SPRING 2015

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Printed in the United States of America

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"Corporate Scienter" and Due Diligence: A Suggested Approach to Standardizing the Current Split among the Circuit Courts

Uanna M. F. Alves[1]

The Greek philosopher Aristotle defined friendship as a single soul dwelling in two bodies.[2] He seems to have believed that, at least in the case of the fondness of one person for another, a unitary whole arose when, under the right circumstances, two beings were linked. One might imagine two puzzle pieces that were not the same but that fit together perfectly to make a single aggregate piece. One might reasonably ask what Aristotle and his insight into the nature of human relationships might have to do with "corporate scienter," the central theme of this work. In the course of this article, I will endeavor to explain.

I. INTRODUCTION

Corporations increasingly are named as defendants in litigation involving allegations of: (i) material misstatements and omissions in public offering documents under Sections 11 and 12(a)(2) of the Securities Act of 1933 (the "Securities Act") and (ii) fraud under the Securities Exchange Act of 1934 (the "Exchange Act"). In those based on the Securities Act, defendants commonly assert the due diligence defenses of a "reasonable investigation" and "reasonable care."[3] Unlike Sections 11 and 12(a)(2) of the Securities Act, neither Section 10(b) nor Rule 10b-5 of the Exchange Act contains a specific reference to a due diligence defense. However, despite a dearth of scholarly material on the topic, a number of courts and scholars have observed that due diligence is also a relevant concept for fraud claims under the Exchange Act in that the conduct of reasonable due diligence by a defendant may assist it in defeating allegations that it had scienter, which is a requisite element of fraud claims under the Exchange Act and Rule 10b-5.[4] This article addresses scienter and its role in due diligence as relates to "corporate scienter," a concept explained more fully below.

Scienter is a requisite element in the proof of such a violation, therefore these cases often involve allegations of what was or should have been learned in the course of conducting due diligence into the various elements of the underlying transaction.[5] In the case of corporate actors (such as an issuer of securities), these cases turn, at least in part, on a finding of "corporate scienter" via the actions of directors, officers, employees, or other agents.

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[2] *Aristotle Quotes*, BRAINYQUOTE, http://www.brainyquote.com/quotes/quotes/a/aristotle 105270.html (last visited Apr. 25, 2015).

[3] *See* 15 U. S. C. §§ 77k(a), 77l(a)(2).

[4] *See, e.g.*, GARY M. LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, ch. 4 (CADDS Scholars Press, 2nd ed. 2013); *In re: Software Toolworks Inc. Securities Litig.*, 38 F.3rd 1078, 1088 (9th Cir. 1994).

[5] 15 U.S.C.A. § 78j.

Despite the relevance, indeed centrality, of "corporate scienter" in these cases, the federal securities laws are largely silent on how one might ascertain the intent of a business entity. And, both district and appellate courts, until relatively recently, have been hesitant to offer explicit rationales for their own conclusions regarding what is required to establish corporate scienter. As a result, the question of what specific elements are prerequisites of a finding of corporate scienter remains open, with different courts adopting differing approaches.

Part I of this paper reviews the history and development of section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 (the "Rule") promulgated thereunder by the Securities Exchange Commission. Part II examines the Rule's current status and elements, explaining what each one represents and how courts have generally interpreted them. Part III analyzes the concept of scienter, adopting the common legal definition as attributed to both individuals and corporate entities, and as expressed by the courts. Part IV offers a more in depth examination of the various judicial approaches to the issue. Finally, Part V suggests a "middle ground" solution for resolving conflicting views regarding corporate scienter based on an incorporation of Aristotle's philosophy (as expressed in the opening quotation) applied to the legal proposition that courts should require that the complaint identify one or more relevant corporate agents and connect the allegations of knowledge to them, but only where the agents are inside directors, corporate officers, or other key members of management and/or individuals who play a meaningful role in the day-to-day operations of the entity or the implementation of its corporate strategy.

Because the securities laws traditionally treat those in positions of power with access to relevant information (insiders) as being held to high standards of conduct in various contexts,[6] this article argues that a proposed middle ground to a finding of corporate scienter would be consistent with this same line of reasoning, and would further the original congressional and regulatory purpose by finding corporate scienter only when relevant actors are at fault.

II. PART I – HISTORICAL BACKGROUND: "RELIEF, RECOVERY, AND REFORM"

A. The Securities Act of 1933 and The Securities Exchange Act of 1934

Before the Wall Street crash of 1929, there was essentially no regulation of securities at the federal level. In an effort to avoid a second crash, Congress enacted the Securities Act, which reflected the findings of a Senate Committee charged with investigating stock market practices conducted between 1932 and 1934. The Committee's report identified various abuses in the securities markets to which it attributed a large share of the responsibility for the crash of 1929 and the subsequent depression.[7]

Much can be said about the period that followed the crash and the disclosure philosophy that came with it. For example, President Franklin D. stated in a message to Congress: "This

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[6] An example of this may be found in the application of the due diligence defense under Sections 11 and 12(a)(2) of the Securities Act. In that context, courts have consistently held that officers and inside directors, for example, who are closer to the information than outside directors, must meet a more stringent standard in order to assert the affirmative due diligence defense. *See, e.g.*, *Feit v Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 577 (E.D.N.Y. 1971); *Escott v. BarChris*, 283 F. Supp. 643 (S.D.N.Y. 1968).

[7] *Id.*

proposal adds to the ancient rule of *caveat emptor* the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence."[8] The action required a "full and fair disclosure" in the securities market, and "persons who sponsor the investment of other people's money should be held up to high standards of trusteeship."[9] Clearly, the imposition of such standards implied an intended a high standard for those dealing with the investing public in the relevant capacities. Relying on this philosophy of disclosure and honesty, the Securities Act and the Exchange Act (collectively, the "Acts") were adopted by Congress.[10]

The substance of the Securities Act focuses on the initial distribution of securities. In general, it requires full and fair disclosure of the character of securities sold in interstate commerce and through the mails.[11] The Act seeks to accomplish this by requiring the filing of a "registration statement" containing material information about the issuer and the securities, and the use of a prospectus when attempting to sell securities.[12] The Exchange Act, on the other hand, regulates post-distribution trading, that is, trading of securities after their initial issuance.

There is no doubt that the New Deal legislators wished to minimize the risks of fraud in the original issuance (Securities Act) and subsequent trading (Exchange Act) of securities.[13] When speaking in favor of adoption of the Securities Act, for example, Duncan U. Fletcher, United States Senator from Florida, offered a cogent summary of the Act and its purposes:

> The purpose of the bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation. That is the general purpose of the bill. The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investors; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by questionable securities offered to the public through crooked promotion.[14]

The Bill's sponsors perceived there to be an increasing emergency in the securities markets and agitated strongly for adoption of the Act in order to address that emergency and to promote the dissemination of better and more reliable information with respect to newly-issued securities. While proponents acknowledged the ancient doctrine of *caveat emptor* ("let the seller

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[8] Charles S. Telly, *Proxies and the Modern Corporation: Scienter under Sections 14a and 10b of the Securities Exchange Act*, 19 TULSA L. J. 491 (1983).

[9] Craig L. Griffin, *Corporate Scienter Under the Securities Exchange Act of 1934*, 1989 BYU L. REV. 1227, 1238 (1989).

[10] *See* Telly, *supra* note 9, at 533.

[11] *Id.* at 533-34.

[12] *Id.*

[13] *Id.* at 545.

[14] *Id.* (citing 77 Cong. Rec. 2982 (1933)).

also beware"), they felt strongly that the doctrine had to be balanced with an assurance of honest dealing in order to restore public confidence in the securities markets.[15] Thus both the Bill's proponents and The Committee on Interstate and Foreign Commerce (which was the primary legislative body charged with investigating the matter) concluded that Congress must take steps to ensure (1) full and fair disclosure, (2) high standards of trusteeship, and (3) honesty, care, and competence. These three points emphasized the immediate necessity in formulating laws to protect the *general public*.[16]

The Exchange Act and its anti-fraud provisions (Section 10(b) and subsequently promulgated Rule 10b-5)[17] were aimed at abuses in the sale of new issues or distributions of securities that already were outstanding.[18] While many versions and variations of Section 10(b) were created and replaced, the final version that was enacted into law now 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 […] (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 in investors."

Subsequent to the enactment of Section 10(b), the SEC used its rule-making power to adopt Rule 10b-5, which filled a regulatory void that failed to preclude fraudulent purchases of securities.

> 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 (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit 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 (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[19]

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[15] *Id.* at 546 (citing H.R. REP. No. 85, 73d Cong., 1st Sess. 1-2 (1933)).

[16] *Id.* at 547.

[17] 15 U.S.C.A. § 78j (West 2010); 17 C.F.R. § 240.10b-5 (2015).

[18] Telly*, supra* note 9*,* at 548 (citing H.R. REP. No. 85, 73d Cong., 1st Sess, 1-5 (1933)).

[19] 17 C.F.R. § 240.10b-5 (1983).

Even though Section 10(b) and Rule 10b-5 did not specifically give any private right of action to any person who had been injured by a violation of these rules, the Supreme Court first expressly recognized one in *Blue Chip Stamps v. Manor Drug Stores*.[20] Because Rule 10b-5 was intended to be a general, expansive, and broad rule, and because it forms the basis for the different tests used by courts to find corporate scienter, I have dedicated a separate section for a brief analysis of the rule's elements and respective meanings.

B. A Brief Historical Analysis of Rule 10b-5

The SEC's first case discussing the Rule 10b-5 was *Ward La France Truck Corp.*,[21] in which the Commission concluded that "that the purchase of the securities under the circumstances set forth [t]herein unaccompanied by appropriate disclosure of material facts constituted a violation [of the rule]."[22] While non-disclosure amounted to liability, the elements of intent and scienter were never discussed. Following this ruling, the Second Circuit decided that proof of fraud was a requirement in suits under Section 10(b) and Rule 10b-5;[23] the Fifth Circuit, in a footnote, cited an article imposing standards of disclosure higher than those of the common law and concluded that the intent of Rule 10b-5 was to cover fraud in a broad sense.[24] The Ninth Circuit agreed with the position that proof of scienter was not a necessary element, and that Section 10(b) and Rule 10b-5 were to be interpreted broadly.[25] Shortly after *Ellis,* the Ninth Circuit decided *Royal Air Properties, Inc. v. Smith*.[26] In that case, the court stated that "In an action brought under Section 10(b), common law fraud need not be alleged or ultimately proved.[27] Further, the court allowed for a negligence standard by saying that all that is necessary is "[p]roof of a material misstatement or an omission of a material fact in connection with the purchase or sale of a security to make out a prima facie case."[28]

In settling the circuit's split on the question of intent, one of the first most significant cases decided by the Supreme Court on the requirement of fraud and scienter was *SEC v. Capital Gains Research Bureau Inc.*,[29] (with the Court's opinion written by Justice Goldberg). The case involved the issuer of "whether Congress had intended fraud and deceit to be interpreted in their narrow and technical sense or in a broad remedial construction, which would include

[20] *Blue Chip Stamps v. ManorDrug Stores*, 21 U.S. 723, 730 (1975).

[21] *In the Matter of the Purchase & Ret. of Ward La France Truck Corp. Class A & Class B Stocks*, 13 S.E.C. 373 (May 20, 1943).

[22] *Id.*

[23] *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

[24] *Kopald-Quinn & Co. v. United States*, 101 F.2d 628 (5th Cir. 1939).

[25] *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

[26] *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962).

[27] *Id.* at 213.

[28] *Id.*

[29] *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 186 (1963).

nondisclosure of material facts."[30] Even though the case dealt with the Investment Advisers Act, the Court began with the premise that all federal securities legislation (including the Exchange Act) had a fundamental purpose: "to substitute the philosophy of full disclosure for the philosophy of *caveat emptor* and thus, 'to achieve a high standard of business ethics in the securities industry.'"[31]

Reasoning that fraud included "all acts, omissions and concealments which involve[d] a breach of equitable duty, trust, or confidence, justly reposed, and were injurious to another, or by which an undue and unconscientious advantage [was] taken of another," the Court concluded that "failure to disclose material facts must be deemed fraud or deceit within its intended meaning, for, as experience of the 1920's and 1930's reveal[ed], the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive[d]." Requiring a showing of intent would thus "effectively nullify the purposes of the statute" when there is a fiduciary relation with the other.[32]

Following this line of thinking, the Ninth Circuit decided *White v. Abrams*. In *White*, the district court had instructed the jury to find for a violation of 10b-5 even if "the defendant did not know the falsity of the misrepresentation he made to the plaintiff."[33] The Ninth Circuit reversed the district court's decision for the plaintiff, both stressing that Rule 10b-5 could not impose an absolute standard of liability, as the foundation of security law was that the *caveat emptor* doctrine required the defendant to have at least some sort of knowledge, and rejecting the idea that scienter was a necessary element of a 10b-5 suit.[34]

Finally, in *Ernst and Ernst v. Hochfelder*, the Supreme Court ruled that an allegation of negligent conduct alone was insufficient to prove a violation of the Exchange Act.[35] The Court had to decide "whether a private cause of action for damages [would] lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter'-intent to deceive, manipulate, or defraud."[36] In *Ernst*, private investors in a brokerage firm brought suit against an accounting firm after the principal investor left a suicidal note revealing that the brokerage firm was a scam.[37] Following that event, the investors brought suit for damages against the brokerage firm's accounting firm.[38] The investors, rather than alleging that the accounting firm had had an intent to defraud the investors, alleged only that the accounting firm had been negligent in its accounting and that the negligence constituted a violation of Section 10(b) and Rule 10b-5.[39]

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[30] *See* Telly, *supra* note 9, at 561.

[31] *Id.* (citing *Capital Gains Research Bureau Inc.*, 375 U.S. at 186).

[32] *Id.* at 562-53.

[33] *White v. Abrams*, 495 F.2d 724, 728 (9th Cir. 1974).

[34] *Id.* at 732.

[35] *Id.* at 201.

[36] *See Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1104 (7th Cir. 1974), *rev'd sub nom. Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

[37] *See Hochfelder*, 503 F.2d at 1103.

[38] *Ernst*, 425 U.S., at 185.

[39] *Id.*

The Supreme Court ruled that an allegation of negligent conduct alone was insufficient to prove a violation of the Securities Exchange Act.[40] According to the Court, the language in the act as well as the Act's legislative history reflected a congressional intent to require plaintiffs to prove scienter on the part of the defendant in order to establish a claim under the act. The Court reasoned that "the use of the words 'manipulative,' 'device,' and 'contrivance' in section 10(b) clearly show[ed] that it was intended to proscribe a type of conduct quite different from negligence, […] and connote[d] intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[41] Less than four years later, in *Aaron v. SEC*, the Supreme Court chose to resolve the issue left open in *Ernst*, holding that the SEC must also establish scienter to obtain injunctive relief under 10(b) and 10b-5.[42]

III. PART II – CURRENT STATUS OF RULE 10b-5

Courts have interpreted Section 10(b) and Rule 10b-5 of the Exchange Act to contain the following elements:[43] (a) a misrepresentation or an omission of a material fact; (b) scienter; (c) a connection between the misrepresentation or omission and the purchase or sale of a security; (d) reliance upon the misrepresentation or omission; (d) economic loss; and (e) loss causation.[44] The Supreme Court has observed that Rules 10b-5(a) and 10b-5(c) serve to accomplish § 10(b)'s prohibition on the use of "'any manipulative or deceptive device or contrivance"' in connection with the trading (purchase or sale) of a security.[45] However, unlike the extensive precedent of cases attached to 10b-5(b) concerning misstatements and omissions, there seems to be very little case law explaining more specifically what types of claims are actionable under the rule.[46] Because the second element ("scienter"), as applied to corporations, is the core subject of this article, it will have its own separate section and analysis.

A. "A Misrepresentation or Omission"

In *SEC v. Texas Gulf Sulphur Co.,* the Second Circuit defined a misrepresentation or omission as an act that conveys a false impression of the facts or is misleading.[47] The court explained that this determination requires inquiry "into the meaning of the statement to the

[40] *Id.* at 201.

[41] *Id.* at 197-98.

[42] *Aaron v. Sec. & Exch. Comm'n*, 446 U.S. 680, 701 (1980).

[43] 15 U.S.C. § 78j (2006 & Supp. V 2011); 17 C.F.R. § 240.10b-5 (2015).

[44] *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 157 (2008); *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341–342 (2005).

[45] Ronald J. Colombo, *Cooperation with Securities Fraud,* 61 ALA. L. REV. 61, 70 (2009); *Chiarella v. United States*, 445 U.S. 222, 225 & n.5 (1980) (quoting 15 U.S.C. § 78j (2008)).

[46] *Id.* (citing *Benzon v. Morgan Stanley Distribs*., 420 F.3d 598, 611 (6th Cir. 2005)).

[47] Rebecca Gross, Lauren Britsch, Kirk Goza, Jaclyn Epstein, *Securities Fraud*, 49 AM. CRIM. L. REV. 1213, 1217 (2012) (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (en banc)).

reasonable investor and its relationship to the truth.[48] Accordingly, the court held that the rule was violated whenever assertions were made in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media, if such assertions were "false or misleading or [were] so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes."[49] However, generally, any means of publicized deception can generate liability.[50]

B. "Of A Material Fact"

Rule 10b–5 makes omissions and misstatements actionable only if they are "material."[51] In *TSC Industries, Inc. v. Northway, Inc.,* for example, the Supreme Court explained that a fact is

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[48] *Id.*

[49] *Texas Gulf Sulphur Co.*, 401 F.2d at 861.

[50] *See, e.g., SEC v. Pirate Investor LLC*, 580 F.3d 233, 251 (4th Cir. 2009) (upholding civil liability under Rule 10b-5 for misleading information contained in a stock tip e-mail); *In re Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153, 156-57 (2d Cir. 1998) (holding that a company may be liable for false advertisements in technical journal); *SEC v. Eurobond Exch. Ltd.*, 13 F.3d 1334, 1341 (9th Cir. 1994) (upholding conviction of a defendant who tried to sell non-existent foreign bonds and failed to disclose his previous conviction and fugitive status); *United States v. Gibbons*, 968 F.2d 639, 641-42 (8th Cir. 1992) (holding impersonation of a broker and false statements sufficient evidence for conviction). *But see Oran v. Stafford*, 226 F.3d 275, 283-84 (3d Cir. 2000) (holding defendant not liable for omission of drug research results). The SEC also vigorously prosecutes for misrepresentations or omissions in securities filings under Rule 10b-5. *See, e.g., SEC v. Fehn*, 97 F.3d 1276, 1280 (9th Cir. 1996) (finding violation of securities laws where company and attorney failed to correctly describe promoter's role and to disclose contingent liability stemming from earlier securities law violations in SEC disclosure documents). However, misrepresentations or omissions in security filings required by the 1934 Act may be separately actionable. *See* 15 U.S.C. § 78ff(a) (2006) (imposing liability for misrepresentations or omissions in "any application, report, or document required to be filed under this chapter"); *McConville v. SEC*, 465 F.3d 780, 787-88 (7th Cir. 2006) (upholding finding that former CFO violated Rule 10b-5 and a mandatory security filing provision of the 1934 Act where former CFO caused corporation to make material misstatements in SEC filings even though CFO did not sign the filings); *Ponce v. SEC*, 345 F.3d 722, 729-38 (9th Cir. 2003) (upholding finding that accountant violated Rule 10b-5 and a mandatory security filing provision of the 1934 Act by preparing and certifying financial statements filed with SEC that contained data he knew or should have known were false).

[51] 17 C.F.R. § 240.10b-5 (2011) (prohibiting any person from making false statements or omissions of a material fact in connection with the purchase or sale of securities); *see Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988) ("It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant."); *Stratte-McClure v. Morgan Stanley*, No. 13-0627-CV, 2015 WL 136312, at *6 (2d Cir. Jan. 12, 2015); *see also Finnerty v. Stiefel Labs., Inc.*, 756 F.3d 1310 (11th Cir. 2014) (explaining that for an omission to be material under § 10(b), there must be a substantial likelihood that the disclosure of the omitted fact would have been

material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote," and that determining materiality "require[d] delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of these inferences to him."[52] In other words, a misstated or omitted fact is material if substantial likelihood exists that a reasonable investor would have viewed the disclosure of the omitted fact as having significantly altered the "total mix" of information available.[53]

Courts generally view broad expressions of optimism by a company as evidence of immateriality.[54] Therefore, vague and optimistic statements that are so obviously unimportant are usually considered immaterial as a matter of law, while numerically particular predictions are considered an actionable claim due to their specificity and limited reach.[55] It can thus be said that

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viewed by the reasonable investor as having significantly altered the total mix of information made available).

[52] *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[53] Gross, *supra* note 48, at 1220 (citing *TSC Indus.*, 426 U.S. at 450); *see also ECA v. JP Morgan Chase Co.*, 553 F.3d 187, 204 (2d Cir. 2009) (explaining that bank's misstatement of prepaid transactions with counterparty as trades rather than loans was not a material misstatement because the transactions were not a significant portion of the bank's operations); *Hampshire Equity Partners II, LP v. Teradyne, Inc.*, 159 F. App'x 317, 318 (2d Cir. 2005) (holding that the alleged misrepresentations made by defendant were "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance" (quoting *Feinman v. Dean Witter Reynolds, Inc.*, 84 F.3d 539, 540-41 (2d Cir. 1996))); *Greenhouse v. MCG Capital Corp.*, 392 F.3d 650, 655 (4th Cir. 2004) (holding that CEO's false statements about his education background in documents filed for investors were immaterial as a matter of law); *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (holding plaintiff could not show that one-day delay in availability of funds would have been material in decision to purchase treasury-bill).

[54] <u>See Bd. of Inv. v. Authentidate Holding Corp.</u>, 369 F. App'x 260, 263 (2d Cir. 2010) (explaining that forward looking representations were immaterial because "it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language set out in the same offering"); *City of Austin Police Ret. Sys. v. Kinross Gold Corp.*, 957 F. Supp. 2d 277 (S.D.N.Y. 2013) (explaining that under the bespeaks caution doctrine, a forward-looking statement accompanied by sufficient cautionary language is not actionable under securities laws because no reasonable investor could have found the statement materially misleading); *Sitrick v. Citigroup Global Markets, Inc.*, No. CV053731AHMPJWX, 2009 WL 1298148, at *5 (C.D. Cal. Apr. 30, 2009) (holding that a financial corporation's alleged omission of a prominent risk off loss in offering documents in a collateralized bond investment were immaterial as a matter of law because a reasonable investor would not find that their exclusion altered the 'total mix' of information available. Thus, the corporation's alleged omissions did not constitute fraud).

