Specifically, the complaint alleged that

---

44. Id. at 556.
45. Id. at 558. The original offer would subject the tenderor to tax on installments as he realized gain; the preferred offer was immediately taxable. There is language in the opinion which clearly regards this action as a breach of fiduciary duty on Roberts' part. See id.
46. Two postscripts to these events deserve mention. In January, 1969, Leasco filed a registration statement and prospectus which, in discussing the recently-acquired insurance company, expressly estimated Reliance's surplus surplus at $125,000,000. Id. at 560. Second, Reliance did declare a special dividend of $39,394,369 in August, 1969 as the ultimate vehicle for transferring surplus surplus to Leasco. The court took judicial notice of the 1969 stock market decline as the primary explanation for the decline in Reliance's surplus surplus to less than one-third of the original estimate. Id. at 586.
47. The three directors also served respectively as Leasco's chief executive officer, president, and general counsel, the latter also as a partner in the law firm which represented Leasco. All three were held to be "insiders." Id. at 575-76. The chief underwriter was White, Weld & Co., the other dealer-manager was Lehman Brothers.
48. Dudley Feit, the named representative of the class of aggrieved shareholders, tendered his shares on October 14, 1968. Id. at 560.
50. Id. §§ 78j(b), 78n(e) (1970).
Leasco had failed to disclose an estimate of the surplus surplus of Reliance and to fully reveal its “intentions” to reorganize Reliance or to otherwise remove its surplus surplus in a manner other than through a holding company.52 The defendants responded that the omissions were not material because an estimate of surplus surplus would have made the offer more attractive. Further, the defendants argued that not only would inclusion of such a figure have been “bullish” and thus proscribed but also that an accurate estimate was impossible because Reliance’s financial data, its management’s own estimate, and the opinion of the insurance commissioner were unavailable. Finally, the defense contended that other plans for removal of the surplus surplus were merely contingent at the time of the tender offer.53 The court held that an estimate of the amount of the surplus surplus was indeed material and available to Leasco but that “preliminary contingency planning” concerning its use need not have been included in the prospectus.54

After discussing the issue of materiality, Judge Weinstein considered the due diligence defenses of the defendants and held liable the issuer and three directors—two “insiders” and one “attorney director.” In applying the “independent verification” test prescribed in BarChris, Judge Weinstein looked to each director’s involvement, his expertise, and his access to the pertinent information needed to verify representations in the registration statement.55 Rejecting the defense that data was unavailable due to Reliance’s hostility, the court found critical the directors’ knowledge of the August 1 rapprochement between Reliance’s board and Leasco.56 The court further concluded that “adequate inquiry” demanded that the defendants attempt to calculate the surplus figure even without Reliance’s cooperation.57 As to the underwriters, the court held that they “just barely” established due diligence defenses despite their knowledge of the August 1 bargain.58

52. The only reference in the prospectus concerning the surplus surplus concept neither mentioned an estimate nor suggested the importance thereof to Leasco. The prospectus echoed what it referred to as Reliance’s intent to form a holding company and announced Leasco’s intent to promote the realization thereof, with Reliance providing “the maximum amount of funds legally available . . . .” See the excerpt from the prospectus at 332 F. Supp. at 552.

53. Id.

54. Id. at 568.

55. Id. at 577-78. See note 99 infra and accompanying text.

56. 332 F. Supp. at 580.

57. Id. at 581.

58. Id. at 582.
Liability having been found, Judge Weinstein turned to the question of appropriate damages.\(^{59}\) In this portion of the opinion, he attempted to perform the “impossible” feat of extracting the effects of the market decline from the total losses suffered by the plaintiff. His analysis, which in all likelihood will be heavily relied on by future defendants, will be discussed in greater detail in a later section of this Note.\(^{60}\)

**Analysis of Leasco**

*Materiality.* Liability under section 11 arises only when the omission or misrepresentation is “material.”\(^ {61}\) Although the SEC has attempted to provide guidance in the application of the “materiality” standard, its rule 405, defining as “material” those matters of which an “average” prudent investor ought reasonably to be informed,\(^ {62}\) has only served as a springboard from which courts have leaped in quest of a more workable standard. That search has been complicated by the reappearance of the materiality standard in a number of the other antifraud sections, notably in sections 12(2) and 17(a)(2) of the 1933 Act, as well as rule 10b-5, and the proxy and tender offer provisions of the 1934 Act.\(^ {63}\) The result has been a semantic merry-go-round, a loosely-veiled attempt by the courts to pay lip service to some objective test while, actually, the standard demands a subjective evaluation to determine what financial incentives motivate the elusive “average” investor.\(^ {64}\) The quest for such a uniform standard should originate within the individual context of the particular securities setting with the ultimate decision tailored accordingly. Thus, what is material to a purchaser of an original offering might be different in an exchange offer, a proxy contest, or in a corporation’s decision to disclose or suppress intra-corporate information.\(^ {65}\)

