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BARCHRIS AND THE REGISTRATION PROCESS*

by

John R. Jordan, Jr.**

ONE of the most significant court decisions in the history of federal securities regulation was handed down in March 1968 in the case of *Escott v. Bar Chris Construction Corp.*¹ The decision involved the obligations and liabilities of company officers, directors, underwriters, counsel and accountants in connection with registration statements filed under the federal securities laws. Judge McLean's opinion in this case represents an important adjudication of the broad spectrum of questions raised by section 11 of the Securities Act of 1933 dealing with liability for misstatements or omissions of material facts in registration statements. That section provides in part:

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 . . . sue [persons who signed the registration statement, directors of the issuer, underwriters and certain 'experts']²

Several defenses are available to each such person (except the issuer) in the event of suit. These include:

- (1) [T]hat . . . as regards any part of the registration statement not purporting to be made on the authority of an expert . . . 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.³

. . . .

- (2) [T]hat . . . as regards any part . . . made on the authority of an expert (other than himself) . . . he had no reasonable ground to believe . . . at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein⁴

Statements made by a person upon his authority as an expert must be de-

* The author of this Article is a practicing certified public accountant—not a lawyer. Consequently, it is not his purpose to offer legal interpretations, or to present an exhaustive discussion of civil liability under section 11 of the Securities Act of 1933. However, any person who is involved in the securities registration process should be at least familiar with the *Bar Chris* decision and its implications. It is the author's objective to set forth his understanding as a layman of the *Bar Chris* opinion and its probable effects on registration procedure based on his post-*Bar Chris* experience and discussions with a number of attorneys and underwriters.

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¹ 283 F. Supp. 643 (S.D.N.Y. 1968).

² Securities Act of 1933, § 11(a), 15 U.S.C. § 77k(a) (1964). Unless the context indicates otherwise, any further reference, either in text or in footnotes, to section 11 and subsections should be assumed to refer to section 11 of the Securities Act of 1933.

³ *Id.* § 11(b)(3)(A), 15 U.S.C. § 77k(b)(3) (1964).

⁴ *Id.* § 11(b)(3)(C), 15 U.S.C. § 77k(b)(3) (1964).

fended under the standard set forth in (1) above, *i.e.*, reasonable investigation and reasonable ground for belief.

In determining for the above purposes what constitutes "reasonable investigation" and "reasonable ground for belief," the law provides that "the standard of reasonableness shall be that of a prudent man in the management of his own property."⁵

The above provisions pose a number of significant questions: What is a "material" fact? Who are "experts" within the meaning of the Act? What parts of a registration statement are made on the authority of experts? What constitutes "reasonable investigation" and "reasonable grounds for belief"? To what extent do standards of investigation differ for the various parties (directors—inside and outside, officers, underwriters, experts, etc.) who may be liable?

Very few actions have been brought by investors under the civil liability provisions of the 1933 Act and no decision has meaningfully discussed the above questions. Accordingly, *Bar Chris* must be regarded as a landmark decision. The court commented at length and explicitly on the responsibilities of inside and outside directors, company officers, company counsel (who was a director), underwriters, underwriters' counsel, and independent accountants. Moreover, the court set forth standards of responsibility and investigation for some of these parties far beyond those traditionally assumed in the registration process. Some legal experts feel that some of the positions and statements of the court were broader than necessitated by the facts of the case. Nevertheless, most corporate lawyers appear to agree that in view of the dearth of judicial expressions in these areas, the statements and positions of the court call for serious consideration and a re-examination of procedures and techniques currently being followed.

The *Bar Chris* opinion is lengthy, and the facts and issues are numerous and complex. To establish proper understanding and perspective of the case, a systematic approach will be employed. Some pertinent background will be presented first, and then the various issues and findings of fact will be discussed. Each defendant's position will be considered separately. Finally, the implications of the decision will be discussed, together with probable procedural changes in the registration process.

The *Bar Chris* opinion will be treated at length and in considerable detail for the following reasons: (1) there apparently has been an over-reaction to the decision, probably because of misunderstanding of the issues involved and the court's holdings; (2) some background and discussion of the facts will give insight into the circumstances and context in which the registration statement in question was prepared; (3) a detailed examination of the opinion will disclose the extent of each defendant's investigation and the court's holdings with respect thereto.

I. BACKGROUND

Bar Chris Construction Corporation was engaged in the construction of bowling alleys. The introduction of automatic pin setting machines in

⁵ *Id.* § 11(c), 15 U.S.C. § 77k(c) (1964).

1952 had given a marked stimulus to bowling; therefore, Bar Chris's alley construction operations grew rapidly. Its sales increased from \$800,000 in 1956 to over \$9,000,000 in 1960.

The company's method of operation and financing is of particular importance. In general, it entered into a contract with a customer, received a small down payment, and constructed and equipped the bowling alley. When the alley was finished, the customer executed installment notes, payable over a period of years, for the balance due. Bar Chris discounted the notes with a factor and received a part of their face amount in cash. The factor retained a portion as a reserve. Bar Chris was contingently liable in the event a customer defaulted to the extent of fifty per cent of the unpaid balance.

In 1960 Bar Chris began financing alleys in part through a sale and leaseback arrangement. When the equipment ("interior package") was installed, Bar Chris would sell the "interior package" to a factor who would in turn lease it either (1) to Bar Chris's customer, or (2) to a subsidiary of Bar Chris. In the latter case, the subsidiary would lease the "interior package" to the customer. In both cases, Bar Chris immediately received the entire proceeds in cash. The company's contingent liability for performance of the lease obligations was limited to twenty-five per cent of the lease obligation in arrangement (1), but it was one hundred per cent under arrangement (2).

The company expended considerable sums of money on work in progress before it received reimbursement. This factor, coupled with the rapid expansion of business, resulted in a chronic shortage of cash.

In December 1959, the company sold common stock to the public. In early 1961, in order to meet its need for additional working capital, the company sold \$3,500,000 of convertible debentures through an underwriting syndicate. The issue was covered by a registration statement which became effective May 16, 1961.