[55] *See generally Southland Sec. Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353, 372 (5th Cir. 2004) (explaining that positive statements about company's competitive strengths, experienced management, and future prospects were immaterial and not actionable under Rule 10b–5); *In re K-tel Int'l., Inc. Sec. Litig.*, 300 F.3d 881, 897-98 (8th Cir. 2002); *Longman v. Food Lion, Inc.*, 197 F.3d 675, 683-84 (4th Cir. 1999).

the test for "materiality" in the securities fraud context is whether a reasonable man would attach importance to the fact misrepresented or omitted in determining his course of action, meaning an investment decision.[56]

C. Connection Between the Misrepresentation or Omission and the Purchase or Sale of a Security

The Supreme Court has recognized that Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.[57] Because the fundamental purpose undergirding the Securities Act and the Exchange Act was to eliminate serious abuses in a largely unregulated securities market, "in defining the scope of the market that it wished to regulate," it can be said "Congress painted it with a broad brush."[58] Congress did not, however, mean to provide a broad federal remedy for all kinds of fraud.[59] Accordingly, the task fell to the SEC and ultimately to the federal courts to decide "which of the myriad financial transactions in our society come within the coverage of these statutes."[60]

For this purpose, it is important to understand the definitions of security, purchase, and sale in order to determine whether a transaction has taken place and whether the government can proceed with a prosecution for fraud. However, because Congress' purpose in enacting the securities laws was to regulate *investments* as a whole, in whatever form they are made, and by whatever name they are called, a commitment to an examination of the economic realities of all possible transactions that may fall under the statute would require a thorough analysis not permissible on this article. Suffice it to say that this ample approach to the language of security laws has enabled the government to frame investment schemes not expressly covered by the statutes, stemming rather confusing and often conflicting interpretations by the courts.[61]

D. Reliance

Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the private cause of action for securities fraud under Section 10(b) because it ensures that, for liability to arise, the "requisite causal connection between a defendant's misrepresentation and a

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[56] *S.E.C. v. Goble,* 682 F.3d 934 (11th Cir. 2012) (citing *S.E.C. v. Merch. Capital, LLC*, 483 F.3d 747, 766 (11th Cir. 2007) (quoting *SEC v. Carriba Air*, 681 F.2d 1318, 1323 (11th Cir. 1982))).

[57] *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990).

[58] *Id.* (citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975)).

[59] *Id.* (quoting *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982)).

[60] *Id.* (quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975)).

[61] *See generally Landreth Timber Co. v. Landreth*, 471 U.S. 681, 691-92 (1985); *SEC v. Wallenbrock*, 313 F.3d 532, 540-41 (9th Cir. 2002); *SEC v. SG Ltd.*, 265 F.3d 42, 48 (1st Cir. 2001).

plaintiff's injury" exists as a predicate for liability.[62] The traditional and most direct way a plaintiff can demonstrate reliance on a Section 10(b) or Rule 10b-5 cause of action is by showing that he was aware of a company's statement and engaged in a relevant transaction, e.g., purchasing common stock, based on that specific misrepresentation.[63] In *Basic,* however, the Supreme Court recognized that requiring such direct proof of reliance "would place an unnecessarily unrealistic evidentiary burden on the Rule 10b–5 plaintiff who has traded on an impersonal market."[64]

To address these concerns, the Supreme Court adopted the "fraud on the market" theory of reliance for material public misrepresentations, which hypothesizes that misleading statements will "defraud stock purchasers even if they do not directly rely on the misstatements" because, "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business."[65] Therefore, instead of requiring each individual in class action to show direct reliance on misstatements, there will automatically be a presumption of reliance. However, that presumption may be rebutted through an attempt to demonstrate that price was not affected by the misrepresentation or that purchasers or sellers did not trade in reliance on integrity of market price.[66] Hence, the presumption is not absolute.

E. Loss Causation And Economic Loss

To prevail on the merits in a private securities fraud action, investors must demonstrate that the defendant's deceptive conduct caused their claimed economic loss.[67] Loss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock. Reliance, as an element of a § 10(b) private cause of action for securities fraud, involves whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock, while loss causation requires an investor to show that a misrepresentation that affected the integrity of the market price also caused a subsequent economic loss.[68]

For example, in *Dura Pharmaceuticals*, the Court held that the fact that a stock's "price on the date of purchase was inflated because of [a] misrepresentation" did not necessarily mean

[62] 17 C.F.R. § 240.10b-5; *see Basic*, 485 U.S. at 243 (stating that "reliance is an element of a Rule 10b-5 cause of action"); *see also Stoneridge Inv. Partners, LLC*, 552 U.S. at 159; *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2407 (2014); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 154 (1972) (requiring "causation in fact").

[63] *See Halliburton Co.*, 134 S. Ct. at 2408.

[64] *See Basic*, 485 U.S. at 245.

[65] *See id.* at 241-42; *Halliburton Co.*, 134 S. Ct. at 2408; *Amgen Inc. v. Connecticut Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1192 (2013).

[66] *See Basic*, 485 U.S. at 246-47.

[67] *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2183 (2011).

[68] *Erica P. John Fund, Inc.*, 131 S. Ct. at 2186.

that the misstatement was the cause of a later decline in value.[69] The court observed that the drop could instead have been the result of other intervening causes, such as “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events.”[70] Therefore, if one of those factors were responsible for the loss or part of it, a plaintiff would not be able to prove loss causation to that extent.[71] That would be true “even if the investor purchased the stock at a distorted price, and thereby presumptively relied on the misrepresentation reflected in that price.[72]

In some circumstances, loss causation is not required.[73] In some others, courts have explained that a way to prove loss causation was by showing that when the “relevant truth” about the fraud began to make its way into the marketplace, it caused the price of the stock to depreciate and, thereby, proximately caused the plaintiff's economic harm.[74] Whatever the case may be, in a securities fraud claim plaintiff must prove that when the relevant truth about the fraud began to leak out, it caused price of stock to depreciate, thereby proximately causing plaintiff's economic loss; thus, plaintiffs are required to allege the truth that emerged was related to or relevant to the defendants' fraud and earlier misstatements.[75]

IV. PART III: SCIENTER

A. Definition as Applied to Individuals

Before the Supreme Court decided *Ernst & Ernst v. Hochfelder*, the verbal formulations of the standard to be applied varied, and several courts of appeals held in substance that negligence alone was sufficient for civil liability under Section 10(b) and Rule 10b-5.[76] *Ernst*

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[69] *Id.* (citing *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005)).

[70] *Id.*

[71] *Id.*

[72] *Id.*

[73] *Id.* (holding that plaintiffs in a private securities fraud action need not prove loss causation in order to obtain class certification).

[74] *Pub. Employees Ret. Sys. of Mississippi v. Amedisys, Inc.*, 769 F.3d 313, 320 (5th Cir. 2014) (explaining that “loss causation in fraud-on-the-market cases can be demonstrated circumstantially by (1) identifying a “corrective disclosure,” i.e., release of information that reveals to the market the pertinent truth that was previously concealed or obscured by the company's fraud, (2) showing that the stock price dropped soon after the corrective disclosure, and (3) eliminating other possible explanations for this price drop, so that the factfinder can infer that it is more probable than not that it was the corrective disclosure, as opposed to other possible depressive factors, that caused at least a substantial amount of price drop).

[75] *Id.* at 321.

[76] *See, e. g., White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974) (“flexible duty” standard); *Myzel v. Fields*, 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (negligence sufficient); *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963) (knowledge not required). Other Courts of Appeals have held that some type of scienter i. e., intent to defraud, reckless

overruled that practice and required a plaintiff to prove scienter in order to establish intent.[77] Thus, a private cause of action for damages under Section 10(b) and Rule 10b-5 could no longer stand without an allegation of scienter. In *Ernst*, the Court explained that term "scienter" referred to a "mental state embracing intent to deceive, manipulate, or defraud."[78] The Court later made explicit that the same element of "knowing or intentional misconduct" applied in SEC enforcement actions because it was drawn from the language of the statute.[79]

Even though in that case the Supreme Court did not address whether recklessness was considered to be a form of intentional conduct for purposes of imposing liability,[80] most courts now hold that reckless conduct may also constitute scienter.[81] The definition of recklessness includes conduct that reasonable persons know is unsafe or illegal. Black's Law Dictionary, for example, defines it as being "a term that means to be careless and indifferent to the welfare of other people."[82] Thus, even if a defendant did not have actual knowledge that his behavior was criminal, *scienter* may be implied by his reckless actions.

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disregard for the truth, or knowing use of some practice to defraud was necessary in such an action. *See, e. g., Clegg v. Conk*, 507 F.2d 1351, 1361-1362 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975) (an element of "scienter or conscious fault"); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2nd Cir. 1973) ("willful or reckless disregard" of the truth). But few of the decisions announcing that some form of negligence suffices for civil liability actually have involved only negligent conduct. *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 286 (3d Cir. 1972) (Adams, J., concurring and dissenting).

[77] *Ernst*, 425 U.S. at 193.

[78] *Id.*

[79] *Aaron v. SEC*, 446 U.S. 680, 689-95 (1980) (quoting *Ernst*, 425 U.S. at 197).

[80] *Ernst*, 425 U.S. at 193 n.12.

[81] *See In re Gold Res. Corp. Sec. Litig.*, No. 13-1323, 2015 WL 221614, at *7 (10th Cir. Jan. 16, 2015) (defining reckless "as conduct that is an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it"); *Yates v. Mun. Mortgage & Equity, LLC*, 744 F.3d 874, 884 (4th Cir.) *cert. denied sub nom*. *Dammeyer v. Mun. Mortgage & Equity, LLC*, 135 S. Ct. 113 (2014) (explaining that a reckless act is "one that is so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."); *S.E.C. v. Monterosso*, 756 F.3d 1326, 1335 (11th Cir. 2014) (explaining that recklessness required a "showing that defendant's conduct was extreme departure of standards of ordinary care, which presents danger of misleading buyers or sellers that is either known to defendant or is so obvious that actor must have been aware of it."); *In re Smith & Wesson Holding Corp. Sec. Litig.*, 669 F.3d 68, 77 (1st Cir. 2012) (clarifying that recklessness is a "highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious the actor must have been aware of it.").

[82] BLACK'S LAW DICTIONARY 435 (9th ed. 2009).

B. "Collective Scienter" Defined

As discussed above, scienter is a mandatory element of a claim for damages under Section 10(b), but what is a corporation's state of mind? The judicial answer has varied. The Supreme Court's decision in *Ernst*, requiring a finding of scienter as a prerequisite to liability reinforced the need for uniform guidelines in determining when a corporation possesses the requisite "intent" or "state of mind" necessary for liability. A corporation, by definition, is a "body formed and authorized by law to act as a single person although constituted by one or more persons and legally endowed by various rights and duties."[83] Intent, on the other hand, is defined as "[a] state of mind in which a person seeks to accomplish a given result through a course of action" or "[a] state of mind existing at the time a person commits an offense and may be shown by act, circumstances and inferences deducible therefrom."[84] So, the question becomes how can a corporation—an entity usually formed by more than one person—possess only one state of mind? And when anything goes wrong, who is the one to blame?

For many years, American courts, adopting the English common law view that where there was no willfulness there was no guilt, held that a corporation could never be guilty of a criminal conduct. The predicate of this conclusion was the assumption that a fictional entity was incapable of possessing a culpable mental state.[85]

The first cases holding corporations criminally liable disregarded *mens rea*, as the remedy sought was to either protect public health or safety.[86] The first case to impute intent to a corporation was *New York Central & Hudson River Railroad*, where the court imputed the corporation's agents' acts and intentions to the corporate entity as it were its own.[87]

The Securities Act and the Exchange Act speak only once about the intent of a corporation. The statutory safe harbor for forward-looking statements, contained both in Section 27A of the Securities Act and Section 21E of the Exchange Act, allows a defendant to evade responsibility for certain forward-looking statements, and is expressly made available to both the corporate issuer and ''[a] person acting on behalf of such issuer,'' as well as an underwriter and an ''outside reviewer retained by such issuer,'' such as an auditor.[88] Liability may be imposed only if the statement,

> if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or if made by a business entity, was made by or with the approval of an executive officer of that entity, and made or approved by such

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[83] Patricia S. Abril & Ann Morales Olazábal, *The Locus of Corporate Scienter*, 2006 COLUM. BUS. L. REV. 81, 83 (2006) (citing WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 292 (1991)).

[84] *Id.* (citing BLACK'S LAW DICTIONARY 810 (6th ed. 1990)).

[85] Griffin, *supra* note 10, at 1229.

[86] *Id.*

[87] *Id.* (citing *New York Central & Hudson River Railroad v. United States*, 212 U.S. 481 (1909)).

[88] 15 U.S.C. §§ 77z-2, 78u-5(c)(1)(B).

> officer with actual knowledge by that officer that the statement was false or misleading.[89]

This safe harbor indicates Congress' appreciation of the practical problems in proving corporate intent, and indeed it allowed for the possibility that liability would otherwise arise from a statement made with scienter by some nonexecutive corporate officer (further imposing the additional requirement of "actual knowledge" rather than mere recklessness). But it is of very restricted value in showing Congress' understanding of Section 10(b) considering that the safe harbor also applied to the various express and implied causes of action throughout the Acts.[90] To fill in the blanks, lower courts have been created various legal tests to assess a corporation's scienter under securities frauds' claims.

In this context, "collective scienter" is the theory that a plaintiff can plead fraud by pointing to a corporation's "collective" knowledge and intent and not the information possessed by any particular corporate officer or director. Many courts, however, recognizing that corporate knowledge is a fictitious creature, have sought to create limitations on imputing knowledge and intent of subordinate employees onto the corporate level, sometimes expressly rejecting the "collective scienter" doctrine. Hence the current circuit split.

V. PART IV – THE CIRCUIT SPLIT

In assessing the state of mind of a corporation under the securities laws, the circuit courts have divided on the issue of whether the knowledge (or recklessness) of all employees may be aggregated, whether it is enough for one single employee to possess a culpable state of mind and another make a false misrepresentation, or whether the same employee who made the misrepresentation should also be the one to have the scienter necessary to bring an action under a Section 10(b) and Rule 10b-5.[91]

The traditional approach to establishing corporate scienter requires proof that the individual who made a false or misleading statement attributable to the corporation acted with an intent to defraud—the speaker must have scienter.[92] This would be similar to the common law approach of making a corporation liable for actionable statements of its officers and employees,

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[89] 15 U.S.C. § 78u–4(b)(2)(A).

[90] Daniel A. Mclaughlin and Mark Taticchi, *Corporate Scienter Under Section 10(b) and Rule 10b-5*, BLOOMBERG BNA, SECURITIES REGULATION & LAW REPORT (May 5, 2014), http://www.sidley.com/~/media/files/publications/2014/05/corporate%20scienter%20under%20section%2010b%20and%20rule%2010b5/files/view%20article/fileattachment/bloomberg%20bnacorporate%20scienter%20under%20section%2010__.pdf.

[91] Griffin, *supra* note 10, at 1242.

[92] *See generally Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 197 (2d Cir. 2008); *In re Apple Computer, Inc.*, 127 F. App'x 296, 300 (9th Cir. 2005); *Southland Secs. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353 (5th Cir. 2004); *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 93 (2d Cir. 2001); *Caterpillar, Inc. v. Great Am. Ins. Co.*, 62 F.3d 955, 962 (7th Cir. 1995); *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1436 (9th Cir. 1995); *Piper Jaffray Co. Inc. v. National Union Fire Ins. Co.*, 38 F. Supp. 2d 771, 779 (D. Minn. 1999).

regardless of the corporation's intent.[93] Courts adopting this singular state of mind doctrine have often relied on Restatement (2nd), Agency § 275, comment "b," and § 268 comment "d" for their decisions.[94]

In sharp contrast to the traditional approach, some courts have followed or endorsed in *dicta* the collective scienter approach, treating corporate scienter as a distinct state of mind, separate from that of a corporation's individual officers and employees. Under this theory, a court views corporate knowledge as an undifferentiated aggregation of its employees' knowledge.[95] Thus, a plaintiff need not identify any particular individual as having scienter; it is sufficient to show that the corporation "knew" that the statements were false based on information available to corporate personnel.

Few courts explicitly refer to the doctrine of corporate scienter by name, however, their decisions will bluntly apply the doctrine or not. The Circuit split illustrates the divergent treatment of corporate scienter by courts, leading one way or the other. In each circuit, each case involves a well-known company and assesses corporate scienter in the context of a § 10(b) and Rule 10b-5. While the underlying fact scenarios of the cases differ only slightly, the reasoning and decisions on the issue of corporate scienter under the security laws may be diametrically opposed.

A. A Singular State of Mind: Speaker Must Have Scienter

In *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, investors in health care financing venture brought suit against a group of related corporations, some of which had financial stake in venture, against broker retained by venture to sell securities to investors, broker's employee, and officer of one of corporations, asserting claims for securities fraud, and

[93] *C.I.T Corp v. United States*, 150 F.2d 85 (9th Cir. 1945) (holding that it is the function delegated to the agent that determines his power to engage the corporation in a criminal transaction); *Standard Oil Co. of Texas v. United States*, 307 F.2d 120 (5th Cir. 1962) (requiring that the furtherance of the employer's business be the agent's primary motivation in order to hold the corporation liable).

[94] *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 367 (5th Cir. 2004); RESTATEMENT (SECOND) OF AGENCY § 275 (1958) ("If knowledge, as distinguished from reason to know, is the important element in a transaction, and the agent who has the knowledge is not one acting for the principal in the transaction, the principal is not affected by the fact that the agent has the knowledge. In many situations, in order for one to be responsible, it is necessary that the act should be done with knowledge in a subjective sense, and it is not sufficient that one has means of information."); *id.* § 268 ("If the state of mind of a principal in a transaction is a factor, a notification by a third person giving information to an agent who does not communicate it to the principal does not operate with like effect as a similar notification given to the principal. This is not, however, because its effect as a notification is different, but because of its subsidiary effect in conveying information.").

[95] *See generally City of Monroe Employees Retirement System v. Bridgestone Corp.*, 387 F.3d 468 (6th Cir. 2004), *amended by* 399 F.3d 651 (6th Cir. 2005), *cert. denied*, 126 S. Ct. 423 (2005); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 552 (6th Cir. 2001); *In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005).

under New York law.[96] Defendants persuaded plaintiffs to invest in a health-care financing venture, SAM Group, in which defendants already had a large financial stake.[97] The enterprise soon failed, and plaintiffs brought federal securities and state negligence and fraud claims against defendant, alleging that defendants had concealed various adverse facts concerning background of enterprise's CEO.[98]

Specifically, plaintiffs alleged that defendants discouraged them from inquiring into the background of SAM Group's principal, J. Christopher Mallick, and instead provided them with what was purportedly the findings of an independent investigator who had performed a background check on Mallick. But, even that report had been modified (unbeknownst to investors) to delete selected adverse information.[99] Plaintiffs thereafter invested in SAM Group in reliance on the modified report. When SAM Group subsequently failed financially, securities fraud litigation ensued.

The district court dismissed plaintiff's complaint for several reasons which respect to which the court of appeals subsequently found fault.[100] For example, the appellate court helf that allegations by investors that an employee of the issuer, who had a large financial stake in the entity, had modified report on venture's principal (by deleting adverse information) and disseminated it on behalf of the issuer and related entities, were sufficient to show scienter on part of employee, corporation, and related entities, and thus to state securities fraud claim under Securities Exchange Act.[101] The Second Circuit' reasoning appears to be that this was sufficient to establish scienter because the employee was acting as defendants' agent, and in their interest, in perpetrating the alleged deception. According to the appellate court, such action constituted conscious misbehavior on the part of some of the defendants.[102]

However, the court found that a third-party corporation and its employee, hired by the issuer to act as its agent in selling securities, did not know of the misrepresentations. Therefore, the court held, they did not have the requisite scienter required by Section 10(b) and Rule 10b-5.[103]

Later, in *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc.*, the Second Circuit reaffirmed its reasoning that in order to state a claim for securities fraud against a corporate defendant, plaintiffs may not rely upon the theory of "collective scienter," but instead must plead a strong inference of scienter by the individual "who was responsible for the [allegedly false or misleading] statements made" by or on behalf of the corporation.[104]

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[96] *Suez*, 250 F.3d at 93.

[97] *Id.*

[98] *Id.*

[99] *Id.* at 93-94.

[100] *Id.* at 99-100.

[101] *Id.* at 100.

[102] *Id.*

[103] *Id.*

[104] *Teamsters Local 445 Freight Div. Pension Fund*, 531 F.3d at 197.

At issue in *Dynex* was a series of statements issued by the defendant, Dynex Capital, in connection with its lending practices.[105] Plaintiffs named Dynex, its subsidiary Merit, and two of Dynex's officers, alleging that the defendants were liable for fraud because certain officers and directors at both the parent and the subsidiary (1) had access to records and failed to review documents that could have revealed the fraud and (2) were motivated to "sustain the appearance of corporate profitability" at Dynex.[106] The district court held that, while these allegations were insufficient as to the individual defendants, they were adequate to plead a claim against the corporate defendants based on the doctrine of "collective scienter."[107] Recognizing a split of authority on the issue, however, the district court took the unusual step of certifying the issue for interlocutory appeal to permit the Second Circuit to resolve the issue.

The Second Circuit reversed the district court's decision. Expressly rejecting "collective scienter" as a permissible means of pleading knowledge and intent under the Private Securities Litigation Reform Act of 1995, the court held that "[w]hen the defendant is a corporate entity . . . the pleaded facts must create a strong inference that someone whose intent could be imputed to a corporation acted with the requisite scienter."[108] The court explained that while this might not preclude a plaintiff from pleading scienter as to a corporation based on the conduct of certain officers and directors not named in the complaint, it would require a plaintiff to plead specific facts raising a strong inference that the officer or director who acted with the requisite scienter was not only "someone whose scienter is imputable to the corporate defendants" but also "someone who was responsible for the statements made." [109]

Similarly, in *Caterpillar v. Great Am. Ins. Co*, plaintiff insured and defendant insurer both appealed a summary judgment that concerned plaintiff's coverage under a directors' and officers' liability insurance policy with defendant after plaintiff settled a federal class action securities suit.[110] The Seven Circuit followed the Ninth Circuit case *Nordstrom, Inc. v. Chubb & Son, Inc.*,[111] and recognized that there are conceivable situations where the individual actors would not be liable but their corporate employer would be, for example where a case depended on the collective scienter of its employees.[112]

In *In re Apple Computer*, appellant investors filed a putative class action against Apple and its CEO at the time, Steve Jobs, alleging that they violated § 10(b) and Rule 10b-5 because

[105] *Id.* at 192.

[106] *Id.* at 196.

[107] *Id.* at 194-96.

