A TEMPERING OF JUDICIAL LEGISLATION: GLOBUS REVISITED

Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969)

Defendant Law Research Service, Inc. (LRS), made a Regulation A offering of 100,000 shares of its stock.\(^1\) Defendant Blair & Co. underwrote this issue. The offering circular prominently featured an attractive contract between LRS and the Sperry Rand Corporation. It failed, however, to state that serious disputes had arisen regarding the contract, making its future value doubtful. Alleging that the failure to disclose the doubtful value of the contract made the offering circular misleading, thirteen purchasers of the stock brought suit to recover damages. The jury found that LRS, its president, E.C. Hoppenfeld, and Blair had violated § 17(a) of the Securities Act of 1933\(^2\) and § 10(b) of the Securities Exchange Act of 1934\(^3\) because of the omission from the offering circular of information necessary to make it not misleading. It accordingly awarded compensatory damages to all

---

\(^1\) Regulation A of the 1933 Securities Act permits an issuer to make a small public offering without filing the complex registration statement and prospectus normally required by law. Nonetheless, the issuer must still submit to the SEC an offering circular containing basic information about the stock and its issuer. After review by the SEC, the offering circular is distributed to prospective purchasers of the stock. 17 C.F.R. §§ 230.251-.263 (1969).

\(^2\) 15 U.S.C. § 77q(a) (1964). § 17(a) reads:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

\(^3\) 15 U.S.C. § 78j(b) (1964). Section 10(b) reads:

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

\(\ast \ast \ast \ast \ast \ast \ast \ast \)

(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1969), is virtually identical to § 17(a), except that the statutory provision applies only to the conduct of sellers, while the rule governs the conduct of both buyers and sellers.
plaintiffs. The jury also found that Hoppenfeld and Blair actually knew of the omission; it therefore awarded punitive damages against them for the § 17(a) violation.

Blair had crossclaimed against LRS, its president, and its secretary-treasurer under an indemnity clause of the underwriting agreement. This clause provided that LRS would indemnify the underwriter for any loss arising because of the omission from the offering circular of a material fact necessary to make the statements not misleading, unless Blair was guilty of willful misfeasance, bad faith or gross negligence in the performance of its duties or reckless disregard of its obligations and duties under the agreement. The jury found Blair entitled to indemnity under this agreement.

The district court set aside the verdict on the crossclaims, but upheld the punitive and compensatory damage awards. Defendant appealed. Held: when an underwriter's misconduct in violation of the Securities Act of 1933 involves more than ordinary negligence, it will (1) not be permitted to enforce an indemnity agreement with the issuer; and (2) punitive damages cannot be recovered under § 17(a).

INDEMNITY

The court began by asserting that its holding was limited to situations in which the underwriter was guilty of more than ordinary negligence. It then noted that even at common law one could not insure himself against his own reckless or intentional conduct, and that under the terms of the indemnity agreement itself Blair could probably not recover from LRS. Nonetheless, it chose to place its holding, like that of the lower court, on the grounds of public policy. First, the court noted that § 11 made underwriters jointly liable with directors, experts and other signers of a registration statement for any misstatement. Secondly, the court pointed out that the SEC views indemnification of directors and controlling persons as against the policy of the 1933 act. Because § 11 indicates that underwriters should be treated like controlling persons, and because indemnification of controlling persons is contrary to public policy, the court reasoned that indemnification of underwriters should not be allowed. To support its syllogism, the court

pointed out that the purpose of the 1933 Act was to secure full and fair disclosure for the investor. One of the means of implementing this purpose was to impose a duty of reasonable investigation upon underwriters. To allow indemnification for more than ordinarily negligent breaches of their statutory duty would invite laxity in these investigations. This would frustrate the Act's objective of full disclosure through multiple independent investigations.7

