RECENT DEVELOPMENTS UNDER SECURITIES REGULATIONS IN THE UNITED STATES

The decision in *Escott* v. *BarChris Construction Corporation*[1] has raised serious problems for the U.S. financial community. Previously accepted procedures in public financings are being questioned. Not only corporations and their officers and directors but their professional advisers including lawyers, accountants and underwriters are undertaking more intensive and thorough examinations resulting in increased financing costs.

The decision deals with civil liabilities on those signing a prospectus to prospective investors for mis-statements of material facts or omissions to state material facts. More particularly, it deals with what constitutes reasonable investigation of the accuracy of such facts by one signing a prospectus. Although the case may not be of direct application in Canada it is significant to anyone in Canada engaged in public financing.

The Facts

BarChris Construction Corporation (BarChris) was engaged in the construction of bowling centres and on March 30, 1961, filed a registration statement (the statement) with the United States Securities and Exchange Commission. The statement became effective on May 16, 1961, and on November 1, 1961, BarChris defaulted on the $3,500,000 principal amount of 5½% convertible debentures covered by the statement. BarChris has been in bankruptcy proceedings since.

An action on behalf of the purchasers of the debentures was brought under Section 11 of The Securities Act 1933[2] (the Act). The action was brought against:

1. the persons who signed the statement, being the Company itself, the nine directors, five of whom were officers and therefore considered "inside directors" and four of whom were "outside directors", plus the controller who was not a director;
2. eight investment banking firms which had acted as underwriters for the issue;
3. BarChris' accountants.

The Act

Section 11 of the Act provides that, if the prospectus of a security issuing company contains an untrue statement of, or omits to state "a material fact", the following are liable to an innocent purchaser therefor, namely:

(i) every signer of the prospectus,
(ii) all of the company's directors,
(iii) every accountant, engineer, appraiser, or other professional person who has (with his consent) been named as having prepared any report used in connection with the prospectus, and
(iv) every underwriter of the security offered.

Mis-statements and Omissions in the Statement

These were divided into three principal classes:

1. Those relating to the audit of financial statements as of December 30, 1960;

1 (1968) 283 F. Supp. 643; D C, S.D.N.Y.
2 Public—no. 22—73 D Congress.

2. Those relating to certain unaudited figures included in the text of the statements;
3. Those relating to other information provided in the text.

The audited financial statements as of December 31, 1960, overstated net sales by $653,900, net operating income by $246,605 and earnings per share by 10c. Current assets were overstated by $60,689 and there were certain other mis-statements including an understatement of direct liabilities by $325,000.

The text of the statement contained understatement of contingent liabilities of $618,853. Net sales, ($2,138,455) for the three months ended March 31, 1961, were overstated by $519,810. The most serious mistake was that the prospectus stated as follows, "the Company as of March 31, 1960, had $2,875,000 in unfilled orders on its books. As of March 31, 1961, the comparable amount was approximately $6,905,000." It was found a fact that as of March 31, 1961, backlog figures of unfilled orders had been overstated by at least $4,490,000 by the inclusion of orders which had either previously been cancelled or were not on a firm contract basis.

With respect to other information, the statement showed that all advances from officers of BarChris to BarChris had been repaid when in fact $386,615 was outstanding as of the effective date. Further, the statement showed the proceeds of the sale of the subject debentures would be used for additional working capital and for the purpose of expansion when in fact over 60% was used to immediately pay then overdue debts. The statement mis-stated other problems BarChris had, and failed to state that BarChris was engaged in the operation as well as the design, manufacture, construction, installation, modernization and repair of bowling alleys.

Defence of Due Diligence

All of the Defendants, except BarChris itself which as issuer was prohibited from doing so, raised the defence of reasonable investigation or due diligence which is found in Section 11 of the Act.

This section provides that any person is not liable "who shall sustain the burden of proof that he had *after reasonable investigation, reasonable ground to believe* . . . that the statements therein were true and that there was no omission to state a material fact."[3]

The regulations under the Act provide that the term "material":

"limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered."

Section 11 (c) of the Act defines *"reasonable investigation"* as follows:

"In determining . . . what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."

The Court held that the statement contained material mis-statements and omissions and that none of the defendants had shown they had exercised due diligence.

What the Judge said about the various defendants.

1. *Persons who signed registration statement*

(a) *The President and Vice-President*—were founders of the business and were men of limited education. They claimed that for them the

[3] *Id.*, 11 (b) (3) (B).

statement was difficult reading but the Court said "whether it is or was not is irrelevant. The liability of a director who signed a registration statement does not depend upon whether or not he read it, or if he did, whether or not he understood what he was reading . . .[4] he could not have believed that the registration statement was wholly true and that no material facts had been omitted. And in any case, there was nothing to show that they made any investigation of anything they may not have known or understood."[5]