[108] *Id.* at 196.

[109] *Id.* at 197.

[110] *Caterpillar, Inc.*, 62 F.3d at 962.

[111] *Id.* (citing *Nordstrom, Inc.*, 54 F.3d at 1436).

[112] *Id.* (disagreeing with the district court's holding that plaintiffs had failed to meet § 10(b)'s *scienter* requirement, which demanded that plaintiffs establish a "strong inference" of fraudulent intent "either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness).

of misrepresentations that were made regarding the corporation's performance.[113] The District Court dismissed the complaint based on its finding that the investors failed to allege facts showing that the CEO and other corporate officers made false statements with the scienter required under the law.[114] On appeal, the Ninth Circuit found that the district court properly dismissed the complaint, flatly rejecting any type of collective scienter theory, and affirmed the district court's analysis.

In that case, the plaintiffs alleged that corporate officers made misrepresentations to bolster the company's stock price during technology stock tumble of 2000.[115] The "misstatements" or "omissions" at stake referred to (1) statements made about revenue projections, (2) statements regarding the success of Apple's reorganization of its sales force, and (3) statements regarding the commercial viability and success of their new product, the G4 Cube.[116]

As to the first set of statements, the court said that plaintiff's allegation that Apple's CFO had a duty to know Apple's "correct financial conduction," could only be actionable under a Negligence theory not supported in claims under § 10(b) and Rule 10b-5, as that by itself was not enough to show the requisite scienter required for liability.[117] Similarly, the plaintiffs failed to show that Apple's controller knew that the statements he made about the success of Apple's reorganization of its K-12 educational sales force was false.[118] Finally, in addressing Apple's CEO's statements about the new G4 Cube computer and its financial projections, the court concluded that even though engineers, senior managers, and executives were aware that there were production problems that threatened the computer's commercial viability, the plaintiffs had failed to plead the allegations with sufficient particularity to attribute the necessary knowledge or scienter to Apple's CEO, and through him, to the company.[119]

More specifically, the court explained that there were no facts pleaded to demonstrate that Jobs observed and knew of the extent of the production problems the G4 Cube computer was having, or that he learned of them from a report.[120] Because plaintiffs failed to allege the contents of "specific memos, messages, or meetings," showing what Jobs knew and when he knew it, scienter could not be inferred from their broad allegations.[121]

Thus, rejecting any type of collective scienter theory, the Ninth Circuit affirmed the district court's reasoning that it is not enough to establish fraud on the part of a corporation that one corporate officer makes a false statement that another officer knows to be false.[122] A

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113 *In re Apple Computer, Inc.*, 127 F. App'x at 300.

114 *Id.*

115 *Id.* at 299-300.

116 *Id.*

117 *Id.* at 300.

118 *Id.* at 301.

119 *Id.* at 303.

120 *Id.* at 302.

121 *Id.*

122 *Id.*

corporation is thus only deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter at the time that he or she makes the statement.[123]

Similarly, in *Southland Secs. Corp. v. INSpire Ins. Solutions, Inc.*, the Fifth Circuit held that whether defendant corporation acted with scienter is determined by looking "to the state of mind of the individual corporate official or officials who make or issue the statement . . . rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment."[124]

Courts within the Eighth Circuit have also explicitly rejected the concept of "collective scienter," choosing to follow the Ninth Circuit.[125] For example, in *Piper Jaffray*, a corporation brought action against directors' and officers' liability insurer for reimbursement of sums paid in settlement of securities fraud litigation against corporation and officers and directors.[126] The court clarified that while theoretically, collective scienter could be a basis for liability,[127] there was no case law supporting an independent "collective scienter" theory.[128] Therefore, corporate entity's Rule 10b-5 liability required demonstration that at least one agent of the corporation possessed the requisite scienter.[129]

B. Aggregate or Collective Scienter: "Unified" Knowledge Counts

The Sixth Circuit's decision in *City of Monroe Employees Retirement System v. Bridgestone Corp.* adopted a different line of reasoning than the one employed by the Ninth Circuit. Though the opinion does not expressly invoke collective scienter theory, a review of the facts, reasoning, and ruling reveals that, unlike the Ninth Circuit in *Apple Computer*, the Sixth

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[123] *Id.* at 303 (citing *Nordstrom, Inc.*, 54 F.3d at 1435).

[124] *Southland Secs. Corp.*, 365 F.3d at 353 (noting that this approach was "consistent with the general common law rule that where, as in fraud, an essentially subjective state of mind is an element of a cause of action also involving some sort of conduct, such as a misrepresentation, the required state of mind must actually exist in the individual making (or being a cause of the making of) the misrepresentation, and may not simply be imputed to that individual on general principles of agency.").

[125] *Piper Jaffray Co. Inc.*, 38 F. Supp. 2d at 779. "[A]ny liability faced by Piper as a corporate entity under rule 10b-5 requires a demonstration that at least one agent of the corporation ... possessed the requisite scienter." *Id.* (relying on *Nordstrom, Inc.*, 54 F.3d, at 1435-36). *See also In re Navarre Corp. Securities Litig.*, 2006 WL 3759750, at *5 (D. Minn. Dec. 21, 2006), (holding that allegations made against defendants as a group are too nebulous to support a strong inference of scienter against a particular defendant).

[126] *Piper Jaffray Co. Inc.*, 38 F. Supp. 2d at 779.

[127] *Id.* (citing *Nordstrom*, 54 F.3d, at 1436).

[128] *Id.*

[129] *Id.*

Circuit squarely embraces the possibility of liability for a corporation when one actor speaks and another has knowledge that those statements are false.[130]

In *Bridgestone*, lead class plaintiff retirement fund sued defendants, two corporations and two officers, in the United States District Court for the Middle District of Tennessee, at Nashville, alleging claims under § 10(b) and Rule 10b-5.[131] The case arose out of the Firestone ATX tire/Ford Explorer product defect.[132] One corporation was a multinational corporation with international headquarters in Japan (Bridgestone).[133] Its stock did not trade on any American stock exchange. The second corporation was wholly owned by the first (Firestone).[134] Its headquarters were in Nashville.[135] Shareholders brought a class action suit under Section 10(b) against Bridgestone, Firestone, and two corporate officers.[136]

The complaint alleged a series of public, fraudulent statements by the corporation and its subsidiary, relying heavily on the company's annual reports for fiscal years 1996-2000.[137] Specifically, the suit contended that the defendants made misrepresentations that concealed their knowledge about the potential for thousands of successful tort suits alleging that ATX tires caused injurious and fatal rollover accidents.[138] The fund appealed the dismissal of all claims against one officer for lack of personal jurisdiction and the remaining claims for failure to state a claim upon which relief could be granted for failure to allege adequately the scienter necessary for Section 10(b) claims.[139] On appeal, the Circuit's approach to liability for the statements at stake—specifically the sufficiency of the plaintiffs' scienter allegations—was the complete opposite of that of the Ninth Circuit in *Apple Computer*.[140]

Unlike the Ninth Circuit, the Sixth Circuit was obviously unconvinced that to establish liability under § 10(b) and Rule 10b-5, scienter and a misstatement must reside in the same natural person, which theory incorporates the premise that a corporation acts only through its agents, and therefore, that corporate liability can only be vicarious.[141] One statement at issue here dealt with Firestone's press release that announced that they continually monitored the performance of all their tire lines, and that the objective data clearly reinforced their belief that they were high quality, safe tires.[142] The second consisted of two written representations made in

[130] Abril, *supra* note 84, at 83.

[131] *See Bridgestone Corp.*, 387 F.3d at 468.

[132] *Id.* at 661-63.

[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] *Id.*

[137] *Id.*

[138] *Id.* at 658, 663-64.

[139] *Id.* at 664.

[140] *Id.*

[141] *Id.* at 688.

[142] *Id.* at 659.

financial statements incorporated in Bridgestone's 1999 Annual Report to shareholders, in which they failed to mention that the defective tires gave rise to potentially enormous contingent liability.[143]

The court explained that scienter of senior controlling officers of corporation may be attributed to corporation itself to establish liability as primary violator of § 10(b) and Rule 10b-5 when those senior officials were acting within scope of their apparent authority.[144] The court relied heavily on a case they decided years earlier, *Helwig v. Vencor, Inc.* and the nine factors that the Sixth Circuit had previously identified as bearing on scienter in securities fraud actions. These included: "(1) insider trading at a suspicious time or in an unusual amount; (2) divergence between internal reports and external statements on the same subject; (3) closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information; (4) evidence of bribery by a top company official; (5) existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit; (6) disregard of the most current factual information before making statements; (7) disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication; (8) the personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and (9) the self-interested motivation of defendants in the form of saving their salaries or jobs."[145]

Regarding Firestone and its statement that "[w]e continually monitor the performance of all our tire lines, and the objective data clearly reinforces our belief that these are high-quality, safe tires," the Court pointed out that at least five of the nine non-exclusive *Helwig* factors were apparent in the Complaint's alleged facts, specifically factors two, three, six, seven, and nine. When considering factor two, the court explained that Firestone's awareness of the circumstances at the Decatur plant, including in particular the strike, the untrained replacement workers, the production schedule time increase imposed by Bridgestone and Firestone in the labor negotiations with the union, and the test results pointing to higher rates of problems in the Decatur-produced ATX tires, make the imputation of scienter reasonable.[146] It is thus clear then that the Sixth Circuit's framework for analyzing scienter contemplates corporate liability separate and apart from the conduct of the individual defendants who might create vicarious liability for the corporate defendant.

When analyzing whether there was the "existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit," the Court indicated that even though there was not, strictly speaking, such evidence because the claims in question were not based on fraud per se, the presence of closely related evidence carried some weight, particularly given that the list of factors was "non-exhaustive.[147] For example, Firestone entered into multiple settlement agreements in response to product liability suits under which the settlement agreements with plaintiffs were sealed, the parties entered into stipulated protective orders to

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[143] *Id.* at 678-79.

[144] *Id.* at 688.

[145] *Helwig*, 251 F.3d at 552 (citing *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir. 1996) (collecting cases)).

[146] *Bridgestone Corp.*, 399 F.3d at 684.

[147] *Id.* at 685.

conceal discovery, and Firestone would have returned to it "damaging documents." The gravamen of these claims and lawsuits, though framed as pre-litigation claims or lawsuits in tort, was closely parallel to that of the security laws suit: the tires were not safe and Firestone should be held accountable for that fact.[148]

Moreover, Firestone secretly settled with State Farm all claims for insurance in exchange for lack of disclosure by State Farm and avoided through a secrecy agreement with the Venezuelan government any disclosure of its having added nylon layers to ATX tires in Venezuela.[149] The Court concluded that the evidence of these secret settlements got at the same notion as did the *Helwig* factor instructing courts to analyze whether there have been ancillary lawsuits filed charging fraud followed by quick settlement of such suits.[150] Notably, this factor by definition applied only to a corporate defendant, which reinforced the court's presupposition that corporations may have the requisite mental state to be held liable as primary violators of Section 10(b) without imputing scienter from a particular individual corporate agent.[151]

Next, the court discussed whether Bridgestone possessed the requisite scienter. The fraud allegations against Bridgestone were based on two representations made in a 1999 Annual Report to shareholders: (1) the "No Impairment" representation—that no impairment of Bridgestone's corporate assets was substantially certain to occur through problems arising from customers or regulators' actions and (2) the "No Loss" representation—that there were no actual, material losses connected to the lawsuits and responses to the regulatory scrutiny of the ATX tires.[152] In assessing Bridgestone's scienter in connection with these misrepresentations, the court focused primarily on the divergence between internal reports and external statements on the same subject.[153]

The facts known or available to Bridgestone—including the fifty consumer lawsuits already filed against the parent and its subsidiary by 1999, the red flags set out in internal corporate memoranda, and Firestone's prior history with a massive tread separation recall problem—were seemingly in tension with the representation that no impairment risk of Bridgestone's corporate assets was substantially certain to occur through problems arising from customers or regulators' actions and that there was no contingency risk of such a loss.[154] Considering the totality of the circumstances, in particular the divergence of internal and external statements with respect to clearly material information going to one of Bridgestone's major flagship brands, the court concluded that the facts, when considered as a whole, gave rise to a strong inference of at least recklessness.[155]

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[148] *Id.*

[149] *Id.*

[150] *Id.*

[151] Abril, *supra* note 84, at 95.

[152] *Bridgestone Corp.*, 399 F.3d at 686.

[153] *Id.*

[154] *Id.* at 687.

[155] *Id.* at 688.

Similarly, in *In re WorldCom, Inc. Secs. Litig.*, Judge Cote of the District Court for the Southern District of New York recognized the collective scienter doctrine.[156] In that case, investors brought securities class action against Arthur Andersen who audited telecommunications company's financial statements, which plaintiffs claimed were materially false.[157] Andersen sought summary judgment, partially based on its contention that plaintiff had failed to demonstrate that a particular Andersen auditor acted with scienter.[158] Although the court stated that "[i]t is a fundamental principle that a corporation can only act through its employees and agents," it nevertheless went on to hold that "to carry their burden of showing that a corporate defendant acted with scienter, plaintiffs in securities fraud cases need not prove that any one individual employee of a corporate defendant also acted with scienter.[159] Proof of a corporation's collective knowledge and intent was thus sufficient.[160]

The court likened its collective scienter approach to that taken in cases involving corporate criminal liability under the Currency Transaction Reporting Act.[161]

VI. PART V – MIDDLE GROUND SOLUTION: A SINGLE SOUL DWELLING IN TWO BODIES

The cases reviewed above expose a fundamental difference in the approaches that courts have taken when faced with the question of a corporation's "state of mind." The Ninth Circuit, along with other courts, presuppose that corporations can only be vicariously liable for their agents' statements if the individual corporate officer making the statement has the requisite level of scienter in at the time that he or she makes the statement.[162] It is important to remember that, in *Apple*, the court acknowledged plaintiffs' allegations of scienter on the part of some corporate executives and employees, but then focused only on whether that guilty knowledge was conveyed to Steve Jobs, the person who actually made the alleged misrepresentations.[163] Furthermore, and critical to its ultimate disposition, the court failed to attribute the other employees' knowledge directly to the company, which, coupled with Jobs's misrepresentations, could have exposed the corporation to liability in a court willing to aggregate.[164]

Those who follow the collective scienter doctrine contemplate the aggregation of scienter and apparently assume that an issuer corporation that makes misstatements to the market cannot have guilty knowledge or intent separate and apart from its multiple agents. These courts view

[156] *In re WorldCom, Inc.*, 352 F. Supp. 2d, at 497.

[157] *Id.* at 475-76.

[158] *Id.* at 497-98.

[159] *Id.* at 497.

[160] *Id.* (citing *United States v. Bank of New England, N.A.,* 821 F.2d 844, 855 (1st Cir.1987) for the proposition that "jurors would have to "look at the bank as an institution" and understand the bank's knowledge as "the sum of the knowledge of all employees.").

[161] *Id.* (citing *Bank of New England*, 821 F.2d 844).

[162] *In re Apple Computer, Inc.*, 127 F. App'x, at 303.

[163] *Id.*; Abril, *supra* note 84, at 97.

[164] *In re Apple Computer, Inc.*, 127 F. App'x, at 303.

the corporation as a separate entity and, perhaps more importantly, as a legal "person" with scienter apart from any individual speaker or writer.

This Section attempts to create a middle-ground-hybrid approach to this legal dichotomy in an effort to move toward a better rule for the attribution of scienter to corporate entities. The proposition this paper intends to adopt is an innuendo to Aristotle's famous quote "[F]riendship is a single soul dwelling in two bodies." This section will try to argue that a corporation should not be able to escape liability by restricting the intracorporate flow of information. Thus, when a member of management has the requisite scienter and another "qualified" member speaks for the corporation, any misrepresentation made by the speaker could be attributed to the corporation because the corporation's own soul dwells in the collective knowledge of those two bodies.

The Restatement rule[165] requires that, in a Section 10(b) lawsuit against a corporate entity, the plaintiff must identify one or more specific officers or employees who individually satisfy the requirements of Section 10(b) liability. It is not necessary that these corporate agents be named as defendants, but there must be *some* individual who committed a complete violation of Section 10(b) with the relevant intent. Historically, whether a corporation has acted with scienter is determined by looking "to the state of mind of the individual corporate official or officials who make or issue the statement […] rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment."[166] Despite the Restatement's truthfulness and highly followed idea, courts should recognize that corporations only act through their officers and directors, and, therefore, can only be held liable for fraud if one or more of those individuals can be held liable for fraud. Unlike the circuits that expressly or impliedly reject the "collective scienter" doctrine, this article proposes the idea that while not every employee or agent for the corporation should have the ability of exposing it to potential securities fraud liability, corporations should not be able to escape liability simply because the person who spoke to the market is not the same person that created the misleading information.

It is commonly accepted that a corporation's board of directors, for example, is ultimately responsible for its management. This power is codified in Section 141 of the Delaware General Corporation Law (DGCL)[167] and by similar statutes in other states.[168] Although the power to manage the corporation is often broadly stated and not clearly defined, responsibility for making decisions on behalf of the corporation is clearly vested with the directors and not the shareholders.[169] The board can, however, discharge this responsibility by appointing officers who will run the day-to-day operations of the corporation, propose strategies and objectives, and

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[165] RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. d(2) (2006). ("[A] principal may not be subject to liability for fraud if one agent makes a statement, believing it to be true, while another agent knows facts that falsify the other agent's statement. Although notice is imputed to the principal of the facts known by the knowledgeable agent, the agent who made the false statement did not do so intending to defraud the person to whom the statement was made.")

[166] *Southland Sec. Corp.*, 365 F.3d at 366.

[167] 8 Del. C. § 141. Because the majority of companies are incorporated in Delaware, and because Delaware's corporate law is well established and widely followed by other states, this article uses the Delaware Business Code as its main illustration.

[168] *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 21.002 (West 2007).

[169] *See generally* 8 Del. C. § 141(c)(2).

implement corporate plans; by supervising those officers; and making other major decisions for the corporation (for example, entering into a significant joint venture or licensing its key intellectual property platform).

Often selected for their expertise in a particular area or industry, inside directors also typically hold an advisory or supervisory role. Statutory law and a corporation's charter normally allow the board to delegate any of its powers to a committee of directors. Under Delaware law, for example, a duly appointed committee holds all powers delegated to it by the full board other than (a) the power to approve, adopt, or recommend to the stockholders any action or matter expressly required by law to be approved by the stockholders, and (2) adopt, amend, or repeal any of the corporation's by-laws.[170] Further, directors can reasonably rely on reports from committees, officers, and other experts when making decisions for the corporation.[171]

In this context, a business owner often relies on an employee or another person to conduct a business. In the case of a corporation, since a corporation is a fictitious legal "person," it can only act through human agents – its directors, officers, employees, and others. Because under common law rules of agency the corporation is bound by the contract entered into by the agent, so long as the agent performs within the scope of the agency,[172] and because a corporation is not capable of conducting business until bylaws are adopted, shares are issued, permanent officers, directors elected, and so forth, it is only reasonable to say that scienter of directors and senior controlling officers of a corporation may be attributed to the corporation itself to establish liability as a primary violator of § 10(b) and Rule 10b-5 when those directors and senior officials were acting within the scope of their apparent authority. This is not to say that every employee's, directors' or officer's scienter can or should be imputed to the one who speaks to the pubic, like Steve Jobs in the Apple case,[173] and thereafter to the company. However, when the person who had the requisite scienter and the one who presented the information to the public are corporate agents whose intent could be imputed to the corporation through the common law of agency, scienter should be seen "collectively" between them two, and should therefore be attributed to the entity they represent and have the ability to bind.

As an illustration, the Tenth and D.C. Circuits have not squarely addressed the collective scienter question in the Section 10(b) context, but both have indicated a disposition towards the Restatement rule. The Tenth Circuit, explaining why it based a corporation's liability on the scienter of its senior officers, held that ''[t]he scienter of the senior controlling officers of a corporation may be attributed to the corporation itself to establish liability as a primary violator of § 10(b) and Rule 10b-5 when those senior officials were acting within the scope of their apparent authority."[174]

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[170] *Id.*

[171] *Id.* § 141(e).

[172] RESTATEMENT (SECOND) OF AGENCY § 1. (Agency; Principal; Agent. "(1) Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his or her behalf and subject to her control, and consent by the other so to act. (2) The one for whom action is to be taken is the principal. (3) The one who is to act is the agent.").

[173] *In re Apple Computer, Inc.*, 127 F. App'x at 302.

[174] *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1106-07 (10th Cir. 2003); *see Woodmont, Inc. v. Daniels*, 274 F.2d 132, 137 (10th Cir. 1959).

The Restatement rule has deep roots in the same agency law doctrines that allow corporations to be sued under Section 10(b) and Rule 10b-5 in the first place. It has been explicitly or implicitly adopted by nearly every Circuit that has considered the question. Meanwhile, the competing collective scienter approach, the way it has been used by some circuit courts, has gained little traction, is in some tension with settled aspects of Section 10(b) law, and would present significant problems in practice if it continues to be applied as it has by the Sixth Circuit, for example. Accordingly, the better practice would be for courts addressing Section 10(b) and Rule 10b-5 claims against corporate defendants to adopt the Restatement rule interpreting it broadly so as to allow Corporate defendants to answer for material misleading public statements made by high-hierarchy officers and directors using their aggregate knowledge, while not necessarily subjecting the company to unlimited liability based on the collective knowledge of lower-level corporate officers and employees.

So, for example, if in the Apple case, Apple's CFO caused the corporation to make material misstatements in SEC filings when he *knew* the statements to be false and misleading, but Apple's CEO was the one to sign the filings and convey the statements to the public, it is only fair to stockholders who have invested in the company to have the court use the high-hierarchy officers' aggregate knowledge in analyzing a securities fraud claim. Because the CFO is usually the corporate officer responsible for financial planning and record-keeping, as well as financial reporting to higher management and for analysis of data, and because he often reports directly to the CEO, even though the CEO should be able to rely on information conveyed to him by the CFO, it would not be fair or just to shield the company from section 10(b) liability simply because the speaker was not the one who had the actual state of mind required by Rule 10b-5.

This article thus concludes that corporate titles given to a corporate's highest-level executive officials, such as inside directors and officers—CFOs (Chief Financial Officers), CEOs (Chief Executive Officers), COOs (Chief Operations Officers), and CMOs (Chief Marketing Officers) just to name a few—suggest what duties they have in the organization, and the level of responsibility that is entrusted in them by the corporate entity. On this same token, the background in which they are inserted—the Securities Act and the Exchange Act—serves to remind us that these laws were made to emphasize the immediate necessity in formulating guidelines and rules to protect the *general public* by promoting honest dealing in securities and thereby bringing back the once lost public confidence in the system. These two predicates substantiate the proposition that the best way to accommodate Congress's goal in fighting abuses in the securities markets is by permitting courts to mix-and-match certain high-level corporate agent's conduct with another corporate agent's state of mind to fabricate a corporate violation *so long as* these officers occupy a position of trust and confidence within the corporate entity.