---

59. *Id.* at 584.
60. See text accompanying notes 123-36 infra.
61. See note 4 *supra*.
64. Professor Bromberg’s definition of materiality in the 10b-5 context attests to this semantic dilemma. He suggests that “[s]ome sort of reasonable man, objective test of investment judgment, intrinsic value, or . . . significant market effect is appropriate.” A. BROMBERG, SECURITIES LAW—FRAUD § 8.3 at 199 (1967). Bromberg concedes that “[a] certain amount of subjectivity of this sort affords desirable flexibility.” *Id.* at 201. Contrast his treatment in disclosure cases: Bromberg, Disclosure Programs for Publicly Held Companies—A Practical Guide, 1970 DUKE L.J. 1139.
65. The SEC, speaking through its General Counsel, has given tacit recognition to this “functional” approach but concludes: “No very useful purpose would be served by attempting
In *BarChris*, Judge McLean applied a cursory but wholly adequate test of materiality to the simple original issue purchase context: material matters are those "which such an investor needs to know before he can make an intelligent, informed decision whether or not to buy the security,"—that is, "facts which have an important bearing upon the nature or condition of the issuing corporation . . . ." Since it refers to decisions to purchase and to facts about the issuer, the *BarChris* standard is only indirectly applicable to an investor's decision in response to an exchange offer to give up the stock of the target company. In *Leasco*, Judge Weinstein clearly recognized this deficiency and turned instead both to judicial treatment of the concept in other settings and to his own ingenuity in fashioning yet another rendering of "materiality." According to Judge Weinstein:

66. 283 F. Supp. at 681.
67. Id. (emphasis added). Judge McLean found still relevant the precedent of an early Securities Act case in which a material fact was defined as one which may have "deterred or tended to deter the average prudent investor from purchasing the securities in question." Charles A. Howard, I S.E.C. 6, 8 (1934).
68. "*BarChris* cannot be read as permitting exclusion of important facts merely because they involve the condition of the company being taken over rather than the issuer since these facts will bear on the relative value of the issuer's securities." 332 F. Supp. at 569.


Noting that these formulations, standing alone, "fail to prescribe a precise standard," Judge Weinstein observed that they evidence a broadening trend in the definition of materiality, thus "raising the requirement of disclosure . . . ." 332 F. Supp. at 571. See also A. Bromberg *supra* note 64, § 8.3 at 199.
"A fact is proved to be material when it is more probable than not that a significant number of traders would have wanted to know it . . . ."\textsuperscript{70} Since a prospectus is held to a high legal standard, Judge Weinstein stated: "Anything in the order of 10\% of either the number of potential traders or those potentially making 10\% of the volume of sales would seem to more than suffice."\textsuperscript{71} Thus, a single buyer of ten percent of the issue could render a fact "material" by his desire to know it. Since the court must still speculate as to what the investor would "want to know," however, this definition, if left solely to the intuition of the court, appears to remain circular.

Judge Weinstein attempted to break the circuitous bonds of his own test by proposing that potential litigants submit statistical surveys to guide the court's intuition. In future litigation, investor desire to know specific facts could be demonstrated by "mathematical models buttressed by valid sampling techniques for determining trader reactions . . . ."\textsuperscript{72} Apart from questions of economic and evidentiary feasibility of extrajudicial surveys, this technique is open to serious challenge on the ground that it substitutes the man-in-the-street's uninformed reaction for the court's application of the SEC standard embodied in rule 405.

Since the parties were not prepared to litigate the case armed with such data, Judge Weinstein fell back upon more traditional and safer ground, analyzing materiality by a non-quantitative "hypothetical reasonably prudent shareholder" test: "A fact is 'material' . . . whenever a rational connection exists between its disclosure and a viable alternative course of action by any appreciable number of investors."\textsuperscript{73} Having discussed at great length the "preliminary" quest for a standard, Judge Weinstein concluded that the estimate of surplus surplus was so significant "that under any test proposed it is material."\textsuperscript{74} The court listed several reasons why knowledge of surplus surplus might have altered the investment decisions of the Reliance shareholders.\textsuperscript{75} For example, the shareholders could not ade-

\textsuperscript{70} 332 F. Supp. at 571 (emphasis added). Note that the opinion adopts the more stringent "would" approach as opposed to "could" or "might." See note 63 supra. Cf. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), where the Supreme Court applied the "might have considered important" standard to a 10b-5 case. Id. at 154.
\textsuperscript{71} 332 F. Supp. at 571.
\textsuperscript{72} Id.
\textsuperscript{73} Id.
\textsuperscript{74} Id. at 572.
\textsuperscript{75} Id. at 573-75.
quate assess the extent of investor interest in Leasco (particularly of institutional investors with access to the fire and casualty studies) in order to decide whether to hold out for a better offer. Further, they were denied the benefit of market reaction to such disclosure, consequent price appreciation, and probably were deterred from the option of holding their shares in pursuance of the original Reliance proposal to form its own holding company.

In finding that an estimate of surplus surplus was material, however, the court may have given insufficient attention to the defendants' contention that inclusion of such a figure would be purely speculative and hence contrary to SEC and stock exchange policy. Such rules have presented management with a disclosure dilemma: it is liable for failure to disclose projections if material, yet it is equally liable if projections, once made, are either overly-optimistic or too conservative. Since any estimate of surplus surplus necessarily would have incorporated an estimate of "specific future market values" of the securities held in the Reliance investment portfolio, it is not difficult to understand Leasco's reluctance to walk a chalk line so narrowly drawn. That such an estimate would have been truly speculative was borne out by the ultimate value of the surplus surplus available for distribution—as a result of the 1969 market decline, Leasco was able to siphon off less than $40,000,000 as a special cash dividend. If Leasco had included its own internally-generated approximation (roughly $100-125,000,000) in the registration statement, it

76. The presumption is that knowledge of surplus surplus and its potential use would have forced the market to revalue Reliance shares, thus forestalling the exchange until Leasco's offer was made more attractive. The court rejected defendants' argument that the premium offered was so attractive that disclosure would have been of no consequence. Id. at 572.