By the time Bar Chris received the debenture financing proceeds it was experiencing difficulties in collecting from its customers, several of whom were in arrears on payments of the discounted notes. The bowling industry was suffering from an overbuilt condition and many inadequately financed alley operators began to fail. Bar Chris continued to build alleys; however, it also continued to be desperately short of cash. In October 1962 it filed under chapter XI of the Bankruptcy Act, and on November 1, 1962 it defaulted on the debenture interest payment then due.

Some of the purchasers of the debentures brought suit under section 11 of the Securities Act of 1933, alleging that the registration statement with respect to the debentures filed with the Securities and Exchange Commission contained material false statements and failed to state material facts. Defendants included the persons who signed the registration statement⁶ (inside and outside directors—including the principal officers, the general

⁶ In the instant case, all directors of the issuer signed the registration statement. However, the law makes directors liable whether or not they sign a registration statement. *Id.* § 11(a)(2), 15 U.S.C. § 77k(a)(2) (1964).

counsel for the company, a partner in the lead underwriting firm, and several other outside directors—and the controller), the underwriters and the independent accountants.

II. ISSUES AND HOLDINGS

Broadly stated, the issues before the court on the question of liability were: (1) did the registration statement contain false statements of fact and/or did it omit to state facts which should have been stated in order to prevent it from being misleading; (2) if so, were the misstatements or omissions "material" as defined under the Act; and (3) if so, did the defendants establish their respective affirmative defenses as provided in the Act?

A. *Misstatements and Omissions*

The alleged misstatements and omissions related to the prospectus, which contained, among other things, a description of Bar Chris's business and information regarding its real property, subsidiaries, methods of operation, and financing. The financial information included an audited consolidated balance sheet at December 31, 1960, with explanatory notes and audited income statements for the three years then ended. It also contained unaudited net sales, gross profit, and net earnings for the quarter ended March 31, 1961, and comparative amounts for the 1960 first quarter. Additionally, it stated the company's backlog of unfilled orders at March 31, 1961, compared with March 31, 1960, and Bar Chris's contingent liability as of April 30, 1961, on customers' discounted notes and under the sale and leaseback financing arrangements.

Plaintiffs charged that certain of these figures were inaccurate and that the text contained certain false statements or omitted certain information. With regard to the 1960 financial statements (audited), the court found that in accordance with generally accepted accounting principles Bar Chris recognized sales and gross profit on bowling alleys under construction based on the percentage completed to a given date. Due in part to use of erroneous completion percentages and in part to inclusion in "sales" of certain alleys in fact not sold, "sales," "net operating income," and "earnings per share" for 1960 were misstated as follows:

	<i>Reported in the Prospectus</i>	<i>Determined by the Court</i>	<i>Misstatement</i>
Sales	\$9,165	\$8,511	\$654
Net operating income	1,742	1,496	246
Earnings per share	\$.75	\$.65	\$.10

(figures given in thousands)

With respect to the 1960 balance sheet it was found that current assets of \$4,524,000 were overstated by \$610,000 as a result of incorrect inclusion of restricted cash and accounts receivable relating to an alley in fact

not sold, failure to provide an adequate reserve for doubtful accounts, and misclassification of all of the factor's reserve as a current asset.

Contingent liabilities were found to be understated by \$376,000, due principally to misinterpretation of the contract contingency provisions regarding contingent liabilities on sale and leaseback transactions. In addition, the company was directly liable for one lease (\$325,000) shown as a contingent liability.

With regard to the 1961 first quarter unaudited figures and contingent liabilities at April 30, 1961, the pertinent amounts as reported in the prospectus and found by the court were:

	<i>Reported in the Prospectus</i>	<i>Determined by the Court</i>	<i>Misstatement</i>
1961 First quarter:			
Net sales	\$2,138	\$1,619	\$520
Gross profit	483	252	231
Net earnings	126	Assumed proportionate to adjustment of gross profit	
Contingent liabilities at April 30, 1961:			
Notes discounted	5,101	5,101	—
Sale and leaseback arrangements	825	1,444	619
Direct lease liability	—	314	314
	(figures given in thousands)		

The errors were attributable to the same factors as before—inclusion of intercompany transactions (sales of alleys to subsidiaries) in "sales" and "gross profits" and misinterpretation of the contingent liability provisions.

In addition to the misstated figures, the court found several errors in the text of the prospectus.

Backlog. The prospectus stated: "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. Substantially all of the latter orders are scheduled and are expected to be completed in 1961." The court stated that "'unfilled orders on its books' which are 'scheduled,'" meant in this instance "firm, enforceable contracts with purchasers who have made their down payments and who can reasonably be expected to perform their contracts." The court found that these criteria were not met with respect to some \$4,490,000 of the "orders" included in the backlog figure. Thus, the adjusted backlog was approximately \$2,415,000, an amount less than a year earlier.

Officers' Loans. Statements in the prospectus that the maximum amount of advances by the officers to Bar Chris was \$155,615, and that all such advances had been repaid were false because (1) the recipient officers did not deposit the checks they received in repayment of their advances until after Bar Chris received the proceeds of the debenture offering, and (2) shortly before the effective date there were additional advances by officers

which had not been repaid and the existence of which was not disclosed. In the latter case, the officers advanced the funds and simultaneously received checks in the same amount from the company which the evidence indicated they agreed not to deposit, and did not deposit, until the debenture proceeds were received. In all, advances by officers amounted to approximately \$387,000 as of the effective date.

Application of Proceeds. The prospectus stated that \$1,745,000 of the financing proceeds (the amount remaining after providing for the costs of a new plant, development of a new equipment line, and a loan to a financing subsidiary) was to be employed as "additional" working capital in the "expansion" of alley construction. In fact, the court found that \$1,160,000 of this amount was used to repay bank and officer loans, to pay construction expenses incurred prior to the effective date and to make a loan to a company owned by friends of an officer of Bar Chris.

