WACHTELL, LIPTON, ROSEN & KATZ

December 9, 1975

To Our Clients:

Recent Developments

(1) Underwriters; Due Diligence; Commercial Paper and other Non-Registered Offerings. In a decision of major importance to investment bankers and dealers the Seventh Circuit in Sanders v. John Nuveen & Co. Inc., CCH ¶ 95,347 (7th Cir. 1975) has equated the duty of an "underwriter" of commercial paper with that of an "underwriter" of a 1933 Act offering. The court held that an underwriter has a duty to investigate for fraud even in the case of an old established issuer with a fine reputation. "The underwriter is under a duty to make at least some investigation directed at the question whether the ever present possibility of fraud is in fact a reality." The court specifically noted as evidence of failure of a reasonable investigation that the underwriter did not examine the issuer's tax returns, did not meet with the accountants for the issuer and did not review the accountant's work papers. The Court rejected the argument that review of audited financial statements and checking with the issuer's commercial bank lenders was sufficient due diligence.

The court indicated that an underwriter's due diligence investigation should vary in accordance with the nature of the security and the issuer:

> "In reaching this conclusion we have taken into consideration the fact that the security was short term commercial paper rather than stock or long term indebtedness. The nature of this security minimized the investor's interest in the long range prospects of the issuer and therefore would justify a lesser consideration by the underwriter of such matters as growth prospects and dividend policies. On the other hand, the fact that the investors concern was limited to the issuer's ability to pay its bills in the immediate future enhanced the importance in determining the basic integrity of the issuer's financial statements. Although the underwriter cannot be a guarantor of the soundness of any issue, he may not give it his implied stamp of approval without having a reasonable basis for concluding that the issue is sound."

(2) Rule 10b-5, Aiding and Abetting. The continuing efforts of the courts to formulate rules in this area appears to be moving toward a requirement of active participation. The Fifth Circuit has now joined the Sixth (Coffey) and Third (Landy) in Woodward v. Metro Bank of Dallas, CCH ¶ 95,351 (5th Cir. 1975). The court said:

> "We think that the best solution is a blend of the Coffey test and the Strong test. When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high "conscious intent" variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter. . . . In a case combining silence/inaction with affirmative assistance, the degree of knowledge required should depend on how ordinary the assisting activity is in the business involved. If the evidence shows no more than transactions constituting the daily grist of the mill, we would be loathe to find 10b-5 liability without clear proof of intent to violate the securities laws. Conversely, if the method or transaction is atypical or lacks business justification, it may be possible to infer the knowledge necessary for aiding and abetting liability. In any case, the assistance must be substantial before liability can be imposed under 10b-5. . . . Substantiality is a function of all the circumstances.
>
> "Thus, before someone can be caught within the net of aiding and abetting liability under Rule 10b-5, another party must have violated the securities laws, the alleged aider-abettor must be generally aware of his role in improper activity, and he must knowingly render substantial assistance. Without these limitations, the securities laws would become an amorphous snare for guilty and innocent alike."

(3) Mutual Funds; Separate counsel for Fund and Adviser. In Zedwaski v. Johnson, Lemon & Co., CCH ¶ 95,353 (D. D.C. 1975) the court disqualified counsel for the fund from acting as counsel for the adviser in a suit attaching the advisory fees paid by the fund to the adviser. This is another example of the desirability of separate counsel for fund and adviser.

M. Lipton