77. Projections in proxy statements are limited by the suggestion, which presumably now has been incorporated into exchange offer disclosure requirements, that "predictions as to specific future market values" may be misleading. 17 C.F.R. § 240.14a-9, Note 9 (1972). The New York Stock Exchange expresses a similar policy:

Any projections of financial data, for instance, should be soundly based, appropriately qualified, conservative and factual. Excessive or misleading conservatism should be avoided. Procedure for Public Release of Information, NYSE COMPANY MANUAL A-22 (1968).


78. Alberg, supra note 65, at 1230. According to Professor Bromberg, projections will be judged by "whether the forecast had a reasonable basis, both in fact and in method of preparation, when made." A. BROMBERG, supra note 64, § 7.1 at 148.

79. See note 77 supra.
conceivably would have been liable to the same plaintiffs for a material misrepresentation when it ultimately realized only one-third of the original estimate. Since the securities statutes arm the plaintiff with such a two-edged sword, the only safe avenue open to management, when in possession of a projection presumably material, is full but conservative disclosure, affirmatively qualified to take into account future variables of both favorable and unfavorable consequence.80

*Leasco* expressly held that the only actionable omission was the

---

80. A recent decision in the proxy setting further clouds the judicial gloss imposed upon the disclosure of projections and the valuation of assets or securities material to the transaction. In *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D.N.Y. 1969), the full disclosure mandate of rule 10b-5 and *Texas Gulf Sulphur* collided head-on with traditional SEC conservative accounting rules which have insisted on asset valuation at historical cost as opposed to current market value.

The complaint in *Gerstle* alleged insufficient disclosure in a proxy solicitation seeking approval of a statutory merger of a fifty percent owned company, General, into its dominant shareholder, Gamble-Skogmo. Prior to the merger, General was eliminating its billboard advertising units, which, while unprofitably operated, nonetheless were worth substantially more than their book values. The alleged omissions, upheld by the court, included a failure to disclose the company's own *appraisal* of the fair market value of these assets, 298 F. Supp. at 92, and to state expressly the company's *intent* to sell those assets immediately after merger, id. As a result, the court held that the exchange ratio based on historical values was misleading and thus deprived General shareholders of their undiluted share of the gains on the subsequent sales. One writer finds critical the SEC's reversal of its long-standing position on asset valuation; the Commission's amicus brief asserted that "a failure to disclose appreciation of assets may under some circumstances be actionable quite apart from any specific intention to realize that appreciation." Manne, *supra* note 77, at 308. Although *Gerstle*, unlike *Leasco*, involved plans to sell physical assets to third-party buyers, the two cases provide striking parallels in their holdings as to the necessity of disclosure of asset approximations at fair market values by the acquiring corporation in a merger regardless of clear intent to liquidate the same. The cases thus forebode considerable future dispute over disclosure of assets valuation in exchange offer transactions.

*Leasco* and *Gerstle* bring into serious question the continuing precedential validity of the decision in *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951), 135 F. Supp. 176 (D. Del. 1955), *modified on other grounds*, 235 F.2d 369 (3d Cir. 1956). In *Speed*, the court held that no cause of action under rule 10b-5 existed for failure to disclose appreciation in inventory values, since such information was readily available to the market; however, Transamerica's failure to disclose its intent to liquidate Axton-Fisher, the holder of the inventory, was a material omission.

The defense of "market knowledge" which was successful in *Speed* was avoided by the court in *Gerstle* despite acknowledgement that the market price probably reflected the knowledge of appreciation of the assets of General. The defendants were thus precluded from showing widespread dissemination of such information and its potential relevance to the issue of damages and the overall fairness of the exchange. Professor Manne finds this to be a serious but understandable weakness in the court's approach. Manne, *supra* note 77, at 313. The parallel to *Leasco* is obvious; the *Gerstle* rationale would deny to defendants the opportunity to establish that the market was fully cognizant of the importance of surplus surplus because of the widespread dissemination of the fire and casualty study reports.
failure to include an estimate of surplus surplus.\textsuperscript{81} Thus, the case could be cited as support for permitting nondisclosure in a registration statement of the plans which the successful corporation has for the target, at least where those plans are merely contingent or expressed in the alternative. It should be noted, however, that a mere numerical approximation of surplus surplus, in the absence of either knowledge of its legal availability or its most probable utilization, is a meaningless input into the investor’s decision to swap; rather, in the court’s own words, the investor should be told “what the deal is all about.”\textsuperscript{82} It has been said that: “[t]he disclosure of plans seems to run counter to a powerful SEC tradition prohibiting projections and other references to the future.”\textsuperscript{83} But to conclude that Leasco need not have disclosed the contingent plans which were the sole motivation of the offer and which would lead inevitably to the separation of the surplus surplus from Reliance’s insurance business would raise more serious conflicts with other sections of the securities laws and challenge the underlying disclosure philosophy of securities regulation.