Delinquency Experience. The prospectus stated that "[s]ince 1955, the Company has been required to repurchase less than 1/2 of 1% of promissory notes discounted [with] unaffiliated financial institutions." The court found this statement "literally true" but "impliedly false" because it suggested that customer delinquency problems were minimal when in fact such problems were extremely serious at the time the registration statement became effective. A number of customers were seriously in arrears and Bar Chris was continually negotiating with the factor to avoid repurchasing discounted notes.

Description of Business. The description of the business section was found to be incomplete and misleading in that it did not disclose that Bar Chris operated one bowling alley, intended to operate two more, and might, with impending repossessions, be operating several more alleys in the near future.

B. Materiality of Misstatements and Omissions

The court then turned to the issue of whether the misstatements and omissions were "material" within the meaning of section 11, a matter of particular interest to accountants. The Securities and Exchange Commission regulations define "material" as follows: "The term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to *those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.*" The court refined this test as follows:

A material fact [is] a fact which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question.

The average prudent investor is not concerned with minor inaccuracies or with errors as to matters which are of no interest to him. The facts which

⁷ SEC Regs., 17 C.F.R. § 230.405(1) (1968) (emphasis added).

tend to deter him from purchasing a security are facts which have an important bearing upon the nature or condition of the issuing corporation or its business.⁸

These criteria or tests, the court acknowledged, boil down to a question of judgment "to be exercised by the trier of the fact as best he can in the light of all the circumstances."⁹

Judge McLean concluded that "there was no doubt" that all of the misstatements and omissions which related to 1961 were material (*i.e.*, overstatement of sales and gross profit for the first quarter, understatement of contingent liabilities at April 30, failure to disclose the true facts with respect to backlog, officers' loans, delinquencies, application of proceeds, and present and prospective operation of several bowling alleys).

With respect to the misstatements of the 1960 figures, the judge pointed out that a prudent investor would have known that the debentures were a speculative investment and that even after adjustment, the sales and earnings growth was "striking." He concluded that, viewed in this context, it was unlikely that an investor would have been deterred from buying the securities if he had been apprised of the comparatively minor misstatements of sales and earnings. The same was true of the misstatement of contingencies at December 31, 1960. On the other hand, the court concluded that the 1960 balance sheet errors which reduced the ratio of current assets to current liabilities from 1.9 to 1 to 1.6 to 1 were material, on the interesting grounds that "[t]here must be some point at which errors in disclosing a company's balance sheet position become material, even to a growth-oriented investor."¹⁰

C. "Due Diligence" Defenses

We now turn to the crux of the opinion—the court's holdings with respect to whether the defendants established their respective affirmative defenses as provided in the Act. It is here that judicial history was made, since there had been no previous significant judicial interpretation of the section of the Act providing for "due diligence" defenses. The judge commented at length on the responsibilities of each of the parties involved in preparing and signing the registration statement. He also discussed separately the "due diligence" defenses pleaded by the respective defendants, both with respect to the portions of the registration statement which were "expertised" and those that were not made on the authority of experts.

The court first established that the only "experts" within the meaning of the Act were the independent accountants. Some defendants had asserted that Bar Chris's attorneys and the underwriters' attorneys were also experts and that everything in the registration statement was "expertised" because the two law firms were responsible for the entire document. However, the court held that "[t]o say that the entire registration statement

⁸ *Escott v. Bar Chris Constr. Corp.*, 283 F. Supp. 643, 681 (S.D.N.Y. 1968), citing *In re Charles A. Howard*, 1 S.E.C. 6, 8 (1934).

⁹ *Id.* at 682.

¹⁰ *Id.*

is expertised because some lawyer prepared it would be an unreasonable construction of the statute."¹¹

This was a crucial preliminary matter because it precluded certain parties such as outside directors and the underwriters from asserting a defense under section 11(b)(3)(C) (no reasonable ground to believe untrue, etc.) and forced them to assert a defense under section 11(b)(3)(A), which required proof of reasonable investigation and reasonable grounds for belief on their part. Furthermore, it appears that underwriters' counsel (not otherwise a party to the suit) could have been sued under section 11(a)(4) as an "expert" had the court ruled otherwise.

The court then determined what portions were "expertised" (another matter of particular concern to accountants). The parties asserted three views as to which portions were expertised: (1) only the 1960 and prior years audited figures (including notes to the financial statements); (2) every figure in the prospectus; and (3) the audited figures and that section of the text referred to in a footnote to the balance sheet (a common cross-referencing practice inserted for the convenience of the reader and designed to eliminate repetition of text material in the footnotes). The court held that the narrow view (1) was correct, since the registration statement contained a report of the independent accountants which clearly covered only the 1960 balance sheet and the income and retained earnings statements for the three years then ended. This, of course, is the way accountants have always viewed and intended their responsibility.

The Defendants—Signers of the Registration Statement.

Director and Chief Executive Officer. As chief executive officer he "knew all the relevant facts." He was a member of the executive committee, and he was familiar with all aspects of the business. He personally handled many of the transactions which figured prominently in the case. He arranged the company's financing and negotiated with the factors; he was aware of the customer delinquency problems; he was aware of the tight cash position of Bar Chris, and he personally advanced some \$175,000 to the company which remained unpaid at the effective date and which fact was not disclosed to company counsel or, as we have discussed, in the registration statement. The court's holding is not surprising: "He could not have believed that there were no untrue statements or material omissions in the prospectus. [He] has no due diligence defenses."¹²

Director and Chief Financial Officer. A certified public accountant, the court found that he was thoroughly familiar with the financial affairs of Bar Chris. As a member of the executive committee, he was kept informed of the non-financial aspects of the business, such as the present and prospective operation of bowling alleys. He withheld information from the company counsel and the underwriters' counsel. This officer asserted that

¹¹ *Id.* at 683.

¹² *Id.* at 684.

he was inexperienced in registration statement matters and that he relied on counsel and the independent accountants to guide him.

The court, however, held that "[e]ven if he had told [counsel] all the facts, this would not have constituted the due diligence contemplated by the statute."¹³ Knowing the facts, he had reason to believe that the expertised portion was in part incorrect and he did not have reasonable ground to believe the rest of the prospectus was true. In fact, "he must have known that in part it was untrue. Under these circumstances, he was not entitled to sit back and place the blame on the lawyers for not advising him about it."¹⁴ He had no due diligence defenses.