VII. CONCLUSION

Although the two opposite views on how to deal with corporate scienter seem to be irreconcilable, given courts often either explicitly reject or opt for one over the other, this paper's goal was to show that a hybrid solution using both is not only possible, but in fact, desirable. As previously discussed, while securities legislation has a fundamental purpose of achieving a high standard of business ethics in the securities industry, it is also not always fair and economically viable to impute any employee's mistake and state of mind to the corporation as a whole, especially when knowledge is an important element in the transaction. However, high-level officers and people within the corporation with management control, due to agency principles, contractual authority, and their senior position per se, should have their state of mind, collectively and interchangeably amongst themselves, attributed to the corporation, as they are the mind and soul through which a corporation lives.

To the query, "What is a friend?," the Greek philosopher's reply has been registered as being "A single soul dwelling in two bodies." To the legal issue of "Where is a Corporate's *mens rea*?," this article's proposed answer is " In the aggregate state of mind and action of two beings: the individual(s) who authorized, created, requested, commanded, prepared, reviewed, or approved the statement in which the misrepresentation was made, and the one who ratified, recklessly disregarded, tolerated the misrepresentation at the time of or after its utterance or issuance—so long as both beings are a high managerial agents, officers or inside directors of the corporation. These two individuals, bodies, or beings, together in single harmony, will spring from one source—the corporation—and will end by carrying out what the securities laws have been created to stop: a securities fraud.

**Sponsor Due Diligence In Initial Public Offerings In Hong Kong:
A Review Of The New Regulatory Standards**

Mei Zhang[1]

In 2011, the Stock Exchange of Hong Kong ("SEHK") was the world's largest initial public offering ("IPO") market for the third consecutive year.[2] As such, Hong Kong is increasingly an important (though often overlooked) jurisdiction for the study of due diligence regulation and practice. This paper seeks to add to the body of due diligence scholarship focused on Hong Kong. Specifically, it offers an overview of the recently adopted new standards for due diligence by IPO sponsors.

I. A CATALYST FOR CHANGE: MEGA CAPITAL

On April 22, 2012, Securities and Futures Commission ("SFC") of Hong Kong announced that it fined Mega Capital (Asia) Company Limited's ("Mega Capital") HK$42 million (US$5.5 million) and revoked its corporate financial advisory license due to its failure to discharge its sponsor's duties in relation to the listing application of Hontex International Holdings Company Limited in 2009.[3] The SFC's disciplinary action against Mega Capital was the first revocation of an IPO sponsor's license and the highest pecuniary penalty ever handed down by the SFC.[4] With the SEHK's inherent weighting towards Chinese-related businesses and the recent adverse publicity of accounting scandals involving Chinese issuers (both inside and outside of Hong Kong), the SEHK deemed it important to tighten regulatory requirements to further improve the integrity of the Hong Kong market, increase the transparency in fund raising, and maintain investors' confidence.[5] The SFC's action against Mega Capital sets the backdrop for this paper's exploration of sponsor due diligence in Hong Kong IPOs.

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[1] L.L.M., SMU Dedman School of Law, 2009; J.D. Candidate, SMU Dedman School of Law, 2015; LL.B, Wuhan University Law School (China), 1999.

[2] *See* Chan Freeman & Mark Johnson, *Hong Kong imposes first revocation of IPO sponsor's license*, LEGAL BRIEFING (June, 2012), http://hongkongbusiness.hk/sites/default/files/. hongkongbusiness/print/HKB_JuneJuly2k12_LR%2036.pdf.

[3] *See SFC fines and revokes the license of Mega Capital (Asia) Company Limited*, SECURITIES AND FUTURES COMMISSION (Apr. 22, 2012), http://www.sfc.hk/edistributionWeb/gateway/EN/ news-and-announcements/news/doc?refNo=12PR39.

[4] *See* Freeman, *supra* note 2.

[5] *See Consultation Paper on regulation of sponsors*, SECURITIES AND FUTURES COMMISSION (May 2012), http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo= 12CP1, (hereinafter Consultation Paper).

II. REGULATORY REQUIREMENTS OF IPO SPONSOR DUE DILIGENCE

Under Hong Kong Securities laws, a sponsor[6] is responsible for the due diligence of a listing application before an IPO.[7] In May 2012, the SFC issued for public comment a Consultation Paper (the "Consultation Paper") on regulation of IPO sponsors.[8] In December 2012, upon conclusion of the public comment period, the SFC issued its conclusions (the "Consultation Conclusions") and announced new sponsor rules, which took effective on October 1, 2013.[9]

The main requirements for due diligence of IPO sponsors under the new regulatory regime are contained in Chapter 3A[10] and Practice Note 21 ("Practice Note 21")[11] of the Rules Governing the Listing Securities (the "Listing Rules"), and the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct").[12] These regulatory regimes require a sponsor to take reasonable steps to ensure that true, accurate, and complete disclosure of a listing application is made to the public.[13]

The new rules do not reflect fundamental changes in the general principles of a sponsor's role in an IPO process in Hong Kong; rather they add more restrictive and disciplined

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[6] "Sponsor" means a licensed corporation or registered institution licensed or registered under the SFO for Type 6 regulated activity and permitted under its license or certificate of registration to undertake work as a Sponsor appointed to act as a sponsor in respect to an application for the listing of any securities on a recognized stock market under the Listing Rules of the Stock Exchange of Hong Kong Limited. *See Fit and Proper Guidelines*, SECURITIES AND FUTURES COMMISSION (Oct. 2013), http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_548_VER30.pdf.

[7] *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission*, SECURITIES AND FUTURES COMMISSION, § 17.2 (Oct. 2013), http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_1868_VER50.pdf (hereinafter Code of Conduct).

[8] *See Consultation Paper*, *supra* note 5, ¶¶ 1-2.

[9] *Consultation Conclusions on Regulation of Sponsors*, SECURITIES AND FUTURES COMMISSION (Dec. 2012), https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=12CP1 (hereinafter Consultation Conclusions).

[10] Rules Governing The Listing Of Securities On The Stock Exchange Of Hong Kong Limited, Sponsors And Compliance Advisors (updated Mar. 31, 2015) § 3A.11(2), *available at* https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_3a.pdf (hereinafter Sponsors And Compliance Advisors).

[11] Rules Governing the Listing of Securities, The Stock Exchange of Hong Kong Limited, Practice Note 21 (updated Mar. 31, 2015), *available at* https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/pn_21.pdf (hereinafter Practice Note 21).

[12] *See Code of Conduct*, *supra* note 7, § 17.

[13] *See id.* § 17.2(c).

requirements for due diligence and further clarify how sponsors should conduct due diligence.[14] Importantly, however, commentators have expressed the view that the new rules hold sponsors, whom investors rely on as key gatekeepers of market quality, to a higher standard of due diligence work than the previous rules.[15]

A. Chapter 3A

Section 3A.11 (2) of the Listing Rules provides that a sponsor must "conduct reasonable due diligence inquiries to put itself in a position to be able to make the declaration" required under the law.[16]

B. Code of Conduct

In the Consultation Conclusions, the SFC emphasized that a sponsor's due diligence on a listing applicant was fundamentally important to the quality of the application.[17] As a result, the proposals on revising the obligations of a sponsor's due diligence were centralized and consolidated in Section 17 of the Code of Conduct.[18] Section 17.5 sets out the reasonable standard of a sponsor's due diligence work for non-expert section and expert section, respectively:

(1) Non-expert sections

> "At the time of issue of a listing document, a sponsor, after reasonable due diligence, should have reasonable grounds to believe and should believe that:
> (i) the information in the non-expert sections of the listing document is true, accurate and complete in all material respects and not misleading or deceptive in any material respect; and

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[14] *Sponsors in the Spotlight: a more stringent Hong Kong regulatory framework for due diligence in initial public offerings*, KING & WOOD MALLESONS, http://www.mallesons.com/publications/marketAlerts/2013/Pages/Sponsors-in-the-Spotlight-a-more-stringent-Hong-Kong-regulatory-framework-for-due-diligence-in-initial-public-offerings.aspx (last visited Jan. 20, 2013).

[15] *See* John Moore, *The Impact of A Paradigm Shift*, IFLR (Oct. 2014), http://www.slaughterandmay.com/media/2432915/the-impact-of-a-paradigm-shift.pdf; *see also PN21 (Practice Note 21 of the SEHK Listing rules)*, PWC, http://www.pwccn.com/home/eng/rc_pn21.html (last visited Feb.16, 2015).

[16] Sponsors and Compliance Advisors, § 3A.11(2).

[17] *See* Consultation Conclusions, ¶ 23.

[18] *New Hong Kong Regime on Obligations of Sponsors*, JOHNS DAY (Jan. 2013), http://www.jonesday.com/new_hong_kong_regime/#.

(ii) there are no matters or facts the omission of which would make any information in the non-expert sections of a listing document or any other part of the listing document misleading in a material respect."[19]

(2) Expert sections

"At the time of issue of a listing document, a sponsor as a non-expert, after performing the due diligence set out in paragraph 17.7 of the Code of Conduct (due diligence on expert reports), should have no reasonable grounds to believe and should not believe that the information in the expert reports is untrue, misleading or contains any material omissions."[20]

As to the question of how a sponsor should conduct due diligence, Section 17.6 lists seven aspects of the requirements and the underlying obligations they reflect. These obligations are summarized as follows:

(1) to exercise reasonable judgment on the nature and extent of due diligence work;
(2) to examine with professional skepticism the accuracy and completeness of statements and representations and other information;
(3) to perform verification procedures that are appropriate in the circumstances;
(4) to be closely involved in preparing the document, achieve a thorough understanding of the application and the industry; examine the integrity, qualification, and competence of the directors; examine and consider the accuracy and reliability of the financial information; assess business performance, financial condition, development, prospects, any financial projection or profit forecast, the legality and compliance of business operations, and any changes since the date of last audited balance sheet; undertake independent verification of all material information;
(5) to take independent steps to inquire directly of persons who have knowledge of the listing applicant; conduct inspection of key physical assets, interview major business stakeholders; review relevant underlying records and supporting documents in relation to material matters; independently obtain information in relation to material matters from outside sources;
(6) to select independently major business stakeholders to be interviewed based on objective and proportionate criteria; carry out the interview directly with the interviewees; confirm the bona fide, authority, and knowledge of the interviewees; hold an in-depth discussion with a view to obtaining adequate and satisfactory answers; identify any irregularities noted during the interview and ensure any irregularities are adequately explained and resolved; and
(7) to seek assistance from third parties and assess the qualification, work scope and results of third parties.[21]

[19] Code of Conduct, § 17.5(b).

[20] *Id.* § 17.5(c).

[21] *Id.* § 17.6.

A sponsor is permitted to assign specific due diligence to third party experts. However, the sponsor may not blindly rely on the experts' reports. In reaching its conclusion of the expert's report, Section 17.7 specifies that a sponsor should: (a) assess and examine the expert's qualification, (b) assess his work scope, (c) examine his material bases and assumptions, and (d) critically review the report.[22]

With these considerations in mind, the SFC notes that each listing application is unique, and what is reasonable in one context may or may not be reasonable in another.[23] Therefore, just as in the United States, there is no exclusive list of due diligence steps that would apply to all applications, and contextual considerations are of great importance in applying the standards of conduct.

The SFC also explained in its Consultation Conclusions that it does not intend to assess sponsor work from the perspective of hindsight, and the reasonableness should be determined based on "what a sponsor's peers would consider to be objectively appropriate having regard to all relevant facts and circumstances at the time of making a listing application."[24]

C. Practice Note 21

The Practice Note 21 requires a sponsor to conduct reasonable due diligence on the listing applicant to enable the sponsor to declare to the SEHK that the listing applicant has established procedures, systems, and controls (including accounting and management systems) which are sufficient in regard to the obligations of the listing applicant and its directors to comply with the Listing Rules and other relevant legal and regulatory requirements.[25] Similar to the Code of Conduct, the Practice Note 21 sets out specifically the SEHK's expectations of due diligence that a sponsor will typically perform, which include:

(1) typical due diligence inquiries in relation to the collective and individual experience, qualifications, competence, and integrity of the directors;
(2) typical due diligence inquiries in relation to the new applicant's compliance with the qualifications for listing;
(3) typical due diligence inquiries in relation to each new applicant and the preparation of its listing document and supporting information;
(4) typical due diligence inquiries in relation to the expert sections of the listing document; and
(5) typical due diligence inquiries in relation to the new applicant's accounting and management systems.[26]

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[22] *Id.* § 17.7.

[23] *See id.* § 17.6(h).

[24] *See* Consultation Conclusions, ¶ 106.

[25] Practice Note 21, ¶ 1.

[26] *Id.* ¶¶ 11-15.

Like in the Code of Conduct, the Practice Note 21 also specifically points out that reasonable due diligence should be made in the context and circumstances of each application.[27] The sponsor must exercise its judgment as to what investigations or steps are appropriate for a particular new applicant and the extent of each step.[28]

III. CRIMINAL LIABILITY

In its Consultation Conclusions, the SFC recommended that the current statutory liability provisions (i.e., civil liability under section 40 and criminal liability under Sections 40A and 342F of the Companies Ordinance) be amended to clarify that Sections 40 and 40A will apply to sponsors.[29]

Section 40A provides that if a prospectus includes any untrue statement, any person who has authorized the issue of such prospectus is subject to imprisonment and a fine unless he proves either the statement was immaterial or that he had reasonable grounds to believe, and did believe, at the time of the issue of the prospectus, that the statement was true.[30] The SFC also proposed in the Consultation Conclusions that the criminal liability provisions be amended so that the prosecution bears the burden of proving that: "(a) a person authorizing the issue of the prospectus knew that, or was reckless as to whether, a statement in the prospectus identified by the prosecution was untrue; and (b) the untrue statement was materially adverse from an investor's perspective."[31] Although the SFC further clarifies that the criminal liability would be directly applied to sponsor firms only, not any individuals,[32] an individual can be held liable under general criminal law principles if he or she aids and/or abets in the commission of the offence.[33]

Interestingly, the SFC appears to have withdrawn the proposal to amend the statutory liability provisions. On August 22, 2014, the SFC issued a "Supplemental Consultation Conclusions on the Regulation of IPO Sponsors – Prospectus Liability" that stated that the amendment proposal was unnecessary because a sponsor was already a person who authorizes

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[27] *See id.* ¶ 4.

[28] *See id.* ¶ 3.

[29] *See* Consultation Conclusions, ¶ 39.

[30] Companies (Winding Up and Miscellaneous Provisions) Ordinance, (2012) Cap. 32, § 40A (H.K.).

[31] Consultation Conclusions, ¶ 40.

[32] *Id.* ¶ 41.

[33] *See Sponsors in the Spotlight: a more stringent Hong Kong regulatory framework for due diligence in initial public offerings*, *supra* note 14.

the issue of a prospectus within the meaning of the ordinance.[34] The SFC reaffirmed the view that sponsors potentially could have criminal and civil liability under the existing provisions.[35] Moreover, it stressed that it had no hesitation in relying on the existing criminal liability provisions when considering whether to pursue criminal actions against sponsors in appropriate cases.[36]

Some commentators have expressed the belief that there was a legislative loophole with respect to sponsors' prospectus liability in the existing regulatory regime.[37] There is no case law ruling on whether the provisions apply to sponsors, which is one of the reasons why the amendment was originally proposed by the SFC.[38] Since the SFC withdrew its support for the amendment it had originally proposed, the relevant provisions will remain ambiguous regarding whether sponsors are subject to the liability.[39]

IV. SPONSOR'S GUIDELINES BY THE SPONSOR COMMUNITY

The Code of Conduct sets out the SFC's expectations of a sponsor's due diligence work, but it largely ignores the practical issue of how to satisfy the expected standard. In response to this situation, a number of investment banks, law firms, accounting firms, and other industry participants, came together to issue "Hong Kong Sponsor Due Diligence Guidelines" in September, 2013 (the "Due Diligence Guidelines").[40] The Due Diligence Guidelines contain over seven hundred fifty pages of materials intended to assist sponsors in achieving the quality of due diligence work expected by the SFC under the new sponsor's due diligence rule. While not binding, the Due Diligence Guidelines offer an important reference point for IPO sponsors. This is especially true given that a sponsor's due diligence effort is ultimately, according to the SFC's Consultation Conclusions, "based on what a sponsor's peers would consider objectively

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[34] *Supplemental Consultation Conclusions on the Regulation of IPO Sponsors – Prospectus Liability*, SECURITIES AND FUTURES COMMISSION (Aug. 22, 2014), ¶ 12, http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openConclusionAppendix?refNo=12CP1&appendix=0.

[35] *See id.*

[36] *See id.* ¶ 13.

[37] Yuen Sang Selina Pang, *Due Diligence Failure Because of Existing Legislative Loophole?*, HONG KONG COMPANY LAW (Oct. 29, 2014), http://hkcompanylawblog.com/2014/10/29/due-diligence-failure-because-of-existing-legislative-loophole/.

[38] *See* Consultation Conclusions, ¶ 39.

[39] *See* Pang, *supra* note 37.

[40] *Hong Kong Sponsor Due Diligence Guidelines* (Sept. 2013), http://duediligenceguidelines.com/publication/.

appropriate having regard to all relevant facts and circumstances at the time of making a listing application."[41]

V. OUTLOOK

It has been almost one and a half years since the new sponsor rules took effect on October 1, 2013. At the time the new rules were first proposed in 2012, the Hong Kong market was going through a challenging period, with substantially lower volumes in IPOs.[42] Industry insiders were concerned that the more restrictive new rules might result in companies choosing to list in other markets and that some investment banks might refuse to act as sponsors in order to avoid being subject to the new rules.[43]

However, these concerns appear to have been overstated. Based on the latest published data, the total number of listing applications submitted in 2014 was 165, which remained almost the same as in 2013, which was 160.[44] Total funds raised from IPOs in Hong Kong in 2014 were $29.3 billion.[45] It positioned Hong Kong as the second highest IPO market in the world, with only the United States ranking higher.[46] Moreover, the total funds raised from Hong Kong IPOs increased 34%, compared to 2013, which set the new record for the SEHK.[47]

While the full impact of the new sponsor rules remains to be seen, these statistics suggest that the new rules may not have a negative impact on the overall level of IPO activity in the Hong Kong market. Hopefully, as what the SFC expected at the time of proposing the amendment, the new sponsor regulatory regime will have the opposite effect, enduring though market cycles and helping to build a healthy pipeline of IPOs in the Hong Kong market.[48]

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[41] Consultation Conclusions, ¶ 106.

[42] *Id.* ¶ 14.

[43] *See* Moore, *supra* note 15.

[44] *Hong Kong IPO Market Update*, KPMG, (Dec. 2014), http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/Hong-Kong-IPO-Market-Update/Documents/HK-IPO-Market-Update-1412.pdf.

[45] Xinhua, *China mainland records 125 IPOs in 2014*, CHINA.ORG.CN (Jan. 2, 2015), http://www.china.org.cn/business/2015-01/02/content_34460554.htm.

[46] *Id.*

[47] *See id.*

[48] *See* Consultation Conclusions, ¶ 14.

Underwriter Due Diligence in the Modern Era:
An Overview of the Committee on Federal Regulation of Securities Report Regarding the Evolution of Due Diligence Investigations

Michael Walraven[1]

I. INTRODUCTION

In May 1993, the Committee on Federal Regulation of Securities[2] (the "Task Force") set forth a report analyzing how sellers' due diligence efforts have evolved over time since Congress initially provided certain defendants due diligence defenses in the Securities Act of 1933 (the "Securities Act").[3] Thus, the nature of these defenses and the policy and practical goals they originally aimed to achieve are not necessarily the same today as they were in the era before expedited offerings and shelf registrations.[4] This paper will summarize selected elements of the report of the Task Force and express the views of the author regarding how the interpretation and application of the due diligence defenses (as defined below) should be modified to properly reflect the modern market pressures and the customary practices and standards that affect an underwriter's due diligence efforts.[5]

II. BACKGROUND

The term "due diligence" is not defined (or even mentioned) in the Securities Act, but it has come to be commonly understood to refer collectively to the "reasonable investigation" defense of Section 11 and the "reasonable care" provisions of Section 12(a)(2) of the Act.[6] These portions of the Act offer certain defendants a defense against claims that the offering materials pursuant to which securities were sold contained material misstatements or omissions.[7] Note that

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[2] Committee on Federal Regulation of Securities, *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Law*, 48 BUS. LAW. 1185, 1185 (1993).
[3] 15 U.S.C. § 77a (2014).
[4] An "expedited offering" generally refers to those offerings that are quickly brought to the market by utilizing the shelf registration process. "Shelf registration" refers to the process by which issuers of securities file registration statements that cover several issues of the same security. Through its adoption of Rule 415, the SEC allows a corporation to comply with the registration requirements up to two years before a public offering of securities. The registration remains "on the shelf" and is updated regularly by annual, quarterly, and related reports filed with the SEC. When the conditions are favorable, the corporation can bring the securities to the market by using the pre-prepared registration document. Campbell R. Harvey, *Shelf Registration*, NASDAQ (2011), http://www.nasdaq.com/investing/glossary/s/shelf-registration.
[5] It is important to note that the findings of the Task Force are intended to apply to types of offerings where the seller's due diligence is a potential issue, except for (1) initial public offerings and (2) debt securities that are not investment grade.
[6] *See* Committee on Federal Regulation of Securities*, supra* note 2, at 1185 n.3.
[7] *Id.* at 1185.

the due diligence defense is not available to the issuer of the securities, but rather only to the underwriters and other third parties.