In a strict sense, this portion of the Leasco holding has been mooted by the Williams Act and its amendments to sections 13 and 14 of the 1934 Act.\textsuperscript{84} Prospectuses used in exchange offers must now disclose the same information to offerees as that which is required in

\begin{footnotes}
\item[81] 332 F. Supp. at 575, 588.
\item[82] Id. at 549.

Prior to the Williams Act provisions, the primary protection afforded offerees was the antifraud prohibition of rule 10b-5. Under the Williams Act, however, cash tender offers were made subject to express disclosure requirements, including a parallel antifraud provision, by the expansion of sections 13 and 14 of the 1934 Act. Under the 1968 scheme, the 14(d) requirements were waived if the offeror proposed the deal by means of a 1933 Act registration statement; presumably, the Leasco registration statement, filed July 8, 1968, was exempted from the more stringent requirements. The Leasco court makes no reference to these requirements since the complaint alleged violation only of the antifraud provisions of 14(e). This exemption of 14(d)(8)(A) was eliminated by the 1970 amendments (the major significance of which was the inclusion of stock exchange offers within the disclosure requirement of section 14(d)). The 1970 amendments thus avoided the possibility raised by Leasco that an issuer in an exchange might avoid the disclosure of certain plans mandated by the exchange offer requirements by use of a registration statement which, according to Leasco, need not mention “contingent” plans.
\end{footnotes}
cash tender offers. When the purpose of the offer is to acquire control, the offer must disclose any plans or proposals which the purchasers may have to liquidate the issuer, to sell its assets or to merge it with any other persons, or to make any other major change in its business or corporate structure... Although Leasco in 1968 was subject to the disclosure requirements applicable to registration statements under the 1933 Act, the issue it raises for tender offers—the extent of the requirement to disclose “plans or proposals”—remains an omnipresent and perplexing problem. Although there is at present no indication as to the degree of detail necessary under the Williams Act, one commentator has concluded that, despite the offeror’s uncertainty, he “must say what the plans are, or that there are none.” In Leasco, therefore, the summary dismissal of the allegation that the registration statement omitted disclosure of contingent plans for utilization of surplus surplus other than the holding company concept might, if reheard under the Williams Act requirements, be reversed.

Not surprisingly, the uncertainty as to the extent of Williams Act disclosure requirements has led to litigation. As in Leasco, the cases have centered on the degree of certainty required before plans or proposals need be disclosed. The Supreme Court’s consideration of the problem came indirectly in SEC v. National Securities, Inc., in which the Court implicitly recognized as a material omission in a proxy solicitation the failure to disclose plans for the survivor of the merger to assume obligations incurred in purchases of the target’s stock.

85. Under the 1968 scheme, it was unlawful for any person to make a tender offer if he would then be the owner of ten percent (now five) of the class of securities unless he first filed a statement containing the information requested in section 13(d). The 1970 amendments brought exchange offers within the same dictates. See 17 C.F.R. § 230.434(b) (1972). The items to be disclosed are found in Schedule 13D, id. § 240.13d-101. Items required include the name and address of the issuer; the title of the securities; identity and background material; source and amount of funds or other consideration; purpose of the transaction; interest of the issuer in the securities; contracts, arrangements or understandings with respect to the securities; and persons employed or to be compensated in connection with the issue.

86. Id. § 240.13d-101, Item 4 (emphasis added). See also Griffin & Tucker, supra note 84, at 672.

87. Bromberg, supra note 83, at 499. As to detail, Bromberg suggests a test of “materiality.” Nonetheless, he suggests the use of hedges by reference “not only to present knowledge and intention, but also to future investigation, changing situations and needs, and perhaps to the best interests of the target corporation and its shareholders as they appear in the light of future examination and developments.” Id.


89. In response to the respondents’ argument that rule 10b-5 did not extend to misrepresen-
Two subsequent circuit cases have examined this issue in greater detail. In *Electronic Specialty Co. v. International Controls Corp.*,

complex litigation arose out of a successful cash tender offer for shares of a volatile electronics firm. The offeror's statement filed with the SEC declared that it might "give consideration" to a merger if the offer were successful. Finding that the offeror had neither committed itself nor "evidenced a firm intention" to merge, the Second Circuit held the statement to be an accurate and *sufficient* statement of plans. The holding is thus squarely in line with Judge Weinstein's *Leasco* rationale—that "preliminary contingency planning" is not sufficiently material to be required in a 1933 Act registration statement. It should be noted, however, that the *Electronic Specialty* decision draws a narrow line upon which issuers must balance the degree of detail to be disclosed. In his decision, Judge Friendly wrote: "It would be as serious an infringement of these regulations to overstate the definiteness of the plans as to understate them."

*Susquehanna Corp. v. Pan American Sulphur Co.*, also illustrated the divergence between the circuits and the SEC on construction of the disclosure requirements. Pan American, the target, sued...
Susquehanna, the successful offeror, for alleged violation of the disclosure and antifraud provisions. The Fifth Circuit overruled the district court's finding of a material omission in Susquehanna's failure to disclose its intent to gain control of Pan American's board and to merge the target into another corporation once control was acquired. The court found that a reasonable shareholder would realize that Susquehanna "intended to exercise strong control" of the target. Furthermore, since such plans were expressly repudiated two days after their suggestion, any concrete proposal of merger "never got off the ground." The most instructive portion of the transaction, though, was the "hedge" clause which Susquehanna appended to its denial of any merger plans and which illustrates the degree of equivocation necessary to walk the "tortuous path" of disclosure in exchange offers. It is equally illustrative of the manner in which courts have weakened the disclosure underpinnings of the most essential and most controversial requirement of the Williams Act—that relating to "plans or proposals."

