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China's New Foreign Investment Draft Law's Impact On Underwriters' Due Diligence Responsibilities

Luna (Liang) Yue¹

I. INTRODUCTION

In China, Foreign Direct Investment (hereinafter referred to as “FDI”) is regulated by the Ministry of Commerce (“MOFCOM”) of People’s Republic of China (“PRC”), which is the governmental department charged with administering and ensuring that foreign investment is in line with the state policy. Over the years, MOFCOM and other related governmental agencies have issued various laws, regulations and detail procedural measures regarding FDI. To be noted, one thing unique about China is that, over the years, among PRC’s persuasive authorities, public policy has always been the starting point and the dominant focus, instructing every facet of the domestic and international businesses. However, while policies dominate over other legal authorities, policies do change.

Over the past twenty years, it is undeniable that China’s GDP has been dramatically improving², and the Chinese government kept the same goal and public policy—attracting, inviting, and welcoming foreign funds and foreign investors. During this period of time, numerous favorable FDI laws and regulations were promulgated and enforced; those favoring FDI mechanics include but are not limited to tax preferences, market-entrance favoring rules, lower standards of continuous regulation procedures, etc. These rules and regulations, in turn,

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² Beginning in the 1980s.

attracted more and more foreign investors into China, not only boosting Chinese economy, also providing profitable returns for foreign investors.

Since China entered into the WTO in 2001, the climate has been changing gradually. Throughout the years of regulating and supervising international businesses, instead of completely reversing its attitude towards FDI from hospitality to hostile, the Chinese government decided to draw back on the general favoring trend. Thus, PRC's Foreign Investment Law (Draft)³, which was released last spring and is currently in the phase of accepting comments, has been regarded as one of the milestones in Chinese FDI laws history.

By introducing into China's FDI regime the concept of "negative list", this Draft Law changed the basic structure of the past several editions of Foreign Investment Industrial Guidance Catalogue (hereinafter referred to as the "FDI Catalogue")⁴; added a new supervisory mechanic called "Information Reporting System"; most importantly, it clearly defined what shall be recognized as "foreign investment." As a result, this Draft Law may fundamentally change the illegitimacy of many publicly listed companies with foreign funds that are using a legally

³ Waiguo Touzi Fa Cao'an (外国投资法 (草案)) [PRC's Foreign Investment Law (Draft)] (Ministry of Commerce, Jan. 19, 2015), art. 22, *available at* <http://finance.sina.com.cn/china/hgjj/20150119/171021332844.shtml>.

⁴ See Kam ink bird, "Catalogue for the Guidance of Foreign Investment Industries Professional |2015 edition release (with full text)" (March 13, 2015), English version *available at* https://translate.google.com/translate?sl=zh-CN&tl=en&js=y&prev=t&hl=en&ie=UTF-8&u=https%3A%2F%2Fmp.weixin.qq.com%2Fs%3F__biz%3DMzA3MzcxMTEzOQ%3D%3D%26mid%3D204819076%26idx%3D3%26sn%3De9a8a03fdc2f8cf03591de330709ff42%26scene%3D2%26from%3Dtimeline%26isappinstalled%3D0%26key%3D8ea74966bf01cfb6cbd301e8cbbd898fc98b0575a31cbc86591754db6002c287c126d73878838cef1fdb3caba31f46a%26scene%3D2%26uin%3DOTQ1OTI0OTQy%26devicetype%3DiPhone%2BOS8.1.2%26version%3D16010014%26fontScale%3D100%26pass_ticket%3DdLkDDwmSsXxLHCWy7%252BYPQX0v%252FZso1dtpwxtcGSHFArFJb8mHQNHvkupJNiHvC%252BrG&edit-text=&act=url.

devised corporate structure called VIE (Variable Interest Entities).⁵ In short, this Draft Law marks the beginning of a new era for FDI in China, and this paper explores it in the perspective of American investors who are thinking of investing in China. Specifically, this paper endeavors to provide the underwriters who are helping those American investors with guidance regarding their due diligence tasks, from an insider's view. Part II discusses the similarities and differences between American underwriters' due diligence responsibilities in the U.S. and that in China; Part III describes China's new FDI regime and further analyzes its impact on underwriter's due diligence, especially listed out step-by-step how VIEs work in China before the release of this Draft Law and how it is affected after the release of this Draft Law; Part IV offers some concluding observations.

II. OVERVIEW OF UNDERWRITERS' DUE DILIGENCE RESPONSIBILITIES IN THE U.S. AND IN CHINA

Under United States law, the overall goal of Securities Act of 1933 (the "1933 Act") is full and fair disclosure to the public of "all material information concerning the offering and the issuer so that potential investors can make informed investment decisions."⁶ Moreover, as President Franklin Roosevelt stated in his message to Congress, the purpose of the 1933 Act is "to protect the public with the least possible interference to honest business."⁷ These interwoven goals and purposes—fair disclosure and freedom from unreasonable burdens on parties

⁵ See Adam Li, *The Draft Foreign Investment Law and Its Impact on VIEs* (Jan 23, 2015), available at http://mp.weixin.qq.com/s?__biz=MzA5MzYzMzYyNQ==&mid=203472060&idx=1&sn=f6f56018803546096ff9eee8d39ca37e#rd.

⁶ William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 550-51 (2006).

⁷ *The Expanding Liability of Securities Underwriters: From Barchris to Globus*, DUKE L. JOURNAL, 1191.

diligencing the disclosures—apply to the entirety of the 1933 Act including an underwriter’s affirmative due diligence defenses under Sections 11 and 12(a)(2) of the Act.

Similarly, under Chinese law, the counterpart of SEC is called the China Securities Regulatory Commission (CSRC), and on its official website, it illustrated its three-level goal as: “(1) maintain a transparent, fair and equitable market; (2) strengthen the protection of investors, small investors in particular; (3) facilitate the sound development of the capital market.”⁸ Although these are more like slogans than specific policies which function as the key guidance in CSRC’s daily role, they still clearly indicate the general idea of how the securities regulation in China works—to further ensure fair and full disclosure concerning the offerings, in order to protect the majority interest of potential investors, which resembles the overall goal of SEC in United States.

In both the U.S. and China, most public offerings of securities involve one or more underwriters (sometimes called a “syndicate”) to provide advice, facilitate the offering and sale, and to participate in customary due diligence activities as defined by the law, standards and practice of due diligence. Because underwriters may be seen as informational intermediaries for the investing public, they conduct due diligence (and rely on others whose duties place them in a position of knowledge⁹) into the statements made in the offering documents. While underwriters are not *guarantors* of the accuracy or completeness of the disclosures, they nonetheless play an important role in both U.S. and Chinese public offerings by conducting due diligence designed to promote full and fair disclosure.

⁸ CHINA SECURITIES REGULATION COMMISSION, http://www.csrc.gov.cn/pub/csrc_en/.

⁹ *Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act*, SEC Release No. 33-6335, 8/6/81.

Another similarities in both countries are the responsibilities of underwriters. Traditionally, one or more members of the underwriting syndicate will be designated by the issuer as the lead or managing underwriter(s).¹⁰ Among other things, the lead underwriter(s) “perform[s] due diligence on the issuer and applicable registration statement on behalf of all underwriting syndicate members.”¹¹ However, in both countries, not only leading underwriter(s), but *all* the underwriters are potential defendants. In fact, under U.S. Section 11, they are specifically listed as such in section 11(a).¹² Similarly, article 27 of PRC’s “Securities Issuance and Underwriting Regulations” describes the full and fair disclosure duty of underwriters, requiring the disclosure to be “true, accurate, complete, and promptly;” while forbidding “false and misleading information or any material omissions.”¹³ Accordingly, violation of such underwriting duties is a serious offense. Article 191 and 193 of PRC’s Securities Law, promulgated in 2005, defined the punishment for violations of PRC’s securities laws.¹⁴ The more lenient punishment is, “warning, and confiscation of the illegal income,” which are mandatory, plus the “imposition of a fine of the amount between 300,000 RMB and 600,000 RMB.”¹⁵ The more serious punishment is, “suspend[ing] or revok[ing] the underwriting license.”¹⁶ In addition, under article 37 subsection (5)(9) of PRC’s “Securities Issuance and

¹⁰ Jones Day, *supra* note 2, at 584-85; Article 21 of PRC’s “Securities Issuance and Underwriting Regulations”.

¹¹ *Id.*; Article 21 of PRC’s SECURITIES ISSUANCE AND UNDERWRITING REGULATIONS requires all Chinese underwriters conform their underwriting conducts according to the underwriting agreements.

¹² Jones Day, *supra* note 2, at 584-85.

¹³ *See* Article 27 of PRC’s SECURITIES ISSUANCE AND UNDERWRITING REGULATIONS.

¹⁴ Article 191, 193 of PRC’s Securities Law.

¹⁵ *Id.*

¹⁶ *Id.*

Underwriting Regulations,” “violation of such full and fair disclosure duty” and any other violations, shall result in such persons’ underwriting businesses being frozen for a period of three to twelve months.¹⁷

On the other hand, U.S. provides its underwriters a specific legal defense—U.S. underwriters may avail themselves of several affirmative defenses including that of a “reasonable investigation” (including reasonable reliance on non-expertised material), “reasonable reliance” (in the case of expertised material), and “reasonable care.”¹⁸ But there’s no such due diligence defense for Chinese underwriters.

III. PRC’S NEW FDI REGIME AND ITS IMPLICATIONS FOR UNDERWRITERS’ DUE DILIGENCE

A. Legislative Background—PRC’s Current Foreign Investment Laws Are Outdated

Currently, there are three existing laws regulating Foreign Investments Enterprises in China (“FIE laws”): (1) the *Sino-foreign Equity Joint Venture Enterprise Law*, also known as the “Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (2001 Amendment);”¹⁹ (2) the *Sino-foreign Cooperative Joint Venture Enterprise Law*, also known as the “Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures

¹⁷ Article 37 (5), (9) of PRC’s SECURITIES ISSUANCE AND UNDERWRITING REGULATIONS.

¹⁸ “A reasonable investigation standard applies to non-expertized portions and a reasonable reliance standard applies to expertized portions.” See Jones Day, *supra* note 2, at 554-55.

¹⁹ See Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiye Fa (中华人民共和国中外合资企业法) [Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (2001 Amendment)] (Standing Comm. Nat’l People’s Cong., March. 15, 2001), available at http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=34972&keyword=中外合资&EncodingName=&Search_Mode=like.

(2000 Amendment);”²⁰ and (3) the *Wholly Foreign-invested Enterprise Law*, also known as the “Law of the People's Republic of China on Foreign-funded Enterprises (2000 Amendment).”²¹ With the world as the witness, China had gone through tremendous changes since the first foreign investment regulating law—the Sino-foreign Equity Joint Venture Enterprise Law—was promulgated in 1979.²² China’s rapid economic growth resulted in “strong and sustained growth in outbound investments by Chinese enterprises,” which resulted in China’s change “from a net capital inflow country to a net capital outflow country in 2014.”²³ Because of both economic and social changes, the three FIE laws became outdated, “and to some extent, impeded free competition and liquidity flow.”²⁴ In short, it became necessary to change the outdated FIE laws that are currently in place.²⁵

Finally, on January 19, 2015, the MOFCOM of PRC released the new Foreign Investment Draft Law (“Draft Law”) to solicit for public discussion.²⁶ This Draft Law was intended to be open for public opinion only until February 17, 2016; however, a month after this

²⁰ See *Zhonghua Renmin Gongheguo Zhongwai Hezuo Jingying Qiye Fa* (中华人民共和国中外合作经营企业法) [Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures (2000 Amendment)] (Standing Comm. Nat’l People’s Cong., Oct. 31, 2000), available at <http://en.pkulaw.cn/display.aspx?cgid=31466&lib=law#>.

²¹ See *Zhonghua Renmin Gongheguo Waizi Qiye Fa* (中华人民共和国外资企业法) [Law of the People's Republic of China on Foreign-funded Enterprises (2000 Amendment)] (Standing Comm. Nat’l People’s Cong., Oct. 31, 2000), available at <http://en.pkulaw.cn/display.aspx?cgid=31468&lib=law>.

²² Ping, Schaub & Yao, “A New Era for the PRC Foreign Investment Regime—An Introduction to the Discussion Draft Foreign Investment Law of PRC” (Jan 22, 2015), available at <http://www.chinalawinsight.com/2015/01/articles/corporate/mergers-acquisitions/a-new-era-for-the-prc-foreign-investment-regime-an-introduction-to-the-discussion-draft-foreign-investment-law-of-prc/>.

²³ *Id.*

²⁴ *Id.*

²⁵ See Li, *supra* note 6.

²⁶ Ping, Schaub & Yao, *supra* note 28.

initial commentary period deadline, while some matching regulations have been issued, the Draft Law is still a draft and no definite version of PRC FDI law has been confirmed.²⁷ This Draft Law has triggered continuous heated debates domestically and internationally (since many prior valid issuers initiated their IPOs abroad), and possibly will change the entire foreign investment regime in China.²⁸ Overall, the Draft Law grants foreign investors “better and easier access to Chinese markets”, while at the same time “imposes further scrutiny for industries that are deemed to have national security implications.”²⁹ It introduces several new systems such as the “Negative List” and the “Information Reporting System.”³⁰ Specifically, the Negative List focuses on the entering stage of FIEs; it contains all the industries that are not encouraged or permitted for foreign investors (aka FIEs) to enter. While the “Information Reporting System” focuses on the ongoing supervision of such legally entered FIEs. Overall, this Draft Law aims at creating a “more stable, transparent, and predictable legal environment” using international recognized rules.³¹

B. The Draft Law’s Impact on Variable-Interest-Entities (VIEs) and Due Diligence Considerations Impacting Underwriters

To be noted, once the final version of the Draft Law becomes effective, those Foreign Investment Entities (hereinafter referred to as FIEs) “previously established pursuant to the three FIE laws, will be required to adjust their organization form and corporate governance according

²⁷ See Norton Rose Fulbright, *China: new law shakes up foreign investment regime* (January 2015), available at <http://www.nortonrosefulbright.com/knowledge/publications/125226/china-new-law-shakes-up-foreign-investment-regime>.

²⁸ *Id.*

²⁹ *See id.*

³⁰ Waiguo Touzi Fa Cao’an (外国投资法 (草案), *supra* note 4.

³¹ See Xinli Law Firm, *Explanations About the Draft Law* (Jan 19, 2015), available at <http://www.xinlilaw.com/news/shownews.php?lang=cn&id=166>.

to PRC Company Law, within three years of the date the Foreign Investment Law takes effect.”³² Under the current FIE laws, “foreign investment is primarily evaluated and estimated based on equity investment.”³³ In contrast, this new Draft Law changed the definition of “foreign investor.”³⁴ Specifically, article 15(6) and article 18(3) expand the scope of FDI (Foreign Direct Investment) to “include contractual control by foreign investors.”³⁵ This change *may* cause “hundreds of listed companies that used the so-called ‘variable interest entity (VIE)’ structures to go through structural changes,” as illustrated in detail below.³⁶

Currently in China, VIEs function in two ways: (1) “foreign actual controller”; and (2) “Chinese actual controller.”³⁷ First, the term “foreign actual controller” refers to foreign investors using VIE structure “to bypass Chinese restrictions on certain market access.”³⁸ According to the FDI Catalogue (both the 2011 Revision and the 2015 Revision), there were four catalogues of foreign investment projects: (1) permitted; (2) encouraged; (3) restricted; and (4) prohibited.³⁹ Generally, the “encouraged” projects are “those that utilize high and advanced

³² See Catherine Miao & Vivian Pan, *Foreign Investment Bulletin January, 2015* (Feb 25, 2015), available at https://mp.weixin.qq.com/s?__biz=MzA5MzYzMzYyNQ==&mid=204631306&idx=1&sn=80ba6866cebe67feed2ddb2623274fc9&key=8ea74966bf01cfb635936595bb18af6bc16087aa05603f35ea2e3d12fb8fe37be168c4a9be56c14d1b35824a148cc784&ascene=14&uin=OTQ1OTI0OTQy&devicetype=iPhone+OS8.1.2&version=16010014&fontScale=100&pass_ticket=nfOCJfeB8JWBfv7BgK8hC4znFTC9%2BISkyDDrQBc6%2FW2tMHB4EqmWvf%2FYvBLV7PL5.

³³ See Norton Rose Fulbright, *supra* note 28.

³⁴ See Waiguo Touzi Fa Cao'an (外国投资法(草案), *supra* note 4.

³⁵ *Id.* art. 15(6), 18(3); see also Li, *supra* note 6.

³⁶ *Id.* (emphasis added).

³⁷ *Id.*

³⁸ *Id.*

³⁹ See Kam ink bird, *supra* note 5.

technology and those that promote environmental protection and energy conservation.”⁴⁰ Some industries are listed as “prohibited” or “restricted” areas for foreign investors and foreign funds (such as telecommunication industries),⁴¹ “[B]ut the reality is that ‘development of these areas’ depends on foreign funds, technologies, [and] management experiences.”⁴² This has been especially true during China’s “opening-up reform,” which has been active since 1980, during which “entrepreneurs, venture capitalists, and service professionals (accountants, lawyers, etc.) jointly [invented] a unique corporate structure to circumvent governmental control,” and the Chinese government allowed it.⁴³ This structure is called Variable Interest Entities (hereinafter referred to as “VIE”).