In general, Section 11 of the Securities Act provides a purchaser of a registered security with a remedy for damages stemming from material misstatements or omissions in offering documents.[8] The statute explicitly extends liability to the underwriters of such securities who are deemed strictly liable for any material misstatements or omissions, but who also enjoy the protections of the affirmative due diligence defenses.[9]

Section 12(a)(2) of the Securities Act (formerly, Section 12(2))[10] gives purchasers of securities the right to rescind the transaction if the purchaser can prove that the prospectus or oral communications used to sell the security contained material misstatements or omissions.[11] Section 12(a)(2) applies regardless of whether the security is registered. Thus in cases of non-registered securities, the plaintiff may be able to reach sellers who may not be sued under Section 11.[12] Congress enacted both of these sections in an effort to ensure that the "truth" is told to the investing public.[13]

Section 11 allows a defendant, other than the issuer, a defense if he can prove as to "non-expertized" materials that after a reasonable investigation and reasonable ground for belief, he did believe that "the statements therein were true" and "not materially false or misleading."[14] As to "expertized" material (such as audited financials, other financial statements, and the reports of subject matter experts, for example), the defendant can also avail himself of the due diligence defense (in this case, sometimes referred to as the "reliance defense") if he can prove that "he had no reasonable ground to believe and did not believe" that the statements were materially false or misleading,[15] and that "he did not know, and in the exercise of reasonable care could not have known, of such [alleged] untruth or omission."[16] Note that Section 12(a)(2) does not distinguish between "expertized" and "non-expertized" materials.[17]

Section 11(c) of the Securities Act originally stated that in determining "what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that of a person occupying a fiduciary relationship."[18] The reasonableness standard was amended in 1934 to be that of a "prudent [person] in the management of his own property."[19] Since this

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[8] *See* 15 U.S.C. § 77k (2014).
[9] *See id*.
[10] The Task Force report speaks in terms of Section 12(2), but for conformity and better understanding in the current temporal context, this paper will refer to that section as 12(a)(2) throughout.
[11] *See* 15 U.S.C. § 77l (a)(2) (2014).
[12] *See* Committee on Federal Regulation of Securities, *supra* note 2, at 1189.
[13] *See id.* at 1188.
[14] *See id.* at 1189; *see also* 15 U.S.C. § 77k(b)(3)(A) (2014).
[15] *See* Committee on Federal Regulation of Securities*, supra* note 2, at 1189; *see also* 15 U.S.C. § 77k(b)(3)(C) (2014).
[16] *See* Committee on Federal Regulation of Securities*, supra* note 2 at 1189; *see also* 15 U.S.C. § 77l(a)(2) (2014).
[17] *Id.*

[18] *See* Committee on Federal Regulation of Securities*, supra* note 2, at 1191.
[19] *See id.*

alteration in 1934, the statutory due diligence defenses have remained essentially unchanged.[20] However, significant developments in the securities markets, including the introduction of expedited offerings such as shelf takedowns, have affected underwriting practices, and introduced new elements of uncertainty regarding how these changes affect the determination of what constitutes a "reasonable investigation" under Section 11 and "reasonable care" under Section 12(a)(2). This paper explores this topic as viewed through the lense of the Task Force report.

III. MODERN DEVELOPMENTS AFFECTING TRADITIONAL UNDERWRITING AND UNDERWRITER DUE DILIGENCE PRACTICES

With respect to underwriter due diligence, the original premise of the Securities Act was that the underwriter was a "sponsor" of the issuing securities, and as such had a major influence on the content of the registration statement.[21] In theory, having the "seal of approval" of an underwriter was deemed a sufficient reason for issuers to cooperate with an underwriter's due diligence investigation of an offering.[22] Thus, underwriters historically were seen to play a crucial role in the development of the issuer's registration statement and to some extent to serve a confirmation and certification role with respect to the accuracy of the information set forth therein. In part, this line of reasoning derived from the fact that, during this earlier era, investors might not have had the same kind of ready access to rating agency data, financial press reports, and other "soft" information that is more accessible in the modern era.[23]

However, the traditional form of registration statement and the typically slow-paced preparation, filing and diligence process related thereto, began to change in the early 1970s when the Securities Exchange Commission ("SEC") introduced registration forms that permitted certain reporting companies to expedite the public offering of securities and to incorporate by reference into the related disclosure documents their public filings pursuant to the Securities Exchange Act of 1934 (the "Exchange Act").[24] In a further step in speeding the time to market for certain types of issuers, the SEC permitted registering securities "for the shelf," which led to the development of the "integrated disclosure system."[25] For example, in 1982, the SEC adopted Rule 415[26] which liberalized shelf registration of securities for some categories of issuers.[27]

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[20] *Id.* at 1190.
[21] *Id.* at 1199.
[22] *Id.*
[23] *Id.*
[24] *Id.* at 1200.
[25] *Id.* Prior to the adoption of the "integrated disclosure system" separate disclosure requirements existed under the Securities Act and the Exchange Act. This was burdensome for issuers because the requirements were often duplicative and overlapping. In 1966, Milton Cohen recommended the integration of the two disclosure regimes under the two statutes. In 1982, the SEC finally adopted the integrated disclosure system to eliminate the overlapping or duplicative disclosure requirements, thereby reducing the burden on registrants while still ensuring that the investing public is provided with adequate and meaningful information upon which to base investment decisions. SEC, Report on Review of Disclosure Requirements in Regulation S-K as Required by Section 108 of the Jumpstart Our Business Startups Act, 8-11 (Dec. 2013), *available at* http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf. For the complete history of the integrated disclosure system, *see id.* at 8-29.

As a result of these developments, "soft" information became more common in offering documents, and rating agencies began to play a more important role in the process.[28] As a result, many investors began to rely increasingly on this information in the course of making their investment decisions, and it became debatable whether the underwriter truly continued to act as a "sponsor" of the issuer's public offerings of securities.[29] The development of case law, the introduction of the integrated disclosure system, and the adoption of Rule 415 all had significant effects on due diligence investigations performed by underwriters which the Task Force sought, at least in part, to address.

A. Pressures to Settle and the Corresponding Dearth of Relevant Court Decisions Regarding Underwriter Due Diligence in the Modern Era

As an initial matter, it is important to note that the tendency for underwriter due diligence cases to settle prior to the entry of final rulings has created a dearth of case law on the topic.[30] In practical application, underwriters tend to have strong incentives to settle these suits, although the rationale for settlement may have less to do with the merits of a given case than with the lack of current judicial guidance and a desire to avoid the risk of unfavorable outcomes no matter how well-structured the underwriter's due diligence process and attendant execution.[31] As a result, a largely outdated and underdeveloped body of case law is forced to serve as one of the primary elements of guidance for underwriters and others conducting due diligence investigations in the era of expedited offerings and condensed due diligence timeframes.[32]

Although a number of older court opinions have offered some guidance on the constituent elements of a "reasonable investigation" and "reasonable care," a series of sometime divergent or only marginally enlightening rulings have left much confusion for underwriters regarding the proper scope of an underwriter's investigative duties under Sections 11 and 12(a)(2).[33] For example, in *Sanders v. John Nuveen & Co.*,[34] the purchasers of defaulted commercial paper sued

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[26] 17 C.F.R. § 230.415 (2015).
[27] Committee on Federal Regulation of Securities*, supra* note 2, at 1200.
[28] *Id.*
[29] *Id.*
[30] *Id.* at 1187.
[31] *Id.* at 1230. As a result, some commentators have raised doubts regarding the cost of underwriter due diligence and whether its benefits outweigh these costs. *Id.*
[32] *Id.* The Securities and Exchange Commission (in Rule 176, for example) and the Financial Industry and Regulatory Authority ("FINRA"), the self-regulating organization for underwriters, (in proposed but unadopted Release 73-17, for example) however has issued a number of proposed and adopted statements regarding underwriter due diligence practices, and a host of scholarly articles have been written on the topic. *See, e.g.*, GARY M. LAWRENCE, DUE DILIGENCE IN BUSINESS TRANSACTIONS (2014); GARY M. LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, (CADDS Scholars Press, 2nd ed. 2013).
[33] Committee on Federal Regulation of Securities*, supra* note 2, at 1194 (referring to the *Sanders v. John Nuveen & Co.* line of cases).
[34] *Sanders v. John Nuveeen & Co.*, 524 F.2d 1064 (7th Cir. 1975), *vacated and remanded on other grounds*, 425 U.S. 929 (1976), *on remand*, 554 F.2d 790 (7th Cir. 1977), *reh'g denied*, 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981).

the broker-dealer (in some respects the conceptual equivalent of an underwriter in public offering) who had marketed it.[35] The case ultimately focused on Section 12(a)(2) of the Securities Act, with the Seventh Circuit ruling that the broker-dealer failed to make a reasonable investigation of the issuer because it did not review the issuer's tax returns and accounting paperwork.[36] The defendant broker-dealer argued that the previous panel of judges had confused the "reasonable investigation" standard of Section 11 and the "reasonable care" standard of Section 12(a)(2), [37] arguing that in doing so, it had been held to a higher standard of reasonableness under Section 12(a)(2) than imposed in under Section 11.[38] In this case, the Seventh Circuit effectively held that it could not find a difference in the language reflecting on the standards of reasonableness under Section 11 and Section 12(a)(2).[39] The Court further suggested that it did not believe that it was clear that there was always a higher standard in Section 11 cases.[40] The Supreme Court denied *certiorari*.[41] The dissent by Justice Powell and Justice Rehnquist noted that the SEC argued that imposing the same degree of investigation of a registered and non-registered security would undermine the Congressional intent in distinguishing two due diligence defenses between Section 11 cases and Section 12(a)(2) cases.[42]

Unfortunately, the Sanders case is one of the few federal appellate cases regarding the precise nature and scope of the affirmative defense provided under Section 12(a)(2), leaving underwriters with little guidance regarding the degree of investigation required to meet the "reasonable care" standard of Section 12(a)(2).[43]

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[35] Committee on Federal Regulation of Securities*, supra* note 2, at 1194.
[36] *Id.* at 1195.
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.* Other authorities however have reached different conclusions regarding the standards of reasonableness in Sections 11 and 12(a)(2). For example, in *In re WorldCom*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004), the court held that the defense under Section 12(a)(2) is less demanding than the duty of due diligence imposed under Section 11. In addition, the SEC has held that Section 11 requires a more diligent investigation than Section 12(a)(2), but any of the due diligence practices considered favorably in Section 11 setting would also apply to a Section 12(a)(2) context. The Regulation of Securities Offerings, SEC Release No. 33-7606A, 63 Fed. Reg. 67174-01 Section IX.D (Dec. 4, 1998). Scholars have found that courts generally interpret Section 12's "reasonable care" defense as being comparable to Section 11's "reasonable investigation" defense. *See* LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, *supra* note 32.

[41] Committee on Federal Regulation of Securities*, supra* note 2, at 1195.

[42] *Id.*

[43] In *Davis v. Avco Financial Services, Inc.*, however, the Sixth Circuit set forth a number of contextual considerations relevant to an analysis of whether a defendant has established its "reasonable care" defense under Section 12. 739 F.2d 1057, 1068 (6th Cir. 1984). Although portions of *Davis* were overturned by *Pinter v. Dahl*, 486 U.S. 622 (1988), the Supreme Court did not expressly address or reject the contextual factors identified by the Sixth Circuit in the *Davis* case. They thus remain as guidance for understanding how subsequent courts may address the issue.

B. Enter the SEC Advisory Committee

In 1977, the SEC's Advisory Committee on Corporate Disclosure recommended that the SEC propose a rule enumerating the following circumstances that would be relevant in determining whether an underwriter had established a due diligence defense:

> (1) the type of registrant; (2) the type of defendant; (3) reasonable reliance on officers, employees and others whose duties should have given them knowledge of the particular facts; (4) the type of underwriting arrangement, the role of the particular defendant as an underwriter and *the accessibility to information with respect to the registrant* (emphasis added); and (5) whether, with respect to a fact or document incorporated by reference, the particular defendant had any responsibility for the fact or document at the time of the filing from which it was incorporated.[44]

While the SEC ultimately adopted the preponderance of the Advisory Committee's recommendations, it deleted the reference to "accessibility to information" stating its belief that the immediately preceding phrase regarding "the role of the particular defendant as an underwriter . . . . adequately recognize[d] the junior role of a non-managing underwriter without inviting undue dilution of his diligence responsibility.".[45]

In its proposed form, Rule 176 suggested that underwriters should develop and maintain "reservoirs of knowledge" about issuers which introduced the idea of conducting "continuous" or "cumulative" due diligence investigations.[46] The Rule also proposed to adopt the relevant circumstances in determining an underwriter's liability suggested by the Advisory Committee.[47] The then applicable investment banking industry group, the Security Industry Authority ("SIA"),[48] criticized this Rule arguing that continuous due diligence may not always be appropriate, that "all the surrounding circumstances" should be considered in determining an underwriter's liability not just those enumerated in the rule. Moreover, the SIA asserted that the

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[44] Committee on Federal Regulation of Securities*, supra* note 2, at 1201.

[45] *Id.* Tangentially, it is relevant to note that under longstanding custom and practice, junior underwriters rely on the due diligence of the lead underwriters for the benefit of the entire syndicate. *See, e.g.*, *Enhancing Investor Protection and the Regulation of the Securities Markets: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 75 (2009) (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School) [hereinafter "Enhancing Protection"] ("Each underwriter need not personally perform this investigation. It can be delegated to the managing underwriters and to counsel . . .).

[46] Committee on Federal Regulation of Securities*, supra* note 2, at 1204.

[47] *Id.*

[48] The Securities Industry Authority was a non-regulatory industry group for the securities industry generally. It was a predecessor to today's Securities Industry and Financial Markets Association ("SIFMA"). *See generally*, *History*, SIMFA, http://www.sifma.org/about/history/ (last visited Mar. 3, 2015).

SEC should not have deleted the reference to the underwriters' "accessibility to information" with respect to the issuer.[49]

When the SEC adopted the final version of Rule 176, it recognized that "there are other circumstances beyond those enumerated in the rule which may bear upon the reasonableness of the conduct of persons subject to Section 11."[50] It also stated that the continuous information-gathering technique in the proposed rule was not intended to be mandatory or exclusive.[51] Instead, the Commission asserted, the underwriter should be free to evaluate the surrounding circumstances of the issue and use the "techniques of investigation appropriate to the circumstances of the offering."[52] Lastly, the SEC defended why it removed the reference to "accessibility to information" from the Rule.[53] It argued that such reference could imply that an underwriter would be justified for not investigating if the issuer refused to grant access to information.[54] However, in adopting the final Rule, the SEC did include a general reference to information not being "available" (i.e., a target company withholding information).[55]

C. Condensing the Time for an Underwriter's Current Due Diligence: Rule 415 and the Concept of Shelf Registration

With the adoption of Rule 415, the SEC took a further step toward condensing the time available for an underwriter's current due diligence by approving shelf registration and its related system of integrated disclosure. The integrated disclosure regime allowed issuers to incorporate their Exchange Act fillings by reference into their securities offering documents. In practical application, this development reduced the time available to underwriters for the conduct of current due diligence and led to increasing concerns within the securities industry about an underwriter's ability to investigate the information contained in the offering documents, including those incorporated by reference. While shelf registration permitted faster offerings of securities (thus bringing the U.S. standards more in line with those adopted by other financial center countries[56]), underwriters understandably questioned whether adequate due diligence could be conducted in such an environment.[57]

In response, the SIA encouraged the SEC to enact a due diligence safe harbor provision for underwriters engaged in a shelf registration and to adopt a mandatory "cooling off period" before the offering could be brought to the market. However, the SEC rejected this proposal.[58] Instead, the SEC stated that it believed the new methods of "continuous" or cumulative due

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[49] Committee on Federal Regulation of Securities*, supra* note 2, at 1204.
[50] *Id.* at 1205.
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.; see also* 17 C.F.R. § 230.17 (2015).
[56] *See generally*, Michael J. Halloran and Richard Scudellari, *Securities Offerings Abroad by Domestic Issuers, Both Public and Private*, 6 INT'L TAX & BUS. LAW 262 (1988), *available at* http://scholarship.law.berkeley.edu/bjil/vol6/iss2/3.
[57] *See id.*
[58] Committee on Federal Regulation of Securities*, supra* note 2, at 1207.

diligence offered an adequate substitute for traditional due diligence.[59] The Commission went so far as to state its belief that in some cases the effectiveness of underwriter due diligence might be enhanced because of the new continuous investigation methods,[60] noting among other things that hiring a single law firm to serve as the underwriter's counsel and to hold "periodic due diligence sessions" on a quarterly and annual basis, might be part of this enhanced due diligence.[61]

In its press release regarding the adoption of Rule 415, the SEC did provide some comfort to underwriters. The Commission referred to Rule 176 and acknowledged that the due diligence techniques of those using short form registration would be different from "due diligence investigations under other circumstances."[62] Arguably, this provided some assurance that underwriters conducting due diligence of a shelf registration could use alternate means (such as continuous or cumulative due diligence) to fulfill their investigative obligations. However, at the same time, the Commission expressly noted that the standard for due diligence (that of a prudent person in the management of its own property) was unchanged.[63]

D. Underwriter Due Diligence in the Modern Era

Unquestionably, the nature of securities offerings and the means of fulfilling an underwriter's due diligence obligations have evolved since the initial enactment of the Securities Act. As the Task Force noted, underwriting firms no longer act simply as the primary underwriter of a traditional public offering. They now find themselves competing for roles in shelf takedowns where profit margins are compressed and the time available for current due diligence is short. This is especially true in the context of expedited offerings such as those involving shelf registrations where the time available for an underwriter's current due diligence is far more abbreviated than in the context of a "traditional" offering. Such transactions, by their very nature, are fast-paced, forcing underwriters to rely to an ever greater extent on the due diligence they conduct over time. Thus underwriters face even greater exposure to allegations that they failed to conduct a "reasonable" investigation (Section 11) or to act with "reasonable care" (Section 12(a)(2)).

The following section of this paper explores the broader dimensions of this dilemma by examining the underwriter situations expressly discussed by the Task Force and endeavors to offer insight into the contours of the "reasonable investigation" and "reasonable care" defenses in those specific contexts.

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[59] *Id.*

[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] In adopting the integrated disclosure system, the SEC noted that Rule 176 would identify *certain* circumstances bearing upon the "reasonableness" of a due diligence investigation under Section 11. While reference to Rule 176 indicated that cumulative due diligence would be a relevant factor in assessing whether a defendant conducted a "reasonable investigation," it was not intended to be a definitive list, and the Commission directly cited the reasonableness standard enumerated in Section 11 evidencing its continued applicability. *See* Shelf Registration, SEC Release No. 6499, 48 Fed. Reg. 52899-03 (Nov. 23, 1983); Adoption of the Integrated Disclosure System, SEC Release No. 33-6383 (Mar. 3, 1982).

E. The Contours of the Dilemma

In the context of shelf-registered takedowns, underwriters face two main challenges in establishing a due diligence defense under Section 11: (1) the opportunity to conduct current due diligence is limited due to the expedited timeline of the offering and (2) the fact that some issuer public filings, such as those made under the Exchange Act, may be incorporated by reference into the offering notwithstanding the fact that they may predate the underwriter's involvement and that the underwriter may have had no hand in their preparation.[64] In this regard, the Task Force examined the following three specific transactional contexts.

F. Shelf Takedowns of Debt Securities

First, the Task Force examined shelf takedowns of debt securities. In this context, the Task Force expressed its view that an underwriter for such an offering may only be able to review the issuer's Exchange Act filings, consult analyst reports, review rating agency reports, and assess the reputation of the issuer and its management.[65] Although cumulative or continuous due diligence may afford a more thorough investigation of the issuer, the Committee acknowledged that, realistically, current investigative procedures such as those mentioned above might define the entire scope of the current due diligence inquiry in the context of a shelf takedown of debt securities, and that absent the discovery of something of "extraordinary significance" further current due diligence might not be involved.[66]

The second issue the Task Force addressed in this context relates to the information incorporated by reference into the offering documents. According to the Task Force, the registration statement's effective date sets the reference point for liability under Section 11 of the Securities Act.[67] The responsibility of the issuer, directors, signing officers, and experts for subsequently filed and incorporated Exchange Act reports derives from Section 12(a)(2).[68] However, under Section 11(d), the liability of a firm that becomes underwriter after the effective date of the registration statement (as is typically the case in a shelf takedown) is measured from the time the firm becomes an underwriter.[69] In the case of a shelf takedown, this may be months or even years after the effective date of the registration statement.[70] As a result, underwriters are faced with having to determine with respect to which of these documents they are required to conduct due diligence in order for that diligence to be deemed part of a reasonable investigation or the exercise of reasonable care.

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[64] Committee on Federal Regulation of Securities, *supra* note 2, at 1223-24.
[65] *Id*.
[66] *Id.*
[67] *Id.* at 1224 ("Under Section 11, the liability of the issuer, directors, signing officers, and experts is measured as of the registration statement's effective date.").
[68] *Id.* ("Their responsibility with respect to subsequently filed and incorporated 1934 Act reports presumably is subject to Section 12[(a)](2)).
[69] *Id.*
[70] *Id.*

G. Medium Term Notes

The second transactional context addressed by the Task Force was medium term note ("MTN") programs involving the offering debt securities on a continuous basis.[71] In these settings, the Task Force noted, issuer-designated agents are usually hired to continuously offer the MTN securities through an electronic posting process.[72] As noted by the Task Force, when purchasing these securities, investors may be seen to be primarily concerned with the rating agency information, the issuer, and the yield of the investment.[73] In the view of the Task Force, MTN agents may be considered to be an underwriter for Section 11 purposes because of the role they serve in the offering process.[74]

The offering documents for MTN programs incorporate by reference many of the issuer's Exchange Act reports.[75] Thus, the prospectuses used in MTN programs may contain limited issuance specific information, such as the ratio of earning to fixed earnings. The balance of the offering documents may rely substantially or entirely upon the incorporated documents.[76] Due diligence investigations for MTNs are usually conducted by the agent's counsel and all agents.[77] Additional due diligence may be conducted when the prospectus is periodically updated (typically called a "ProSupp") or additional Exchange Act reports are incorporated by reference.[78]

The Task Force noted that MTN agents typically request the right to review the Exchange Act documents before they are filed, but they rarely have any influence over the contents of such documents.[79] Because of the continuous nature of MTN offerings, the agents are under substantial time pressure to conduct due diligence designed to confirm the adequacy of the issuer's disclosure.[80] Thus, MTN agents are often concerned about the degree of investigation they must perform in order to satisfy the requirements of a "reasonable investigation" and of "reasonable care."

H. Non-Underwritten Registered Equity Secondaries

The final transactional context explored by the Task Force was non-underwritten secondary issuances of equity securities. In these settings, issuers may request that their broker-dealers sell stock in the open market that has been registered under the Securities Act.[81] The Task Force noted that these broker-dealers may be considered statutory underwriters of these secondary offerings for Section 11 purposes.[82]

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[71] Committee on Federal Regulation of Securities, *supra* note 2, at 1224.
[72] *Id.* at 1225.
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.* at 1226.
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.* at 1228.
[82] *See id.*

Given the potential for liability under Section 11, the Task Force noted that the broker-dealer might reasonably be expected to conduct some form of due diligence beyond reviewing the Exchange Act reports.[83] However, many of the stockholders' agreements with issuers indemnify the selling stockholder and his broker from Securities Act liability arising from the issuer's prospectus.[84] Therefore, the broker-dealer's investigation of the issuer's disclosure, according to the Task Force, may consist of nothing more than checking with its research analysts to see if any unexpected surprises are likely to occur in the near future.[85] Just as with the two prior transactional contexts, broker-dealers in such secondary offerings have substantial uncertainty regarding the degree of investigation they must perform in order to satisfy the requirements of a "reasonable investigation" and of "reasonable care."