Other Officers Also Directors. The remaining two director-officers were the founders of the business; however, they limited their activities principally to the areas of sales and construction supervision. They were men of limited education who probably found the prospectus difficult to understand (if in fact they read it). However, they were members of the executive committee, and the affairs of the business were discussed at length at its meetings. They were aware generally of what was going on and had reason to know that certain information in the prospectus was false. They also failed to prove their due diligence defenses.

The following statements in the opinion relating to these officers are of particular interest: "The liability of a director who signs 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 . . . there is nothing to show that they made any investigation of anything which they may not have known about or understood."¹⁵

Chief Accounting Officer and the Secretary. Although the chief accounting officer had been in the employ of Bar Chris only a short time and was "a comparatively minor figure" in Bar Chris's management, the court held that he knew or should have known that certain parts of the prospectus were untrue.

Insofar as the instant case is concerned, the court could have stopped with this holding. However, Judge McLean expanded on the standards of responsibility which apply to a signer of a registration statement:

Even if he [believed the entire prospectus to be true], he still did not establish his due diligence defenses. . . . He failed to prove [as to the unexpertised portions] that he made a reasonable investigation which afforded him a reasonable ground to believe that it was true. As far as it appears, he made no investigation. He did what was asked of him and assumed that others would properly take care of supplying accurate data as to the other aspects of the company's business. . . . As a signer, he could not avoid responsibility by leaving it up to others to make it accurate.¹⁶

The secretary (also a director and house counsel) was in a position similar to the chief accounting officer in that his knowledge was limited to certain aspects of the business. The standard set forth by the court in es-

¹³ *Id.* at 685.

¹⁴ *Id.*

¹⁵ *Id.* at 684-85.

¹⁶ *Id.* at 686.

tablishing his responsibility is significant: "As a lawyer . . . he should have known that he was required to make a reasonable investigation of the truth of all the statements in the unexpertised portion of the document which he signed."¹⁷

Neither officer established his due diligence defenses except the secretary as to the expertised portion.

Outside Directors. The court commented at some length on the responsibility of an outside director who was a commercial banker and who became a member of the board after the registration statement in its original form had already been filed. He signed the signature page for the first and second amendments, the latter constituting the registration statement in its final form. He never saw the registration statement in its final form, and he relied on the assurances of the officers of the company as to the accuracy and completeness of the information contained therein and on certain general credit inquiries he had made prior to joining the board.

The court held that he had established his due diligence defense with respect to the expertised portion because he was acquainted with the firm of independent accountants and had confidence in them and relied upon them. With respect to the unexpertised portions, the court held that he had not established his due diligence:

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 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 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 responsibility merely because they are new.¹⁸

Several points regarding this outside director are worth noting. First, he made a general investigation of the company before joining the board. This included obtaining a Dun & Bradstreet report and making inquiries of Bar Chris's banks and of Bar Chris's principal factor. All inquiries produced satisfactory responses. He subsequently obtained a copy of Bar Chris's 1960 annual report and noted the report of the independent accountants who were also the auditors for his bank. This director, therefore, had at least a reasonable basis for relying on the company and its management. Secondly, he was present at a board meeting on May 15 when the final amendment was signed. At this time the principal officers stated that everything in the prospectus was correct. Yet, according to the court, the director did not establish his due diligence defense. Two conclusions flow from this holding. First, a general inquiry of officers of the company and the officers' representations to the effect that all information in the prospectus was correct and accurate did not in the circumstances constitute

¹⁷ *Id.* at 687.

¹⁸ *Id.* at 688.

reasonable investigation. Second, an investigation of the general affairs of the company vis-à-vis the specific matters covered in the prospectus did not constitute reasonable investigation.

It is interesting to contrast this holding with the statement of a former chairman of the SEC:

Under some circumstances [the 'prudent man' standard] would require personal knowledge of the facts assumed to be true. Delegation to others of the duty to verify the facts would under other circumstances suffice to meet the requirements. A director, for example, would have little excuse for not having personal knowledge of what his stock holdings in the issuer and its subsidiaries were, but he should obviously be entitled to rely upon his fellow directors . . . as to what their stockholdings were¹⁹

Director and Company Counsel. Company counsel who worked on the registration statement was also a director and *was sued in his capacity as a director*. He had previously drafted registration statements for a stock issue in 1959 and for certain warrants in January 1961, several months before the effective date of the debenture registration statement in question.

In considering his due diligence defenses the court stated, "the unique position which he occupied cannot be disregarded. As the director most directly concerned with writing the registration statement and assuring its accuracy, more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work."²⁰

In preparing the registration statement, counsel worked from the previous prospectuses modifying them as he considered necessary. He obtained information from management and relied upon his client's statements. The court commented as follows:

It is claimed that a lawyer is entitled to rely on the statements of his client and that to require him to verify their accuracy would set an unreasonably high standard. This is too broad a generalization. It is all a matter of degree. To require an audit would obviously be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable. Even honest clients can make mistakes. The statute imposes liability for untrue statements, regardless of whether they are intentionally untrue. The way to prevent mistakes is to test oral information by examining the original written record.²¹

The court found that counsel did not check matters which could readily have been checked. For example, he did not read the agreements with the factor; he did not review the contracts for orders comprising the backlog; he did not read the minutes of the subsidiaries which would have revealed that Bar Chris was in fact about to operate certain alleys; he did not insist that certain executive committee minutes be typed for his re-

¹⁹ Landis, *Federal Securities Act and Regulations Relating to The Work and Responsibility of the CPA*, in ADDRESS AND DISCUSSION RELATING TO THE FEDERAL SECURITIES ACT AND ACCOUNTING REQUIREMENTS UNDER THE NATIONAL INDUSTRIAL RECOVERY ACT 5-18, discussion, 19-33, questions and answers, 33-50 (presented before the 11th Annual Fall Conference of the New York State Society of Certified Public Accountants, Oct. 30, 1933).