The VIE works in a specific way when being used by a “foreign actual controller.” First, the foreign fund finds a Chinese domestic person (or entity) as shareholder to set up (or acquires) a *domestic company*. Second, the foreign fund sets up a *parent company* (typically in the Cayman Islands), which further sets up a subsidiary in Hong Kong (for tax preferential treatment consideration). The Hong Kong subsidiary then sets up a Wholly Owned Foreign Enterprises (“*WOFE*”) in China. Next, the *domestic company* and the *WOFE* enter into a set of agreements including a “share pledge agreement,” a “business operating agreement,” an “equity disposal

⁴⁰ Jones Day, *supra* note 2.

⁴¹ See Kam ink bird, *supra* note 5.

⁴² See Yunting You, *Will the foreign investment law eliminate VIE structures?* (Jan 22, 2015), English version available at https://translate.google.com/translate?sl=zh-CN&tl=en&js=y&prev=_t&hl=en&ie=UTF-8&u=https%3A%2F%2Fmp.weixin.qq.com%2Fs%3F__biz%3DMzA4MTE4OTQzNQ%3D%3D%26mid%3D202958786%26idx%3D1%26sn%3Df5b9e1de4fde1ec1dddafa3c89068961f%26scene%3D2%26from%3Dtimeline%26isappinstalled%3D0%26key%3D8ea74966bf01cfb66c0854803ff3919f1bc5b03d6f30cc5d392cee14a0d140ff8eae00bb03ffb40ce36bba37468ed2e9%26ascene%3D2%26uin%3DOTQ1OTI0OTQy%26devicetype%3DiPhone%2BOS8.1.2%26version%3D16010014%26fontScale%3D100%26pass_ticket%3DCIlgGFK3kdrHcJKpEli7y8f2VLJLKQWRl0l7UcTw44iwxInqp6ayR7iRi7hhCT13i&edit-text=&act=url

⁴³ See *id.*

agreement,” an “exclusive consulting and service agreement,” a “loan agreement,” and a “spousal agreement” etc. These agreements guarantee that the foreign fund’s company in the Cayman Islands can have actual control as to the Chinese *domestic company*’s operation, profits, and everything.⁴⁴ In this way, the *WFOE* (foreign fund) “gains de facto control” of the *domestic company* through these service agreements—this “is not ownership through assets, but ownership through management contracts.”⁴⁵ As some attorneys summarized, “[t]he core of the VIE structure is that a WOFE effectively controls a Chinese-owned entity through an elaborate series of contracts.”⁴⁶

Nevertheless, the VIE structure, once regarded as brilliant, now faces fundamental challenges. Some even conclude that it has come to an end⁴⁷. As discussed above, the Draft Law now uses the “actual controller” standard to identify “foreign investors.”⁴⁸ Article 11(2) and article 18 explicitly list some “domestic companies” to be deemed FIEs, because they are actually controlled (including contractual control) by foreign funds.⁴⁹ Therefore the natural consequence shall be that, those companies can no longer invest or operate in those industries that fall within the “prohibited” or “restricted” areas.⁵⁰

⁴⁴ *See id.*

⁴⁵ *See* Christopher Beddor, *How Chinese Companies Bypass Foreign Investment Restrictions* (Sept. 1, 2014), available at <http://knowledge.ckgsb.edu.cn/2014/09/01/china/the-alibaba-ipo-and-how-chinese-companies-bypass-foreign-investment-restrictions/>.

⁴⁶ *See* Steve Dickinson, *China VIEs are Dead. Done. Over. Stick a Fork on Them* (Jan 22, 2015), available at <http://www.chinalawblog.com/2015/01/china-vies-are-dead-done-over-stick-a-fork-in-them.html>.

⁴⁷ *See id.*

⁴⁸ Waiguo Touzi Fa Cao'an (外国投资法 (草案), *supra* note 4 at art. 18.

⁴⁹ *Id.* at art. 11(2), 18.

⁵⁰ *Id.*; *see also* Dickinson, *supra* note 47.

The second way the VIE structure functions is through a “Chinese actual controller.”⁵¹ This method “make[s] businesses available for foreign stock markets, which generally do not accept Chinese companies to be listed.”⁵² The first and most well-known example of this “Chinese actual controller” method is Sina’s Initial Public Offering (IPO) through VIE structure in 2000,⁵³ which is why it is also called the “Sina structure.”⁵⁴ “At present, there are more than 200 companies listed in the US stock market that are using VIE structures”⁵⁵ such as Baidu, Sina and Renren. Back in those days, the Chinese government had not officially admitted or announced the VIE structure as completely legal, and it “remain[ed] as gray area and unproven in Chinese courts” until the release of this Draft Law.⁵⁶

Some conclude that this Draft Law “makes clear that [Chinese] State Council [now] understands how VIEs work and that their sole function is to evade the requirements of Chinese law” by announcing that “such evasion is illegal and will be prohibited upon the effective date of the new investment law.”⁵⁷ It is undeniable that Chinese government intends to eliminate *future* VIE structures by this Draft Law—because under the new Draft law, only companies controlled by Chinese person(s) are eligible to operate in the “forbidden or restricted” areas according to the FDI Catalogue (before this Draft Law) or the “Negative List” (after this Draft Law).⁵⁸ Moreover, the Draft Law is taking a hard position—even imposing criminal penalties via article

⁵¹ Li, *supra* note 6.

⁵² *Id.*

⁵³ See Beddor, *supra* note 46.

⁵⁴ See Ouyang Liang Yi, *Red Chips and VIE: Not Easy to Say Love You*, <http://econ.pku.edu.cn/displaynews.asp?id=8862> (last visited on March 18, 2015).

⁵⁵ See Li, *supra* note 6.

⁵⁶ See Beddor, *supra* note 46.

⁵⁷ See Dickinson, *supra* note 47.

⁵⁸ See Yunting You, *supra* note 43.

149—on those FIEs trying to circumvent Chinese FDI regulations by “contractual schemes.”⁵⁹

This fundamental change raises serious concern for those listed companies using VIE structure, and for underwriters who conduct due diligence for such issuers, because potential investors may reconsider their choices due to potential risk brought by the Draft law. If the company using the VIE structure is not controlled by a Chinese person, its operation will be declared illegal in China after the Draft Law takes into effect, which is undeniable a major fundamental risk.⁶⁰ Therefore, the impact brought by this new Draft Law will be considered “material information,” thus constituting “material omissions” if not duly disclosed.

Furthermore, this impact raises an even more important question: how will the Chinese government deal with the numerous currently existing companies that already utilized and benefited from VIE structures?⁶¹ Some foresee that “[t]here is no way that the PRC regulators will shut down Baidu, Sina, Alibaba and other major VIE entities.”⁶² So far, the Chinese government gives out the following suggestions:

(i) the parties may declare that the business is controlled by Chinese investors and the VIE structure can remain in place [via article 45]⁶³; (ii) MOFCOM may certify that the business is controlled by Chinese investors and the VIE structure can remain in place; and (iii) where the business is controlled by foreign investors, a market entry approval by MOFCOM will be required [via applying for certain licenses] and MOFCOM will assess the situation based on a multitude of factors.⁶⁴

⁵⁹ See Qiang Li, Wendy Pan, Larry Sussman, Walker J. Wallace, Ning Zhang, *China’s New Foreign Investment Law* (Jan 22, 2015), available at <http://www.omm.com/chinas-new-foreign-investment-law/>.

⁶⁰ See Yunting You, *supra* note 43.

⁶¹ See *id.*

⁶² *Id.*

⁶³ See Waiguo Touzi Fa Cao’an (外国投资法 (草案)), *supra* note 4 at art. 25.

⁶⁴ See Qiang Li, Wendy Pan, Larry Sussman, Walker J. Wallace, Ning Zhang, *China’s New Foreign Investment Law* (Jan 22, 2015), available at <http://www.omm.com/chinas-new-foreign-investment-law/>.

IV. CONCLUSION

In short, China's newly released FDI Draft Law raises a major red flag for all the underwriters performing their due diligence duties. Because of the underlying policy change, this Draft Law complies with the general goal of the current Chinese government's FDI regulations. Previous issuer companies using Variable Interest Entities structure to become public overseas (including IPOs in NYSE, NASDAQ or HKSE), now face the fundamental risk of being ruled illegal to their roots. One typical problem that follows is that, such companies may not legally function or even legally exist in China. They cannot engage in daily business operations such as wholesale or retail according to the new Chinese FDI laws. Therefore, existing investors may naturally consider selling their stocks, while potential investors would reconsider buying their stocks. Eventually, such companies will fail and be wiped out of the stock exchange markets.

For underwriters who are helping such issuers with their stock offerings, they need to be alert. Because if they perform their due diligence without being aware of such new policy change, especially if they treat such VIE structured issuers the same way as they had been treated prior to the Draft Law's release, they will face serious problems. Failure to adequately perform their underwriting duties under Chinese Securities laws would result in serious financial as well as criminal liabilities as analyzed above. And there are no such reasonable investigation defense provided to Chinese underwriters as that for American underwriters. However, for American underwriters, even though there are "reasonable investigation" defenses available, under *Feit v. Leasco*, there are different level of scrutiny in deciding the "reasonable investigation" for a different defendant in a due diligence case. Because underwriters are considered "insiders", who

have a higher standard of “reasonableness” than “outsiders,” the risk of violating their due diligence responsibilities is high.

Therefore, besides fully and fairly disclosing such material information under the new FDI regime in China, another possible approach to limiting underwriters’ liability is to clearly state that an attorney's opinion letter is subject to the existence of facts, which the attorney has not investigated.⁶⁵ Furthermore, another possible way of defense would be that, if an issuer-defendant can prove that the plaintiff “knew of the misstatement or omission at the time he acquired the security” or that the plaintiff’s damages “did not result from the misstatements or omission” then he may escape liability. Last but not the least, there is a “forward-looking statement safe harbor” stipulated in 15 U.S. Code § 78u-5.

⁶⁵ Don A. Lesser, *Using Disclaimers in Offering Documents*, Legal Malpractice Rep., sept1990, at 7, 8.

**Exploring Selected Bases for Summary Judgment Decisions
in Statutory Due Diligence Defense Cases**

Susan Wheat¹

I. INTRODUCTION

In the aftermath of the Enron, Refco, WorldCom and Bernard Madoff cases, due diligence practitioners continue to search for effective and reliable ways to protect themselves and their firms from costly and potentially damaging due diligence based litigation. In this regard, a number of relatively recent cases involving due diligence-based summary judgment rulings may be instructive and helpful toward that end.² While varying in the degree of detailed analysis and practical guidance offered, these cases nonetheless offer valuable benchmarks and points of reference for due diligence practitioners. This paper explores some of these summary judgment cases and probes them for tangible elements of insight into the constituent elements of reasonable due diligence. In Part II, I offer an overview of relevant statutory and regulatory background. In Part III, I briefly review a number of relevant summary judgment cases, and in Part IV, I offer a few concluding observations.

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² *See* Weinberger v. Jackson, No. C-89-2301-CAL, 1990 WL 260676, at *4 (N.D. Cal. Oct. 11, 1990); *see also* In re WorldCom, Inc. Sec. Litig., No. 02 CIV. 3288DLC, 2005 WL 638268, at *11 (S.D.N.Y. Mar. 21, 2005); In re Avant-Garde Computing Inc. Sec. Litig., No. CIV. 85-4149(AET), 1989 WL 103625, at *8 (D.N.J. Sept. 5, 1989) In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1424 (9th Cir. 1994); In re Software Toolworks Inc., 50 F.3d 615, 622 (9th Cir. 1994); In re Int'l Rectifier Sec. Litig., No. CV91-3357-RMT(BQRX), 1997 WL 529600, at *7 (C.D. Cal. Mar. 31, 1997); Phillips v. Kidder, Peabody & Co., 933 F. Supp. 303, 323 (S.D.N.Y. 1996) *aff'd sub nom.* Phillips v. Kidder Peabody & Co., 108 F.3d 1370 (2d Cir. 1997).

II. AN OVERVIEW OF STATUTORY DUE DILIGENCE DEFENSES

Notably, the term “due diligence,” while referenced extensively in cases, scholarly publications, and other authoritative or informative literature, has no statutory definition.³ However, it is generally understood as referring to the investigation undertaken by any of a number of different parties in connection with a business transaction. The preponderance of due diligence case law, including those involving summary judgment grants, involve securities offerings and the due diligence activities of various defendants including inside directors, outside directors, and underwriters.

Even without a statutory definition, due diligence plays a central role in most business transactions, including securities offerings. For example, under Section 11 of the Securities Act of 1933 (“Securities Act”), enumerated non-issuer defendants can avoid liability for material misstatements and omissions in offering documents by showing that they “had, after *reasonable investigation*, reasonable ground to believe and did believe . . . 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.”⁴ Such a defendant also may assert a “reliance defense” with respect to expertised material if he can demonstrate that he “had no *reasonable* ground to believe and did not believe” that expertised material contained mistakes or omissions.⁵ Because the reliance defense involves material prepared by experts, the defendant is not required to conduct or prove a “reasonable investigation.”⁶

³ GARY M. LAWRENCE, *DUE DILIGENCE, A SCHOLARLY STUDY* (CADDs Scholars Press, 2nd ed. 2013).

⁴ 15 U.S.C. § 77k(b)(3)(emphasis added).

⁵ 15 U.S.C. § 77(k)(a)(emphasis added).

⁶ *See generally* 15 U.S.C. § 77(k).

Section 12(a)(2) of the Securities Act provides another, slightly different due diligence defense for the offering or solicitation of offers in securities offerings involving a prospectus or oral communication.⁷ For this defense to be successful, the defendant must show that he “did not know, and in the exercise of *reasonable care*, could not have known, of [the] untruth or omission.”⁸ Note that there is no reliance defense under Section 12(a)(2), and there is no distinction between expertised and non-expertised material in that portion of the statute.⁹

While it has generally been recognized that the “reasonable care” defense under Section 12(a)(2) poses a less stringent standard than the “reasonable investigation” defense under Section 11,¹⁰ both clearly incorporate the term “reasonableness.”¹¹ The current provision of Section 12(a)(2) provides no definition whatsoever for what “reasonable care” means. Under Section 11, “reasonableness” is defined as what a “prudent man in the management of his own property” would have done in a similar context.¹² Yet even this definition is amorphous and subject to wide variations in judgment.¹³ Thus in order to better understand the concept of reasonableness, one must consult the relevant case rulings. Most important among these are those involving the grant of summary judgment on the issue, a topic to which we now turn.

⁷ See 15 U.S.C. § 771(a)(2).

⁸ 15 U.S.C. § 771(a)(2)(emphasis added).

⁹ See 15 U.S.C. § 771(a)(2); see also LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, *supra* note 5.

¹⁰ See LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY *supra* note 5 (citing *WorldCom*, 346 F. Supp. 2d at 663).

¹¹ See LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, *supra* note 5; see also 15 U.S.C. § 771(a)(2).

¹² 15 U.S.C. § 77(k)(c).

¹³ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 (1976)).

III: SELECTED CASES INVOLVING SUMMARY JUDGMENT AND THE DUE DILIGENCE DEFENSE

In recent years, a number of courts have offered important guidance as to “reasonableness” in their rulings regarding summary judgment motions. While courts recognize that the issue of reasonableness is typically a matter for the jury, they also have observed that “reasonableness becomes a question of law and loses its triable character if the undisputed facts leave no room for a reasonable difference of opinion.”¹⁴ Several cases have proven to be particularly noteworthy in providing guidance as to what level of care causes “only one conclusion about the conduct’s reasonableness [to be] possible.”¹⁵ However, the rulings have consistently noted that what is reasonable depends in part on what position the defendant holds and what role he or she played in the due diligence investigation. In effect, different levels of due diligence may be expected depending on whether the defendant is an underwriter, an inside director, or an outside director. For this reason, this paper will explore each position separately.

A. Directors

A key aspect of analyzing the level of due diligence to be performed by a director is whether the director is an inside director or an outside director. Generally, the bar for analyzing the due diligence defense is set much higher for inside directors than for outside directors.¹⁶ This idea comes from the landmark due diligence case, *Escott v. BarChris*, in which the court recognized that inside directors’ access to significant information about the company, particularly financial information and information relating to registration statements, allows the

¹⁴ *Software Toolworks*, 50 F.3d at 622.

¹⁵ *Id.*

¹⁶ *Escott v. BarChris*, 283 F. Supp. 643, 643 (S.D.N.Y. 1968).

court to hold insiders to a higher standard than other non-issuer defendants.¹⁷ This idea was reaffirmed in *Feit v. Leasco Data Processing Equip. Corp.*, where the court compared the liability of inside directors to “approach[ing] that of the issuer,” who has strict liability under the federal securities laws.¹⁸ Because of the high expectations that must be overcome by inside directors, summary judgment is much more likely to be granted to outside directors.¹⁹ In *WorldCom*, Judge Cote recognized the difficulty that might be had in defining who constitutes an “outside director,” but highlighted the definition put forth by the New York Stock Exchange:

“[A] director who is not an employee, officer, or former officer of the listing firm or one of its subsidiaries or divisions, or a relative of a principal executive of the firm, or an individual or member of an organization acting as an advisor, consultant, legal counsel, receiving compensation on a continuing basis from the company other than director's fees.”²⁰

An outside director is typically someone who is more remote with respect to the internal functioning and operations of the company and who therefore is limited in his or her involvement in operational matters.²¹ The nature of this position is what allows them to reap the benefits of a lower bar than that of an inside director in regards to the due diligence defense. Outside directors have an especially strong argument for the reliance defense under Section 11, which they often assert, particularly since their distance from the company essentially requires deference to expertised documents and management decisions. Thus, they are likely to be

¹⁷ *Id.*

¹⁸ *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 583 (E.D.N.Y. 1971).