(b) *The Treasurer-in-Chief and financial officer*—was a certified public accountant who was thoroughly familiar with BarChris' financial affairs, and had read and understood the prospectus and the background material. "Kircher's contention is that he had never before dealt with a registration statement, that he did not know what it should contain, and that he relied wholly on Grant, Ballard and Peat, Marwick to guide him. He claims that it was their fault, not his, if there was anything wrong with it. He says that all the facts were recorded in BarChris's books where these "experts" could have seen them if they had looked. Under the circumstances he was not entitled to sit back and place the blame on the lawyers for not advising him about any untrue statement."[6]

(c) *The Controller*—The Controller apparently made no investigation of the accuracy of the statements "As a signer he could not avoid responsibility by leaving it up to others to make it accurate."[7]

(d) *House counsel*—He was not part of top management, he took care of the Company's routine legal business. With respect to him the Court said "as a lawyer he should have known his obligations under the statute. He should have known that he was required to make a reasonable investigation of the truth of all of the statements in the unexpertised portion of the document which he signed. Having failed to make such investigation, he did not have reasonable ground to believe that all these statements were true."[8]

(e) *Outside Directors*—The Court took into account that the outside directors had been elected shortly before the effective date of the statement and had made inquiries of the Company officers concerning the accuracy of the statements. They had been assured they were correct, however, the Court held that under the circumstances they had not done enough and said, "Section 11 imposes liability in the first instance upon a director, no matter how new he is. He is presumed to know his responsibility when he becomes a director. He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property. In my opinion, a prudent man would not act in an important matter without any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case. To say that such minimal conduct measures up to the statutory standard would, to all intents and purposes, absolve new directors from responsi-

4 *Supra*, n. 1, at 684.
5 *Id.*, at 685.
6 *Id.*, at 685.
7 *Id.*, at 686.
8 *Id.*, at 687.

bility merely because they are new. This is not a sensible construction of Section 11, when one bears in mind its fundamental purpose of requiring full and truthful disclosure for the protection of investors."[9]

2. *The Underwriters*—The underwriter relied on the lead of Drexel & Co. who delegated its investigation to its attorney. The effect of such delegation was described by the Court as follows "On the evidence in this case, I find that the underwriters' counsel did not make a reasonable investigation of the truth of those portions of the prospectus which were not made on the authority of Peat, Marwick as an expert. Drexel is bound by their failure. It is not a matter of relying on counsel for legal advice. Here the attorneys were dealing with matters of fact. Drexel delegated to them as its agent, the business of examining the corporate minutes and contracts. It must bear the consequences of their failure to make an adequate examination. . . .[10] The underwriters say that the prospectus is the company's prospectus, not theirs. Doubtless this the the way they customarily regard it. But the Securities Act makes no such distinction. The underwriters are just as responsible as the Company if the prospectus is false. Any prospective investors rely upon the reputation of the underwriters in deciding whether to purchase the securities. . . .[11] The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection. To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them."[12]

3. *The auditors*—Since the due diligence defence under Section 11(b)(3)(B) of the Act requires "that the investigation and ground for belief be reasonable at the time the registration statement became effective,"[13] the Court felt compelled to consider "not only what Peat, Marwick did in its 1960 audit, but also what it did in its subsequent 'S-1 review'[14] (Reviewing events subsequent to the date of a certified balance sheet). Apparently, even if it had made no errors at all in its 1960 figures, Peat, Marwick might still have been liable if the 1960 figures became misleading because of a material change in BarChris' financial position.

9 *Id.*, at 688.
10 *Id.*, at 697.
11 *Id.*, at 696.
12 *Id.*, at 697.
13 *Id.*, at 698.
14 *Id.*, at 698.

Such a change could only be excused if Peat, Marwick's S-1 review met the statutory standard. The Court found that the Peat, Marwick written programme for the S-1 review conformed to generally accepted auditing standards, but as carried out in little over two days (20½ hours) by an unexperienced person, it was inadequate. Among other things the Court noted that:

(1) he did not read the minutes of any subsidiary; he only read the minutes of the Board of BarChris;

(2) he did not examine any important financial records other than a trial balance as of March 31, 1961;

(3) he did not look at any contracts;

(4) he did not discover that BarChris was holding up cheques because there was no money in the bank to cover them; and

(5) he did not read the prospectus and thus was not aware of the loans from officers in the past and did not discover the present ones.

Summing up the Court said "Accountants should not be held to a standard higher than that recognized by their profession. I do not do so here. Bernardi's review did not come up to that standard. He did not take some of the steps which Peat, Marwick's written programme prescribed. He did not spend an adequate amount of time on a task of this magnitude. Most important of all, he was too easily satisfied with glib answers to his inquiries."[15]

CONCLUSION

This decision means that everyone connected with a registration statement under the Securities and Exchange Act must make a thorough independent examination of every material fact contained in such a statement at the risk of being held personally liable for every material inaccuracy or omission.[16]

—R. G. BLACK, Q.C.*
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15 *Id.*, at 703.

16 For more developments under U.S. Security regulations see Securities and Exchange commission
Texas Gulf Sulphur Co. et al. (CA-2, 1968) no. 30882, and
Glen Alden Corporation D C, S.D.N.Y. 1968 (68 Cu-3203).

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