The traditional rule for testing the validity of contracts by which a defendant attempted to limit his liability for negligence was articulated in *New York Central R.R. v. Lockwood*. In *Lockwood* the Supreme Court held that exculpation contracts are valid unless (1) the purpose of imposing liability was to assure compliance with a legal duty and allowing exculpation would frustrate that purpose, and (2) allowing exculpation would deprive an injured party of compensation.8 Though *Lockwood* involved an exculpation agreement in which one party agreed to hold the other harmless for a breach of duty toward the first,9 its rule was subsequently applied to indemnity agreements,10 in which the first party agreed to hold the other harmless for breaches of a duty toward a third.11

*New York Central R.R. v. Lockwood* was the only case the *Globus* court cited in arguing that Blair's indemnification should be held invalid because it would discourage thorough investigation by an underwriter and therefore violate public policy.12 Indemnity contracts challenged under the *Lockwood* rationale, however, normally have been upheld unless they denied the victim compensation.13

---

7. *Id.* at 1287-89.
8. 84 U.S. (17 Wall.) 357 (1873).
9. *Id.* at 381-84.
10. At common law, contracts exculpating one from the consequences of his negligence were generally valid; however, a bargain for exemption from liability for the consequences of a willful breach of duty was illegal. See *Restatement of Contracts* §§ 574-75 (1932); *Annot.*, 175 A.L.R. 8, 12-20 (1948).
14. *See Note,* 72 *Yale L.J.* 406, 409 (1962). Of course, if the validity of indemnity agreements is to be tested solely by the second *Lockwood* condition they will always be found valid because indemnification, by definition, arises only after the injured party has received compensation. Therefore, occasional cases are found in which indemnity agreements have not been enforced because they were inconsistent with the first principle in *Lockwood*. *See Otis Elevator Co. v. Maryland Cas. Co.*, 95 Colo. 99, 33 P.2d 974 (1934); Employers' Liability Assur. Corp. *v. Post & McCord, Inc.*, 286 N.Y. 254, 36 N.E.2d 135 (1941); *Page v. Turner Constr. Co.*, 262 App.
The reason behind allowing such indemnification contracts to stand has been the courts’ unwillingness to acknowledge that the *in terrorem* effect of potential liability might substantially affect the likelihood of negligent conduct.\(^\text{15}\) The *Globus* court specifically noted that it was dealing with situations in which the person seeking indemnity was more than ordinarily negligent. Indeed, the court states that it is dealing with a situation in which the jury “necessarily found . . . that Blair had actual knowledge of the material misstatements.”\(^\text{16}\) Two rationales were available to the *Globus* court to bring the invalidation rule of *Lockwood* into play. If the *Globus* holding is limited to situations of reckless or intentional conduct the deterrent value of potential liability would be obvious: the defendant would have knowledge that his actions were exposing him to potential liability. On the other hand, the *Globus* decision may mean that previous refusals to admit the deterrent effect of liability are superseded by the Congressional policy of using liability for an enforcement mechanism in dealing with the securities industry. The second of these alternatives seems more consistent with the *Globus* court’s citation of general policy.\(^\text{17}\) If this is the basis for the court’s holding, however, it seems as consistent to deny compensation for “ordinarily” negligent wrongs as those “more than ordinarily” negligent.

Compensation is provided for under the Securities Act as a means of allowing private individuals to enforce compliance with the disclosure provisions.\(^\text{18}\) It is not intended primarily as a means of compensating an injury. Courts implying liability have also admitted its utility in enforcing the Act’s provisions.\(^\text{19}\) If indemnification is permitted, even for negligent acts, the Act will be stripped of one of its deliberately built-in enforcement mechanisms. Further, by admitting to the utility of civil liability as an enforcement mechanism, the court is simply acceding to a long line of cases implying liability for Securities Act violations.

\(^\text{15}\) Div. 858, 28 N.Y.S.2d 164 (1941); St. Louis & S.W. Ry. v. Arnold, 32 Tex. Civ. App. 272, 74 S.W. 819 (1903); Johnson’s Adm’t v. Richmond & D.R.R., 86 Va. 975, 11 S.E. 829 (1890).

\(^\text{16}\) See Note, 72 YALE L.J. 406, 409 n.30 (1962).