¹⁹ *See WorldCom*, No. 02 CIV. 3288DLC at *11 (“Although such fact-intensive inquiries do not lend themselves easily to resolution on summary judgment, with a properly supported motion it is conceivable that summary judgment could be granted, particularly when brought on behalf of an outside director. Without recognition of the burden placed by this defense on the director to demonstrate diligence, however, a motion for summary judgment is doomed.”).

²⁰ *WorldCom*, No. 02 CIV. 3288DLC at *10 (citing *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L.REV. 1007, 1022 n. 55 (1990)).

²¹ *See id.*

deemed to have “reasonable reliance” as a matter of law in summary judgment proceedings, so long as their “belief. . .[is] found reasonable by an objective standard.”²²

Two cases are particularly relevant to the due diligence defenses of directors. The first case, *In re Avant-Garde Computing Inc. Sec. Litig.*, allowed an outside director to attain summary judgment.²³ This case involved a claim that Avant-Garde had issued stock at an inflated price that conveyed false information regarding its financial health in its prospectus.²⁴ As part of the claim, the plaintiffs sought to hold an outside director liable for “conspiring” with Avant-Garde and its accountants to create an inaccurate prospectus to induce stock purchases.²⁵ However, the outside director provided a detailed affidavit showing his limited, seven-month relationship with Avant-Garde.²⁶ The court found that “the plaintiffs [had] not come forward with anything substantial to rebut the defendant’s sworn statement,” and granted the outside director’s motion for summary judgment.²⁷

The second case, *Laven v. Flanagan*, involved directors who were merely majority stock-owners and participated in very few management activities.²⁸ Curtiss-Wright acquired a significant amount of stock from Western Union, and as part of the agreement appointed three directors to the Western Union board.²⁹ After some questionable decision-making by Western Union management, Curtiss-Wright decided to end the relationship.³⁰ Western Union’s stock

²² *Flanagan*, 695 F. Supp. at 811.

²³ *Avant-Garde*, No. CIV. 85-4149(AET) at *8.

²⁴ *Id.* at * 1.

²⁵ *Id.* at *8

²⁶ *Id.*

²⁷ *Id.* at *9

²⁸ *Id.* at 804.

²⁹ *Id.*

³⁰ *Id.*

plummeted after Curtiss-Wright sold its share, and plaintiffs sought to recover from both companies and the appointed directors.³¹ The court found that the Curtiss-Wright officers served as “outsiders whose presence was never welcome...in Western Union management,” clearly marking them as outside directors.³² These outside directors’ due diligence was deemed “reasonable” as a matter of law, when they relied on statements by the company’s accounting firm and investment bankers in supporting their belief that Western Union was in “robust health.”³³ The court was careful to highlight that while the standard of due diligence remains the same—what a reasonable person would have done in the management of his own property in a similar context—the bar for an outside director to meet that standard is lower.³⁴ These two cases highlight the significance of being deemed an outside director for application of the “reasonableness” standard and their ability to successfully argue due diligence as a matter of law.

Another relevant summary judgment case involving outside director is *Weinberger v. Jackson*. In this case, plaintiffs who purchased stock based on inaccurate information in the prospectus sought to hold an outside director liable.³⁵ However, the court held that, an outside director had acted with sufficient reasonableness so as to earn the due diligence defense under Section 11 as a matter of law.³⁶ The court noted that he reasonably relied on expertised information and that “he was not obliged to conduct an independent investigation into the accuracy of all the statements contained in the registration statement,” but he could only “rely on

³¹ *Id.*

³² *Id.* at 808.

³³ *Id.* at 811.

³⁴ *Id.*

³⁵ *Weinberger*, No. C-89-2301-CAL at *1.

the reasonable representations of management if his own conduct and level of inquiry were reasonable under the circumstances.”³⁷

Among other things, the *Weinberger* court laid out an instructive list of what the outside director had done that the court considered relevant in its summary judgment decision. These included that he:

- (1) was reasonably familiar with the company’s business and operations;
- (2) regularly attended board meetings at which the board discusses every aspect of the company’s business;
- (3) reviewed the company’s financial statements;
- (4) was familiar with the company’s development of its new product lines
- (5) was involved with various company decisions;
- (6) reviewed six drafts of the registration statement and saw nothing suspicious or inconsistent with the knowledge he had acquired as director; and
- (7) discussed certain aspects of the registration statement with management.³⁸

The outside director was deemed to have acted reasonably overall, and in particular to have reasonably relied on the prospectus and its approval by accountants, counsel and underwriters.³⁹

In *WorldCom*, Judge Cote recognized that there are times where a director, whether inside or outside, must do more to be recognized as being “reasonable” as a matter of law.⁴⁰ Judge Cote denied summary judgment to a director defendant noting that she found there was no need to address the issue of whether he was an inside or outside director.⁴¹ She held that regardless of his classification, the director had sufficient knowledge of the industry to make reliance on expertised material an insufficient justification for a “reasonable investigation.”⁴²

³⁶ *Id.* at *4.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *WorldCom*, No. 02 CIV. 3288DLC at *17.

⁴¹ *Id.*

⁴² *Id.*

Further, Judge Cote focused on the particular circumstances, which involved a “red flag,” that should have signaled the director of a problem.⁴³ Given this particular director’s expertise in the telecommunications field, a jury could find that Worldcom’s significant revenue decline would have been a sign for him to look into the problem or raise concern with management.⁴⁴ Judge Cote highlights that the director’s assumption that he had a lower due diligence obligation as an “outside director” was flawed reasoning, particularly given his background and the presence of a red flag.⁴⁵

B. Underwriters

Underwriters are generally held to a slightly different standard than directors, although many of the factors are similar. It is generally understood that underwriters, rather than simply having the ability to assert the defense under Section 11, have an affirmative *duty* to conduct due diligence.⁴⁶ This means that, particularly when compared to outside directors, underwriters are held to a slightly higher expectation of due diligence since “[t]he public looks to the underwriter for protection and expects him to verify the accuracy of the statements in the registration statement.”⁴⁷

In determining whether an underwriter meets this higher “reasonable investigation” standard under Section 11, as with directors, the *Weinberger* case provides an instructive list of significant factors.⁴⁸ The key factors the court focused on were whether the underwriters:

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *In re Richmond Corp.*, 41 S.E.C. 398 (1963).

⁴⁷ LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, *supra* note 5 (quoting Edward F. Greene, *Determining the Responsibility of Underwriters Distributing Securities Within an Integrated Disclosure System*, 56 NOTRE DAME L. REV. 755, 755 (1981)).

⁴⁸ *Weinberger*, 1990 WL at *3

- (1) were familiar with the company's finances, management and operations;
- (2) possessed knowledge of the industry in which the company is involved;
- (3) conducted interviews of the company's employees; and
- (4) obtained written verification from the company and/or outside accountants that the information contained in the prospectus was accurate.⁴⁹

It is significant to note that while these factors provide guidance, they still must be applied to the specific context of the situation at hand, and therefore, are not set in stone.⁵⁰ However, they have been reaffirmed in several cases. In *In re Software Toolworks*, plaintiffs brought action against Software Toolworks when stock prices plummeted after losses on the sale of Nintendo gaming systems were concealed.⁵¹ The plaintiffs alleged that the underwriter should have known that these losses were hidden, causing the prospectus to be misleading.⁵² The court used the *Weinberger* factors to allow an underwriter to meet the due diligence defense as a matter of law for the first time.⁵³ The particular factors the court focused on in this case were:

- (1) interviewing customers and suppliers;
- (2) touring facilities;
- (3) interviewing the issuer's auditors;
- (4) getting comfort letters from the auditors;
- (5) getting written representations from the issuer and selling stockholders that the information in the registration was accurate and did not include any material omissions; and
- (6) retaining legal counsel.⁵⁴

These factors are slightly more specific than those in *Weinberger* and indicate more involvement with the issuer and company management in order to succeed in the defense on summary judgment. *Software Toolworks* also contains valuable information as to still attaining

⁴⁹ *Id.*

⁵⁰ LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY, *supra* note 5.

⁵¹ *Software Toolworks*, 50 F.3d at 624.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.* at 850.

summary judgment, even when the court finds “red flags.”⁵⁵ In *Software Toolworks*, The court found that the underwriter properly addressed a red flag when it took “significant steps” upon discovering a backdated contract by confronting the accounting firm involved, assuring the firm made proper changes and checking with other experts to ensure what the firm was doing was sufficient.⁵⁶ This indicated to the court that reliance on the accounting firm was reasonable as a matter of law because the underwriter clearly did not “blindly rely” on the accounting firm and investigated a troubling matter.⁵⁷

Judge Cote has issued two opinions that are helpful in educating underwriters in what will harm their due diligence defenses.⁵⁸ Her focus are on red flags, and what underwriters must do to address them reasonably⁵⁹. In denying summary judgment for the underwriters in *WorldCom*, she highlighted that the underwriters ignored a red flag in reliance on an audit. She referenced *Software Toolworks* and *Weinberger* to remind underwriters that, simply discovering the red flags while doing nothing about it will not be sufficient to attain summary judgment for reasonable reliance.⁶⁰ She warns that summary judgment is not to be expected, but rather is only awarded when “underwriters have demonstrated extensive due diligence efforts.”⁶¹ Most significantly, however, Judge Cote granted summary judgment for a plaintiff against an underwriter’s due diligence defense in *Nomura*.⁶² In that case, she held that red flags were so

⁵⁵ *Id.*

⁵⁶ *Id.* at 624.

⁵⁷ *Id.*

⁵⁸ *See WorldCom*, 346 F. Supp. 2d at 672; *see also Nomura*, 68 F. Supp. 3d at 479.

⁵⁹ *See WorldCom*, 346 F. Supp. 2d at 672; *see also Nomura*, 68 F. Supp. 3d at 479.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Nomura*, 68 F. Supp. 3d at 479.

apparent that “any reasonable jury” would find that they would “shake a reasonably prudent person’s confidence in the . . . representation.”⁶³ Judge Cote seems to be reminding underwriters that they can’t simply rely on the reliance defense in the face of red flags, particularly ones that they should recognize as significant.

IV. CONCLUSION

In conclusion, the summary judgment cases involving due diligence defenses offer potential defendants insight into some of the constituent elements of “reasonableness” due diligence in select contexts. While the standard of the due diligence defense remains the same—what a reasonably prudent person would do in the management of his or her own property—its application typically varies depending on the persons’ level of involvement as a director or an underwriter in the positional context. The seven *Weinberger* factors discussed above offer tangible guidance regarding specific kinds of director conduct that may be viewed favorably by courts in assessing “reasonableness”.⁶⁴ *Weinberger* court also offers guidance for underwriters, who are typically held to a higher bar of “reasonableness”, by highlighting the importance of active involvement in communicating with management, monitoring past and present company activity, gaining an understanding of the industry, and other factors.⁶⁵ Indeed, the court in *Software Toolworks* specifically cited the *Weinberger* factors in its grant of summary judgment, emphasizing the underwriters’ involvement across the many facets of the due diligence process by communicating with the auditors, stockholders, lower-level employees and legal counsel as well as the issuer.⁶⁶

⁶³ *Id.*

⁶⁴ *Weinberger*, No. C-89-2301-CAL at *4.

⁶⁵ *See id.*

⁶⁶ *See Software Toolworks*, 50 F.3d at 624.

The summary judgment cases also offer more nuanced insights. For example, both *WorldCom* and *Nomura* courts have suggested that defendants should be mindful that their own background and expertise may be considered by a court when ruling on the reliance defense, and that the presence of red flags may override many other considerations.⁶⁷ Judge Cote makes it clear that no one is exempt from addressing red flags, not even outside directors.⁶⁸

Thus, potential defendants should bear in mind their position when conducting due diligence and recognize that, the closer they are to the information, the more likely they are to be found liable. The summary judgment cases give valuable guidance as to what kind of actions have been found “reasonable” to courts so as to render a jury trial unnecessary. These kinds of factors typically involve active engagement with business decisions, documentation and financial review, particularly taking special care when a red flag is encountered to both addressing it and taking action to investigate it. By paying close attention to what has been recognized as convincing to courts when granting summary judgments, business practitioners can better define what is “reasonable,” and work toward a definition of “due diligence,” that will limit liability and prevent financial disasters.

⁶⁷ See *WorldCom*, No. 02 CIV. 3288DLC at *17; see also *Nomura*, 68 F. Supp. 3d at 479.

⁶⁸ See *WorldCom*, No. 02 CIV. 3288DLC at *17.

**Due Diligence on Summary Judgment: Judge Cote Issues a Landmark Ruling,
but Misses an Opportunity to Guide**

Sarah-Michelle Stearns¹

I. Introduction

For many years, parents have taught their children the potential dangers of “following the crowd,” often posing the familiar question, “If your friends jumped off a cliff would you too?” There is wisdom in such caution, but neither the warning nor the question offers any tangible practical guidance regarding alternative courses of action when confronted with pervasive group conduct and attendant peer pressure.

In *Federal Housing Finance Agency v. Nomura Holding America Inc.*, Judge Cote of the Southern District of New York found that the defendants, who were sponsors and/or underwriters of residential mortgage backed securities (“RMBS”), were not entitled *as a matter of law*,² to assert a statutory due diligence defense, even though their conduct met or exceeded the prevailing standards and practices of other similarly situated parties during the time in question. In essence, Judge Cote’s ruling, like the admonitions of the parents noted above, warned of the dangers of following the crowd but offered no practical guidance regarding the best alternative courses of action. This was notwithstanding the fact that neither government regulators nor self-regulatory organizations had taken issue with these “standards of the street” nor had offered different guidance regarding due diligence conduct in RMBS offerings. In this

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² *FHFA v. Nomura Holding America Inc.*, 68 F. Supp. 3d 439, 481 (S.D.N.Y. Dec. 18, 2014).

author's view, did Judge Cote miss a valuable opportunity to guide due diligence practices toward a safer harbor.³

II. Overview of RMBS Generally

Residential Mortgage Backed Securities (RMBS) are securities backed by a pool of thousands of individual residential mortgages.⁴ The pool of mortgage loans becomes securitized through a “special-purpose vehicle” that issues securities “backed solely by those assets” and “not by the credit quality of the sponsoring company.”⁵ RMBS are often sold to “Government-Sponsored Enterprises” (GSEs) such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).⁶

GSEs grew out of the housing crisis of the Great Depression.⁷ GSEs were created so that the government, by “seiz[ing] control of the secondary mortgage market” could “induce home mortgage lending.”⁸ By creating Fannie Mae and Freddie Mac as government investors, the

³ For example, in *Weinberger v. Jackson*, the district court faced a similar issue on summary judgment with regard to the due diligence defense. No. C-89-2301-CAL, 1990 WL 260676, at *2–3 (N.D.Cal. Oct. 11, 1990). The court made a great effort to specifically point out what practices and processes the court considered when determining whether the actors had merited the due diligence defense. *Id.*

⁴ *Federal Housing Finance Agency v. Nomura Holding America, Inc.*, 104 F. Supp. 3d 441, 458 (S.D.N.Y. May 11, 2015).

⁵ Gregory A. Markel, *Defending Claims Against Underwriters of Asset-Backed Securities: The Due-Diligence Defense*, 12 NO. 17 ANDREWS SEC. LITIG. & REG. REP. 2, 2 (2006).

⁶ *Federal Housing Finance Agency v. Nomura Holding America, Inc.*, 104 F. Supp. 3d 441, 453 (S.D.N.Y. May 11, 2015).

⁷ *A Brief History of the Housing Government-Sponsored Enterprises*, FEDERAL HOUSING FINANCE AGENCY, OFFICE OF INSPECTOR GENERAL, 1-2, available at: <http://fhfa.ig.gov/Content/Files/History%20of%20the%20Government%20Sponsored%20Enterprises.pdf>.

⁸ Christopher L. Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOY. J. PUB. INT. L. 149, 153 (2009).

government hoped to “diversify and promote modest competition in the secondary market.”⁹ In 2003 Freddie Mac and Fannie Mae¹⁰ began taking “aggressive positions in the—at that time—highly profitable private label subprime and alt-A mortgage markets.”¹¹ When GSEs bought RMBS, these companies “still guaranteed the principal and interest income of their securities even when mortgagors defaulted,” so investors saw these as “low risk” and as having both “stability and liquidity.”¹² The leadership of these companies at the time justified these purchases based on the notion that these “investments were profitable and furthered their mission of providing support for home ownership.”¹³ As the former CEO of Fannie Mae (Daniel Mudd) indicated, “no one at Fannie Mae could have accurately predicted the extent of the housing crisis.”¹⁴

The securitization process that creates RMBS comes about initially through a sponsor.¹⁵ Sponsors purchase loans from originators and this purchase is “governed by a Mortgage Loan

⁹ *Id.* at 156.