²⁰ 283 F. Supp. at 690.

²¹ *Id.*

view; he did not appreciate the company's tight cash position; he did not review customer delinquency records or make inquiries of the factoring company. According to the court, the preponderance of evidence indicated that company counsel-director did not make a reasonable investigation and, accordingly, did not have a due diligence defense as to the unexpertised portion of the prospectus.

It is important to reiterate that *the company counsel was sued in his capacity as a director and signer of the registration statement*. Presumably there would have been no basis of suit if company counsel had not been a director. In his capacity as company counsel and preparer of the registration statement, counsel followed what might be described as conventional, accepted procedures. He reviewed previous registration statements (one of which had been filed only several months prior and thus in normal circumstances could be considered as reasonably current with respect to many matters). He made inquiries of his client and requested and obtained the information for the registration statement. The fact that he did not require executive committee minutes to be written up (after inquiring orally as to what transpired), that he did not make inquiries of the factor, or that he did not review accounting records and thus failed to appreciate the seriousness of the delinquency situation and the tight cash position cannot be regarded as unusual for a company counsel.²³ Traditionally, the principal task of company counsel has been to assist the management of the issuer in gathering the requisite information and drafting the registration statement in acceptable format.

However, as this case indicates, company counsel who also serves as a director assumes far greater risks and responsibilities. Like any other signer, he must make a reasonable investigation and have reasonable grounds to believe that the unexpertised portions are true and do not omit any material facts. Furthermore, because of his unique position as preparer of the registration statement, he must perform an investigation more thorough than that expected of directors who have no connection with writing the registration statement and assuring its accuracy. In this regard, Judge McLean established, at least in part, standards for reasonable investigation and grounds for belief. The standards are: (1) oral information must be tested by examining the original written record; and (2) matters readily verifiable should be checked.

The Defendants—Underwriters and Experts

The Underwriters. The court held that the underwriters, including a partner of the managing underwriter who was a director of Bar Chris, were entitled to rely on the 1960 audited figures. However, their investigation into the other portions of the prospectus was not adequate ("reasonable") under the circumstances and, accordingly, they did not establish their due diligence defenses.

The underwriters other than the "lead" underwriter made no investiga-

²³ Such procedures as requiring executive committee minutes to be written up undoubtedly vary depending upon counsel and the circumstances.

tion of the accuracy of the prospectus, relying instead upon the "lead" underwriter. The underwriting syndicate was held bound by the "lead" underwriter's failure. Thus, the court deemed it "unnecessary to decide" whether, if the managing underwriter had made a reasonable investigation, the other underwriters would have been protected.

The lead underwriter did make an investigation. Its partner handling the work (a) familiarized himself with general conditions in the industry, primarily by reading reports and prospectuses of the two leading bowling alley builders, AMF and Brunswick, (b) read the 1959 Bar Chris prospectus, annual reports and unaudited financial statements, (c) inquired of several banks and of Bar Chris's factor and received favorable replies, (d) obtained a Dun & Bradstreet report, (e) interviewed the principal officers, and (f) attended three meetings to discuss the prospectus with Bar Chris's representatives and company and underwriters' counsel. At one meeting a representative of the independent accountants was present. At these meetings, the information in the prospectus was discussed extensively and the chief financial officer of Bar Chris was specifically interrogated regarding the accuracy of information in the prospectus relating to officer loans, reserve for bad debts, backlog, delinquency experience, application of proceeds, contingent liabilities, operation of alleys, etc. The underwriters' representative and underwriters' counsel received what they considered to be satisfactory answers to their inquiries.

The court held that much of the investigation for the underwriters had been made by their counsel, that counsel did not sufficiently verify management's statements and representations, and that the underwriters were bound by the insufficiency of counsel's investigation. In denying due diligence defense as to the unexpertised portions, the court stated:

It is clear that no effectual attempt at verification was made. The question is whether due diligence required that it be made. Stated another way, is it sufficient to ask questions, to obtain answers which, if true, would be thought satisfactory, and to let it go at that, without seeking to ascertain from the records whether the answers are in fact true and complete.

. . . .
The underwriters say that the prospectus is the company's prospectus, not theirs. Doubtless this is 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. And prospective investors rely upon the reputation of the underwriters in deciding whether to purchase the securities.²³

The court noted that, "[i]n a sense, the positions of the underwriters and the company's officers are adverse."²⁴ Statements by company officers to an underwriter may be self-serving, unduly enthusiastic or deliberately false. Thus, the underwriters are thrust into a position vis-à-vis the company officers not unlike the position of independent accountants. The standards for underwriters set forth by the court are rather clear: "Underwriters [under section 11] are made responsible for the truth of the pros-

²³ 283 F. Supp. at 696.

²⁴ *Id.*

pectus. . . . 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."²⁵

Procedurally speaking, the court stated that it is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case.²⁶

Independent Accountants. The independent accountants were sued as experts. They pleaded the affirmative defense provided under section 11(b)-(3)(B); namely, that at the time the registration statement became effective they had, after reasonable investigation, reasonable ground to believe and did believe that the statements made in the registration statement on their authority as experts were true and that there were no omissions of material facts.

The court previously had ruled that the only portions of the registration statement which were made on the authority of experts were the 1960 (and prior years) audited financial statements. The issue, therefore, was whether at the time the registration statement became effective the independent accountants, after reasonable investigation, had reasonable ground to believe and did believe that the 1960 figures were true and that no material fact had been omitted from the registration statement which should have been included in order to make the 1960 figures not misleading. The accountants' reasonable investigation included their 1960 audit and the subsequent period or "S-1 review" undertaken to determine if there were any developments subsequent to the effective date which would have a material bearing on the 1960 audited financial statements or which should be disclosed in order to make the statements not misleading.

The accountants also issued a so-called "comfort letter" to the underwriters. As is typical, the letter was issued solely for the information of the underwriters and thus the representations in the letter and basis thereof were not at issue except as they related to the crossclaims which the various defendants asserted against each other.