IV. THE RECOMMENDATIONS OF THE TASK FORCE

As the Task Force discussed in some detail in the sections noted above and through its report, the introduction of the integrated disclosure system and the expanded use of short-form registrations clearly have affected an underwriters' ability to conduct due diligence in modern underwriting transactions. As a result, there is substantial confusion regarding what procedures underwriters must follow in order to satisfy the "reasonable investigation" and "reasonable care" standards of the due diligence defenses. Thus, the Task Force acknowledged that strict time constraints undermine underwriters' ability to obtain and verify the accuracy of issuer's information through the traditional modality of current due diligence. The Task Force further acknowledged that the amount of information incorporated by reference in the registration statements further complicates the situation. Moreover, the Task Force suggested that underwriter due diligence arguably no longer serves the same historical purpose it once did because investors in modern transactions increasingly have access to and rely on independent information provided by rating agencies and other parties aside from the information diligenced by underwriters.

Accordingly, the Task Force set forth various factors that it recommended courts consider when evaluating an underwriter's due diligence in these transactional contexts. It is important to note that the Task Force recommendations were addressed only to the context of the three types of transactions discussed above: shelf takedowns, medium-term note program, and non-underwritten registered secondary stock distributions. But one might reasonably conclude that the observations made by the Task Force and the conclusions reached in those contexts may be fairly applied to other similar contexts.[86] These conclusions endeavored to reflect the changes in the scope and character of due diligence investigations and the evolved role of the underwriter in the modern securities market, and are summarized in the following section.

A. Task Force Conclusion I

In its first conclusion, the Task Force addressed the factors that a court should consider when evaluating due diligence under rule 176. The conclusion is directly quoted below:

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[83] *Id.* at 1229.
[84] *Id.*
[85] *Id.*
[86] *See id.* at 1240.

A court should regard the references in rule 176 to the "type of issuer," the "type of security,"" reasonable reliance," "the type of underwriting arrangement," and the "availability of information" as including, as "relevant" to the "reasonableness" of an investigation by an underwriter, the following circumstances (in addition to those specifically enumerated in rule 176):

(1) The degree to which the anticipated results of a particular investigative procedure are likely, in view of such factors as the size and financial strength of the issuer, to result in a material change in the issuer's disclosure documents.

(2) The degree to which relevant investors rely on a rating assigned to the underwritten securities by an independent rating agency.

(3) The degree to which such investors rely on the underwriter or agent for arriving at an independent credit judgment or a view on the accuracy of the issuer's disclosure, as evidenced in part by whether or not the securities are sold in transactions resembling secondary trading transactions.

(4) The degree to which relevant investors have independent access to information and credit judgments about the issuer that are of a comparable degree of reliability to those to which the underwriter or agent has access.

(5) The time available for investigation in connection with a transaction, whether it was reasonable under the circumstances for the underwriter to proceed and the use made by the underwriter of the available time.

(6) The economic resources reasonably anticipated by the underwriter or agent to be available for due diligence purposes as a result of the transaction.[87]

B. Task Force Conclusion II

Second, the Task Force proposed that a court should regard the due diligence procedures described in this paper regarding shelf takedowns, MTN offerings, and non-underwritten registered secondary stock offerings as appropriate to the particular circumstances of those transactions (that is, the context).[88] However, such a presumption would not prohibit a court from concluding that the procedures were improperly or inadequately applied under particular facts of a transaction (that is, the execution of the process).[89] Nor would it prohibit a court from concluding that such procedures did not constitute reasonable investigation or reasonable care under the circumstances of a given transaction.[90]

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[87] *Id.*
[88] *Id.* at 1241.
[89] *Id.*
[90] *Id.*

C. Task Force Conclusion III

In the context of a multi-part shelf registration that has been updated on one or more occasions, the Task Force stated that a court should consider the fact that there is no SEC requirement "that all information in the registration statement be updated as of the offering date of a particular securities transaction."[91] Accordingly, it asserted that the court should "assess the accuracy and completeness of the registration statement" including the "reasonableness" of the underwriter's due diligence efforts by considering the "'total mix' of information presented by the registration statement as of such offering date."[92]

D. Task Force Conclusion IV

The Task Force also recommended that a court should find that the degree of reasonableness under Section 12(2) is a lesser standard than that required by Section 11.[93] It also stated that when determining whether a disclosure deficiency could have become known to an underwriter under Section 12(2), the underwriter should be entitled by a court to the same presumptions regarding expertized materials that are afforded under a Section 11 case.[94] In addition, the Task Force recommended that a court should consider the "relevant circumstances" enumerated in rule 176 as well as the circumstances listed in "Conclusion I" above as equally relevant under Section 12(2).[95]

E. Task Force Conclusion V

In its final conclusion, the Task Force asserted that the SEC should amend rule 176 to include the recommendations made in "Conclusion I" above, or pending such action, appear as *amicus curiae* to urge a court to accept such recommendations under Section 11 litigation.[96] It also declared that the SEC should prepare recommendations to amend the Securities Act to accomplish the same objective.[97]

V. CONCLUSION

The recommendations set forth by the Task Force serve as instructive tools for those firms and agents subject to underwriter liability under the Securities Act. Prior to the Task Force report discussed in this paper, the transactional developments in the modern era and the correspondingly required due diligence efforts to establish a "reasonable investigation" or "reasonable care" under

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[91] *Id*.
[92] *Id*.
[93] *Id.* Note the discussion in *supra* section, "Pressures to Settle…," at 6, discussing the contrary view held by some authorities that Section 12(a)(2) imposes a higher standard of reasonableness than that required under Section 11; *see also* LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, *supra* note 32, illustrating that other authorities have held the standards to be similar.
[94] Committee on Federal Regulation of Securities, *supra* note 2, at 1241.
[95] *Id.*
[96] *Id.*
[97] *Id.*

the Securities Act in such contexts had remained unaddressed. While the Task Force report is written as a recommendation for courts to consider when evaluating the reasonableness of a due diligence investigation, it too serves as a fundamental guide for those subject to liability under Sections 11 and 12(a)(2) of the Securities Act by enumerating those practices such as cumulative due diligence and other factors that, taken in light of the circumstances, may establish the reasonableness standard of a due diligence defense. Although the Task Force conclusions are not mandatory authority upon courts, the unique nature and original subject matter of the report will certainly be persuasive because it is one of the first comprehensive evaluations of the customary due diligence practices and standards in the context of modern transactions. In the face of those who criticize underwriters for no longer conducting proper due diligence in the modern context, the Task Force report and its critical conclusions consider the evolving market pressures on underwriters and serve as a valuable weapon for those faced with such allegations.

Outside Directors: A Review of the Due Diligence Defense Under Section 11 of the Securities Act of 1933

Nataly V. Elberg[1]

Under Section 11 of the Securities Act of 1933 (the "Securities Act")[2], an issuer of securities is strictly liable for material misstatements or omissions in the registration statement and has no defenses to that liability.[3] Section 11 does, however, provide an affirmative "due diligence"[4] defense to various enumerated defendants,[5] including officers who sign the registration statement, inside and outside directors, underwriters, and accountants.[6] This paper explores the due diligence defense under Section 11 as it applies to outside directors.[7]

I. INTRODUCTION

Section 11(b) of the Securities Act provides an affirmative defense to a defendant (other than the issuer), who can sustain his burden of proof,

> (3) that (A) 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 belief 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 . . . [and] (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) . . . he had no reasonable ground to believe and did not 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 therein or necessary to make the statements therein not misleading.[8]

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1 J.D. Candidate, Southern Methodist University Dedman School of Law, 2015; Bachelor of Law with Honors, Institute of the Ministry of the Interior of Russian Federation (1998).

2 15 U.S.C. § 77k (2006).

3 *See id.* § 77k(b) (providing affirmative defenses to Section 11 defendants "other than the issuer").

4 Interestingly, the Securities Act neither uses nor defines the words "due diligence." However, in the eight decades since adoption of the Act, the term has come into common usage and is regularly employed by courts, regulators, self-regulating organizations, trade groups, scholars, and others.

5 *See* 15 U.S.C. § 77k(b).

6 *Id.* §§ 77k(a)(1)-(5).

7 There is also a due diligence defense under Section 12(a)(2) of the Securities Act, but that defense is not addressed in this paper.

8 15 U.S.C. § 77k(b).

For purposes of establishing the defense, Section 11 defines the standard for "what constitutes reasonable investigation and reasonable ground for belief" as "that required of a prudent [person] in the management of his [or her] own property."[9] In addition, "[t]he defense is calibrated to the objective reasonable person in each defendant's position."[10]

The due diligence defense is an important weapon in the arsenal of defendants in a lawsuit alleging violations of Section 11 as a result of material misstatements or omissions in the offering documents associated with a securities offering. As such, it is commonly relied upon by various parties, including outside directors. Indeed, this defense is used so commonly that lack of due diligence is sometimes erroneously considered to be an element of a Section 11 action.

To assert the due diligence successfully, an outside director must demonstrate that he had no reasonable ground to believe, and in fact did not believe, that any untrue statements or omissions of material facts were made in the registration statement.[11] In the context of an officer or outside director, the standard is considered by some commentators to be more exacting than the ordinary "reasonable person" standard for negligent actions.[12] The basis of this line of reasoning appears to be that they deem the Section 11 standard to impose an elevated "reasonable prudent director or officer"[13] standard that implies the expected level of sophistication of directors and officers of similarly situated entities.

Although under its express terms, the Section 11 due diligence defense and its standard of reasonable prudence applies to all directors and officers, the standard is more merciful toward outside directors who by definition are not involved in the day-to-day operations of the issuer.[14] Conversely, courts and other authoritative sources have consistently held that inside directors must meet a higher standard of conduct than outside directors in order to meet the burden of proof.[15]

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[9] *Id.* § 77k(c).

[10] *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1174 (C.D. Cal. 2008).

[11] *See* 15 U.S.C. § 77k(b)(3).

[12] Though this issue is by no means settled, and the prevailing view of the applicable standard for the Section 12(a)(2) due diligence defense is one of negligence. *See, e.g.*, GARY M. LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, 89-90 (CADDS Scholars Press, 2nd ed. 2013).

[13] 15 U.S.C. § 77k(b)(3).

[14] *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

[15] *See* Richard A. Spehr, Joseph De Simone, Andrew J. Calica, *Securities Act Section 11: A Primer and Update of Recent Trends*, WASHINGTON LEGAL FOUNDATION, CONTEMPORARY LEGAL NOTE SERIES, 49, 12 (Jan. 2006); *see also Laven v. Flanagan*, 695 F. Supp. 800, 812 (D.N.J. 1988) (outside directors have "lesser obligation to conduct a painstaking investigation than an inside director with intimate knowledge of the corporation"). The SEC's Rule 176 also implies a higher standard of care for inside directors. 17 C.F.R. § 230.176 (last amended 1982). Tangentially, subject to some conditions, directors who resign their positions may also be exempt from liability. *See* 15 U.S.C. § 77k(b)(1). In addition, an outside director may avoid availability if the challenged portion of the offering documents became effective without his knowledge and, once the director became aware, he advises the SEC and the general public of this occurrence. *Id*. § 77k(b)(2). However, a New York district court in 1968 recognized in the *BarChris* case that a case-by-case approach was necessary when making a due diligence inquiry since not all directors will be equally involved in a corporation business. This court adopted a flexible approach: what constitutes reasonable due diligence depends largely on the degree of the

II. ACCESS TO ISSUER INFORMATION

Interestingly, Congress instructed the SEC to create a legal definition of the terms "outside director" and "inside director" for purposes of Section 11. However, to date, this mandate has been ignored by the Commission and the terms remain undefined.[16] But this situation is not particularly problematic for due diligence scholars and practitioners since the meaning of these words is not typically in controversy. An outside director is generally understood to be a member of the issuer's board of directors, who is not affiliated with the corporation (that is, neither a current officer nor employee). As such, the outside director commonly is relatively "remote" from day-to-day corporate affairs (that is, dependent on management for information, and excluded from decision-making).[17] There is, though, a hybrid type of outside director—one unaffiliated with management, yet active in corporate affairs. This type of an outside director may experience greater difficulty in asserting the due diligence defense because he may be deemed to have access to substantial amounts of non-public information about an issuer.[18]

Another hybrid type of an outside director is the director who sits on an important committee of the board and as a result has access to considerable information about the issues governed by his committee.[19] This state of affairs may lead courts to conclude that such an "active outsider" is in a better position to be exposed to information affecting the material accuracy and completeness of statements made in the offering documents. As a result, such directors may find themselves facing additional hurtles to successfully asserting the due diligence defense under Section 11.[20] In essence, more information an outside director receives as a result of additional roles he has with the issuer, the more likely a court will find that he was in position to know of or learn about the alleged material misstatements or omissions.

In summary, there are no definitive checklists regarding what additional roles might lead a court to conclude that an outside director had enhanced access to relevant information nor are there any "black and white" rules regarding the conduct of due diligence by outside directors in the context of a securities offering. However, some insight into these issues may be gained from a review of relevant case law, the topic to which we now turn.

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defendant's involvement in the preparation of the defective registration statement. *See Escott*, 283 F. Supp. at 684-701 (applying a case-by-case approach to the due diligence defense asserted by each of the defendants).

[16] William K. Sjostrom, Jr., *The due diligence defense under Section 11 of the Securities Act of 1933*, BRANDEIS L.J. 44, 549 n.193 (2006).

[17] Karmel, *Realizing the Dream of William O. Douglas – The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DELAWARE J. OF CORP. LAW 79, 134-35 (2005).

[18] *See* David S. Hammer, *Protecting the Outside Director: The Red Flag Review*, VC EXPERTS BLOG (July 1, 2005), https://vcexperts.com/buzz_articles/354.

[19] *Id.*

[20] *Id.*

III. SUCCESSFUL DUE DILIGENCE DEFENSE FOR OUTSIDE DIRECTORS UNDER SECTION 11.

A. Laven v. Flanagan

In *Laven v. Flanagan*, shareholders brought suit against the issuer, (the largest shareholder of a telecommunications corporation's stock) and company officers and directors alleging, among others, violations of Securities Act.[21] Three outside directors were among those named as defendants.[22]

In this case, plaintiffs purchased Western Union Corporation preferred stock in a public offering.[23] Plaintiffs alleged that the prospectus for the offering contained misstatements and omissions of material facts.[24] The outside directors moved for summary judgment asserting the due diligence defense.[25] As noted above, in order to prove the defense, the directors were required to establish that they acted reasonably in the context.[26] To this end, the outside directors asserted that they had carefully reviewed the prospectus and in so doing that they had relied on the issuer's audited financials, the independent investigation of the issuer by the underwriters of the offering, and the assurances of the issuer's management.[27]

The court found that "[t]heir reliance on the representations of [issuer's] management cannot be characterized as unreasonable, particularly when it was confirmed by the investigations of [the auditors] and [the underwriters]."[28] The court reasoned that the outside directors "actively worked to bring their knowledge of [the issuer's] activities up to speed in the [approximately eight] months between their accession to the [issuer's] board and the . . . offering."[29] In the court's view, the outside directors put forth a reasonable effort to seek verification of the material accuracy and completeness of the registration statement.[30]

In conclusion, the court determined that the "activities [of the outside directors] were a far cry from the passive and total reliance on company management that defeated the due diligence defense in [*BarChris*]."[31] Moreover, the court noted that outside directors are under "lesser obligation to conduct a painstaking investigation than an inside director with intimate knowledge of the corporation."[32] Accordingly, the court decided that the outside directors had

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[21] *Laven*, 695 F. Supp. 800.
[22] *Id.* at 804.
[23] *Id.* at 803.
[24] *Id.*
[25] *Id.* at 805-06.
[26] *See* discussion *infra* at 2; 15 U.S.C. § 77k(b)(3)(A), (c) (reasonableness, not perfection, is the applicable standard).
[27] *Laven*, 695 F. Supp. at 811.
[28] *Id.* at 812.
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*; *see also* JOHN ARNHOLZ, OFFERINGS OF ASSET-BACKED SECURITIES § 7.05(B) (Walters Kluwer, 2nd ed., 2014 Supplement).

satisfied the requirements of the due diligence defense, even though their due diligence had not been perfect.[33]

In summary, *Laven* stands for the principle that outside directors, having a limited role in the company, can satisfy their due diligence defenses by doing what outside directors typically do – attend board meetings, review and understand company financials, and rely on the representations by the various parties who are intimately involved in company affairs.

B. In re: Avant-Garde Computing Inc. Securities Litigation

Registration statements typically have two constituent parts – general information and information that is included on the authority of an expert. These two parts are typically referred to, respectively, as non-expertised material and expertised material. In assessing the relative merits of a defendant's assertion of the affirmative due diligence defense, both Section 11 and the courts differentiate the expertised and non-expertised portions of the registration statement.[34] The expertised parts are prepared by experts, for instance, financial statements prepared by certified public accountants, and may, in the absence of red flags, properly be relied upon by parties asserting the due diligence defense.[35] If directors are found not to have known or have had reason to know that there were inaccuracies in the expertised portions of the offering documents, they may rely on the expert's portion (this is commonly referred to as the "reliance defense," a sub-category of the more general due diligence defense).[36]

In 1989, the Federal District Court for the District of New Jersey granted summary judgment to an outside director in *In re Avant-Garde Computing Inc. Sec. Litig.*[37] In that case, the plaintiff class was represented by the executors of the estate of an individual who purchased 200 shares of Avant–Garde stock during its initial public offering ("IPO") at $16.00 per share.[38] Approximately one and one-half years following the IPO, the value of the Avant–Garde stock began to decline. Subsequently, in August 1989, defendant Avant–Garde filed for bankruptcy.[39]

The thrust of plaintiff's complaint was that Avant–Garde sold its stock at an inflated price and concealed critical, relevant information about Avant–Garde's financial health, or lack thereof, in the prospectus, and in the period following the public offering.[40] Specifically, plaintiffs contended that when Avant–Garde changed the terms of one agreement to list certain transactions as "sales," instead of "leases," and allegedly shopped for a new accounting firm to approve the change in accounting methodology, Avant–Garde reported inaccurate sales and income.[41] Plaintiffs alleged that had Avant–Garde not taken this action, Avant–Garde could not have offered its stock at $16.00/share, and perhaps could not have gone public at all.[42] Plaintiffs

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[33] *Id.*
[34] *See* 15 U.S.C. § 11k(b)(3); *see also* LAWRENCE, *supra* note 12, at 55.
[35] *See* LAWRENCE, *supra* note 12, at 55.
[36] *Id.*
[37] *In re Avant-Garde Computing Inc. Sec. Litig.*, No. CIV. 85-4149(AET), 1989 WL 103625, *1 (D.N.J. Sept. 5, 1989).
[38] *See id* at *1.
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*

also alleged that Palmer, an outside director who signed Avant-Garde registration statement, conspired with Avant-Garde shareholders to induce the public to purchase shares at artificially inflated prices.[43]

The defendants contended that the sales accounting treatment of Avant–Garde transactions was correct as a matter of law and that the prospectus and registration statement contained all necessary disclosures, included those made on the authority of the accounting experts.[44] Defendants further contended that the decline in value in Avant–Garde stock was caused by a general market decline in value of high-tech stock, not by the factors alleged by plaintiffs.[45]

Defendant Palmer, who had joined the board as an outside director approximately three months before the company's initial public offering (and had resigned five months after the offering), was successful in establishing a due diligence defense by proving that he had, among other things: "(2) participated in four board meetings prior to the offering, and had several independent conversations with other board members in which the proposed public offering was discussed, he was aware that Avant-Garde's outside accountants had examined its financial statements and found they conformed with GAAP; . . . (4) he was told that Avant-Garde's financial statements were examined by the accounting firm that found that these statements were in conformity with generally accepted accounting principles; (5) he received and reviewed a draft preliminary prospectus, the filed preliminary prospectus, and the final prospectus; (6) to assure himself that, as an outside director, he understood the company's business, he interviewed company personnel, including members of senior management, inquired into the company's organizational structure, marketing programs, advertising plans, sales force, field service, product development, hardware and software engineering capabilities, product documentation, production methods, and financial controls; he concluded that [the company] was well positioned for future growth and believed that the prospectus accurately described the company's business and affairs.[46]

Invoking the due diligence defense, Palmer stated that, under Section 11, as an outside director, he was entitled to rely and did rely on the prospectus, prepared by the experts.[47] He also argued that he knew that the financial statements were audited, believed them to be correct, and had no reasonable ground to believe and did not believe that the financial statements were misleading.[48]

According to the court, plaintiffs' assertion of what the director knew and when he knew it under those circumstances was "completely speculative" and inadequate to rebut his assertion of the due diligence defense.[49] The court held that the outside director had established the requisite elements of the defense by reasonable reliance on the "conducting a reasonable investigation at the time of the filing and had no reason to doubt the accuracy of the registration statement."[50]

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43 *See id.* at *7.
44 *Id.* at *8.
45 *Id.* at *7.
46 *Id.* at *8.
47 *Id.*
48 *Id.*
49 *Id.* at *9.
50 *Id.* at *10; *see also* ARNHOLZ, *supra* note 32.

The court's decision was also based on the notion that the plaintiffs had "not come forward with anything substantial to rebut the defendant's sworn statement."[51] Consequently, this case showed that if an outside director conducts a proactive inquiry before the issuance of the securities, the due diligence defense is available for him even when material omissions were later uncovered.