¹⁰ Both of these companies were placed in receivership, under the authority of the FHFA, in 2008 but are now in conservatorship. Christopher L. Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOY. J. PUB. INT. L. 149, 154 (2009); *FHFA as Conservator of Fannie Mae and Freddie Mac*, FEDERAL HOUSING FINANCE AGENCY, available at: <http://www.fhfa.gov/Conservatorship/pages/history-of-fannie-mae--freddie-conservatorships.aspx>.

¹¹ Christopher L. Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOY. J. PUB. INT. L. 149, 163 (2009).

¹² *Id.* at 157.

¹³ *Id.* at 163.

¹⁴ Brian Honea, *Former Fannie Mae CEO Testifies in FHFA v. Nomura Trial*, DSNEWS (Mar. 31, 2015), available at: <http://www.dsnews.com/news/03-31-2015/former-fannie-mae-ceo-testifies-in-fhfa-v-nomura-trial>.

¹⁵ *Federal Housing Finance Agency v. Nomura Holding America, Inc.*, 104 F. Supp. 3d 441, 463 (S.D.N.Y. May 11, 2015).

Purchase Agreement, which contains representations and warranties.”¹⁶ Sponsors sell these loans to depositors. Depositors are special purpose vehicles (SPVs)¹⁷ who then deposit the loans into a trust in exchange for certificates.¹⁸ During this process of securitization the depositor is in charge of issuing the Registration Statements, Prospectus Supplements, and other documents for the Offering.¹⁹ The depositor then sells these certificates to underwriters.²⁰ It is the underwriters who then in turn sell these now-securities to the market of investors, including GSEs.²¹

The lead underwriter in the transaction has a lot of responsibilities. For example, it is typically the lead underwriter who “designs the structure of the securitization and coordinates with the rating agencies to obtain credit ratings for the deal.”²² They are also charged with “performing due diligence to ensure that the Offering Documents are accurate and complete.”²³ Underwriters are charged with this so that, if discrepancies are discovered “between the loans intended for the RMBS and the description of the loans in the Offering Documents” it can fix those discrepancies in one of two ways: by eliminating non-conforming loans from the pool or by revising the Offering Documents so that they are accurate.²⁴ Similarly, the sponsor or depositor is also required to review the information.²⁵ In RMBS deals, it was and is considered

¹⁶ *Id.*

¹⁷ Depositors are often shell corporations. *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ 17 C.F.R. § 229.1111; June Rhee, *Getting Residential Mortgage-Backed Securities Right: Why Governance Matters*, 20 STAN. J.L. BUS. & FIN. 273, 307 fn. 79 (2015).

“appropriate” to “review a sample of loans large enough to be representative of the pool” rather than review every single loan individually.²⁶

RMBS can be sold in what is called a “shelf registration” as was the case in *FHFA v. Nomura*.²⁷ Shelf registrations are “pre-approved registration statements that allow new securities to be issued upon filing of a prospectus supplement.”²⁸

III. The Due Diligence Defense in RMBS

Via Section 11 of the Securities Act of 1933, civil liabilities are imposed on issuers, directors, underwriters, and accountants for misstatements or omissions of material fact from a registration statement.²⁹ Section 11 also provides defenses.³⁰ For example, if an issuer-defendant can prove that the plaintiff “knew of the misstatement or omission at the time he acquired the security” or that the plaintiff’s damages “did not result from the misstatements or omission” then he may escape liability.³¹ Defendants other than the issuer or sponsor, such as the underwriter, are able to establish the due diligence defense.³² This requires underwriters to prove, in the case of non-expertised portions of the registration statement, that “had, after

²⁶ *Id.*

²⁷ *Federal Housing Finance Agency v. Nomura Holding America, Inc.*, 104 F. Supp. 3d 441, 466 (S.D.N.Y. May 11, 2015) (“Each of the seven Securitizations was issued pursuant to one of three shelf registrations.”).

²⁸ *Federal Housing Finance Agency v. Nomura Holding America, Inc.*, 104 F. Supp. 3d 441, 552 (S.D.N.Y. May 11, 2015).

²⁹ 15 U.S.C. § 77k (2012); William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 549 (Spring 2006) (citing 15 U.S.C. § 77k).

³⁰ 15 U.S.C. § 77k (2012).

³¹ 15 U.S.C. § 77k (2012); William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 549 (Spring 2006) (citing 15 U.S.C. § 77k).

³² *Id.*

reasonable investigation, reasonable ground to believe and did believe” that there was no material misstatement or omission.³³ Similarly, Section 12 of the Securities and Exchange Act of 1934 imposes liability on sellers or control persons for false or misleading statements or omissions by “prospectus or oral communication.”³⁴ There is also this due diligence defense for non-issuers with regard to expertised portions of the registration statement.³⁵ Similarly, Section 12(a)(a) provides for the defense of “reasonable care” for all potential defendant-sellers, a defense that “is less demanding than the duty of due diligence.”³⁶ A defendant may avoid liability under this provision if “in the exercise of reasonable care, [he] could not have known of the untruth or omission.”³⁷ The reasonableness of an investigation or of grounds for belief is judged according to what a “prudent man in the management of his own property” would have done.³⁸

The defense comes up in RMBS deals with the situation when plaintiffs claim that the offering documents either omitted information or contain false information (material in nature).³⁹ For example, plaintiffs often claim that the loans were not originated in accordance with underwriting guidelines or that information about “property appraisals, loan-to-value [LTV]

³³ 15 U.S.C. § 77k (b)(3)(A) (2012).

³⁴ 15 U.S.C. § 77l (2012).

³⁵ See 15 U.S.C. § 77k(b)(3)(C) (2012).

³⁶ Todd R. David, et al., *Heightened Pleading Requirements, Due Diligence, Reliance, Loss Causation, and Truth-On-The-Market – Available Defenses to Claims Under Sections 11 and 12 of the Securities Act of 1933*, 11 TRANSACTIONS: TENN. J. BUS. L. 53, 67 (Spring 2010); see *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 663 (S.D.N.Y. Dec. 15, 2004); see SEC Release Nos. 33-8591, 34-52056, 70 Fed. Reg. 44,722 at 44,770 (August 3, 2005).

³⁷ 15 U.S.C. § 77l(a)(2) (2012).

³⁸ 15 U.S.C. § 77k(c) (2012).

³⁹ *Common Threads in Mortgage-Backed Securities Cases*, FORUM (2011), available at: <http://www.analysisgroup.com/forums/analysis-group-forum/common-threads-mortgage-backed-securities-cases/>.

ratios, or borrower incomes” was not accurate.⁴⁰ In these situations, “[t]he due-diligence defense is extremely important to underwriters” because underwriters are “necessarily less familiar with the business or, in the context of [asset backed securities], the asset pool underlying the securities, than the issuer or sponsor of the securities.”⁴¹

It is important to note that in shelf offerings, the standard for due diligence is not lower than the standard for other types of offerings.⁴² Prior to the advent of shelf registration, underwriters had “vehemently”⁴³ opposed its proliferation precisely because, by their very nature, these types of offerings dramatically decrease the time allowed for due diligence.⁴⁴ To assure the underwriters that they could still earn their due diligence defense, the SEC began to promote the practice of “continuous due diligence” and suggested practices such as “participat[ing] in the drafting and review of periodic [Exchange Act] disclosure documents before they are filed” and holding “periodic due diligence sessions” with issuers.⁴⁵ The SEC also suggested that the issuer should appoint and utilize an “underwriters’ counsel” to ensure continuity of the due diligence process.⁴⁶ Finally, the SEC “threw underwriters a bone” in the form of Rule 176.⁴⁷ However, Rule 176 merely listed circumstances that courts should consider,

⁴⁰ Gregory A. Markel, *Defending Claims Against Underwriters of Asset-Backed Securities: The Due-Diligence Defense*, 12 NO. 17 ANDREWS SEC. LITIG. & REG. REP. 2, 3 (2006).

⁴¹ *Id.*

⁴² *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 669 (S.D.N.Y. Dec. 15, 2004).

⁴³ Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters’ Continuous Due Diligence After WorldCom*, 30 CARDOZO L. REV. 2001, 2018 (2009).

⁴⁴ *Id.* at 2018-19.

⁴⁵ *Id.* at 2021-22 (internal citations omitted).

⁴⁶ *Id.* at 2021 n. 121.

⁴⁷ *Id.* at 2022-23.

rather than provide guidance for avoiding liability.⁴⁸ Thus, although more appropriate for the SEC, it was left to the courts to provide delineation as to what would constitute “reasonableness” for the purposes of due diligence in these types of offerings.

IV. The Time Period in Which the Transactions Took Place

In the Final Report⁴⁹ that the Financial Crisis Inquiry Commission issued in January 2011, government officials outlined what was considered the industry standards of the time.⁵⁰ “First, firms purchasing and securitizing the mortgages [conducted] due diligence reviews of the mortgage pools, either using third-party firms or doing the reviews in-house.”⁵¹ Second, the parties disclosed what they were selling to investors, pursuant to Securities and Exchange Commission rules.⁵² While these processes were supposed to function as “checks,” neither of them worked as planned.⁵³

This is for many reasons. For example, “[w]hile the percentage of the pool examined could be as high as 30%,” sponsors often examined a much lower amount,⁵⁴ Further, while some

⁴⁸ William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 570 (2006) (“Rule 176 did little more than codify existing SEC views on circumstances impacting the extent of due diligence”); Christian A. Young, *Looking Back on WorldCom: Addressing Underwriters’ Due Diligence in Shelf Registration Offerings and the Need for Reform*, 40 SUFFOLK U. L. REV. 521, 546 (2007); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 541 (2001) (“Rule 176 has not proved useful in practice”); see Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters’ Continuous Due Diligence After WorldCom*, 30 CARDOZO L. REV. 2001, 2022-23 (2009).

⁴⁹ *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, FINANCIAL CRISIS INQUIRY COMMISSION 165 (Jan. 2011), available at: http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ Often “as low as 2% to 3%.” See *id.*

parties in the securitization process “requested that the [third-party] due diligence firm analyze a random sample of mortgages from the pool,” others “asked for a sampling of those most likely to be deficient in some way, in an effort to efficiently detect more of the problem loans.”⁵⁵ The latter is what Nomura had done.⁵⁶ Perhaps most egregiously, when the sponsor asked third-party firms to examine the potentially bad loans (a non-random sample) and the firm returned a bad rating, the commission found that the securitizer would nevertheless accept many of the bad loans and “waive” them in “even though the company had found a basis for rejecting them.”⁵⁷ In fact, given the competitive culture at that time, the commission concluded that securitizers and underwriters “often waived in loans to preserve their business relationship with the loan originator” because “a high number of rejections might lead the originator to sell the loans to a competitor.”⁵⁸ Thus, many prospectuses from sponsors/issuers “indicated that the loans in the pools either met guidelines outright or had compensating factors, even though [the due diligence firm’s] records show[ed] that only a portion of the loans were sampled, and that of those that were sampled, a substantial perception of Grade 3 Event [(bad)] loans were waived in.”⁵⁹

V. Facts of the Case

Nomura Credit & Capital Inc. (NCCI) was the sponsor of all seven of the loans.⁶⁰ Nomura Securities (Nomura) was the lead underwriter for two of the loans and a co-lead underwriter for a third, while the Royal Bank of Scotland (RBS) was the lead underwriter for

⁵⁵ *Id.*

⁵⁶ *FHFA v. Nomura Holding America Inc.*, 68 F. Supp. 3d 439, 450 (S.D.N.Y. Dec. 18, 2014).

⁵⁷ *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, FINANCIAL CRISIS INQUIRY COMMISSION 166 (Jan. 2011), available at: http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

⁵⁸ *Id.*

⁵⁹ *Id.* at 167.

⁶⁰ *FHFA v. Nomura Holding America Inc.*, 68 F. Supp. 3d 439, 448 (S.D.N.Y. Dec. 18, 2014).

three and a co-lead underwriter for a fourth.⁶¹ NCCI and Nomura Securities were so “closely intertwined” that “[a]ll of NCCI’s officers were also officers or employees of Nomura Securities.”⁶² Before deciding to purchase a pool of loans to securitize, a NCCI analyst would obtain and review a “loan tape”⁶³ and would perform its own analysis by calculating “certain values, like the LTV and debt-to-income (‘DTI’) ratios, based on data on the loan tape.”⁶⁴ The point of this process was to ensure the internal consistency of the data that was provided.⁶⁵ However, to even be able to conduct this process, the sponsor (here, NCCI) had to first bid on the pool.⁶⁶ Only if NCCI won the bid was NCCI “permitted to review some or all of the loan files before final settlement of the trade.”⁶⁷ In this case the review and analysis was conducted by NCCI’s own due diligence group as well as by vendors chosen by NCCI.⁶⁸

NCCI’s own due diligence group typically carried out three distinct reviews for each pool: a credit⁶⁹ review, a compliance⁷⁰ review, and a valuation⁷¹ review.⁷² A valuation review

⁶¹ *Federal Housing Finance Agency v. Nomura Holding America, Inc.*, 104 F. Supp. 3d 441, 466 (S.D.N.Y. May 11, 2015).

⁶² *Id.* at 544.

⁶³ This loan tape was “a spreadsheet listing selected characteristics of each loan in the pool.” *FHFA v. Nomura Holding America Inc.*, 68 F. Supp. 3d 439, 448 (S.D.N.Y. Dec. 18, 2014).

⁶⁴ *FHFA v. Nomura Holding America Inc.*, 68 F. Supp. 3d 439, 448 (S.D.N.Y. Dec. 18, 2014).

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ During the credit review the loans were examined “to determine if the loan was originated in accordance with the originator’s credit guidelines.” *Id.* at 448-449.

⁷⁰ During the compliance review the loans were examined “to determine if the loan complied with federal, state, [and] municipal regulations.” *Id.*

⁷¹ During the valuation review the group looked at the appraisals of the “loans’ underlying properties” to verify whether they were “reasonable and accurate.” *Id.*

⁷² *Id.*

was carried out for all loans.⁷³ However, credit and compliance reviews were only carried out for *a sample* of the loans when the deal consisted of an immensely large, bulk pool.⁷⁴

At issue in *Federal Housing Finance Agency v. Nomura Holding America Inc.* case were seven securitizations.⁷⁵ Nomura and RBS, as lead underwriters, issued RMBS to GSE companies that later became controlled by the Federal Housing Finance Agency (FHFA).⁷⁶ In the aftermath of the 2008 Recession, the FHFA brought many lawsuits against Wall Street Banks.⁷⁷ Most of them settled.⁷⁸ In this case against Nomura and RBS, both Nomura and RBS asserted their Sections 11 and 12(a)(2) due diligence defenses as sellers and underwriters.⁷⁹ This case was extraordinary in that it was the first case brought by FHFA that went to trial, a *bench* trial.⁸⁰ It was also a landmark ruling for the reasons discussed in the next section. Eventually the Honorable Judge Cote found Nomura and RBS were liable for securities violations.⁸¹ Nomura and RBS filed their appeals on June 10, 2015.

⁷³ *Id.* at 449.

⁷⁴ *Id.* (emphasis added).

⁷⁵ *Id.* at 458.

⁷⁶ *Id.* at 465.

⁷⁷ David McAfee, *Barclays to Pay \$280M to Settle FHFA's Private MBS Actions*, LAW360 (April 24, 2014, 9:14PM), available at: <http://www.law360.com/articles/531744/barclays-to-pay-280m-to-settle-fhfa-s-private-mbs-actions>; Kat Greene, *Nomura to Pay FHFA Up to \$839M if 2nd Circ. Fight Flops*, LAW360 (Feb. 26, 2016), available at: <http://www.law360.com/articles/699922>.

⁷⁸ *Id.*

⁷⁹ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 444 (S.D.N.Y. Dec. 18, 2014).

⁸⁰ *Federal Housing Finance Agency v. Nomura Holding America, Inc.*, 104 F. Supp. 3d 441, 454 (S.D.N.Y. May 11, 2015).

⁸¹ *Id.* at 453.

VI. Judge Cote's Decision: No Due Diligence Defense as a Matter of Law

Prior to the end outcome in November of 2014, FHFA had moved for partial summary judgment on Nomura's and RBS's due diligence and reasonable care defenses.⁸² In a landmark ruling, Judge Cote held, on summary judgment standard, that both Nomura and RBS had failed to exercise either due diligence or reasonable care and thus were not entitled to either of those defenses.⁸³ Judge Cote explained that,

*The reasonableness of a defendant's due diligence investigation will, in most cases, be a question for the jury. It is a mixed question of law and fact that will often hinge on disputed factual issues. Even when it does not, reasonable minds could often disagree about whether a given investigation would have satisfied a prudent man in the management of his own property. In exceptional cases, where no reasonable, properly instructed jury could find for a defendant, summary judgment is appropriate. For the reasons explained at length below, this is such a case.*⁸⁴

Indeed, with regard to Nomura, in particular Judge Cote stated that the "pre-purchase review that Nomura conducted here was not adequate for [the] purpose [of due diligence] *as a matter of law.*"⁸⁵ The summary judgment standard is that the "moving party bears the burden of demonstrating the absence of a material factual question, and in making this determination, the court must view all facts in the light most favorable to the non-moving party."⁸⁶ Yet Judge Cote still found that neither Nomura nor RBS could assert a due diligence defense given the facts.⁸⁷

⁸² *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 485-86 (S.D.N.Y. Dec. 18, 2014).