The court concluded that the 1960 audit procedures were deficient because they failed to disclose various misstatements. However, the misstatements in the 1961 unaudited figures and the developments in the period subsequent to December 31, 1960 to the effective date of the registration statement (May 1961) were much more significant in the overall picture.

Accountants have no responsibility under section 11 for such subsequent unaudited data and developments except to the extent that disclosure of such material is required in order to make the audited figures not misleading. Accordingly, the court focused its attention on the so-called "S-1 review" made by the accountants. Such a review covers events subsequent to the date of a certified balance sheet. Its purpose is to ascertain whether any material change has occurred in the company's financial position which should be disclosed in order to prevent the most recent audited

²⁵ *Id.* at 697.

²⁶ *Id.*

balance sheet (and related statements) from being misleading. The scope of such a review, under generally accepted auditing standards, is limited. It does not amount to a complete audit.²⁷

The independent accountants prepared a program for their S-1 review which the court held conformed to generally accepted auditing standards. Unfortunately, the program was not reproduced in its entirety in the opinion. However, certain key steps contained in the program were set forth. Generally these steps contemplated review of minutes and interim financial statements and inquiries regarding various matters. Certain steps, such as one requiring a "review" of the "more important financial records," clearly went beyond what most accountants would consider generally accepted procedures for a subsequent events review.

The court noted that, while the written program for the review of subsequent events was adequate, the independent accountants had not adequately carried out the program steps:

He [the representative of the independent accountants] did not examine any 'important financial records' other than the trial balance. As to minutes, he read only what minutes [the secretary] gave him, which consisted only of the board of directors' minutes of Bar Chris. He did not read such minutes as there were of the executive committee.

In substance, what [the accountant] did is similar to what [the lawyers] did. He asked questions, he got answers which he considered satisfactory, and he did nothing to verify them.

There had been a material change for the worse in Bar Chris's financial position. That change was sufficiently serious so that the failure to disclose it made the 1960 figures misleading. [The accountant] did not discover it. *As far as results were concerned, his S-1 review was useless.*

Accountants should not be held to a standard higher than that recognized in their profession. I do not do so here. [The accountant's] review did not come up to that standard. He did not take some of the steps which [the firm's] written program prescribed. He did not spend an adequate amount of time on a task of this magnitude. [He spent twenty and one-half hours.]

²⁷ Under generally accepted auditing standards independent accountants would ordinarily undertake the following procedures in such a review: (1) Read the entire prospectus and review other pertinent portions of the registration statement. (2) Read the latest available interim financial statements and compare with the corresponding statements of the preceding year. Obtain explanations for significant fluctuations (usually limited to inquiry of company officers). (3) Read the minutes of meetings of stockholders, directors and committees of officers or directors and inquire as to matters dealt with in meetings as to which minutes are not available. (4) Obtain a representation letter from management as to whether there have occurred any events in the subsequent period which would have a material effect on the financial statements or require disclosure in the notes thereto. (5) Inquire of officers and other executives having accounting or financial responsibilities as to: (a) Consistency of application of accounting principles in the interim statements read in step (2). (b) Whether all adjustments necessary for a fair presentation have been made in such statements. (c) Any adjustments other than for normal recurring items during the subsequent period. (d) Any substantial contingent liabilities or commitments existing at the interim date. (e) Any adverse change in financial position or results of operations or changes in capitalization subsequent to the date of the certified financial statements. (f) The current status of items accounted for on the basis of tentative, preliminary or inconclusive data.

See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENTS ON AUDITING PROCEDURE NO. 33: AUDITING STANDARDS AND PROCEDURES 78-80, (1963).

Most important of all, he was too easily satisfied with glib answers to his inquiries.

That is not to say that he should have made a complete audit. But there were enough danger signals in the materials which he did examine to require some further investigation on his part. . . . *It is not always sufficient merely to ask questions.*²⁸

III. REGISTRATION PROCEDURE IN LIGHT OF BAR CHRIS

As mentioned at the outset of this Article, procedures and techniques utilized in preparing and investigating the contents of registration statements should be re-examined in light of the *Bar Chris* decision. The following are the author's views as to some of the procedural changes which may be anticipated in the aftermath of *Bar Chris*.

Scope of Investigation. The outside directors, underwriters, and certain officers failed to establish their due diligence defenses in *Bar Chris* because they failed to make investigations of sufficient scope to provide "reasonable ground for belief." While many questions remain unanswered, it seems clear that these parties must undertake an investigation of the matters covered in the registration statement. The degree of investigation will undoubtedly continue to vary depending on the position and role of the person involved and the circumstances. What hurt the defendants so seriously in *Bar Chris* was their failure to make a real investigation of the contents of the registration statement, particularly those portions outside their immediate areas of responsibility. Several defendants failed to read the prospectus at all.

In the case of outside directors and certain officers whose responsibilities limit their knowledge principally to a particular functional area (such as sales), it appears reasonable to the author (who is speaking as a non-lawyer) that they would want to be in the position of having (1) read the entire registration statement for items of information or facts which are inconsistent with their personal knowledge or for omissions of materially important information known to them, and (2) attended a meeting with the officers, independent accountants, and counsel for the company to discuss the contents of the registration statement and procedures employed in gathering data and to ask questions concerning recent financial data, contingencies, etc. Such a meeting would have an additional benefit for all parties involved in that any important inconsistencies in the knowledge or understanding of the parties or any matters having a bearing on the registration statement would tend to be brought to light. For such a meeting to be meaningful, the full registration statement and a brief statement as to the scope of the directors' responsibilities should be mailed or otherwise provided to the directors in advance of the meeting.