\(^\text{17}\) *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969).

\(^\text{18}\) *Id.* at 1288, 1289.

The SEC's differentiation between underwriters and controlling persons and directors in the notes following rule 460\(^{20}\) is usually cited as an argument against the position taken by the *Globus* court,\(^{21}\) *i.e.* that the same public policy that disfavors indemnification of directors is applicable to underwriters. Making a virtue of adversity, the *Globus* court, by its reference to § 11, which treats underwriters identically with controlling persons and experts for the purpose of joint liability,\(^{22}\) utilizes the SEC's policy against indemnification of directors and controlling persons to *support* its conclusion. It ignores the SEC's rather pointed omission of underwriters from the list of persons whose indemnification will deny acceleration under rule 460.\(^{23}\)

There are, however, valid reasons for ignoring any distinctions between underwriters and directors. The basis for the SEC's policy is probably the common law rule denying enforcement of agreements to indemnify directors for negligent mismanagement.\(^{24}\) At common law, an exculpation agreement, and by extension an indemnity agreement, was unenforceable if it defeated the public policy and denied compensation to the injured party.\(^{25}\) The rule of non-indemnification of directors follows from the non-exculpation rule because indemnification of directors not only thwarts the *in terrorem* effect of a possible recovery, but denies compensation to stockholders. Stockholders would have the value of their investment decreased by indemnification payments made from the corporate treasury.

If the policy against indemnification of directors expressed in the notes following rule 460 is based on a denial of compensation to shareholders, it is of questionable validity. If a purchaser sells his stock before he recovers judgment against the directors, he cannot be denied compensation. Even if he has not sold, because of wide stock ownership, the effect of indemnification probably is insignificant compared with his recovery. Moreover, the value of an investment is determined by the market, and market value is not directly controlled

\(^{20}\) Note (a), 17 C.F.R. 230.460 (1969), indicates the SEC's view that indemnification of directors, officers and controlling persons of the issuer violates public policy. Note (b), 17 C.F.R. 230.460 (1969), indicates that indemnification of underwriters violates public policy if the underwriter is also a director, officer, or controlling person.

\(^{21}\) See Note, 72 YALE L.J. 406, 410 (1962).


\(^{23}\) 17 C.F.R. 230.460, notes (a) & (b) (1969).

\(^{24}\) Note, 72 YALE L.J. 406, 411 n. 39 (1962).

by cash in the treasury. Denial of compensation does not provide an adequate basis for distinguishing between directors and underwriters. Nor does public policy provide any basis for such a distinction. Because the effect of indemnity is to shift liability to the indemnitee for all statements made by him, the vigilance of others verifying the correctness of the statement is diminished. It should be noted also that while underwriters have an active duty to investigate, controlling persons have none. It would be incongruous to allow indemnification of an underwriter who has breached his affirmative duty while denying it to a controlling person.

Punitive Damages

In deciding whether to award punitive damages under Section 17(a), the Globus court looked to the potential role of damages in the Act's general enforcement scheme. The scheme's primary objective is the deterrence of violations, and the court recognized that the availability of punitive damages would add to the Act's in terrorem effect. The court held, however, that the Act's existing remedial weapons satisfactorily deter violations and, therefore, that punitive damages are not necessary and should not be awarded. The court buttressed this conclusion by noting that awarding punitive damages might excessively punish, and perhaps financially ruin, a violator because the courts could not effectively control his total liability in the numerous and separate suits which a single securities violation would precipitate. Also, because punitive damages are not available under the Exchange Act of 1934, the court reasoned that awarding them under the Securities Act would create an unreasonable dichotomy between protection available to buyers and to sellers of securities.


29. The court noted that there are conflicting general rules about the appropriateness of awarding punitive damages when a statute is silent as to their award. However, after briefly reviewing these rules, the court rejected them as a basis for deciding whether to allow the punitive damages award to stand. Globus v. Law Research Service, Inc., 418 F.2d 1276. 1284 (2d Cir. 1969).