⁸³ *Id.* at 445.

⁸⁴ *Id.* (emphasis added).

⁸⁵ *Id.* (emphasis added).

⁸⁶ *Id.* at 466.

⁸⁷ *Id.* at 485-86.

a. Nomura's Due Diligence

As a preliminary matter, Judge Cote pointed out that the issue of “whether the challenged representations were or were not accurate, has no bearing on whether Defendants undertook a reasonable investigation or exercised reasonable care to assure themselves they were” for purposes of either the Section 11 or Section 12(a)(2) defense.⁸⁸ Even if the representations “were perfectly true” it “would do nothing to improve Defendants’ due diligence.”⁸⁹ Judge Cote found that Nomura was not entitled to either defense, in its capacity as either a sponsor/issuer or an underwriter.

As a sponsor/issuer, Nomura had failed to formulate a due diligence process for evaluation.⁹⁰ Even “putting aside this fundamental error,” there no reasonable juror could find that Nomura’s poorly-designed preacquisition review could provide an accurate basis for the representations that Nomura made in its offering documents.⁹¹ Nomura had made representations in its initial offering documents that: (1) all of the loans were originated “generally in accordance with the underwriting guidelines;” (2) “57.5% of the loans (or 68.4% of the pool by principal balance) had an LTV ratio of 80% or lower, and 26.5% of the loans (or 31.1% of the pool by principal balance) had a CLTV ratio of 80% or lower;” (3) “93.2% of the underlying properties were owner occupied;” and that (4) “the most senior class, I–A–1 would be given the highest credit rating by Standard & Poor's, Moody's, Fitch, and DBRS.”⁹² For the reasons listed below, according to Judge Cote, Nomura had had no reasonable basis for those

⁸⁸ *Id.* at 484.

⁸⁹ *Id.*

⁹⁰ *Id.* at 445.

⁹¹ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 445 (S.D.N.Y. Dec. 18, 2014).

⁹² *Id.* at 455.

representations. Even after gathering further information that would indicate the representations would need to change in the supplemental prospectuses, Nomura failed to alter the information in the supplemental prospectuses, aside from listing some “compensating factors,” so the court found Nomura similarly had no reasonable basis for the representations in the supplemental prospectuses.⁹³

First, as a sponsor/issuer, Nomura had “never created a due diligence program to confirm the accuracy of the representations.”⁹⁴ Even after winning the bid for the loans, its review relied “entirely on the results of its preacquisition review” of the loan pools “from which it would later take loans to populate the seven [loan groups].”⁹⁵ Second, Judge Cote took issue with Nomura’s sampling methods.⁹⁶ The sample size Nomura used in its review, while higher than most (25-30%)⁹⁷, it was non-random, which meant that the results could not be extended to the entire loan pool.⁹⁸ Third, there was no evidence presented to Judge Cote that “Nomura even considered during the securitization process the impact its processes would have on the accuracy of its representations in the Offering Documents” as the issuer.⁹⁹

⁹³ *Id.* at 456.

⁹⁴ *Id.* at 475.

⁹⁵ *Id.*

⁹⁶ *Id.* at 475-77.

⁹⁷ *Id.* at 454.

⁹⁸ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 475 (S.D.N.Y. Dec. 18, 2014); Ed Walker, *Lessons from the FCIC Final Report in FHFA v. Nomura*, EMPTYWHEEL (May 29, 2015), available at: <https://www.emptywheel.net/2015/05/29/lessons-from-the-fcic-final-report-in-fhfa-v-nomura/>.

⁹⁹ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 476 (S.D.N.Y. Dec. 18, 2014).

Similarly, in its capacity as an underwriter, Nomura’s first mistake was to rely “almost entirely on the testing of samples from loan pools before it purchased them.”¹⁰⁰ Second, even if Nomura had been able to rely on the results of its prior, feeble review and sampling methods, the court found that that review had resulted in “red flags” which Nomura ignored.¹⁰¹ Specifically, the preacquisition review had “revealed high ‘kick-out’ (defective loan) rates; yet, Nomura never upsized any sample to determine if these problems might pervade the entire pool and never considered the implications of these red flags for the quality of the loans chosen for the [loan groups], which included both reviewed and unreviewed loans.”¹⁰² Nomura disregarded an audit that “revealed, before the issuance of four of the certificates, that Nomura could not trust its review process to identify defective loans.”¹⁰³ Third, although Nomura had gotten a third-party credit rating agency to analyze the loans, Nomura disregarded that diligence; even when those firms “graded 38% as failing to meet the originator guidelines” Nomura “waived in 58% of

¹⁰⁰ *Underwriters Denied Due Diligence Defense on Summary Judgment in Securities Act Suit: Federal Housing Finance Agency vs. Nomura Holding America, Inc.*, SECURITIES ARBITRATION COMMENTATOR (Mar. 4, 2015), available at: <http://www.sacarbitration.com/blog/underwriters-denied-due-diligence-defense-summary-judgment-securities-act-suit-federal-housing-finance-agency-vs-nomura-holding-america-inc/>; *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 476-77 (S.D.N.Y. Dec. 18, 2014).

¹⁰¹ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 478-81 (S.D.N.Y. Dec. 18, 2014).

¹⁰² *Underwriters Denied Due Diligence Defense on Summary Judgment in Securities Act Suit: Federal Housing Finance Agency vs. Nomura Holding America, Inc.*, SECURITIES ARBITRATION COMMENTATOR (Mar. 4, 2015), available at: <http://www.sacarbitration.com/blog/underwriters-denied-due-diligence-defense-summary-judgment-securities-act-suit-federal-housing-finance-agency-vs-nomura-holding-america-inc/>; *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 476-80 (S.D.N.Y. Dec. 18, 2014).

¹⁰³ *Underwriters Denied Due Diligence Defense on Summary Judgment in Securities Act Suit: Federal Housing Finance Agency vs. Nomura Holding America, Inc.*, SECURITIES ARBITRATION COMMENTATOR (Mar. 4, 2015), available at: <http://www.sacarbitration.com/blog/underwriters-denied-due-diligence-defense-summary-judgment-securities-act-suit-federal-housing-finance-agency-vs-nomura-holding-america-inc/>; *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 451, 476-81 (S.D.N.Y. Dec. 18, 2014).

those.”¹⁰⁴ This, along with the high kick-out rates meant that “of the examined loans, about 22% had major defects” not even counting the unexamined loans, the inclusion of which would like mean that the “number of defective loans remaining would be much higher” in actuality.¹⁰⁵ Finally, the court found that Nomura had “gamed the credit rating agencies models by submitting only the loan tapes prepared by the originators, even when they knew that the loan tapes were full of errors that would affect the final rating.”¹⁰⁶ Because the accuracy of the ratings depended on accurate information about the LTV ratio and the DTI ratio, and because the LTV ratios “were lower than represented by Nomura in 18-36% of the loans,” and because “many LTV ratios were above 100%, which skewed the models of the credit ratings agencies” it “bought Nomura underserved AAA ratings.”¹⁰⁷

Essentially, “Nomura took no care to design this pre-acquisition review, or the process it later used to select loans from those Trade Pools for the [seven loan groups], to render that review, in conjunction with its selection process, a reliable basis to believe that the Offering Documents' descriptions of the SLGs [(supporting loan groups)] were accurate.”¹⁰⁸ Most egregiously, it appeared from testimony that no one held the responsibility of ensuring the “accuracy of the contents of the Prospectus Supplements.”¹⁰⁹

¹⁰⁴ Ed Walker, *Lessons from the FCIC Final Report in FHFA v. Nomura*, EMPTYWHEEL (May 29, 2015), available at: <https://www.emptywheel.net/2015/05/29/lessons-from-the-fcic-final-report-in-fhfa-v-nomura/>.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 475 (S.D.N.Y. Dec. 18, 2014).

¹⁰⁹ Ed Walker, *Lessons from the FCIC Final Report in FHFA v. Nomura*, EMPTYWHEEL (May 29, 2015), available at: <https://www.emptywheel.net/2015/05/29/lessons-from-the-fcic-final-report-in-fhfa-v-nomura/>.

b. RBS's Due Diligence

RBS did only slightly better than Nomura, according to Judge Cote. “Unlike Nomura, to the extent RBS conducted a review of loans, it did so after the composition of the SLGs had been determined.”¹¹⁰ Yet this review was undertaken for only two securitizations, and in any event was “manifestly inadequate as a matter of law.”¹¹¹ For the other two securitizations RBS “undertook no independent review.”¹¹²

During the review for one of the securitizations, discovery revealed that RBS's Credit Group had “called the loans ‘crap’ and asked to review one-quarter of them” but then, despite that finding, had “ultimately decided to sample less than one-fourth that number.”¹¹³ Then, despite RBS's failure to actually “collect all of the files” needed for that small sample, RBS forged ahead “with a review of incomplete sets” all the while “ignor[ing] entirely the results of its valuation reviews” for both securitizations, “taking no action when a substantial portion of its sampled loans in both groups appeared to have faulty appraisals.”¹¹⁴ Judge Cote considered this a red flag ignored.

Furthermore, for the other two securitizations RBS “undertook no independent review of the loan files,” independent verification being required for reasonableness according to Judge Cote.¹¹⁵ For one of these securitizations, RBS “knew nothing” except for “a one-page summary

¹¹⁰ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 446 (S.D.N.Y. Dec. 18, 2014).

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 481.

listing kick-out rates for all Trade Pools that contributed loans to the Securitization.”¹¹⁶ RBS was faulted for not following up on the representations in this summary and for not “demand[ing] a representation from Nomura that this summary of Nomura’s review was complete and accurate.”¹¹⁷ For the other, RBS was faulted with relying “entirely on Nomura’s pre-acquisition review of the Trade Pools” and for “never asking how loans were selected from the Trade Pools to populate the SLGs” or “undertaking any independent investigation of the representations in the Offering Documents.”¹¹⁸ Essentially, RBS was faulted with trusting and failing to “play devil’s advocate.”¹¹⁹

RBS had argued that “underwriters of RMBS should not be required to duplicate a review already conducted by the sponsor” but Judge Cote rejected that argument stating that RBS had to either undertake its own investigation or take affirmative steps to “assure itself that the other entity’s review” was thorough and accurate.¹²⁰ In this case, Judge Cote found that there was no way RBS could have had a “reasonable basis” to believe Nomura’s review was thorough or reliable.¹²¹

RBS also argued that they had “met or exceeded industry standards at the time.”¹²² Additionally, RBS argued that their due diligence could not be decided before “determining whether the SLGs actually contained a substantial number of defective loans” and thus, whether

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 482.

¹¹⁸ *Id.* at 481.

¹¹⁹ *Id.* (internal citation omitted).

¹²⁰ *Id.* at 482-83.

¹²¹ *Id.* at 483.

¹²² *Id.* at 484.

the Offering Documents “were materially false.”¹²³ Judge Cote disagreed on both counts.¹²⁴ She stated that “whether the challenged representations were or were not accurate has no bearing on whether Defendants undertook a reasonable investigation or exercised reasonable care to assure themselves they were.”¹²⁵ Further, industry standards are not dispositive. In fact, even if a reasonable jury could find that Nomura and RBS had been more diligent than other underwriters of RMBS at that time, they nevertheless “failed to present sufficient evidence from which a jury could find that their performance in connection with these seven Securitizations satisfied the Securities Act’s standards for reasonable investigations and reasonable care.”¹²⁶

VII. Conclusion

In hindsight, after seeing the emails exchanged and the overall decision-making process of both Nomura and RBS, it is understandable why Judge Cote came to the decision she eventually did.¹²⁷ However, the decision was both premature and missed an opportunity to provide guidance for underwriters in future RMBS shelf offerings. The decision was premature in the sense that Judge Cote should not have decided this on summary judgment. Further, in the absence of explicit regulatory guidance, this case provided Judge Cote the opportunity to contribute to the conversation over what specific conduct is reasonable, rather than leave it to the industry to guess and check.

¹²³ *Id.*

¹²⁴ *Id.* at 484-85.

¹²⁵ *Id.* at 484.

¹²⁶ *Id.* at 484-85.

¹²⁷ *See id.* at 461-62 (email between RBS employees referring to a pool as “crap” and later taking the conversation “off line” (without a paper trail) without any good explanation).

a. The Decision Should Not Have Been Made on Summary Judgment

This decision should not have been decided on summary judgment. As Judge Cote noted in her opinion, “[a] defendant’s assertion of the due diligence defense requires an exquisitely fact intensive inquiry into all of the circumstances surrounding the facts upon which the Section 11 claim is premised,’ and the same is true for a defense of reasonable care under Section 12(a)(2).”¹²⁸ In light of the fact-intensive nature of the inquiry and in light of the circumstances of this case, Judge Cote should not have made this determination on summary judgment. Specifically, the lack of guidance at the time; the industry standards of the time; the fact that this was a shelf offering; and the due diligence that was actually performed all raised a genuine issue of material fact as to the reasonableness of Nomura’s and RBS’s actions and should have been explored further in an actual trial setting, rather than in a summary judgment proceeding.

i. The Lack of Guidance and Developed Industry Standards at the Time

Raised a Genuine Issue of Material Fact as to Reasonableness

The “SEC’s mandate is to protect investors” and, “in the case of initial public offerings of a company’s shares, the work has historically involved a lengthy review of the issuer’s prospectus and other ‘offering materials’ prior to sale.”¹²⁹ Where was the SEC and what were they doing during the time period of these transactions?¹³⁰ The answer is: providing more opportunities for issuers and underwriters to escape the scrutiny of registration requirements while simultaneously failing to provide any other safeguards or guidance. In this author’s view, this is something Judge Cote failed to give more weight to in crafting her opinion.

¹²⁸ *Id.* at 466.

¹²⁹ *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, FINANCIAL CRISIS INQUIRY COMMISSION 170 (Jan. 2011), available at: http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

¹³⁰ *Id.*

At the time of these transactions, issuers could utilize a “shelf registration” which required the filing of only a “base prospectus” which could later be followed by a “supplemental prospectus.”¹³¹ Yet the “elephant in the room” was that, according to the SEC’s own deputy director, they “didn’t review the prospectus supplements.”¹³² Thus, many securities—just like the ones at issue in this case—were issued “with practically no SEC oversight.”¹³³

This was in light of the fact that the SEC had itself created the mechanism for shelf-registration, had blessed the use of CDOs,¹³⁴ and had encouraged use of the relatively new Rule 144A¹³⁵ which also released many offerings from the scrutiny of registration requirements.¹³⁶ In 1996, despite the warnings of individuals such as Denise Voigt Crawford, a commissioner of the Texas Securities Board, Congress “reinforced” Rule 144A with the National Securities Markets Improvements Act.¹³⁷ People such as Ms. Crawford chastised this legislation as “prohibit[ing] the states from taking preventative actions in areas that we now know have been substantial contributing factors to the current crisis.”¹³⁸ Thus, this was a situation where the SEC had not only allowed, but encouraged, more lax procedures while concurrently failing to provide guidance as to due diligence standards in order to compensate for these lax procedures.

¹³¹ *Id.*

¹³² *Id.* at 169.

¹³³ *Id.*

¹³⁴ CDOs are “not subject even to the minimal shelf registration rules.” *Id.*

¹³⁵ Rule 144A was created by the SEC to make securities markets “more attractive to borrowers” and to make U.S. investment banks “more competitive with their foreign counterparts.” *Id.*

¹³⁶ *Id.* at 170.

¹³⁷ *Id.*

¹³⁸ *Id.*

Without guidance as to: (i) whether or not pre-acquisition due diligence alone would be considered adequate; (ii) which methods sampling would be considered adequate; and (iii) under what circumstances, if any, it is reasonable for an underwriter to trust the sponsor/issuer, even when they are able to undertake their own review, Nomura's and RBS's actions were, at the very least, understandable and raised a genuine issue of material fact sufficient to go to trial. In making this determination of reasonableness on summary judgment, Judge Cote limited the range of evidence considered and failed to give a fair amount of weight to the lack of guidance and industry standards of the time.

As previously mentioned, neither FINRA nor the SEC had released any guidance as to what specific processes and sampling methods would be considered reasonable for purposes of due diligence in these new types of transactions subject to minimal registration requirements. At the time, it was reasonable to rely on pre-acquisition due diligence alone. At the time, it was reasonable to sample the amount of loans that Nomura and RBS sampled. At the time, not even Fannie Mae considered that type of due diligence inadequate.¹³⁹ Interestingly, the Supreme Court has recognized that it is “commonplace for analysts to ‘ferret out and analyze information.’”¹⁴⁰ Yet here Fannie Mae did not appear concerned with analyzing (or scrutinizing) the due diligence regime of either Nomura or RBS.¹⁴¹ Particularly, there was evidence presented that Fannie Mae and Freddie Mac “were aware, and never objected to, the broad contours of Nomura's pre-acquisition ‘diligence’ regime.”¹⁴² To date, FINRA and the SEC still have not

¹³⁹ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 465 (S.D.N.Y. Dec. 18, 2014).