Due Diligence—Directors. As noted above, the most significant impact of BarChris is its exhaustive application of the "due diligence" defenses of section 11(b) of the 1933 Act. The court held that all director defendants—five insiders (executive officers), two outsiders (a banker and a civil engineer) and two specialists (the attorney-director and the underwriter-director)—failed to establish their defense that, as to the non-expertised portions of the registration statement, they had, after reasonable investigation, reasonable grounds to believe that there were no material omissions or misrepresentations. In applying the standards of care, BarChris appeared to adopt a flexible approach which recognized that the standard necessarily must vary with the parties to which it is applied.

The task of applying the standard to the Leasco defendants was less burdensome than in BarChris, since only three Leasco directors were named—its chief executive officer, president, and general counsel. Conspicuously absent from this group was a Leasco director

94. Id. at 1083.
95. Id. at 1085. This holding obviously gave little weight to the fact that subsequent merger into another subsidiary was proposed immediately after the successful close of the offer.
96. After expressly denying any plans to merge, Susquehanna included the following: However, if, at some subsequent time, it should appear the interests of the Pan American stockholders would be better served by any of the foregoing courses of action, Susquehanna may propose or adopt such course. Id. at 1082.
97. See text accompanying note 14 supra.
whose primary occupation was that of partner in White, Weld & Co., one of the Leasco underwriters exonerated in the case. Relying upon BarChris, Judge Weinstein concluded that an application of the reasonable investigation test to director defendants was essentially a question of independent verification by reference to readily available written corporate documents, as opposed to reliance upon oral representations of concededly interested insiders. By developing an applicable standard of investigation by verification, Leasco then amplifies the implicit functional development in BarChris. Reasonable investigation will therefore "vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data."

Such an analysis modifies the strict "prudent man" test of section 11(c) and substitutes a subjective examination of each individual director, despite Judge Weinstein's qualification of his standard as that of a "reasonably prudent man in that position." Therefore, inside directors are held to a higher standard than outsiders not because of their corporate status or apparent authority, but because of their more intimate knowledge of the corporation's affairs and their access to material information. In fact, Judge Weinstein agrees with one leading scholar that the standard is so stringent with respect to inside directors that "liability will lie in practically all cases of misrepresentation."

Applying this standard to the Leasco directors, the determining factor was simply whether the defendants had enough information available to them to render the estimate of surplus surplus sufficiently accurate when accompanied by a skillfully drafted "qualifying" state-

99. 332 F. Supp. at 577. The court cited with approval a commentator who argues that this reasoning is supported by the legislative history of the Act: "The House report . . . stated that the duty of care to disclose varied in its demands upon the participants with the importance of their places in the scheme of distribution and the degree of protection that the public had a right to expect from them." 332 F. Supp. at 578, quoting Comment, 68 COLUM. L. REV., supra note 15, at 1416.

100. 332 F. Supp. at 578 (emphasis added). For a statement of the "prudent man" test, see note 17.

101. 332 F. Supp. at 578, citing Folk 25. Such a conclusion leads inevitably to an imposition of "guarantor" status upon inside directors. Folk at 25.

102. The court could have rejected the defendants' unavailability argument under the express requirements of rule 409:

(b) The registrant shall include a statement either showing that unreasonable effort or expense would be involved or indicating the absence of any affiliation with the person within whose knowledge the information rests and stating the result of a request made to such person for the information. 17 C.F.R. § 230.409(b) (1972).
Judge Weinstein rejected the contention that such an estimate was impossible without adequate data from Reliance, finding critical the knowledge of the three inside directors that a truce had been reached with Reliance by August 1. After that time, Roberts, president of Reliance, would have cooperated in supplying the essential information. Although the court found that the defendants' lack of a reasonable ground to believe in the accuracy of the statement was a sufficient ground for liability, the court further held, in the alternative, that the defendants failed in their duty to reasonably investigate the accuracy of the registration statement—that is, they had a duty to attempt to estimate surplus surplus even if they fairly believed that effort to be futile. This broadening of the "reasonable investigation" test to encompass independent verification of management's own conclusions and data comports squarely with the court's stringent "guarantor" standard of insider liability. It also raises the spectre that, in some cases, director good faith belief standing alone will not be adequate. Leasco thus must be viewed as a refinement of BarChris. In BarChris, each of the inside directors had actual knowledge of the misrepresentations for which they were held liable, whereas in Leasco liability rested upon a failure to attempt to reach that plateau of awareness.

Leasco's discussion of the liability of each of the three directors is less detailed than that seen in BarChris. However, Judge Weinstein's opinion is valuable in at least two respects. First, its very cursory discussion of Leasco's chief executive officer and its president supports the observation of one commentator that

an inside director who either as an officer or in some other capacity, has intimate familiarity with the corporate affairs or handles major transactions, especially those as to which false statements or omissions appear in the prospectus, is least able to establish due diligence.