31. See notes 18-22, infra, and accompanying text.
Conflict exists as to whether punitive damages should be awarded in private causes of action based on federal statutes which do not specifically provide for them.\(^{32}\) Section 17(a) does not specifically provide for actual or punitive damages,\(^{33}\) but under the rationale of *J.I. Case v. Borak*,\(^ {34}\) courts can imply such remedies if they are necessary to effect the purposes of the statute. The purpose of the Securities Act is to deter fraudulent sales of securities.\(^ {35}\) Thus, the *Globus* court was correct in considering whether punitive damages were necessary to achieve effective deterrence as the determinative question.

### A. Adequacy of Existing Sanctions

The *Globus* court adopted the position that existing sanctions available under section 17(a) pose an adequate deterrent to fraudulent conduct. As the court noted, violators are subject to criminal\(^ {36}\) and administrative\(^ {37}\) sanctions, and the consequent tarnishment of their good name. However, these sanctions are only effective if the potential violator fears discovery. Unfortunately, the Securities and Exchange Commission is overworked and lacks sufficient funds to effectively police the Act. Admittedly, private enforcement of the Act is essential to the discovery of violations.\(^ {38}\)

---

32. Some courts have held that punitive damages may be awarded only if expressly provided by Congress. See UMW v. Patton, 211 F.2d 742 (4th Cir. 1954); Burris v. International Bhd. of Teamsters, 224 F. Supp. 277 (W.D.N.C. 1963). Other courts have expressly or impliedly relied on federal common law in awarding punitive damages under a statute which does not specifically provide for them. See, e.g., Basista v. Weir, 340 F.2d 74 (3d Cir. 1965); Wills v. Trans World Airlines, 200 F. Supp. 360 (S.D. Cal. 1961). Reported cases in which punitive damages have been sought under § 17(a) have been few. Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836 (E.D. Va. 1968), denied punitive damages, holding that they would add little deterrent effect to the threat of compensatory damages and the desire to protect one's reputation. On the other hand, Nagel v. Prescott & Co., 36 F.R.D. 445 (N.D. Ohio 1964), held that a court might award punitive damages in a suit under the 1933 Act because it, unlike the 1934 Act, did not limit recovery to real damages. In Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), an action under both § 17(a) and Rule 10b-5, the court in dictum said that since § 28(a) of the Exchange Act applied only to suits expressly authorized by that act, punitive damages might be allowed under either § 17(a) or Rule 10b-5.


36. A "wilful" violator of any section of the Securities Act is subject to a $5,000 fine, or 5 years in prison, or both. Securities Act of 1933 § 24, 15 U.S.C. § 77x (1964).

37. The Securities and Exchange Commission has the power to suspend or expel violators of the securities acts or suspend trading in a specific stock. *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1285 (2d Cir. 1969).

38. Private enforcement of the Securities Act is not specifically provided, but most courts have
The *Globus* court admitted that the availability of punitive damages would provide greater incentive for private enforcement, but held them unnecessary. First, the court said that because private actions already produce large recoveries, there is sufficient incentive for private enforcement. However, the court's unsupported assertion is questionable: recoveries will be large only if the plaintiff's actual damages are large. To achieve effective private enforcement of the Act, small investors must have an incentive to sue.

Next, the court argued that the existence of class actions counteracts any reluctance of a small investor to sue. However, because class action under the new federal rule is relatively new, it is uncertain how effective it will be as an incentive to the small investor. It is clear already, though, to pursue a class action a plaintiff must successfully negotiate a procedural maze, and it is doubtful whether the return of a relatively small amount of actual damages will give the small investor sufficient incentive to attempt so perilous and potentially expensive a course. But, with the addition of punitive damages to his recovery, the small investor certainly would be more willing to attempt it.

An alternative to the class action is making the award-eroding costs of litigation and attorney's fees available to the successful plaintiff as part of his compensatory damages. Certainly, this would make it more financially feasible for the small investor to sue. However, judicial inclusion of attorney's fees and court costs is unlikely. First, courts would be loathe to include costs which have never been included in the definition of compensatory damages, and second, sections 11(e) and 12(2) of the Securities Act impliedly excluded them from compensatory damages.