¹⁴⁰ *Dirks v. S.E.C.*, 463 U.S. 646, 658 (1983) (internal citation omitted).

¹⁴¹ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 481 (S.D.N.Y. Dec. 18, 2014).

¹⁴² *Id.*

released much guidance. While the SEC has issued rules regarding third-party due diligence,¹⁴³ these rules do not specifically address particular actions that can be taken by sponsors/issuers and underwriters that will be considered reasonable.¹⁴⁴

Nomura's and RBS's decision to default to industry standards, in the absence of guidance, was entirely appropriate, especially in the context of shelf offerings. In this context, a prudent man's common sense *would* default to such industry standards. Moreover, a determination of reasonableness should be made based on the due diligence that was actually performed and not based on what one person thought. Admittedly, there were ugly emails exchanged indicating that, at least according to one person at those entities, the loans were bad.¹⁴⁵ Yet an objective analysis of reasonableness is not based on one person's point of view, and despite those ugly emails, which are tangential to the inquiry at best, Nomura and RBS acted reasonably.

Further, at times a reasonably prudent man would have identified may not identify a certain fact as a red flag when he learns of it, in light of his own knowledge of industry standards, history of the market, and knowledge of deal-making. Although this fact appears later to constitute a "red flag" with the benefit of hindsight, it could have been thought of as "ordinary" at the relevant time period. Judge Cote stated that "the testing of a single set of loans based on adverse sampling provided no reliable basis to believe that all or most of the defective

¹⁴³ These rules require: (i) the review of whether a sample of loans meets underwriting guidelines; (ii) disclosure of how the information was verified in the sampled loan; and (iii) disclosure of the actual sample size and how it was created. SEC Release No. 34-72936 ("NRSRO Release"), *available at*: <http://www.sec.gov/rules/final/2014/34-72936.pdf>.

¹⁴⁴ SEC Release No. 34-72936 ("NRSRO Release"), *available at*: <http://www.sec.gov/rules/final/2014/34-72936.pdf>.

¹⁴⁵ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 446 (S.D.N.Y. Dec. 18, 2014).

loans had been located and culled.”¹⁴⁶ Yet if that is the process Nomura had been using for years, if it had worked in the past, if no investor had raised an issue with that process, then it could have been reasonable for Nomura to adhere to the old adage “if it ain’t broke, don’t fix it” and consider its process reliable.

ii. The Reasonably Prudent Man Can, At Times, Rely Without Independent Investigation

Other than guidance from the regulators themselves,¹⁴⁷ there are few judicial decisions regarding the due diligence defense “because most cases under Section 11 and 12(a)(2) settle early.”¹⁴⁸ The main sources of guidance on due diligence are cases such as *Escott v. BarChris, In re Software Toolworks Inc., Feit v. Leasco*, and *Weinberger v. Jackson*.¹⁴⁹ Thus, “[n]early forty-five years after it was decided, *Escott v. BarChris Construction Corp.* remains the landmark case on the due diligence defense under the Securities Act of 1933.”¹⁵⁰

BarChris provided guidance in so far as it stated that “underwriters must make some reasonable attempt to verify the data submitted to them” and this has been termed the

¹⁴⁶ *Id.* at 475-76.

¹⁴⁷ SEC guidance, such as Rule 176, is “of limited assistance” since the factors that the SEC listed in Rule 176 “reflect, in large part, standard practice” already. Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters’ Continuous Due Diligence After WorldCom*, 30 CARDOZO L. REV. 2001, 2035 (2009) (citing *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 671 (S.D.N.Y. Dec. 15, 2004)).

¹⁴⁸ Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters’ Continuous Due Diligence After WorldCom*, 30 CARDOZO L. REV. 2001, 2035 (2009).

¹⁴⁹ *Underwriter Due Diligence in Securities Offerings*, NEW YORK LAW JOURNAL (1999), available at: <http://corporate.findlaw.com/finance/underwriter-due-diligence-in-securities-offerings.html>.

¹⁵⁰ Joseph K. Leahy, *The Irrepressible Myths of Barchris*, 37 DEL. J. CORP. L. 411, 411 (2012).

“independent verification” requirement.¹⁵¹ *Feit v. Leasco Data Processing Equipment Corp.* came to the same conclusion just a couple of years later.¹⁵² Scholars have criticized this guidance by stating that the “independent verification requirement was never correct, because sometimes it is reasonable to trust rather than verify.”¹⁵³ So far only one court has touched on that idea, albeit very tepidly. The court in *In re Software Toolworks Inc.* found that, at least for underwriters, “[i]t is *not* unreasonable . . . to rely on management’s representations with regard to information that is solely in the possession of the issuer and cannot be reasonably verified by third parties.”¹⁵⁴

Rule 176(f) does instruct courts to consider “reasonable reliance on . . . others whose duties should have given them 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).”¹⁵⁵ With respect to RBS in particular, Judge Cote should have taken this opportunity to recognize what many scholars have already recognized: that, at times, the prudent man will reasonably rely instead of always conduct his own independent investigation.

In light of the need for continuous due diligence in the shelf registration context, many issuers appoint an “underwriter’s counsel,” and some have suggested that this alleviates any

¹⁵¹ *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. Mar. 29, 1968); see Joseph K. Leahy, *The Irrepressible Myths of BarChris*, 37 DEL. J. CORP. L. 411, 412 (2012).

¹⁵² *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 576-77 (E.D.N.Y. Aug. 26, 1971); see Joseph K. Leahy, *The Irrepressible Myths of BarChris*, 37 DEL. J. CORP. L. 411, 430-31 (2012).

¹⁵³ *Id.*

¹⁵⁴ *In re Software Toolworks, Inc. Securities Litigation*, 789 F. Supp. 1489, 1496 (N.D.Cal. Mar. 30, 1992) (emphasis added); see Joseph K. Leahy, *The Irrepressible Myths of BarChris*, 37 DEL. J. CORP. L. 411, 460 (2012).

¹⁵⁵ 17 C.F.R. § 230.176. (Known as “Rule 176”).

“potential need to reform the shelf registration rule.”¹⁵⁶ This is untrue, insofar as it fails to recognize that reliance on underwriters’ counsel should be given greater consideration in these types of situations. While the use of underwriter’s counsel certainly helps, this case demonstrates how the use of the issuer’s counsel can be insufficient to protect an underwriter.

Notably, reliance on lawyers is a circumstance for courts to consider, but here Judge Cote disregarded RBS’s reliance on accuracy of the continuous due diligence performed by the issuer’s counsel for continuous due diligence.¹⁵⁷ Specifically, RBS “received a ‘negative assurance letter’ from Nomura’s counsel” which stated that it was “not aware of any facts that would render the Offering Documents for [the loans] misleading” in addition to receiving “confirmation” from Deloitte that “the Offering Documents accurately calculated the number of loans with certain characteristics, based on the loan tapes.”¹⁵⁸ This begs the question, if receiving comfort letters (or negative assurance letters), while not a substitute for due diligence, is nevertheless a customary part of a reasonable investigation, how much of a part of a reasonable investigation is it? That is, how much weight should the court give to this?

This author contends that, despite all else, these types of actions are instructed (even encouraged) by Rule 176(f) and should be considered more heavily in analyzing the reasonableness of an entity’s decision-making, especially in the context of shelf registrations.

¹⁵⁶ James A. Bedotto, *If it Ain’t Broke, Don’t Fix it: The Frequent Use of “Underwriter’s Counsel” in Shelf-Registered Offerings Scraps the Need for Underwriter Due Diligence Reform*, 42 No. 4 SECURITIES REGULATION LAW JOURNAL ART 1 (2014).

¹⁵⁷ *FHFA v. Nomura Holding America, Inc.*, 68 F. Supp. 3d 439, 459 (S.D.N.Y. Dec. 18, 2014).

¹⁵⁸ *Id.*

Undoubtedly, RBS could have done more,¹⁵⁹ but that is not the question. The question is whether what they actually did do was reasonable in light of the circumstances.

In the shelf registration the SEC has pointed out that it is ever more important to conduct continuous due diligence and to do this, the SEC has encouraged the use of underwriters' counsel appointed by the issuer to perform this continuous due diligence. Thus, in this context reliance on negative assurance letters from the issuer's counsel should be given more weight, towards finding reasonableness. In this scenario a prudent man would rely and trust rather than independently verify. Cost-cutting does not always connote corner-cutting, and this case demonstrates that there are circumstances in which a reasonable underwriter (RBS) would rely without independent verification, as many scholars have already recognized.¹⁶⁰ Judge Cote missed an opportunity to recognize this as well.

b. Judge Cote Misses an Opportunity to Guide

Judge Cote has declined to provide guidance before.¹⁶¹ Specifically, in *In re WorldCom, Inc. Securities Litigation* Judge Cote “failed to address the near impossibility of meeting the traditional due diligence requirements under a shelf registration.”¹⁶² This despite the fact that

¹⁵⁹ Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters' Continuous Due Diligence After WorldCom*, 30 CARDOZO L. REV. 2001, 2057-67 (2009) (suggesting that underwriters utilize client relationship teams more fully).

¹⁶⁰ Joseph K. Leahy, *The Irrepressible Myths of BarChris*, 37 DEL. J. CORP. L. 411, 428-29 (2012) (noting that the court in *BarChris* had cited no authority for this proposition and questioning whether independent verification should be a requirement).

¹⁶¹ Christian A. Young, *Looking Back on WorldCom: Addressing Underwriters' Due Diligence in Shelf Registration Offerings and the Need for Reform*, 40 SUFFOLK U. L. REV. 521, 523-24 (2007) (stating that Judge Cote's decision in *WorldCom* “failed to provide any further guidance”); see *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 673-97 (S.D.N.Y. Dec. 15, 2004).

¹⁶² Christian A. Young, *Looking Back on WorldCom: Addressing Underwriters' Due Diligence in Shelf Registration Offerings and the Need for Reform*, 40 SUFFOLK U. L. REV. 521, 524 (2007).

“short-form registration, the expansion of shelf registration, and Rule 176 were each introduced well after [*BarChris* and *Feit*] were decided.”¹⁶³ This despite the fact that no case up until that point had addressed the due diligence defense in the context of a shelf-registration.¹⁶⁴ This was also despite the fact that Judge Cote recognized in *WorldCom* that the court in *Weinberger v. Jackson* had specifically cited to specific conduct that passed muster.¹⁶⁵ For example, in *Weinberger* the court looked favorably on the fact that the underwriters there had had “over twenty meetings with various management personnel;” had “asked extensive questions” of the issuer’s suppliers, customers, and distributors; had “examined trade journals and other industry-related publications;” and had discussed “any negative or questionable information” with the “appropriate persons” when it came up.¹⁶⁶

While Judge Cote’s restraint is admirable, had Judge Cote followed the guidance-based approach of *Weinberger v. Jackson*, she could have made the opinion in *Nomura* much more helpful for future shelf offerings, rather than simply hold that the underwriters did not get it right with the benefit of hindsight. This author contends that, in interpreting rules, a thorough explanation of what could have been done differently and the conduct, practically, that underwriters could have reasonably known to undertake and should have undertaken, in the absence of guidelines other than industry standards, is necessary to provide guidance. Without

¹⁶³ *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 675 (S.D.N.Y. Dec. 15, 2004).

¹⁶⁴ Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters’ Continuous Due Diligence After WorldCom*, 30 CARDOZO L. REV. 2001, 2035 (2009).

¹⁶⁵ *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 676 (S.D.N.Y. Dec. 15, 2004).

¹⁶⁶ *Weinberger v. Jackson*, No. C-89-2301-CAL, 1990 WL 260676, at *3 (N.D.Cal. Oct. 11, 1990).

explicitly stating the above, it appears that what is being applied is an amorphous “I know it when I see it” type of standard for reasonableness.

Therefore, in my opinion, we can say that, Judge Cote should not have decided the reasonableness of the Nomura’s and RBS’s conduct for purposes of the due diligence defense on summary judgment. However, in making this determination on summary judgment, Judge Cote should have taken the time to, at the very least, provide guidance to future sellers and underwriters.

A Closer Look: Third Party Due Diligence in Asset-Backed Securitization

After Dodd-Frank:

Jordan T. Sawyer¹

I. INTRODUCTION

The Oscar-winning movie *The Big Short*² brought the world of asset-back securities (“ABS”) to the big screen. While the movie was a critically acclaimed, box office success, a more important series of ABS events went largely unnoticed outside legal and industrial circles.³ Under the Dodd–Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”),⁴ the Securities and Exchange Commission (“SEC”) finalized a number of new rules governing third-party due diligence within the ABS market. These rules, which went into effect on June 15th, 2015,⁵ focused on improving and adding transparency to the due diligence conducted by third party service providers,

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² THE OSCARS, *2015 Oscar Nominees, Writing (Adapted Screenplay)*, <http://oscar.go.com/nominees/writing-adapted-screenplay/the-big-short> (last visited Apr. 3, 2016).

³ U.S. SECURITIES AND EXCHANGE COMMISSION, *Final Rule: Nationally Recognized Statistical Rating Organizations*, <https://www.sec.gov/rules/final/2014/34-72936.pdf> (Oct. 14, 2014) [hereinafter: “Final Rule”].

⁴ U.S. SECURITIES AND EXCHANGE COMMISSION, *SEC Adopts Asset-Backed Securities Reform Rules*, <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542776577> (Aug. 27, 2014) [hereinafter “Reform Rules”].

⁵ Jessica Corley, Scott Samlin, Richard Simonds & Joe Tully, *New Securitization Rules for Third-Party Due Diligence Reports Adopted*, <http://www.alston.com/files/Publication/a5923a75-ef12-4822-a75c-b92e56da7447/Presentation/PublicationAttachment/8bdcf6c9-d33d-49f8-bfa4-c3f0139888ea/14-750-DueDilligenceAdvisoryLong.pdf> (Sept. 18, 2014).

who often are involved in ABS offerings.⁶ Therefore, these new rules are designed, in part, to help prevent a “sequel” to *The Big Short*; something even the movie’s biggest fans are almost certain to support.

This paper will introduce these new requirements, provide insight into their purpose and function, and identify how they may impact various parties involved in ABS due diligence. In order to establish a framework for achieving these ends, the paper begins with a brief overview of the ABS process; it then introduces selected changes made to this process by Dodd-Frank. It will then turn more specifically to the new rules affecting third-party due diligence in ABS.

II. ASSET-BACKED SECURITIZATION: WHAT IT IS AND HOW IT WORKS

Securitization is a process by which certain assets and risks are packaged together to “create” a new, tradable security that offers investors an ongoing stream of payments secured by a pool of underlying assets.⁷ Assets commonly securitized in this fashion include, but are not limited to, residential or commercial mortgages, student loans, credit card, and other consumer or commercial receivables. The process converts largely illiquid debt obligations into liquid securities that may be held or traded by investors.⁸

As a general class, the results of securitizations are typically referred to as “asset backed securities” or “ABS.” ABS in turn may be broken into sub-categories often

⁶ *Id.*

⁷ INTERNATIONAL MONETARY FUND, *Back to Basics: What Is Securitization*, <https://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf> (Sept. 2008) [hereinafter: “Back to Basics”].

⁸ VINOD KOTHARI, *SECURITIZATION: THE FINANCIAL INSTRUMENT OF THE FUTURE* 193 (3rd ed. 2006).

reflecting the nature of the underlying collateral assets. These include “mortgage-backed securities” or “MBS,” which may be further segregated into “commercial mortgage backed securities” or “CMBS” and residential mortgage backed securities or “RMBS.”⁹ The overall ABS market evolved from the MBS market in the early 1980s, and includes securities created using non-mortgage assets as their basis.¹⁰ The ABS market has been, and remains, vital to the debt market in the United States and this broader market is the focus of the remainder of this paper.¹¹

While ABS transactions often involve a number of parties, three of the most fundamental are: (1) the loan originator; (2) the securities issuer or sponsor; and (3) the investor who purchases the securities.¹² The originator is a company, such as a bank or finance company, making the loans or holding income-producing assets. The originator can pool some of these assets or loans together and either securitize them directly or sell this pool to a third party aggregator who then acts as the sponsor and issuer. Such aggregators and issuers are typically separate entities set up by investment banks or other financial institutions. The issuers finance the purchase of these pooled assets by selling other securities, those now backed by a group of assets, to an investor. The originator typically continues to service the pooled loans and passes on payments it collects to the issuer, all while the investor collects payments from the security.

⁹ FORBES, *Introduction to Asset-Backed Securities and Mortgage-Backed Securities*, <http://www.forbes.com/sites/investopedia/2013/01/18/introduction-to-asset-backed-and-mortgage-backed-securities/#a6442c44b0b1> (Jan. 18, 2013).

¹⁰ Back to Basics, *supra* note 7.

¹¹ *Id.*

¹² *Id.*

By their very nature, ABS are complex instruments involving a number of loans or other assets that serve as collateral. And, in the course of offering ABS securities to investors, all or some portion of that collateral becomes the subject of one or more layers of due diligence investigation. Because sponsors and issuers often lack fully developed internal teams designed to conduct all phases of such due diligence, they typically engage third party service providers (sometimes called “TPDDS Providers”) to conduct certain aspects of the investigation.¹³ These TPDDS Providers commonly are tasked with undertaking specific kinds of examination of the underlying assets, such as re-underwriting a portion of the loans in the pool to determine if they conformed to the origination guidelines of the lender and are accurately described in the ABS offering documents. The new rules discussed below were designed to enhance this and other aspects of the ABS due diligence investigation.