103. Several months later, Leasco did include such a qualified estimate in a separate registration statement. 332 F. Supp. at 560.
104. The court also rejected the argument that necessary access to the Insurance Commission's cooperation was unavailable since Roberts could have furnished that as well. Id. at 580.
105. Although concededly the court's rendering of the standard may differ from that of section 11(b)(3) only semantically, it is nonetheless instructive in its apparent requirement of verification by a third party:
Surplus surplus was a crucial element of the plan to acquire Reliance. Yet, no one connected with Leasco commissioned an estimate by an insurance consultant; no one asked any Leasco employee to calculate it; Hodes [the Leasco attorney-director] never ordered one of his law firm's associates to attempt to arrive at a figure; and certainly no one made inquiry of the one man who could have easily produced a figure—Roberts. Id. at 581.
106. Folk 22.
Second, in contrast to BarChris, the attorney-director in Leasco was
held to be an insider, based upon his service as a director for over
three years and his intimate involvement in the registration process.107
This result is potentially devastating, for as an “insider” he may be
held to be as “presumptively knowledgeable”108 as a guarantor. In
BarChris, the “outside” attorney was held liable only for failure to
independently verify information which would command his profes-
sional attention. The “inside” Leasco attorney was subjected to the
same broader duty of investigation as other management-directors,
although the duty was still subjectively qualified by his functional
capacity and the extent of his familiarity with the affairs of the corpo-
ration.109 If nothing else, then, Leasco counsels added caution in the
endogamous relations between corporations and their retained legal
counsel.

Due Diligence—Underwriters. The Securities Act subjects under-
writers to the same duty of due care as directors and signers of the
registration statement but affords them the same defenses and a free-
dom from unlimited liability.110 Because of the underwriter's unique
position in the securities offering scheme, one commentator has sug-
gested that the underwriter be subject to a standard of integrity ex-
ceeded only by that of the issuer.111 In BarChris, Judge McLean held
that the underwriter's publicly owed responsibility for the “truth of
the prospectus”112 precluded satisfaction of the reasonable investiga-
tion duty by the mere acceptance and accurate reporting of data

107. 332 F. Supp. at 575-76.
108. Folk 35.
109. Although this distinction may suffice conceptually, there are difficulties in distinguishing
the positions of the two attorneys. Aside from a shorter tenure as a director, the BarChris
attorney appears to have been as fully involved in the registration process as the Leasco
attorney, whose activities are not chronicled beyond his involvement in the takeover bid.
afforded by section 11(e) to underwriters: the total price at which the securities underwritten
by him and distributed to the public were offered to the public. Id. § 77k(e). See generally
111. Professor Folk suggests a number of reasons for this conclusion: the fact that the
underwriter's reputation is imputed to the issuer; that he is in a more objective position conducive
to aggressive investigation of issuer representations; and that the underwriter has substantial
control over final acceptance of the issue. In fact, self interest—the awareness of his liability—should accelerate the adoption of that role. Folk 54-55.
112. 283 F. Supp. at 697. Underwriters thus occupy a fiduciary position vis-à-vis the public
and the issuer. “In a sense, the positions of the underwriter and the company's officers are
adverse.” Id. at 696.
presented to him by management. Judge Weinstein, in *Leasco*, gave full credence to the *BarChris* standard but, at the same time, emphasized the underwriter's "more limited access" to inside knowledge of corporate affairs. Such a qualification of the *BarChris* standard is unobjectionable on its face as a functional approach to securities regulation. As applied in *Leasco*, however, the court's conclusion poses a serious challenge to the disclosure philosophy as mandated in *BarChris*.

In *Leasco*, the directors were held liable for their failure to reasonably investigate and for their failure to estimate the omitted approximation of surplus surplus. That holding turned principally upon the court's conclusion that the August 1 rapprochement with Reliance made available sufficient data and expertise to make such an estimate. However, the underwriters were held to have "just barely" established their reasonable investigation and belief that the omission was justified. Their apparently intense examination of *Leasco*'s documents and financial data seems to have been virtually beyond reproach; nor, absent one crucial fact, could they be faulted for assuming that the surplus surplus estimate was unavailable since they were initially advised of the Reliance hostility and refusal to cooperate in the preparation of the registration statement, and were aware of the lawsuit filed against *Leasco* and of Roberts' unfavorable letter to his shareholders. This state of knowledge, absent awareness of the August 1 agreement with the Reliance board, would have supported the reasonable investigation defense. Although the court expressly found that the underwriters were aware of the agreement, it nevertheless exonerated them on the tenuous ground that they were never "disabused" of their belief that Roberts remained uncooperative. The court's conclusion rested upon an August 13 letter from *Leasco*'s counsel to the SEC (with copies to the underwriters) that

113. "They may not rely solely on the company's officers or on the company's counsel." *Id.* at 697. Reasonable investigation thus demands an independent verification through available information. See Comment, 68 COLUM. L. REV., *supra* note 15, at 1417-22.

114. 332 F. Supp. at 582. One must concede the impracticability, as does Judge McLean, 283 F. Supp. at 691, of a "rigid rule" requiring "the most detailed, independent verification possible of every material representation in the prospectus." Comment, 1969 DUKE L.J., *supra* note 15, at 1200-01. Rather, the standard, as with "materiality," must vary with the facts of each case.