C. Weinberger v. Jackson

In another relevant case, this time from 1990, the Federal District Court for the Northern District of California in *Weinberger v. Jackson*[52] endeavored to formulate a list of due diligence defense elements for outside directors.[53] Moreover, the court sought to shed further light on an outside director's due diligence defense by defining "investigation" for purposes of Section 11 as requiring a showing that the defendant received or sought out information of reasonable scope and from reasonable sources, not a showing of forensic or detective work.[54]

In this case, plaintiffs asserted that the issuer had made a misrepresentation to the brokerage community by projecting that the issuer would have gross revenue of eighty-five million dollars to ninety million dollars for fiscal year 1983, although shortly before and shortly after the public offering defendants were aware that the issuer would not meet the earnings projection.[55] Indeed, it turned out that the issuer's actual gross revenue for the year in question was seventy-five million dollars, short of the projection shared with potential investors.[56] Moreover, plaintiffs asserted that the issuer's statements that its revenue had doubled each year from 1978 to 1982 was inaccurate. With respect to the outside director Valentine, plaintiffs asserted that he had failed to "make specific inquiries of the company's management with respect to the representations contained in the prospectus."[57]

Valentine, moved for summary judgment based on the due diligence defense.[58] Finding that there were no genuine issues of material fact to be considered and that the elements of the affirmative defense had been established, the court granted the motion.[59] Among other things, the court stated that as "an outside director, he was not obliged to conduct an independent investigation into the accuracy of all the statements contained in the registration statement."[60] Specifically, the court reasoned that an outside director had no duty to make specific inquiries of the company's management with respect to the representations contained in the prospectus "as long as the prospectus statements were consistent with the knowledge of the company which he had reasonably acquired in his position as director."[61] The court also emphasized the relevance

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[51] *In re Avant-Garde*, 1989 WL 103625 at *9.
[52] *Weinberger v. Jackson*, No. C-89-2301-CAL, 1990 WL 260676, at *4 (N.D. Cal. Oct. 11, 1990).
[53] *Id.*
[54] *Id.* at *10.
[55] *See id.* at *1.
[56] *See id.*
[57] *Id.* at *4.
[58] *Id.* at *2.
[59] *See id.*
[60] *Id.*
[61] *Id.*

of the fact that the investigation of the issuer had been conducted primarily by experienced managing underwriters, assisted by attorneys and accountants, and that none had raised any issues regarding the material accuracy or completeness of the offering documents.[62]

In an ostensible effort to provide guidance regarding some of the constituent elements of a reasonable investigation, the court noted that Valentine had established that he "was reasonably familiar with the company's business and operations,"[63] and that he "regularly attended board meetings at which the board discussed every aspect of the company's business."[64] Moreover, he had "reviewed the company's financial statements"[65] and "six drafts of the registration statement and saw nothing suspicious or inconsistent with the knowledge that he had acquired as a director."[66] He also "discussed certain aspects of the challenged statements with management."[67] Valentine also established that he was "given comfort by the fact that the prospectus and the information in it were reviewed by underwriters, counsel and accountants."[68] Ultimately, he did not find anything in the registration statement that was "inconsistent with the knowledge he had acquired as a director."[69]

In addition to offering specific examples of the kinds of actions and activities outside directors could use to support their assertion of the due diligence defense, the court also made clear that an outside director may rely "upon the reasonable representations of management, if his own conduct and level of inquiry were reasonable under the circumstances."[70] With respect to such reliance, the court stated that an outside director is not obliged to conduct an independent investigation into the accuracy of all the statements contained in the registration statement and had no duty to "make specific representation and warranty related inquiries of management" as long as the prospectus statements were consistent with the knowledge of the company which he had reasonably acquired in his position as director.[71]

IV. FAILURE OF OUTSIDE DIRECTORS TO SUCCESSFULLY INVOKE THE DUE DILIGENCE DEFENSE UNDER SECTION 11

A. In re: Enron Corp. Securities, Derivative and ERISA Litigation

In 2001, in a much-publicized and subsequently much analyzed case, Enron announced the restatement of its financial statements for the five year period from 1997 to 2001, and shortly thereafter filed for bankruptcy.[72] A number of securities class action suits followed naming a host of defendants that included Enron's outside directors as well as its senior executives, Enron's auditor Arthur Andersen, various investment and commercial banks, and others. Total

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[62] *Id.* at *3.
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 258 F. Supp. 2d 576, 638 (S.D. Tex. 2003).

damages claimed amounted to approximately $25 billion.[73] Plaintiffs argued that Enron had conducted "'an enormous Ponzi scheme, the largest in history,' involving illusory profits generated by phony, non-arm's-length transactions with Enron – controlled entities and improper accounting [tricks]" and that the offering documents associated with Enron's securities offerings had contained material misstatements and omissions.[74]

The outside directors asserted the due diligence defense, including the reliance defense, mentioned above,[75] claiming that they had conducted a reasonable investigation in connection with the securities offerings in question and had reasonably relied on the expert due diligence, statements audit opinions and certifications of Enron's independent auditor.[76] Moreover, they maintained that they had no reason to question its expertised documents.[77] They insisted the claim under Section 11 should be dismissed because the plaintiff failed to plead reliance.[78] The court concurred with the outside directors regarding this element and accordingly dismissed those claims.[79]

The issue before the court at summary judgment was whether the outside directors had reasonably relied on the opinion of an expert under Section 11(b)(3)(C) of the Securities Act.[80] In addressing this issue, the court noted that Arthur Anderson, Enron's auditor, had a history of improper conduct and was "a repeat offender with history of failed audits, conflicts of interest and document destruction in some of the most egregious cases of accounting fraud in history."[81] In particular, the court noted that Andersen had previously provided accounting services to some companies that "had received substantial negative coverage by the media and in all probability [that fact] would have been known to the educated individuals who constituted the outside directors."[82]

Turning to the specific issue of whether the outside directors' reliance had been reasonable, the court stated that "reasonableness in this context in not a question properly resolved on a motion to dismiss,"[83] and noted that "[d]ue diligence in response to a [Section] 11 claim 'is an affirmative defense that must be . . . proved.'"[84] Consequently, the court held that whether the defendant outside directors had established the affirmative defense could not be determined in a motion to dismiss.[85]

In response to this ruling, ten of Enron's former outside directors settled with the lead plaintiff. The agreement ultimately provided that the outside directors would pay $13 million out

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[73] *Id.*
[74] BUSINESS ORGANIZATIONS, CASENOTE LEGAL BRIEFS, 136 (Aspen Publishers, 6th ed., 2008) (summarizing facts of the case *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002)); *Enron*, 258 F. Supp. 2d at 595.
[75] *See* discussion *infra* at 6.
[76] *Enron*, 258 F. Supp. 2d at 623, 639.
[77] *Id.* at 639.
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.* at 640.
[83] *Id.* at 597 (*quoting Griffin v. Paine Webber Inc.*, 84 F. Supp. 2d 508, 513 (S.D.N.Y.)).
[84] *Id.* (*quoting Lane Star Ladies Inv. Club v. Schlotsky's Inc.*, 238 F. 3d 363, 369 (5th Cir. 2001)).
[85] *Id.*

of their own pockets.[86] These payments approximated ten percent of the proceeds the directors had received from selling Enron shares at the time when the company's share price was allegedly fraudulently inflated.[87]

Significantly, the Enron directors' settlement does not set new legal precedents nor does it alter the scope of the due diligence defense generally or the reliance defense specifically. The settlement is an agreement among the parties, not a judicial determination.[88]

V. CONCLUSION

As demonstrated by the cases and other material reviewed and cited in this article, outside directors have neither the responsibilities nor the knowledge of management or of inside directors regarding the issuer's business and the corresponding disclosures made offering documents. But beyond that general principle, the waters of this issue are murky. The due diligence defense as applied to outside directors (or anyone else, for that matter) is never black and white. Different contexts present different issues and different courts may focus on different aspects of a director's conduct. And, outside directors are individuals not automatons. As such, each will inevitably have his own preferred means of receiving, analyzing and digesting information. Some might look through every page of reports and presentations, while others prefer to focus on the executive summary and on particular pages. Some might have asked more questions than others." The cases discussed above highlight that outside director due diligence is not a one-size-fits-all proposition and that context, in all its various dimensions, is an essential element in deciding the issue of whether or not a director has established the reasonableness (not perfection) of his efforts.

But there are a number of things an outside director can do to increase the chances that he will be deemed to have conducted a reasonable investigation with respect to an offering of securities and therefore successfully and rightfully assert the due diligence defense under Section 11 of the Securities Act. These include relatively simple things such as attending and participating in board and committee meetings; asking questions of management about key policies and practices, the state of the business, and unusual developments; and securing copies of and reviewing at some level the offering materials. But they also include more nuanced matters where each outside director will have to make his own judgments about what specific actions to take and how deeply to probe. These may include what records to create (such as personal notes) and whether to retain all or only some of them. As to these matters, each director must use his best judgment measured against the standard of a reasonable person in a similar context would have done in the management of his own property, then proceed accordingly.

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[86] Kurt Eichenwald, *Ex-Directors of Enron To Chip in on Settlement*, N.Y. TIMES, Jan. 8, 2005, at C1, *also available at* http://www.nytimes.com/2005/01/08/business/08enron.html?_r=0.

[87] *Id.*

[88] *The WorldCom and Enron Settlements: Imposing Personal Liability on Public Company Directors*, PILLSBURY WINTHROP LLP CLIENT ALERT (Jan. 20, 2005), https://www.pillsburylaw.com/siteFiles/Publications/C66D1981A7EF943E86EC10699D7F5219.pdf.

Attorney Due Diligence: Potential "Seller" Liability under Section 12(a)(2) of the Securities Act:
A Comparison of *Marshall v. Quinn-L Equities* and *In re Professional Financial Management, Ltd.*

Amy Estes[1]

While attorneys typically conduct due diligence and play other significant roles in public offerings of securities, they are not typically "seller" targets for liability under Section 12 of the Securities Act of 1933. However, this general truth is not an absolute.[2]

Section 12(a)(2) (formerly Section 12(2)) states that any person who "offers or sells a security" by means of a materially false or misleading prospectus or oral communication shall be liable to the purchaser for rescission or damages.[3] Subsequent judicial interpretations of the provision in the context of attorneys conducting due diligence and playing other roles in securities offerings have determined that an attorney who goes beyond merely performing professional services and steps into the realm of soliciting a security, motivated at least in part by financial interests, may be a "seller" and therefore exposed to potential "seller" liability under 12(a)(2).[4]

But when does an attorney's actions constitute solicitation for financial motivation? A comparison of *Marshall v. Quinn-L Equities, Inc.*[5] and *In re Professional Financial Management, Ltd.*[6] illustrates the different factors courts consider in answering this question.

I. FACTUAL AND PROCEDURAL BACKGROUND

Marshall involved twenty-six limited partnerships which were formed for the purpose of engaging in the acquisition, development, and management of commercial real estate properties located in Texas, Louisiana, and Tennessee.[7] The disgruntled investors of these limited partnerships alleged that the defendants, including the law firm, Jones Walker, which represented the issuer, were involved in a comprehensive scheme to defraud them of their investments, and alleged violations of federal and state securities laws, including Section 12(a)(2) of the Securities Exchange Act of 1933.[8] Similarly, *In re Professional* involved the creation of the Energy Brain leasing program, whose units were eventually offered to plaintiffs with the promise of possible profits resulting from the operation of the units and possible tax advantages resulting from

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[1] J.D. Candidate, SMU Dedman School of Law, 2016.
[2] *See* Marc I. Steinberg & Chris Claassen, *Attorney Liability Under the State Securities Laws: Landscapes and Minefields*, 3 BERKELEY BUS. L.J. 1, 3-4 (2005).
[3] 15 U.S.C. § 771(a)(2) (2006).
[4] *See, e.g.*, *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1114-15 (5th Cir. 1988) *cert. granted, vacated sub nom., Fryar v. Abell*, 492 U.S. 914 (1989).
[5] 704 F. Supp. 1384 (N.D. Tex. 1988).
[6] 692 F. Supp. 1057 (D. Minn. 1988).
[7] *Marshall*, 704 F. Supp. at 1386.
[8] *Id*. at 1386-87.

energy credits.[9] The units were allegedly fraudulently overvalued, and the plaintiffs subsequently sued, among others, defendant attorney Barr, who was involved in the creation of the leasing program.[10] Specifically, the plaintiffs in both *Marshall* and *In re Professional* claimed that the defendant attorneys violated Section 12(a)(2) because they were involved in offering and selling securities by means of a prospectus that contained misrepresentations and omissions of material facts.[11] While the cases involved multiple bones of contention, the principal issue that this paper addresses is whether the attorneys moved beyond their traditional due diligence and other securities offering related roles and moved into the realm of "sellers," thus subjecting them to potential liability under Section (12)(a)(2).[12]

II. LEGAL BACKGROUND

Under Section 12(a)(2), "[a]ny person who … offers or sells a security" in violation of the section's provisions "shall be liable … to the person purchasing such security from him."[13] Unlike Section 11, which expressly lists the persons who may be held liable under the provision,[14] Section 12(a)(2) provides no guidance regarding who constitutes an offeror or seller of securities, leaving the task of interpretation up to the Courts.[15] The United States Supreme Court addressed the issue in the 1988 case *Pinter v. Dahl*,[16] and while its discussion focused on who constituted a "seller" under Section 12(1), courts and scholars agree that its "seller" formulation applies to section 12(a)(2) as well.[17]

The *Pinter* Court held that there are two ways in which a person may be deemed a "seller." First, a person constitutes a seller when they pass title or other interest in the security to the buyer for value.[18] This first category of sellers, which the Court considers to already be "settled," leaves little room for interpretation.[19] Second, a person constitutes a seller if they (1) successfully solicit the purchase, and (2) are motivated at least in part by a desire to serve their own financial interests or those of the securities owner.[20] It is under this second category of "sellers" that attorneys, who are not owners of the pertinent securities but are nevertheless involved in the transaction, may be held liable.[21]

Pinter gives some helpful guidance for discerning what constitutes solicitation.[22] The Court characterizes the "solicitation" stage of a buyer to be the "most critical stage of the selling

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9 *In re Prof'l*, 692 F. Supp. at 1059.
10 *Id*.
11 *See Marshall*, 704 F. Supp. at 1388; *In re Prof'l*, 692 F. Supp. at 1058.
12 See 15 U.S.C § 771(a)(2).
13 *Id.*
14 *See id*. § 77k(a).
15 *See id*. § 771(a)(2).
16 *See* 486 U.S. 622, 647 (1988).
17 *See* Therese H. Maynard, *The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of 1933*, 69 NOTRE DAME L. REV. 57, 73 (1993).
18 *See Pinter*, 486 U.S. at 642.
19 *See id*.
20 *See id*. at 647.
21 *See, e.g.*, *In re Prof'l*, 692 F. Supp. 1057 (D. Minn. 1988).
22 *See Pinter*, 486 U.S. 622 (1988).

transaction," as it is "directed at producing the sale."[23] Thus, the Court considers that a solicitor acts as a sort of salesman for the securities owner, as is further evidenced by the Court's citing of brokers as a category of solicitors.[24] Further, the Court stated that solicitors are those who most often disseminate material information to investors.[25]

However, a person does not constitute a solicitor when they merely participate in the sales transaction.[26] Rather, the person needs to "urge" or "persuade" the investor to purchase the security.[27] For example, accountants and attorneys "whose involvement is only in the performance of their professional services," are not solicitors of purchases, since those actions only constitute participation and not persuasion.[28] Therefore, for attorneys to be solicitors, they must go beyond providing professional services and try to produce a sale.[29]

Pinter also provides guidance for how a person can be proven to have been motivated for financial gain. The Court, focusing on the language and intent of the provision, stipulated the financial motivation element so as to exclude from liability those persons who give gratuitous advice merely to assist the buyer.[30] According to the Court, it is common for a person to have been financially motivated if they anticipated a share of the profits or received a brokerage commission.[31] However, as the Court does not elaborate on what must be shown to prove either of these examples, the issue of burden is left to the lower courts. Moreover, while the Court says these situations are "typical" of a financially motivated person,[32] it does not mean that these situations are <u>necessary</u> for a person to have been financially motivated. Thus, while it is a requirement that the person be shown to have been financially motivated, that does not necessarily mean that it must be proven through the examples cited by the Court.

A. Whether the Attorney Constitutes a "Solicitor"

A comparison of the subsequent *Marshall*[33] and *In re Professional*[34] cases is helpful in construing what is required for an attorney to be a "solicitor" under the *Pinter*[35] test. According to the court in *Marshall*, the evidence produced by the plaintiffs was insufficient to show the attorneys acted as solicitors.[36] In *Marshall*, the Jones Walker attorneys prepared tax and securities opinions for inclusion in the prospectuses that were disseminated to the investors.[37]

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[23] *See id*. at 646.
[24] *Id*.
[25] *Id*.
[26] *See id*. at 651.
[27] *Id*. at 644, 647.
[28] *See id*. at 651.
[29] *See id*. at 646, 651.
[30] *Id*. at 647.
[31] *Id*. at 652.
[32] *Id*.
[33] 704 F. Supp. 1384 (N.D. Tex. 1988).
[34] 692 F. Supp. 1057 (D. Minn. 1988).
[35] 486 U.S. 622 (1988).
[36] *See Marshall*, 704 F. Supp. at 1389.
[37] *Id*.

(1389). The *Pinter* Court said that solicitors are those who most often provide material information to investors,[38] and it is logical to presume tax and securities opinions are examples of material information. However, the *Marshall* court deemed such action to be "nothing more than the performance of professional services,"[39] and thus not solicitation, which is consistent with the *Pinter* court's characterization.[40] Furthermore, although the Jones Walker attorneys directly communicated with investors and potential investors about the securities over the phone, this did not amount to solicitation.[41] The *Marshall* court stressed the fact that the communications were not "designed to persuade" the investors into purchasing partnership interests.[42] This "designed to persuade" language is similar to that of the *Pinter* court, which explained that a solicitor is one who "urges" or "persuades" the buyer to purchase a security.[43]

In comparison to those in *Marshall*, the attorney in *In re Professional* was found to be a solicitor.[44] Unlike the attorneys in *Marshall*, the attorney did not have direct contact with the investors.[45] However, this factor did not dissuade the court from deeming the attorney as solicitor, as "plaintiffs need not show direct contact between the 'seller' and ultimate buyer of the security."[46] Like the attorneys in *Marshall* who drafted tax and securities opinions, the attorney assisted with financial appraisals.[47] But here, the attorney went a step further than the *Marshall* attorneys whose opinions were included in the prospectus[48]—he helped draft the prospectus that was distributed to potential investors.[49] Surely those who have control over the content of the entire prospectus rather than just portions are better positioned to fully and fairly inform investors, ensuring that investors will not purchase securities because of bad information. Indeed, this goal of prevention is why Section 12 aims to hold not just actual sellers of securities, but also solicitors, accountable.[50]

Additional facts in the case also led to the conclusion that Barr was more than a mere participant in the sales transaction. The attorney was an early sponsor and principal proponent of the program for whom securities were being sold, which made his argument that he was only providing professional services as an attorney in the transactions that much weaker.[51]

B. Whether the Attorney was Financially Motivated

The evidence provided by the plaintiffs in *Marshall* was insufficient to establish that the Jones Walker attorneys were financially motivated in their actions, thus also not satisfying the

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38 *Pinter*, 486 U.S. at 646.
39 *Marshall*, 704 F. Supp. at 1389.
40 *See Pinter*, 486 U.S. at 651.
41 *Marshall*, 704 F. Supp. at 1389.
42 *See id*.
43 *See Pinter*, 704 F. Supp. at 644, 647.
44 *Compare Marshall*, 704 F. Supp. at 1389, *with In re Prof'l*, 692 F. Supp. at 1064.
45 *In re Prof'l*, 692 F. Supp. at 1064.
46 *Id*.
47 *Id*.
48 *Marshall*, 704 F. Supp. at 1389.
49 *In re Prof'l*, 602 F. Supp. at 1064.
50 *See Pinter*, 486 U.S. at 646-47.
51 *See id*.

second requirement of the *Pinter* test. The attorneys argued that they were not financially motivated because they did not receive a commission from the sale of any limited partnership interests.[52] However, the plaintiffs countered that because the attorneys' remuneration was mostly received in lump sum amounts in connection with each offering, rather than on an hourly fee basis, it was akin to a commission for payment in connection with sales.[53] In considering the plaintiffs' arguments, the court determined that this evidence was insufficient to show that the attorneys worked on commission, and that the attorneys did not have the financial stake in the securities offering that was envisioned by *Pinter*.[54] However, a closer analysis of *Pinter* shows that had the plaintiffs in *Marshall* not focused solely on proving the attorneys worked on commission, another conclusion may have resulted.[55] While the *Marshall* court found that the attorneys did not work on commission,[56] this does not conclusively decide the question of whether they were financially motivated—indeed, the *Pinter* court only lists receiving a commission as one example of how financial motivation might exist.[57] The other example, where the attorneys may anticipate a share of the profits,[58] was notably left out of the discussion in *Marshall*.[59] It could be argued that this was the case here, since the attorneys' payments were traced to the offerings.

In comparison, the attorney in *In re Professional* [60] was found to have been financially motivated for multiple reasons. First, the attorney was already criminally convicted of one count of fraud in the first-degree and nine counts of second-degree grand larceny for his actions in the scheme.[61] Both offenses involve the defendant unlawfully taking another person's property.[62] Unlawfully taking investor money certainly constitutes financial motivation. Not only that, but the attorney was an early sponsor and officer of the investment program.[63] Indeed, the court noted that the supplied evidence showed he was the program's creator and principal proponent.[64]

III. CONCLUSION

As the *Pinter* Court does not expressly state what actions are sufficient to show that a person successfully "solicited" a purchase, or how a person can be shown to have been motivated in part for "financial gain," lowers courts have been left with a fair amount of interpretive discretion.[65] This uncertainty in what actions could constitute someone being deemed a "seller"

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[52] *See Marshall*, 704 F. Supp. at 1388.
[53] *See id*. at 1389.
[54] *See id*.
[55] *See Pinter*, 486 U.S. 622 (1988).
[56] *Marshall*, 704 F. Supp. at 1389.
[57] *See Pinter*, 486 U.S. at 652.
[58] *Id*.
[59] *See Marshall*, 704 F. Supp. 1384.
[60] 692 F. Supp. 1057.
[61] *Id*. at 1059.
[62] N.Y. PENAL LAW §§ 155.40, 190.65 (McKinney 2015).
[63] *In re Prof'l*, 692 F.Supp. at 1064.
[64] *Id*.
[65] *See* J. WILLIAM HICKS, 17 CIVIL LIABILITIES: ENFORCEMENT & LITIG. UNDER THE 1933 ACT § 5:34 (Securities Law Series 2012).

and thus subject to Section 12(a)(2)[66] liability does not bode well for attorneys who are frequently involved in public offerings and wish to avoid potential liability. However, by looking at the facts of two subsequent lower court cases[67] and their application of *Pinter*[68] to attorneys involved in securities sales transactions, a clearer understanding of how an attorney must act to avoid being characterized as a seller subject to potential liability emerges.

First, while an attorney's due diligence role typically presents no risks in this regard, they should take care to limit their involvement in the drafting of prospectuses that are distributed to investors. It is acceptable and customary practice for attorneys to participate in and contribute to the contents of the offering documents, as these are established aspects of an attorney's performance of professional services in the context of a securities offering. However, should an attorney exert control over the entire prospectus, this may signal the court that the attorney is acting more in the capacity as a solicitor.