III. WHY REGULATE: THE ABS MARKET BEFORE DODD-FRANK, AND THE NEED FOR NEW RULES

Dodd-Frank was passed in the aftermath of the 2008 financial recession. Many saw the timing of this Act and the rules it contained as a response to perceived inadequacies within the financial marketplace, including the securitization market, which may have existed prior to the global financial crisis that began in or around 2008.¹⁴ However, there remain disagreements about the role securitization actually played in creating or exacerbating the global downturn, or indeed whether the practices of the

¹³ KOTHARI, at 205, *supra* note 8.

¹⁴ LIBER8, *Financial Regulation: A Primer on the Dodd-Frank Act*, https://research.stlouisfed.org/pageone-economics/uploads/newsletter/2011/201105_ClassroomEdition.pdf (May 2011).

securitization industry, as opposed to government policies, contributed at all.¹⁵

Regardless, the newly introduced third-party due diligence requirements can be seen as an effort to reexamine the ABS market and the assets underlying securitization.¹⁶

It is likely that the SEC chose to focus some of these new rules on the third-party due diligence arena in order to address the troubling lack of authoritative or informative guidance in this area.¹⁷ Even before Dodd-Frank, the SEC recognized this dearth of information and in 2004 adopted what it intended to be a “comprehensive” set of rules for the ABS market, termed Regulation AB.¹⁸ Among other things, this regulation set out four main categories of rules: (1) registration; (2) disclosure; (3) communication; and (4) reporting.¹⁹ While these provided the beginnings of a more formal and enlightening framework for the ABS market, there were, and are still, few, if any, definitive benchmarks for due diligence practice within the ABS arena. Many felt that the Regulation AB had been an attempt to catch up to the modern ABS market,²⁰ however, by the time it was implemented, some felt that the SEC had already fallen back behind the market, and it arguably remains so today.²¹

¹⁵ Dwight Jaffee, Anthony Lynch, Matthew Richardson, & Stihl Van Nieuwerburgh, *Mortgage Origination and Securitization in the Financial Crisis*, <http://whitepapers.stern.nyu.edu/summaries/ch01.html> (last visited Apr. 3, 2016).

¹⁶ Reform Rules, *supra* note 4.

¹⁷ Mike Seelig, David M. Lukach & Thomas Knox, *Understanding Regulation AB*, <https://www.pwc.com/us/en/consumer-finance/publications/assets/regulation-ab.pdf> (2005).

¹⁸ *Id.*

¹⁹ CHAPMAN AND CULTER LLP, *Regulation AB/ Regulation AB II* <http://www.structuredfinanceinsights.com/resources-17.html> (last visited Apr. 3, 2016).

²⁰ Understanding Regulation AB, *supra* note 17.

²¹ Andrew M. Faulkner, Richard F. Kadlick, David H. Midvidy, James S. Stringfellow & Eva Valik, *Structure Finance Alter: SEC Adopts Final Regulation AB II Rules*,

Despite its Regulation AB efforts, neither the SEC nor the relevant self-regulatory organization, the Financial Industry Regulatory Authority (“FINRA”), has provided much practical guidance in the ABS due diligence arena. In turn, ABS sponsors and those providing due diligence in securitization are often left to create their own due diligence “standards of the street.”²² Because of the ABS market’s importance, this lack of guidance is problematic.

IV. THE NEW THIRD PARTY DUE DILIGENCE RULES

A. Introduction and Explanation

Given this historical lack of ABS specific due diligence guidelines, Dodd-Frank and its new rules were a welcome development.²³ However, the process has not been quick, comprehensive, or easy. For example, a number of sections of Dodd-Frank that called for new rules and new sections of both the Securities Act of 1933 and the Exchange Act of 1934, took years to implement.²⁴ In fact, some of the rules discussed below were not adopted by the SEC until 2014,²⁵ and only recently became effective.²⁶

<http://www.skadden.com/insights/structured-finance-alert-sec-adopts-final-regulation-ab-ii-rules> (noting that certain areas of question before are not answered by this regulation).

²² As a relevant FINRA publication has stated: “since the prudent man standard may be construed as ‘a standard of the street,’ one is very reluctant to do anything that varies from street practice because that may weigh heavily in establishing liability. If every other underwriter uses a particular procedure, anyone who varies from that procedure is inviting trouble.” NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., SPECIAL REPORT: DUE DILIGENCE SEMINARS (July 1981) [hereinafter “NASD SPECIAL REPORT: DUE DILIGENCE SEMINARS ”] at 6.

²³ U.S. SECURITIES AND EXCHANGE COMMISSION, *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, <https://www.sec.gov/spotlight/dodd-frank.shtml> (showing 7 total new requirements for the ABS market were called for by Dodd-Frank) (last visited Apr. 3, 2016).

²⁴ Reform Rules, *supra* note 4 (these rules came after many other of the rules).

²⁵ *Id.*

While these new rules have been slow in coming and are still in many ways a work in progress, there can be little doubt that they will have an important impact on ABS market due diligence practices. Therefore, these new rules are a constructive step toward a much-needed set of comprehensive rules, regulations and guidelines.

With respect to TPDDS Providers, there are four general rules discussed in detail below.

1. Rule 15Ga-2:

Rule 15Ga-2 implements parts of Section 15E(s)(4) of the Securities Act of 1934 (“Securities Act”), which was added by Section 932(a)(8) of the Dodd-Frank Act.²⁷ This rule covers disclosures required by issuers in connection with ABS offerings. Under the new rule, an issuer of any new asset backed security that is to be rated by a nationally recognized statistical rating organization (“NRSRO”), must provide the findings and conclusions of a third party due diligence provider on Form ABS 15-G, and this must be signed by a senior officer in charge of securitization, at least five days before the first offering of the security.²⁸

Therefore, to comply with this rule, the issuer or underwriter must gather this information in a report from the due diligence provider. This requires specific communication between the issuer and the due diligence provider. Additionally, this report must be published on EDGAR, which makes it available to investors.²⁹ The rule also expressly provides that the issuer cannot satisfy this requirement by summarizing the

²⁶ *Id.*

²⁷ Final Rule, *supra* note 3.

²⁸ *Id.*

²⁹ *Id.*

third party due diligence report.³⁰ The SEC appears to have included this requirement to prevent any summary from leaving out important information.³¹ Additionally, it appears this rule would require the disclosure of any and all third party diligence reports on Form ABS 15G, including “preliminary or exploratory” reports.³²

The third party due diligence reports that are covered by Rule 15Ga-2 are specifically defined as “any report... of any *due diligence services*... performed by a third party.”³³ The term “due diligence services” is defined as part of the new newly implemented rule, Rule 17g-10, the next rule covering TPDDS Providers.³⁴ As with the other rules, this rule is designed to require a closer look at the assets being securitized and provides for more consistent reporting of this review.

2. Rule 17g-10:

Rule 17g-10 implements Section 15E(s)(4)(B) of the Securities Act.³⁵ This rule specifically defines “due diligence services,” and introduces other new requirements.³⁶ First, it defines due diligence services to include a review of the assets underlying an ABS for determinations including: the accuracy of the information about the assets that was provided; the value of collateral securing the assets; whether the assets meet certain

³⁰ *Id.*

³¹ SIDLEY AUSTIN, *SEC Releases Final Rules on Third Party Diligence Reports for Asset-Backed Securities*, <http://www.sidley.com/news/10-27-2014-global-finance-update> (Oct. 27, 2014).

³² *Id.*

³³ *Id.*

³⁴ Final Rule, *supra* note 3.

³⁵ *Id.*

³⁶ *Id.*

standards, guidelines, or laws; and any other characteristic of the assets that may be material to whether the issuer will pay the interest and principal that it agreed to pay.³⁷

Additionally, whenever a TPDDS Provider undertakes any of these services they are required to provide a certification of these services to a NRSRO.³⁸ The certification provided must be in a specific format provided on Form ABS Due Diligence-15E, a new form created as part of this rule.³⁹ This form requires specific information including the identity of the due diligence provider and the person who paid for the diligence services; the manner and scope of the due diligence performed both to satisfy the specific criteria of a NRSRO and in connection with a review of the assets underlying the ABS; as well as a summary of the findings and conclusions resulting from the due diligence that must be “sufficiently detailed” to provide an understanding of these findings to the person who paid for the diligence services.⁴⁰ The rule also makes certain issuers post this Form online, although not necessarily on EDGAR,⁴¹ and requires that the Form be provided on both initial and subsequent offerings of the ABS.⁴²

³⁷ *Id.*

³⁸ CHAPMAN AND CUTLER LLP, *Third-Party Due Diligence Report Rules*, http://www.structuredfinanceinsights.com/media/sfarea/332_Chapman_Third_Party_Due_Diligence_Rules_1214_SFI.pdf (Dec. 2014) (To quell fears about sending this report to the wrong NRSRO, the rule has a safe-harbor for a provider that sends their report to any NRSRO that requested the report or to the issuer of the related ABS).

³⁹ *Id.*

⁴⁰ Final Rule, *supra* note 3; *SEC Releases Final Rules on Third Party Diligence Reports for Asset-Backed Securities*, *supra* note 31.

⁴¹ *New Securitization Rules for Third-Party Due Diligence Reports Adopted*, *supra* note 5.

⁴² *SEC Releases Final Rules on Third Party Diligence Reports for Asset-Backed Securities*, *supra* note 31.

Whenever a provider prepares Form ABS Due Diligence-15E, it must represent that it provided a “thorough review,” and that all information and statements in the report are “accurate in all material respect.”⁴³ A person duly authorized by the TPDDS Provider must also sign the Form before it is submitted.⁴⁴ Again, a consistently formatted review is required by this new rule.

3. Other Rules that May Effect Third Party Due Diligence

While these two new rules most directly impact TPDDS Providers, other rules previously adopted by the SEC, and which are still being implemented, may also effect the due diligence provider. These rules include Rule 193,⁴⁵ and Item 1111 to Regulation AB.⁴⁶

Rule 193 and Item 1111 require an ABS issuer to perform a “review of the pool of assets” underlying the security and provide this review in the prospectus it files.⁴⁷ The review must, “at a minimum,” provide reasonable assurances that the disclosure in a prospectus is “accurate in all material respects.”⁴⁸ While the requirement is on the issuer, the rule expressly allows the issuer to use a third party for the review.⁴⁹ However, to do so, the issuer must identify the third party and name it as an expert.⁵⁰ The third party

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ Robert Hahn, *Dodd-Frank Act – Securitization-Related Final Rules*, https://www.hunton.com/files/Publication/76f31d76-0884-4fda-a8a5-8f2d29733a3c/Presentation/PublicationAttachment/36170507-f472-4f55-8f83-1d73e1dd575f/Dodd-Frank_Act_Securitization-Related_Final_Rules.pdf (May 2012).

⁴⁶ *Id.*

⁴⁷ 17 CFR § 230.193.

⁴⁸ *Id.*

⁴⁹ *Id.*

reviewer must still comply with the “accurate in all material respects” requirement for the review under this Rule.⁵¹

V. WHAT THESE RULES MEAN FOR THIRD PARTY DUE DILIGENCE PROVIDERS AND HOW TO RESPOND

A. New Potentials for Liability

While none of these rules explicitly creates a new cause of action against TPDDS Providers, each does introduce new areas where a provider could potentially face liability. Each rule introduces this new potential liability in a different way.

Under the new Rule 15Ga-2, the Form ABS 15-E provided by diligence providers will be published on EDGAR and available for review by investors.⁵² Additionally, because Rule 15Ga-2 requires the filing of the findings and conclusions of the due diligence provider and not just a summary of this report written by the issuer itself, a court could potentially find that the due diligence provider may still have “control” (as required for liability) over the information on the form, even if it does not personally file it.⁵³

Because investors can look at these reports, which may still be controlled by the provider, it is possible that mistakes therein could serve as the basis for a Section 10(b) or Rule 10b-5 claim for the misstatement of a material fact.⁵⁴ While in such claims a

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *New Securitization Rules for Third-Party Due Diligence Reports Adopted, supra* note 5.

⁵³ *Id.*

⁵⁴ *Id.*

plaintiff would still be required to show scienter behind the mistake, this Form ABS 15-E filing could potentially provide an investor a new starting point for bringing this claim.⁵⁵

Additionally, under Rule 17g-10, the Form ABS Due Diligence-15E must contain certain certifications by the due diligence provider.⁵⁶ These certifications include that the diligence involved a “thorough review” and that the material is correct in “all material respects.”⁵⁷ Thus, if a report is either insufficiently thorough or contains material mistakes, it is possible the provider could face suit for these shortcomings, either by the NRSRO or the issuer or the SEC.⁵⁸ Further, while Rule 17g-10, does not require posting the Form on EDGAR, it does require that certain issuers post these reports online.⁵⁹ Because these reports are not posted on EDGAR, fewer investors are likely to review them, reducing the likelihood that any investor would be able to bring a misstatement claim against the third party due diligence provider.⁶⁰ However, because it is sometimes still posted online, serious liability for any mistakes is not completely foreclosed.

Finally, under Rule 193 and Item 1111 of Regulation AB, a third party due diligence provider hired to provide the necessary review may potentially face liability for a failure to provide a review that meets the “minimum” requirements, discussed above.⁶¹ Further, because any third party due diligence provider who is used in this review must

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ Final Rules, *supra* note 3.

⁵⁸ *New Securitization Rules for Third-Party Due Diligence Reports Adopted*, *supra* note 5.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ 17 CFR § 230.193.

be named in the prospectus investors may look to these providers as well certain misstatements.⁶² Also, because the due diligence provider must be identified as an expert,⁶³ it is possible that, if sued, it would face the higher standard applied to experts.⁶⁴

To protect against potential liability under these rules, a third party due diligence provider should be sure to properly diligence their own reports before they are provided. This means it should institute another level of due diligence within their own organization to check and double-check that the information provided is correct. The providers should also be willing to address the potential for liability for their reports in the initial agreement letters with the one paying for their services to the extent allowed. While the structure of these rules means the diligence provider is likely unable to completely move all potential liability to the issuer or NRSRO, it should be willing to negotiate and come up with a clear understanding about the potential liabilities facing the provider. Finally, third party due diligence providers may also want to explore liability insurance that protects against these claims, if available.

B. New Specific Requirements for Filing

Additionally, each of these new rules mandates certain filings.⁶⁵ While it is unclear what punishment would follow missing one of these filings, it is possible that the SEC or another body could reprimand a responsible party. Regardless, the inclusion of

⁶² *Id.*

⁶³ Final Rule, *supra* note 3.

⁶⁴ In many contexts, experts have been treated differently than non-experts, and specifically in certain due diligence rules, experts are held to a higher standard. *See*, GARY M. LAWRENCE, DUE DILIGENCE, A SCHOLARLY STUDY 10 (Alex Poor eds., 2nd ed. 2013).

⁶⁵ *New Securitization Rules for Third-Party Due Diligence Reports Adopted*, *supra* note 5.

these rules shows that the SEC believes these filing requirements are important, making it likely they will enforce these rules. Further, even without specific SEC punishment, the parties responsible for these filings, be it the issuer or the due diligence provider themselves, should make sure that these reports are prepared both on time, and in the proper form, so that no business relationships are impacted.⁶⁶

To help avoid any potential liability or negative impact on the business relationship, the due diligence provider needs to communicate with the person paying for their services to understand which party is responsible for making sure the required forms are properly filed. It may be a good business practice to make sure the engagement letter or other agreement between the parties specifically addresses this so as to avoid potential breach of contract claims and to avoid any confusion or loss of respect between the provider and the payor. Additionally, the provider should talk with their client to make sure that they mutually understand the responsibility for properly filing these forms, so they can both avoid any potential liability for missing any of these filing requirements.

C. New Specific Forms to Follow

Finally, the two main rules each introduce a new specific format for the filings.⁶⁷ These forms each have specific requirements for what must be included. Again, while these rules do not expressly create liability for incorrect forms, it is likely that the SEC would look down on due diligence services that do not properly or completely fill out these forms before they are filed.

⁶⁶ *Id.*

⁶⁷ Final Rules, *supra* note 3 (Rule 15Ga-2 requires filing Form ABS 15G, and Rule 17g-10 requires filings on Form ABS Due Diligence-15E).

Third party due diligence providers should spend time becoming familiar with the new forms and should train those who work on providing due diligence in the ABS market on what these forms require. A provider may also want to ensure that its current practices sufficiently cover all items required on these reports. The providers must be willing to make changes to ensure it provides proper information to the extent required by the forms themselves.

VI. CONCLUSION

The new TPDDS Provider rules discussed in this paper are designed to enhance ABS due diligence and related offering document disclosures. They, at long last, appear to have started the process of offering some practical standards and guidelines regarding ABS due diligence requirements.