It is submitted that the *Globus* court incorrectly concluded that punitive damages were unnecessary to achieve effective enforcement of the Securities Act. If the small investor is to have sufficient incentive to police the Act and, consequently, if sellers are to be effectively deterred from acting fraudulently, punitive damages are essential.

---

B. Potentially Awesome Injuries

Against what it considered a marginal deterrent effect, the Globus court weighed the potentially awesome injuries which might result if punitive damages were allowed in a private cause of action under section 17(a). The court argued that making punitive damages available to every purchaser (each a possible plaintiff), could financially ruin the defendant, punishing him beyond his fault.42

Punitive damages are awarded according to the heinousness of a defendant’s conduct. The greater the number of people whom the defendant knows he will injure by his conduct, the more heinous is that conduct. Thus, a defendant should be assessed large punitive damages if he knowingly acts in a manner which will harm many people; he is not being punished beyond his fault. If a court feels large punitive damages may threaten a defendant’s financial security, it could instruct the jury to award damages in relation to his financial resources, avoiding the spectre of bankruptcy.

The Globus court argued further that because the amount of possible litigation resulting from a single fraudulent act was unascertainable, a court could not practically limit the total punitive damages. This argument is premised on the assumption that the first determination of punitive damages is not binding in subsequent litigations brought by other purchasers against the same defendant. The court’s argument loses its effectiveness if the first plaintiff to sue is forced to bring a class action, since a judgment on punitive damages here will bind all possible purchasers, unless they are specifically excluded.44 If this solution is adopted, a punitive damage fund can be established, with a time limit for purchasers to submit their request for participation. Each requesting purchaser would receive a share of the fund equal to the percentage his shares bear to the total number of shares purchased. Alternatively, if the class action is not employed, each court can instruct the jury to award the plaintiffs in that action only punitive damages which bear a relation to each plaintiff’s actual damages, and not to award the total punitive damages appropriate for the defendant’s conduct. Thus, all possible plaintiffs, wherever and whenever they sue, are awarded only an aliquot portion of the total punitive damages appropriate for the defendant’s conduct, so that the defendant is not threatened with financial ruin.45

44. Fed. R. Civ. P. 23(c)(2).
45. In considering the possible overkill effect of punitive damages, the Globus court cited
C. Unreasonable Dichotomy with the 1934 Act

Finally, the *Globus* court argued that allowing punitive damages under the Securities Act (applicable to buyers only) when they are not available under the Exchange Act (applicable to sellers and buyers), would produce an undesirable dichotomy between the treatment of buyers and sellers violating the established attitude that the two Acts should be read *in pari materia*. This argument is based on section 28(a) which limits every person who maintains a suit under any provision of the Exchange Act to recovery of only his actual damages. However, section 28(a) has been held to apply only to suits expressly authorized by the Exchange Act. Because the private enforcement of Rule 10b-5 of the Exchange Act is an implied cause of action, not expressly authorized, section 28(a) does not necessarily prohibit an award of punitive damages to an aggrieved seller. This argument is quite realistic in light of the judiciary's proven desire to protect the investor by any means necessary, whether specifically authorized by statute or not. If the courts recognize the necessity of punitive damages in the enforcement scheme of both the Securities and the Exchange Acts, they would have little difficulty achieving equal treatment of buyers and sellers.

Roginsky v. Richardson-Merrell, 378 F.2d 832 (2d Cir. 1967) as a case in which punitive damages were denied for conduct which injured many people. That case, however, did not hold, contrary to the implication in *Globus*, that the possibility of overkill was reason enough to deny punitive damages. It merely held that, if the number of potential plaintiffs and total damages are very great, a court, in determining the sufficiency of evidence to support a verdict upon which punitive damages could be predicated, should subject the proof to careful scrutiny.

48. See note 3, supra.
49. See note 19, supra.