115. See text accompanying notes 102-05 *supra*.

116. 332 F. Supp. at 582.

117. *Id.* at 583.
Reliance had "declined to furnish information." Judge Weinstein held that the underwriters had "reasonably verified Leasco's representations" of unavailability. Such a conclusion is unacceptable. BarChris expressly precludes underwriter acceptance of management representations at face value; instead, it requires independent verification. Here, the underwriters, clearly aware of the ramifications of the August 1 agreement, should not have accepted Leasco's representation that Roberts remained uncooperative without independently verifying that assertion. Since they did not contact Roberts in the nineteen days between the agreement and the effective date of the offer, they should be held to the same liability imposed upon the directors who were deemed to have a duty to re-assess the availability of the data after August 1. Further, since a member of the underwriting firm was also on the Leasco board, it is at least arguable that his knowledge of the August 1 agreement should have been imputed to his underwriting firm. When his loyalty to the corporation conflicts with his duty to the public, the proper course of action for the underwriter-director is clear—the public interest must prevail. In the words of one leading commentator: "[S]anctions to compel careful scrutiny by underwriters must be sustained intact."

Hence, the underwriter-director is held to a high standard. Whether the policy behind that standard compels affirmative disclosure to his firm or even imputation of his knowledge has not yet been settled.

118. Id.
119. Professor Folk's analysis of BarChris supports such a conclusion:
Probably the rule emerging from BarChris is that sole reliance by underwriters on representations by officers is presumptively insufficient; ordinarily, . . . the underwriter should verify specific facts as fully as possible, or be prepared to prove that his best efforts were thwarted by events he could not control. Folk 72.

120. If sued as an individual, his liability would have been clear, since his position would directly parallel the position occupied by Coleman, an underwriter-director, in BarChris. Although Coleman was personally responsible for the investigation, 283 F. Supp. at 693, the role performed by the underwriter-director in Leasco is unclear.
121. Folk 39.
122. Extended discussion of this imputation theory is beyond the scope of this Note. However, in concluding, one might further speculate that the "deputization" theory applied to certain directors sitting on the boards of more than one corporation in "short-swing" profits violations might be indirectly applicable in imputing the knowledge of Leasco to White, Weld & Co. Cf. Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969).

The theory of deputization in section 16(b) cases, based as it is on the statutory purpose of precluding the use of inside information for trading in the company's own stock, is arguably not applicable to a failure to disclose in the registration setting. Nonetheless, the failure to disclose material information imputed to the underwriter may sustain an otherwise unmarketable issue.
Measure of Damages. Judge Weinstein's application of the section 11(e) damage formula in *Leasco* is highly significant for a number of reasons. It is only the second major decision to give credence to the defendant's causation defense, and the first to apply it to a post-Williams Act tender offer. Furthermore, the decision illustrates the difficulties arising from the present bifurcated securities scheme which forces the court to foreclose one measure of damages in its choice among the civil enforcement sections of both Acts. *Leasco*’s greatest impact, however, probably will ensue from its explicit recognition of market decline and its use of a measurable indicator in the damage formula. Section 11(e) allows the defendant to prove that part of the loss “represents other than the depreciation in value of such securities resulting from” the material omission or misrepresentation. This “causation with a reverse twist” has been viewed as imposing a heavy burden upon the defendant, for even assuming that a portion of the damages is attributable to conditions unrelated to the misrepresentation, any measure of exact proof thereof seems difficult. This problem frustrated defendants until 1966, when limited vitality was breathed into the causation defense in *Fox v. Glickman Corp.*, which reports a settlement agreement arising out of a suit based upon misrepresentations in three registration statements. Under the second statement, the offering price of $12.50 declined to $11.125 over a nine month period ending on the date of first public awareness of the corporation’s “difficulties.”

123. The *BarChris* decision did not reach this issue. See text following note 27 supra. Although Judge McLean rejected the defendants’ contention that the entire amount of damages was due to the decline in the bowling industry, he deferred any decision on whether the causation defense was valid as to some plaintiffs, 283 F. Supp. at 703-04.

124. Section 11(e) authorizes recovery of 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 . . . . 15 U.S.C. § 77k(e) (1970).

125. R. Jennings & H. Marsh, supra note 29, at 809-10. Professors Jennings and Marsh doubt the feasibility of proof even if the market were to have declined before discovery of the false statement. This pessimistic view was refuted in the *Fox* case.

126. Id. at 1010. This terminology is ambiguous; presumably the court refers to the initial discovery of the falsehood such that subsequent decline is attributable thereto.
This decline, the court held, could not be attributed to the misrepresentation but rather was due to other market conditions and thus the maximum recovery was set at $11,125,129. Similarly, a minimum valuation was established at the value of the stock on the statutory cut-off date, any decline in value after that date was deemed not to be due to deficiencies in the statement.