In the case of the lead underwriter (which may act through its counsel), we may infer the following procedural implications and standards of in-

²⁸ 283 F. Supp. at 702, 703 (emphasis added).

vestigation. First, the underwriters (and/or counsel in their behalf) may not rely solely on representations of and information furnished by the company's officers or on the company's counsel. Second, the underwriters should insist that corporate minutes be complete and such records should be reviewed by counsel for the underwriters. Third, all significant contracts and agreements referred to in the prospectus should be reviewed. All information and representations of management should be tested by reference to the applicable records and documents or otherwise when the representations are significant and testing is practicable. Fourth, financial data presented in the unexpertised portion of the prospectus such as sales figures, amount of contingent liabilities, officers' salaries and other remuneration, delinquency experience, research and development or training costs, etc., should be discussed with the independent auditors and, to the extent practicable, covered by a letter similar to the present "comfort" letter which usually deals with unaudited "stub" periods or adverse changes in financial position subsequent to the latest audit date and other matters.²⁹ There are also certain non-accounting data which may be expertised or on which comfort may be obtained; for example, patent status may be expertised by patent counsel, and natural gas or other mineral reserves may be expertised by a petroleum engineer.

The Underwriting Group and the Due Diligence Meeting. A so-called "due diligence" meeting is held, usually after a registration statement is filed but before it becomes effective, under the auspices of the lead underwriter for the purpose of enabling the members of the underwriting group to exercise "due diligence." At the meeting questions are addressed to representatives of management, counsel for the company, the lead underwriter and its counsel, and the independent accountants and other experts, if any, regarding any matters discussed in the registration statement or otherwise relating to the company, its business, etc.

The *Bar Chris* decision did not deal with the question of whether the underwriting group would be protected if the lead underwriter makes a reasonable investigation and the members of the group establish that they relied on the lead underwriter's investigation. However, it seems clear that underwriters are assuming such is the case in the absence of any holding to the contrary. In light of *Bar Chris*, it appears important to the author for each member of the underwriting group to observe the following procedures: (1) read the registration statement and other information available regarding the company, industry, products, etc.; (2) attend the due diligence meeting, asking questions raised from a reading of the registration statement and study of other material; and (3) obtain a copy of the "comfort letter" which should be as inclusive as practicable. This degree of investigation reflects the opinion expressed a number of years ago by the then chairman of the SEC regarding the scope of "reasonable investigation" depending upon the position of the person involved in a registration:

²⁹ The types of data on which accountants may be expected to give "comfort" or negative assurance are discussed in a later section.

The type of investigation which can reasonably be demanded of the sponsoring or principal underwriters is one thing; that which the Act requires of the small participating underwriter in order that he shall satisfy its requirements is another thing; while an even less standard of investigation would be demanded of the dealer selling on commission, who, because of his relationship to the issuer, is considered as an underwriter by the Act.³⁰

Special Representations by Accountants. The *Bar Chris* decision has already had a significant impact on the work performed by independent accountants. It is apparent that underwriters are going to request that the independent accountants perform additional work with respect to matters in the text of the registration statement which relate to the accounting records or data.

Certain underwriters, as a matter of practice, have requested that the accountants' "comfort" letter include, in addition to representations as to the financial statements, representations with respect to other matters contained in a registration statement or prospectus, such as capitalization and remuneration of officers and directors.

It is the author's opinion that accountants should be willing to extend comfort to information which is derived from the company's *accounting* records. Such items as capitalization, compensation, research expenses, certain sales analyses, delinquency experience, etc., fall into this category. Such information is contained in the accounting records and is subject to the normal controls inherent in a double entry historical accounting system. On the other hand, the accountant would not normally extend comfort to such items as backlog of business and certain types of commitments. While the auditor can review procedures surrounding the compilation of backlog, the amount of backlog is not controlled and balanced through the financial accounting records and the auditor should therefore not be expected to arrive at an opinion as to the aggregate amount.

As a result of *Bar Chris*, accountants have carefully reviewed the wording of comfort letters and two changes may be expected. First, accountants will be more precise in setting forth the specific steps performed; second, warnings as to the limitations of such special review procedures and degree of responsibility assumed will be set forth more emphatically. Recent comfort letters illustrate these points.³¹

³⁰ See J. Landis, Address before New York State Society of CPA's, October 30, 1933, *supra* note 19.

³¹ The following excerpts from a recent comfort letter illustrate the emphasis on (1) more precisely describing specific review procedures and (2) warning the reader of the limitations of special review procedures and degree of responsibility assumed by the auditor:

Our examination of the Company's financial statements as set forth in our opinion contained in the Prospectus comprised audit tests and procedures deemed necessary for the purpose of expressing an opinion on the financial statements taken as a whole. We did not perform audit tests for the purpose of expressing an opinion on individual balances or summaries of selected transactions and accordingly we express no opinion thereon. However, at your request we have performed the following additional procedures. These procedures, which were applied as appropriate in testing the items enumerated [below], consisted of:

Items
5-Capitalization

Procedures

1. Inspected underlying supporting documents for all changes in the capital structure from June 30, 1968

Coordination of Preparer, Underwriter, Underwriters' Counsel and Independent Accountants. Post-*Bar Chris* experience indicates that there will be greater emphasis on coordinating the efforts of counsel and independent accountants and a much greater flow of communication between these parties. This is a healthy development. In the past, as in the *Bar Chris* case, the preparation of a registration statement and related documents was often divided, with the drafting of the text and various agreements assigned to representatives of counsel for the company and counsel for the underwriters and the audited financial statements and earnings summary assigned to the accountants. It was not uncommon for there to be relatively little communication between these parties as they performed their respective tasks.

As discussed previously, attorneys and underwriters are requesting that accountants provide assurances regarding various textual information of an accounting nature. Accountants' views are being solicited informally to a greatly increased extent on other matters included in the registration

to the date of the capitalization table.

2. Reviewed proposed capitalization at completion of offering for consistency with disclosures made in the "Use of Proceeds" section of the Prospectus.

* * * *

9-Business

Sales and competition

(insofar as it relates to the table summarizing the Company's net sales to categories of customers)

For the Six Months Ended June 30, 1968

1. Obtained company prepared analyses of general ledger sales accounts which were grouped into those categories appearing on page 10 of the Prospectus, checked mathematical accuracy, and agreed to the general ledger account.
2. Selected for all sales categories . . . 100 sales entries supporting the analyses and inspected the underlying source documents.
3. Reviewed the selected sales entries for propriety of the assigned sales classification.