Second, it is advisable for attorneys to limit, and eliminate altogether if possible, direct communication with investors, even in their role as key members of the issuer's or underwriters' due diligence team. Although an attorney may directly communicate so long as she is not urging or persuading the investor to purchase a security, the lack of direct communication appears to sway courts strongly in the favor of attorneys.

Third, because courts appear to focus their analysis of financial motivation on whether the attorney was paid on commission or anticipated a share of the profits from the sale of securities, attorneys should retain documentation of how their payments are determined.

By following these relatively simple guidelines, attorneys may increase their chances of avoiding liability as a seller under Section 12(a)(2).[69]

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[66] 15 U.S.C. § 771(a)(2).
[67] *Marshall*, 704 F.Supp. 1384; *In re Prof'l*, 692 F.Supp. 1057.
[68] 486 U.S. 622.
[69] 15 U.S.C. § 771(a)(2).

Director Due Diligence in Securities Offerings: The Mandatory Predicate of Material Misstatements and Omissions—A Brief Analysis of UFCWU v. Chesapeake

Kurt T. Miller[1]

I. INTRODUCTION

Board members are important participants in an issuer's public offerings of securities. Among other things, they play a role in helping to ensure that the disclosures made in the offering documents are materially accurate and complete. However, in fulfilling these important roles, especially as it relates to their due diligence with respect to the offering documents, board members increasingly find themselves named as defendants when an offering becomes the subject of litigation. However, unlike the issuer, who is strictly liable for material misstatements and omissions and who has no affirmative defense, directors may assert the "due diligence defense" described in Sections 11 and 12(a)(2) of the Securities Act of 1933.[2] Furthermore, a mandatory predicate of director liability under these provisions of the Act is the actual presence of material misstatements or omissions in the offering documents themselves. Therefore, this paper addresses the issue of director liability under those sections of the Act and relevant considerations related to the due diligence defense by analyzing the apposite rulings in the federal district court case *United Food and Commercial Workers Union v. Chesapeake Energy Corporation.*[3]

II. CASE BACKGROUND

Chesapeake Energy Corporation ("Chesapeake") is an oil and natural gas company headquartered in Oklahoma City, Oklahoma. Although Chesapeake completed its initial public offering in 1993 ("IPO"), it has since completed many additional public securities offerings to raise capital, often pursuant to a previously filed shelf registration statement and subsequent shelf takedown.[4] Chesapeake's operations are focused on discovering and developing unconventional natural gas and oil fields onshore in the United States ("U.S.").[5] It is currently the second-largest producer of natural gas and the eleventh-largest producer of oil and natural gas liquids in the U.S.[6] Chesapeake owns mineral positions in the Eagle Ford, Utica, Granite Wash, Cleveland,

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[1] J.D. Candidate 2015, SMU Dedman School of Law; B.B.A. McCombs School of Business 2012, University of Texas at Austin.

[2] 15 U.S.C. §§ 77k(a) and 77l(a)(2). As discussed more fully below, directors may also be exposed to liability as control persons under Section 15 of the Securities Act of 1933.

[3] *United Food & Commercial Workers Union v. Chesapeake Energy Corp.*, 281 F.R.D. 641 (W. D. Okla. Mar. 29, 2012).

[4] A "shelf registration statement" is a filing with the SEC to register a public offering, usually where there is no present intention to immediately sell all the securities being registered. And a "shelf takedown" is an actual offering of securities from a shelf registration statement that has previously been declared effective by the SEC.

[5] CHESAPEAKE ENERGY, http://www.chk.com/about (last visited Apr. 20, 2015).

[6] *Id*.

Tonkawa, Mississippi Lime, and Niobrara unconventional liquids plays, as well as positions in the Marcellus, Haynesville/Bossier and Barnett unconventional natural gas shale plays.[7]

During the period from 2002 to 2008, Chesapeake experienced rapid growth influenced primarily by an upward shift in U.S. natural gas prices. According to the U.S. Energy Information Administration, the U.S. natural gas wellhead price went from $2.19 per thousand cubic feet ("Mcf") in February 2002 to $10.79 per Mcf in July 2008.[8] But the upward trend sharply reversed after July 2008. In three months, the price of natural gas fell about 45%, an index of stock in Chesapeake's industry peers fell 56%, and Chesapeake's stock fell about 70%.[9] Interestingly, the period around July 2008 represents the highest price on record for natural gas in the U.S., with the current price being very close to only $3 per Mcf at the beginning of 2015.[10]

On July 9, 2008, shortly before the steep decline in Chesapeake's stock, Chesapeake consummated a shelf offering of 25 million shares of Chesapeake Energy Corporation's common stock.[11] Subsequently, as the price of natural gas and Chesapeake's stock declined, investors lost a large portion of their original investment, and some investors brought a lawsuit claiming that Chesapeake and its directors had made material misstatements and omitted other material statements from the registration statement and related documents, thereby rendering the statements made in the offering documents misleading.[12]

This lawsuit will be discussed and analyzed in greater detail below, but it is important to keep these prices and trends in mind to understand the origins of the dispute. Furthermore, as demonstrated by the case, it is equally important to frame the disclosures and overall due diligence efforts in the appropriate temporal and situational context,[13] without letting hindsight bias seep into the judicial analysis and conclusions. Because of its relevance and importance to the Chesapeake litigation, this paper will next discuss relevant due diligence law and customary practices and standards that apply to directors involved in public offerings of securities.

III. BRIEF REVIEW OF RELEVANT DUE DILIGENCE LAW

The Securities Act of 1933 (the "Act") was enacted in the wake of the stock market crash of 1929.[14] At its most fundamental level, the Act imposes civil liability for misstatements or

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[7] *Corporate Fact Sheet*, CHESAPEAKE ENERGY, http://www.chk.com/documents/operations/corporate-fact-sheet.pdf (last visited Apr. 20, 2015).

[8] *U.S. Natural Gas Wellhead Price*, U.S. ENERGY INFORMATION ADMINISTRATION, http://www.eia.gov/
dnav/ng/hist/n9190us3M.htm (last visited Apr. 20, 2015).

[9] *United Food & Commercial Workers Union Local 880 Pension Fund v. Chesapeake Energy Corp.*, 774 F.3d 1229, 1231 (10th Cir. 2014), as amended *nunc pro tunc* (Nov. 12, 2014).

[10] *Energy & Oil Prices*, BLOOMBERG NEWS, http://www.bloomberg.com/energy/ (last visited Apr. 20, 2015).

[11] *United Food & Commercial Workers Union*, 281 F.R.D. 641.

[12] *Id*.

[13] GARY M. LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, 293-94 (CADDS Scholars Press, 2nd ed. 2013).

[14] 15 U.S.C. §§ 77a-77z (2006).

omissions of material facts contained in a registration statement for a public offering.[15] Plaintiff in the Chesapeake litigation alleged violations of Sections 11, 12(a)(2), and 15 of the Act.

Section 11 imposes liability on certain persons when "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."[16] Persons subject to liability include: (i) the issuer, (ii) each signatory of the registration statement, (iii) each director or partner of the issuer, (iv) each person named (or about to become) a director or officer, (v) each accountant, engineer appraiser or other expert; and (vi) each underwriter.[17]

"A statement is material only if a [hypothetical] reasonable investor would consider it important in determining whether to buy or sell stock."[18] Aside from disclosures required by regulation, "[a] duty to disclose arises only where both the statement made is material, and the omitted fact is material to the statement in that it alters the meaning of the statement."[19] Moreover, an omission is material only if disclosure of what is omitted would "significantly alter the total mix of information available."[20] Although the question of materiality is "usually reserved for the trier of fact, [courts] do not hesitate to dismiss securities claims . . . where the alleged misstatements or omissions are plainly immaterial."[21]

Similarly, Section 12(a)(2) imposes liability on each person who "offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading . . . and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."[22] The definition of materiality is the same as under Section 11[23] and the plaintiff, as with Section 11, need not "allege scienter, reliance, or loss causation."[24]

Finally, Section 15 states that "[e]very person who, by or through stock ownership, agency, or otherwise, . . . controls any person liable under Sections [11 and 12], shall also be liable jointly and severally with and to the same extent as such controlled person."[25] In other words, Section 15 allows "a person who controls a party that commits a violation of the securities laws" to "be held jointly and severally liable with the primary violator."[26] Thus, Section 15 claims depend upon the success of claims under Sections 11 and 12(a)(2).

[15] *Id*. § 77k.
[16] *Id*. § 77k(a).
[17] *Id*.
[18] *McDonald v. Kinder–Morgan, Inc.*, 287 F.3d 992, 998 (10th Cir. 2002).
[19] *Id*.
[20] *Slater v. A.G. Edwards & Sons, Inc.*, 719 F.3d 1190, 1197 (10th Cir. 2013).
[21] *Id.*
[22] 15 U.S.C. § 77l(a)(2).
[23] *See In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 359 (2d Cir. 2010).
[24] *Id*. at 359.
[25] 15 U.S.C. § 77o(a).
[26] *Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1304–05 (10th Cir. 1998).

IV. THE DUE DILIGENCE DEFENSE

While strict liability is the standard for issuers in connection with material misstatements and omissions in public offerings,[27] a non-issuer defendant is entitled to a due diligence defense and may avoid liability under Section 11 if it can affirmatively establish that with respect to non-expertised portions of the offering, it "had, after reasonable investigation, reasonable ground to believe and did believe" there were no misstatements or omissions of material facts.[28] The standard for reasonableness is judged by how a prudent person in the management of his or her own property would have acted, and is often described as one of negligence.[29] Similarly, under Section 12(a)(2), non-issuer defendants can avoid liability if they did not know and in the exercise of "reasonable care" could not have known of the material misstatement or omission of a material fact that is the basis of the plaintiff's claim.[30] While Section 11, as noted above, defines reasonableness with reference to a prudent person in the management of his or her own property, Section 12 is silent regarding what constitutes reasonableness in determining what establishes "reasonable care," however some courts have also applied a negligence standard to this determination.

In 1981, in response to concerns regarding the ability of underwriters to perform adequate investigations during shelf offerings[31], the SEC adopted Rule 176 under the Securities Act to identify "certain circumstances bearing upon the reasonableness of the investigation conducted to discharge one's obligation under Section 11(b) of the Securities Act . . . and upon what constitutes reasonable grounds for belief under that Section."[32] Rule 176 states that:

> In determining whether or not the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in section 11(c), relevant circumstances include, with respect to a person other than the issuer. (a) The type of issuer; (b) The type of security; (c) **The type of person**; (d) **The office held when the person is an officer**; (e) The presence or absence of another relationship to the issuer when the person is a director or proposed director; (f) Reasonable reliance on officers, employees, and others whose duties should have given them

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[27] *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).
[28] 15 U.S.C. § 77k(a).
[29] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 258 F. Supp. 2d 576, 596 (S.D. Tex. 2003).
[30] 15 U.S.C. § 77l.
[31] "Shelf offerings" are expedited offerings conducted pursuant to a previously filed registration statement that uses an abbreviated registration form (typically a Form S-3), which allows public companies to incorporate by reference the information contained in the quarterly, annual and other reports they are required to file with the SEC under the Securities Exchange Act of 1934. It allows an issuer to quickly tap the public securities markets and utilizes cumulative due diligence, which relies on pre-existing familiarity and past offerings between the underwriter and issuer.
[32] Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act, Securities Act Release No. 33-6335, 46 Fed. Reg. 42,015 (Aug. 6, 1981) (codified at 17 C.F.R. 230.176).

> knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing); (g) When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant; and (h) Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.[33]

As established by early case law and confirmed by the SEC in adopting Rule 176, the reasonable investigation standard varies by type of defendant. This paper will focus on the differing approached taken with respect to inside directors and outside directors because they are most relevant in the context of the Chesapeake litigation analysis.

An inside director is typically viewed as an individual who is a member of both the issuer's board of directors and the management team, though the definition is not settled.[34] Conversely, an outside director is generally viewed as an individual who is a member of the issuer's board of directors but is not affiliated with the issuer in another capacity. However, similar to the inside director, that loose definition is not settled and will likely involve a fact-specific inquiry. Ultimately, inside and outside directors, as well as the issuer's executive officers, are potential Section 11 defendants as signers of the registration statement.[35]

Relevant Details Regarding the Chesapeake Energy Litigation

As mentioned above, on July 9, 2008, Chesapeake executed a shelf offering of 25 million shares of Chesapeake Energy Corporation's common stock (the "Offering"). Shortly after the consummation of the Offering, the price of Chesapeake's stock declined steeply and investors lost a large portion of their initial investments. Thereafter, a class action was formed and plaintiffs, led by their class representative United Food and Commercial Workers Union ("Plaintiff"), sued Chesapeake and Chesapeake's Chief Executive Officer Aubrey K. McClendon ("McClendon"), and inside and outside directors Marcus C. Rowland, Michael A. Johnson, Richard K. Davidson, Frank A. Keating, Breene M. Kerr, Charles T. Maxwell, Merrill A. Miller, Jr., Donald L. Nickles, and Frederick B. Whittemore (collectively, the "Individual Defendants"), seeking to hold them liable for alleged omissions based on their status as "control persons" under the provisions of § 15 of the Securities Act.[36] Furthermore, Plaintiff sued the underwriters of the Offering, UBS Investment Bank, ABN AMRO, Banc of America Securities LLC, and Wells Fargo Securities (the "Underwriter Defendants") for their role in the Offering.[37]

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[33] 17 C.F.R. § 230.176 (2006) (emphasis added).

[34] *See In re WorldCom, Inc. Sec. Litig.*, 294 F.Supp.2d 392, 402 (S.D.N.Y. Mar. 21, 2005). For example, in *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971), the court held that a partner in the law firm which represented the issuer was an inside director even though he held no management office because of his deep involvement with the issuer. *See id*. at 576.

[35] *See* 15 U.S.C. § 77k(a)(1) (2006).

[36] *United Food & Commercial Workers Union*, 281 F.R.D. 641.

[37] *United Food & Commercial Workers Union v. Chesapeake Energy Corp.*, No. CIV-09-1114D, 2013 WL 3155374, at *1 (W.D. Okla. June 21, 2013), *aff'd sub nom.* as amended *nunc pro tunc*

In the Amended Complaint, Plaintiff alleged that Defendants violated the Securities Act of 1933, alleging that the offering documents contained material misstatements and omissions. Specifically, Plaintiff alleged Defendants violated §§ 11 and 12(a)(2) of the Securities Act by omitting from the registration statement and related documents certain material facts, thereby rendering the statement misleading to potential investors.[38]

Plaintiff identified three categories of allegedly omitted material facts. First, it contended Defendants failed to properly disclose the "true risk and uncertainties" concerning the approximately 29 million shares of Chesapeake common stock held by McClendon, a substantial portion of which was held in margin accounts, and that Defendants failed to disclose that McClendon lacked the financial resources necessary to satisfy his margin loans.[39] Second, Plaintiff alleged Defendants failed to properly disclose Chesapeake's exposure to Lehman Brothers, Inc. ("Lehman") resulting from hedging contracts because Defendants did not disclose that Lehman was the "counterparty to a material portion of the contracts hedging Chesapeake's oil and natural gas production."[40] Plaintiff further contended that the hedging contracts created a potentially risky and significant financial obligation for Lehman, who Plaintiff claims was experiencing serious financial difficulties at the time of the Offering, thus creating a risk that Lehman would be unable to perform its contractual obligations to Chesapeake.[41] Third, Plaintiff alleged Defendants failed to disclose that many of Chesapeake's hedging contracts contained a "kick-out" or "knockout" provision whereby the counterparty's exposure is eliminated if the price of natural gas falls below the price specified in the contract.[42]

Chesapeake and the Individual Defendants moved for summary judgment on these claims, arguing that the undisputed material facts establish they satisfied their legal disclosure obligations in the Offering documents, and there were no omissions. In the Order filed March 29, 2013, Timothy D. DeGiusti, United States District Judge for the Western District of Oklahoma, found that Chesapeake and the Individual Defendants were entitled to judgment as a matter of law on Plaintiff's claims, and granted the Defendants motion for summary judgment.[43] The court ruled that: (1) the registration statement "disclosed in detail the risks associated with Chesapeake's hedging strategy," (2) Chesapeake had adequately disclosed that McClendon had pledged most of his shares as collateral in margin accounts, and (3) additional disclosure about McClendon or Lehman's financial resources were "beyond the scope of that which is reasonable because it requires speculation about unpredictable future events that could not be ascertained at the time of the Offering,"[44]

In reaching its conclusions, the court found that all required information was disclosed in the registration statement itself or in the supplemental materials expressly incorporated by reference in the registration statement, which is a common practice in shelf offerings.[45] The

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(Nov. 12, 2014); *United Food & Commercial Workers Union Local 880 Pension Fund*, 774 F. 3d 1229.

[38] *United Food & Commercial Workers Union*, 281 F.R.D. 641.
[39] *Id*.
[40] *Id*.
[41] *Id*.
[42] *Id*.
[43] *Id.* at 661.
[44] *Id*. at 662-70.
[45] *Id*.

Order granting summary judgment for the Defendants, as well as a dismissal without prejudice order against the Underwriter Defendants, was subsequently affirmed by the United States Court of Appeals for the Tenth Circuit.[46]

V. THE MANDATORY PREDICATE FOR DIRECTOR LIABILITY

The Chesapeake case illustrates the point that, as discussed above, a mandatory predicate of director liability under relevant due diligence law is the actual presence of material misstatements or omissions in the offering documents themselves. Thus, a director's first line of defense in such cases is to argue that there were no material misstatements or omissions. In the absence of material misstatements or omissions, directors need not even assert the due diligence defense. Moreover, only if and when the court finds there were material misstatements or omissions, must the directors then assert the due diligence defense as the fallback. The court in the instant case held that Chesapeake had adequately disclosed the necessary material facts and no material misstatements or omissions existed, therefore, Defendants won in the summary judgment phase of trial, and the directors did not have to individually assert the due diligence defense.[47]

Additionally, while both inside directors and outside directors are entitled to assert the due diligence defense, courts have consistently set the bar higher for inside directors seeking to assert the due diligence defense. Based on Rule 176 and due diligence case law, such as *Escott v. BarChris Construction Corporation*, inside director defendants face a difficult task in meeting the reasonable investigation standard because their involvement with the day-to-day affairs of the issuer, knowledge of its operations, and access to information make it likely that they either knew or should have known about any material errors and omissions in the registration statement.[48] Thus, while the court in the Chesapeake litigation did not impose liability on the inside directors or the outside directors because it ultimately found the initial disclosures were in fact adequate (i.e. the mandatory predicate for liability was not met) the case supports the notion that inside directors face a very difficult task establishing the due diligence defense and will be held to almost as high of a standard as the issuer itself. For example, the district court spent a large portion of its opinion deliberating the merits of Plaintiff's material misstatements and omissions argument, and only dismissed Plaintiff's Section 15 claim after it granted summary judgment on the underlying Sections 11 and 12(a)(2) claims.[49] Therefore, given the fact-intensive inquiry of the due diligence defense and what constitutes a "control person" under Section 15, if the Sections 11 and 12(a)(2) claims had survived, it is likely that directors with even limited access to insider information or control (i.e. "inside directors") would have been denied summary judgment as well, resulting in addition trial and potential settlement expenses.

The Importance of Temporal and Situational Context

Another significant due diligence-based element of the Chesapeake litigation is the importance of temporal and situational context referenced in the court's examination of potential misleading statements or omissions. In granting Defendants' motion for summary judgment, the

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46 *United Food & Commercial Workers Union Local 880 Pension Fund*, 774 F.3d at 1243.
47 *United Food & Commercial Workers Union,* 281 F.R.D. at 654.
48 283 F. Supp. 643, 683-87 (S.D.N.Y. 1968).
49 *United Food & Commercial Workers Union,* 281 F.R.D. at 663.

court spent considerable time discussing the overall context of the Offering and the events immediately preceding and following the Offering.[50]

Temporal context refers to the time during which the due diligence was conducted and the practices that were reasonable and customary at the time.[51] Customary industry due diligence practices evolve over time and "the standard" at one time may vary in many respects from customary practices at another time because of changes in the marketplace, past experiences, relevant events and occurrences, and other similar considerations. Additionally, the regulatory and legal framework changes over time and must also be taken into consideration.

Similarly, situational context refers to a range of other factors present at the time of the due diligence investigation and subsequent public disclosures, such as how much time and money each party had and the relative terms and size of the deal.[52] Situational factors also include the macroeconomic environment and the behavior of investors and other parties in the market leading up to the alleged misstatement or omission. Overall, the situational context, like the temporal context, helps define the broader environment in which the investigation was conducted.

The failure to analyze an alleged misleading statement or omission in its proper temporal and situational context can lead to "hindsight bias." Hindsight bias is best described as the natural human tendency to apply the diligence standards of today to a previous point in time, and it is insidious because it leads to unsound analysis and flawed conclusions.[53] Thus, it is extremely important to evaluate each due diligence investigation against the practices, customs, and reasonableness standard at the time of the alleged misconduct, not as of some later date.

While discussing Lehman's post-Offering collapse in the Chesapeake litigation, the district court properly stated that, there is no "duty to disclose speculative future events contingent upon a company's possible future failure coupled with an uncertain level of exposure, at the time of the offering, which might result from that failure."[54] In addition, the court noted when examining McClendon's margin accounts that "the virtually unprecedented economic melt-down that occurred in the months following the Offering could not have been foreseen" and that the events and contingencies leading up to McClendon being forced to sell his stock held in margin accounts were "too remote and speculative to require their disclosure."[55] The court wisely recognized that financial crises are by definition unpredictable and that issuers and directors do not have a crystal ball showing them what the future will hold, thus, they should not be held liable for unforeseeable future events that could not be ascertained at the time of the Offering.

VI. CONCLUSION

In conclusion, only after analyzing required disclosures and alleged omissions in light of their temporal and situational context, and by avoiding hindsight bias, can one fairly evaluate and

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[50] *Id*. at 247, 231.
[51] GARY M. LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, 293 (CADDS Scholars Press, 2nd ed. 2013).
[52] *Id*.
[53] *Id*. at 294.
[54] *United Food & Commercial Workers Union,* 2013 WL 1336123, at *18.
[55] *Id*. at *21.

analyze the actions of an issuer and its inside and outside directors. Looking backwards in time, there will likely always be decisions that executives and other key personnel could have made differently or improved upon, but the court in the Chesapeake litigation correctly recognized that Chesapeake and its directors should only be judged based on the reasonable standard on the day the offering occurred. Ultimately, there is no higher duty placed on issuers, underwriters, and directors who approve a registration statement just prior to an unpredictable financial collapse – in this case of the stock market and the price of natural gas.