Judge Weinstein's decision in *Leasco* surpassed this limited, though precedential, application of the causation defense in *Fox* by including the effect of market decline forces throughout the *entire* exchange offer period, regardless of the date of public "discovery" of the alleged misrepresentation. The court thus took judicial notice of the drastic decline in market prices during 1969. Since the court concluded that some portion of the decline in the price of Leasco shares was due to market factors affecting all stocks, it held that a part of the plaintiffs' damages was not caused by the disclosure deficiencies. The major deterrent to such an approach has been the difficulty in applying a sufficiently definite adjustment factor to the specific stock. To overcome this obstacle, Judge Weinstein used a novel formula adapting therein the broad-based Standard and Poor's Daily Stock Price Index. By multiplying the amount paid for the security (the Reliance common price) by the reciprocal of the decline in the Standard and Poor's Index from August 16, 1968 to the date of sale by a given plaintiff, the diminution in value due solely to market decline would be extracted from the damage award.

Judge Weinstein's formula is a praiseworthy attempt to effectuate the heretofore frustrated congressional intent to limit recovery to loss resulting from the material omission or misrepresentation. In declining markets, prior defendants have been assessed damages representing, in part, the decline in value due to non-actionable causes,

---

129. *Id.*

130. Pursuant to section 11(a), Glickman had published and distributed an earnings statement covering a period of at least twelve months beginning after the effective date. The court accepted this date as a cut-off because of the publication of the report in the New York financial papers and because Glickman's difficulties were public knowledge by that time.

131. 332 F. Supp. at 586. During the relevant exchange offer period—August 16, 1968 (the last day of trading unaffected by news of the offer) to October 27, 1969 (the date suit was filed)—the Standard & Poor's Index rose from 98.68 to a high of 109 and then fell to 97.97, while the Dow Jones Index rose from 917 to 996 and then plummeted to 860.28.

132. *Id.*

133. The *Leasco* formula is complicated by valuation difficulties as to the warrant-preferred stock package and by a five-for-two split of the warrants. The decision includes a useful example of the formula's application. *Id.* at 588.
although, in fairness, defendants have probably been equally compensated in rising markets where actionable price declines have been driven up by general market enthusiasm. The formula is subject to attack on the grounds of the irrelevancy of general market trends to the specific decline of the defendants' stock. Possibly it should be refined by limiting the examination of market decline to the performance of a composite of related stock—for example, fire and casualty insurers or electronic data processing corporations. Nevertheless, the *Leasco* formula should be regarded as a highly significant development in federal securities law and its application will surely be urged by Securities Act defendants.

Damage resolution in the *Leasco* situation is complicated by the evident incongruity in applying the section 11(e) formula to an exchange offer setting. Thus, in determining the "amount paid" for the security (the *Leasco* Package), the court was forced to choose between the combined market value of the *Leasco* preferred and warrants and the market value of *Reliance* shares to be exchanged. Since the former measure was the amount received and since it included the inducement premium, the court rejected the combined market value of the *Leasco* securities as a measure of the amount paid. Instead, it chose as the price paid the open market value of *Reliance* shares on the last date of trading before the effective date of the offer. Since there was thus a separate "amount paid" figure for each individual exchange, the court's resolution ignores the fluctuation in market values of each of the three securities involved during the exchange period. This sacrifice of precision was necessitated by the court's limitation of damages to those provided in section 11. It rejected three alternative damage formulas which would have imposed liability under the more flexible antifraud provisions. Again, the lack of uniformity in the federal securities scheme precluded a potentially greater and possibly more equitable recovery. The same conduct, arguably actionable under several of the civil liability sections of the

---

134. By analogy, one might surmise whether future *plaintiffs* might not argue that, when faced with a rising market, their loss would have been greater had not the price decline of the stock (or failure to decline) been held up by general market advances. Such a plaintiff, though, has no realized "damages" for that portion of the "decline," nor is there an analogue to the causation defense expressly granted to *plaintiffs*.

135. 332 F. Supp. at 585-86.

136. *Id.* at 584-85. *Plaintiffs* suggested the following formulas: (1) a conversion formula, based upon the highest price at which the *Leasco* package traded, (2) rescission, or (3) restitution.
two acts, should not produce different recoveries varying with the court's inclinations toward the liability sections. Judge Weinstein would undoubtedly have faced this greater dilemma had Roberts, who purposely avoided signing the registration statement to evade liability thereunder, been sued under rule 10b-5 for the breach of fiduciary duty evident in the August 1 sell-out to Leasco.

CONCLUSION

The chief goal of securities regulation is "full and fair disclosure" of all material facts. Judicial attempts to reach that goal are beset with difficulties, however. Materiality is more easily required than defined, and the responsibility of the various parties to a securities transaction for the accuracy of the information disclosed remains unclear. A further complication is introduced by the damage provisions of section 11 of the 1933 Act. Since that section permits recovery only of damages caused by the fraudulent acts of defendants, any award should take into account the fact that securities prices fluctuate constantly within a changing market.

Judge Weinstein's decision in Leasco illustrates the limitations of judicial attempts to apply the standards of the securities acts in a specific fact situation. His discussion of materiality demonstrates the weaknesses inherent in the traditional tests, but his proposed application of sampling techniques and mathematical models to define materiality in a given case creates as many problems as it solves and may be poorly suited for the courtroom. Further, his damage formula is arguably irrelevant to the extent that a particular security shows fluctuations in value which depart from market averages. Leasco, then, is at best an imperfect answer to the questions raised by the securities acts. By attempting to find new ways to solve old problems, Judge Weinstein's decision underscores their existence.