Periods Prior to January 1, 1968

[Work enumerated.]

* * * *

26-Recent sales of unregistered securities

(insofar as it relates to the date of sale and the title and amount of securities sold)

1. Agreed applicable information contained in this section to the notes to the Financial Statements set forth in the Prospectus covered by our opinion dated August 12, 1968, and determined that no pertinent information contained in the aforementioned financial statements has been omitted from this item. . . . The dates of applicable transactions which are not specifically included in the Notes to the Financial Statements, were otherwise substantiated by inspection of source documents.

* * * *

30-Treatment of proceeds of stock being registered

1. Reviewed the Company's proposed treatment for adherence to generally accepted accounting principles and consistency with previous offerings.

It should be understood that the above additional procedures would not necessarily reveal any misstatement of amounts included in the items listed above, such as could result from exclusion of transactions from those places in the Company's records where we would most logically expect to find them. Subject to this explanation and based upon (1) our examination of the Company's financial statements as set forth in our opinion dated August 12, 1968, (2) our limited review described [in another section of the letter not reproduced] and (3) the additional procedures carried out at your request, set forth above, nothing has come to our attention which in our judgment would indicate that the accounting information set forth under the items listed above would require any material adjustment necessary for a fair presentation of the information purported to be shown.

statement. This appears to be a very logical development because the accountant should be better informed regarding the affairs of the company than any other outside party. As one noted authority has observed:

In the usual case, except for the management representatives, there are few persons connected with the [registration procedure] who are as familiar with the company and its affairs as the independent public accountants. In the course of auditing the company's financial statements over the year, the accountants could not help but acquire much information about the company, its plants, its products, its manufacturing processes and problems, its labor situation, its distribution problems, capital needs, and similar matters. Since these matters run to the very heart of the prospectus, the accountant is often in a position to make important and constructive suggestions in drafting the prospectus. . . . Not only does the accountant have an extensive background in the company's affairs but, what may be equally important, he has an independent and objective point of view. The author is not referring now to the need for independence in order for the accountant to be in a position to certify for SEC purposes. He is referring rather to the essential difference in the point of view between the owners of the business or the management on the one hand and the accountant on the other hand. The owners and management are often inclined to be overly optimistic and to minimize their problems. . . . The lawyer knows that the accountant is more likely to have an objective, disinterested view of the problem³³

The informal discussion with accountants is particularly useful in obtaining the independent viewpoint of the accountant on statements or matters in the registration statement on which the accountant cannot give negative assurance because they are data of a non-accounting nature (such as the history of the business or nature of operations).

Responsibility of Auditors for Subsequent Events. *Bar Chris* raises a number of serious questions for accountants insofar as subsequent events, or so-called "S-1," reviews are concerned. The American Institute of Certified Public Accountants (AICPA) has officially set forth its view as to the appropriate procedures to be followed in performing a subsequent events review.³³ Such a review is based largely on review of the latest available interim financial statements, reading of corporate minutes, and discussions with company officials. It is interesting that the written review program employed by the auditors in *Bar Chris* went beyond the AICPA requirements; however, its execution was deficient in several respects. In any event, the court looked mainly to *results* in appraising the S-1 review. The court determined that there had been a change for the worse in the subsequent period, and the failure to disclose the change made the certified statements misleading. Therefore, insofar as results were concerned, the S-1 review actually performed was considered worthless by the court. This was the real test.

A disturbing aspect of the opinion is its implication that accountants should review the accounting data right up to the effective date. Some of the misstatements, such as the credit (*i.e.*, negative) balances in the cash

³³ L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 9.5 (2d ed. 1966).

³⁴ STATEMENTS ON AUDITING PROCEDURE No. 33, *supra* note 27, at 78-80.

account and the existence of officers' loans, apparently occurred after the date of the latest available interim financial statements but before the effective date. The discovery of such misstatements would not typically result from normal review procedure, and, indeed, review procedures would have to be extended considerably to give even reasonable assurance of discovery of such items. It seems clear that accountants will have to consider carefully their S-1 review procedures in the light of *Bar Chris*.

IV. BAR CHRIS IN PERSPECTIVE

Perhaps more than anything else, *Bar Chris* illustrates the role of judgment in the registration process. Judge McLean commented that the extent of verification is a "question of judgment" in the circumstances. After close study of the case, one can hardly avoid the impression that ordinary procedures were applied to highly unusual and complex circumstances, and such procedures simply were not adequate.

Here was a company which had experienced extremely rapid growth and had outpaced its managerial capability. It was chronically short of cash. It had an extraordinarily complex financial structure. It extended large amounts of credit to financially weak concerns. Its legal draftsmanship was "unartistic," if not downright inadequate. Its records were incomplete. It engaged in "sharp" business practices and dealt with companies which were identified in the internal records by more than one name. Its accounting practices were very complex (*i.e.*, multiple financing arrangements, use of percentage of completion method, contingent liability arrangements on notes discounted and leases).

Accountants have long followed the procedure of reviewing the system of internal control in order to determine the extent to which it can be relied upon to produce accurate financial data and the resultant extent of audit testing required in the circumstances. The adequacy of records, procedures and controls, the capabilities of personnel and the capacity of management are important factors in this evaluation. The same type of assessment must be made by attorneys and underwriters in deciding upon the extent of investigation which they consider reasonable in the circumstances.

Thus, in the final analysis, *Bar Chris* must be viewed in perspective. Circumstances required exceptionally thorough and penetrating investigatory procedures. Instead, procedures less thorough and more conventional were applied. It appears to be a serious over-reaction to apply extended investigatory procedures across the board without regard to the circumstances involved in each registration. "The assembly of data for a registration statement is an esoteric art,"³⁴ states one leading corporate lawyer. *Bar Chris*—more than anything else—demonstrates the need for careful analysis and judgment in deciding upon procedures and techniques appropriate for each set of circumstances.

³⁴ Carlos Israels, quoted in *The Wall Street Journal*, May 14, 1968, at 12, col. 3.