These standards and guidelines are promising in at least two respects. First, they offer ABS sponsors, issuers, underwriters, and other parties a benchmark regarding the nature and character of some of the kinds of due diligence required in an ABS offering. Second, they hold the promise of better protection for ABS investors by providing them with clearer and potentially better information about the assets underlying a specific ABS. Those who operate within the ABS marketplace, and specifically TPDDS Providers, must take note of these rules and should spend time to ensure that their business practices satisfy the new requirements they implement so they can avoid any new liability that may follow these rules.

While these rules may never be the subject of an Oscar-winning movie, they will almost certainly have a widely felt impact on the field of third party due diligence in ABS offerings.

**The Evolution of Regulation AB and the Search for a Loan Sampling Due
Diligence Standard**

Adam E. DeSilva¹

I. INTRODUCTION

While there exist many diverse views regarding the causes of the global financial crisis—the role of cheap credit for borrower and lenders, the expansion of securitization, the relaxation of borrowing standards—the truth remains that there are very few absolute answers or certainty about these issues. The purpose of this paper is to explain how Regulation AB² has evolved since its inception in early 2006 and how aggregate loan sampling, a critical component in RMBS, struggles to find a standard methodology and size that could set a minimum due diligence standard for the benefit of issuers, underwriters, and investors. This paper explores how Reg. AB failed, and continues to fail, and addresses some of the major issues that could help prevent the next collapse in the ABS market. More specifically, this paper addresses how Reg. AB should provide for more specific pool sampling that would be representative of the underlying securities in the pool.

¹ J.D. Candidate, 2017, SMU Dedman School of Law. I would like to personally thank my brother, Jeffrey H. DeSilva, for taking time out of his very busy schedule as an analyst on a trading desk to provide me with the original prospectus and current excel file of one of the bonds mentioned in the *FHFA v. Nomura* case (specifically NHELI 2006—HE3). Without this information, I could not have fully appreciated the complexity and density that both the issuers and investors must struggle with when attempting to conduct due diligence.

² 17 C.F.R. §§229.1100

II. HISTORY

On September 15, 2008 Lehman Brothers Investment Bank³ filed for chapter 11 bankruptcy; the largest U.S. bankruptcy to that point in time.⁴ Shortly thereafter, credit lending became non-existent between institutions, followed by congress passing TARP⁵ on October 3, 2008⁶ to stabilize the banking industry. That is the timeline most Americans conjure up when thinking about the financial crisis. However, to truly understand the history and the underpinnings of what led to two weeks of chaos and many years of high unemployment, depressed home prices, and the evaporation of trillions of dollars in income and investment, one must stretch the timeline back to at least the beginning of the new millennium.⁷

In the early 2000s, the U.S., after years of record economic expansion, fell into a recession.⁸ To help stave off of the effects of this recession and to get the economy going again, the Federal Reserve slashed interest rates to an all-time low, which meant

³ WIKIPEDIA, https://en.wikipedia.org/wiki/Lehman_Brothers. (Last visited Apr. 14, 2016)

⁴ *Id.*

⁵ WIKIPEDIA, https://en.wikipedia.org/wiki/Troubled_Asset_Relief_Program. (Last visited Apr. 14, 2016) (Troubled Asset Relief Program, which gave US \$700MM in emergency funds to banks deemed “too big to fail” so that they would be better capitalized. Although congress gave it a nice sounding name, the truth is that no “troubled assets” were relieved through this program. It was simply a capital injection for the banks to reassure investors.)

⁶ *Id.*

⁷ <https://www.stlouisfed.org/financial-crisis/full-timeline>. (A detailed timeline of events that precipitated the crisis, the St. Louis Federal Reserve has posted such a timeline with links.)

⁸ Brooks Jackson, *Clinton and Economic Growth in the '90s*, FACT CHECK, <http://www.factcheck.org/2007/12/clinton-and-economic-growth-in-the-90s/> (Dec. 7, 2007).

commercial and consumer credit was inexpensive by historic standards.⁹ This led to an explosion of home buying by Americans. However, the explosion in home buying didn't just happen because credit was cheap; instead it was drastically aided by relaxed lending standards that gave us terms like "NINJA" loans¹⁰, "Liar" loans¹¹, "teaser" rates¹², etc. These relaxed standards set the stage for MBS¹³ to mutate into what one commentator has called "financial weapons of mass destruction."¹⁴

The initial purpose behind the private-labeled MBS was actually a noble one. Prior to the inception of the private-labeled MBS, consumers had only two ways to finance a home purchase: (1) go to your local bank and have them lend you the money while they keep the loan on their balance sheet; or (2) through securitization by a Government Sponsored Enterprise ("GSE").¹⁵ The problem with both of these

⁹ FEDERAL RESERVE BANK OF NEW YORK, <http://www.newyorkfed.org/markets/statistics/dlyrates/federate/html> (last updated Feb. 19, 2010).

¹⁰ INVESTOPIDA, <http://www.investopedia.com/terms/n/ninja-loan.asp>. (Last visited Apr. 14, 2016) (A loan with documentation that included "No Income, No Job, No Assets.")

¹¹ INVESTOPIDA, http://www.investopedia.com/terms/l/liar_loan.asp. (Last visited Apr. 14, 2016) (A loan with documentation that overstates income or assets so that the borrower may qualify for a higher loan value than they would have originally.)

¹² INVESTOPIDA, <http://www.investopedia.com/terms/t/teaserrate.asp>. (Last visited Apr. 14, 2016) (The initial rate on an Adjustable Rate Mortgage that "entices" the buyer with a below average market rate. This rate, however, automatically adjusts upward to the fully indexed rate after a brief time period.)

¹³ INVESTOPIDA, <http://www.investopedia.com/terms/m/mbs.asp>. (Last visited Apr. 14, 2016) (Mortgage-Backed Security is a class of ABS that pools thousands of mortgages together and sells them to an investor.)

¹⁴ Warren E. Buffett, *To the Shareholders of Berkshire Hathaway Inc.*, BERKSHIRE HATHAWAY INC., (Feb. 21, 2003), at 15, <http://www.berkshirehathaway.com/letters/2002pdf.pdf>.

¹⁵ INVESTOPIDA, <http://www.investopedia.com/terms/g/gse.asp>. (Last visited Apr. 14, 2016) (GSE's are Fannie Mae, Freddie Mac, Ginnie Mae, etc.).

approaches is that they carved out a substantial swath of potential market participants who would have been low risk borrowers but don't necessarily meet the stringent criteria of the GSEs or their bank. This would include participants looking to obtain jumbo loan financing¹⁶, or who don't have enough money to make a twenty-percent down payment, etc.¹⁷ Thus, with the arrival of the private-labeled MBS market, more and more people could get access to the credit they needed to purchase a home.

However, over time, issuers started packaging riskier and riskier pools of assets into Collateralized Debt Obligations ("CDOs").¹⁸ These securities, which are made up of the lower-level tranches of the MBS bond, were typically not considered "sellable" for purposes of the traditional MBS model, as these tranches were typically made up of loans that were considered Alt-A¹⁹ or Subprime.²⁰ However, instead of keeping their original

¹⁶ Ben Lane, *FHFA announces 2016 conforming loan limits*, HOUSING WIRE, <http://www.housingwire.com/articles/35693-fhfa-announces-2016-conforming-loan-limits>. (Nov. 25, 2015) (A jumbo loan is a non-conforming loan that currently exceeds USD \$417,000.00 and will not be backed by a GSE.).

¹⁷ Brena Swanson, *Fannie and Freddie officially approve 3% down payment mortgages*, HOUSING WIRE <http://www.housingwire.com/articles/32269-fannie-and-freddie-officially-approve-3-down-payment-mortgages>. (Dec. 8, 2014) (GSEs have recently reduced down payments to incredibly low levels. What was once a 20% requirement is now 3%, which might explain why the private-labeled market has been static since the financial crisis).

¹⁸ INVESTOPIDA, <http://www.investopedia.com/terms/c/cdo.asp>. (Last visited Apr. 14, 2016) (CDOs allows banks to pool together assets with riskier credit profiles that would not typically be sold in a traditional CMO.).

¹⁹ Jean Folger, *Alt-A Mortgages: How They Work*, INVESTOPIDA, <http://www.investopedia.com/articles/personal-finance/020816/alta-mortgages-how-they-work.asp>. (Last visited Apr. 14, 2016) (Alt-A mortgages were those with little or no documentation).

²⁰ INVESTOPIDA, <http://www.investopedia.com/terms/s/subprime.asp>. (Last visited Apr. 14, 2016) (Sub-prime are borrowers who have credit history issues or low credit scores and have a higher risk of default).

B, BB, and BBB rating²¹ that they were originally assigned, the issuers were able to package these loans with many other similarly rated loans from a host of other MBSs²² and present these CDOs to the NRSROs²³ as diversified.²⁴ This prompted the NRSROs to issue AAA ratings to the senior levels of the tranches even though the loans underlying the tranche were still just slightly better than “junk”²⁵ status. And because the SEC had not adopted any rules until Reg. AB I that would have given investors more transparency, they could not properly assess their risks.²⁶

Thus, as the market for CDOs increased so too did the market for Credit Default Swaps (“CDS”).²⁷ Simply put, a CDS is similar to buying car insurance: you agree to pay a monthly premium for a certain time period and in turn you get protection in case of damage or total loss. So to extrapolate that example to the MBS market, let’s say that the market is selling XYZ CDO tranche worth USD \$100M in subprime mortgages, and being a savvy investor you want to bet that that bond is going to underperform.²⁸ So you, as the investor, buy the CDS worth \$100 million and agree to make yearly premium

²¹ KATHLEEN C. ENGEL & PATRICIA A. MCCOY. *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS* 51-53 (Oxford Univ. Press ed., 2011).

²² *Id.* at 52-53.

²³ *Id.* at 49.

²⁴ *Id.* at 52-53.

²⁵ INVESTOPIDA, <http://www.investopedia.com/terms/j/junkbond.asp>. (Last visited Apr. 14, 2016)

²⁶ Regulation AB I had not been put into effect until 2005.

²⁷ INVESTOPIDA, <http://www.investopedia.com/terms/c/creditdefaultswap.asp>. (Last visited Apr. 14, 2016).

²⁸ Dan Wang, *How are Collateralized Debt Obligations and Credit Default Swaps Structured?* <https://medium.com/@danwwang/the-cdo-the-cds-and-the-subprime-mortgage-crisis-c1aa28c01116#.z5rtfzyoi>. (May 12, 2014).

payments for ten years or so of roughly \$500,000 per year.²⁹ Thus, if the CDO does not default, you are out of pocket \$5 million, but if it does default, you get paid \$100 million.³⁰ And instead of a few of these CDOs defaulting at once, which would have been manageable, the majority of them defaulted, and they defaulted all around the same time, which led to massive losses. To use our car insurance analogy, it would be like having all the cars that the insurer insures crash at once and now insurer is forced to pay out all of the losses suffered within a few weeks—it would bankrupt the insurer.

Finally, to further exacerbate the crisis, the market created synthetic CDOs,³¹ which were basically bets on the CDSs that were the insurance against the original CDO,³² as well as instruments called CDO squared,³³ which is basically taking the lower-level tranches from one CDO and the lower-level tranches from another CDO and putting them together in a single CDO.³⁴ Although the technical aspects of these instruments is not very important in regards to this paper, it is important to understand that in order for the next economic recession not to morph into a global economic meltdown, a coherent due diligence standard should be articulated so that investors and issuers can properly evaluate these esoteric asset-backed investments.

²⁹ *Id.*

³⁰ *Id.*

³¹ INVESTOPIDA, <http://www.investopedia.com/terms/s/syntheticcdo.asp>. (Last visited Apr. 14, 2016).

³² *Id.*

³³ INVESTOPIDA, <http://www.investopedia.com/terms/c/cdo2.asp>. (Last visited Apr. 14, 2016).

³⁴ *Id.*

III. REGULATION AB I: TOO LITTLE TOO LATE.

Prior to 2006, the SEC had issued a long series of no-action letters that dealt with asset-backed securities³⁵ before finally codifying them into Regulation AB I in 2005.³⁶ The purpose of Regulation AB I was to finally list disclosure and due diligence rules related to most ABS, including MBS.³⁷ The problem with this regulation, while not addressing enough of the underlying issues, is that it even if it had properly addressed the underlying issues in relation the mortgage market, it arguably came too late. By this point the RMBS market was reaching its crescendo of home values and number of home buyers, thus default rates were starting to increase, and fraud was pervasive.

However, to understand where the AB I disclosure fails is important. AB I was born out of Regulation S-K.³⁸ The problem with Regulation S-K is that its focus is on business and management, but for ABS there is no business or management to focus on. In the majority of instances, the issuer is an SPV, which is simply a holding company for the ABS.³⁹ And rather than focus of the specific problems that ABS, and more specifically RMBS, present, Reg. AB I models itself as if ABS offerings are the same as corporate debt offerings.⁴⁰ The issue with this type of modeling is that corporations

³⁵ See, e.g., Sec. Indus. Ass'n, SEC No-Action Letter, 2001 WL 849730 (July 13, 2001).

³⁶ 17 C.F.R. §§229.1100.

³⁷ *Id.*

³⁸ 17 C.F.R. §§229.10. (Regulation S-K is part of the SEC's integrated disclosure system. It lists disclosure requirements for non-financial statements).

³⁹ INVESTOPIDA, <http://www.investopedia.com/terms/s/spv.asp>. (Last visited Apr. 14, 2016).

⁴⁰ See Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and how to fix it*, 2009 U. Ill. L. Rev. 1359, 1399 (2009).

usually have a track record of payments made on the securities they are selling into the market place.⁴¹ In contrast, past performance on a majority of mortgages was inadequate since most were new with a scant history of repayment performance.⁴²

Thus, where a pool consists of entirely new mortgages and mortgage types with different characteristics than earlier mortgages, the repayment record becomes a moot point.⁴³ In effect, it forces the investor to presume what the creditworthiness is of the borrower.

Another problem with Reg. AB I is that it required no due diligence on behalf of the issuers or underwriters to assure that the assets they were putting into a securitized pool had proper documentation. In short, the underwriters and issuers were only subject to §11 liability under the Securities Act.⁴⁴ What this did was allow them to circumvent the documentation requirement, something that would have been very helpful to investors, and instead forced them to make assumptions about the pool of assets being securitized based on general statistical data on the characteristics of the entire pool.⁴⁵ And since an ongoing audit past the first year on the underlying loans was not required, investors could never properly judge the quality of the underlying loans within their asset pool.⁴⁶ All Reg. AB I actually mandated was a summary of the aggregate characteristics of the loan pool.⁴⁷

⁴¹ *Id.*

⁴² *Id.*

⁴³ *American Mortgages: Bleak Houses*, THE ECONOMIST, (Feb. 17, 2007), <http://www.economist.com/node/8706627>.

⁴⁴ 17 C.F.R. §§229.1100.

⁴⁵ C.F.R. §229.1110.

⁴⁶ See Mendales, *supra* note 40, at 1384.

⁴⁷ ENGEL & MCCOY, *supra* note 21, at 214.

Finally, Reg. AB I further impaired investors ability to perform due diligence when it didn't mandate that the investment banks had to disclose their due diligence reports that they had commissioned from outside firms.⁴⁸ The disclosure of these reports would have been useful to investor due diligence since they contained evidence of deteriorating lending standards.⁴⁹ Thus, Reg. AB I sets a very low bar for underwriters and issuers to reach the due diligence threshold.

While AB I had the right intentions, it unfortunately did not go far enough. However, as previously stated, even if it had the proper protections in place, a lot of these loans had already been packaged and sold off. In short, the train had already left the station and was speeding along at high rate without the ability to stop. The crash was inevitable, but Reg. AB I gave the SEC and other organizations a building block going forward.

IV. REGULATION AB II: THE MORE THINGS CHANGE, THE MORE THEY STAY THE SAME.

After the collapse of the financial markets, Congress and the SEC started to explore ways to strengthen the disclosure rules and due diligence requirements surrounding ABS and other derivatives. Born from this exploration were two major pieces of reform: The Dodd-Frank Wall Street Reform and Consumer Protection Act and Regulation AB II.⁵⁰ More specifically to MBS and pool sampling, the Dodd-Frank Act required changes to the disclosures required by the original Reg. AB in 2010.⁵¹ In

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ 15 U.S.C. §77g(c).

⁵¹ *Id.*

response to this, the SEC adopted the proposed changes and codified them into what is now Reg. AB II in 2014.⁵² However, it is important to note that like Reg. AB I, Reg. AB II does not apply where the issuer structures the security as a private offering.⁵³

A. New Asset-Level Disclosures

Under the new Regulation AB II, the SEC adopted many of the new asset-level disclosures that were missing under the previous version of Regulation AB. Although Regulation AB II does not include all ABS securities, it does include MBS. In conjunction with § 942 of the Dodd-Frank Act and § 7(c) of the Securities Act, Regulation AB II now requires asset-level disclosures for MBS as necessary for investors to independently perform due diligence.⁵⁴ These disclosures must include “at a minimum...asset-level or loan-level data.”⁵⁵ This is, of course, a departure from Regulation AB I, where only pool-level or aggregate data was required.⁵⁶

To implement this change, the SEC proposed new item 1111(h) and Schedule AL.⁵⁷ This now requires disclosure of each mortgage within a prospectus to contain the borrowers credit score, employment status, income, and income verification method.⁵⁸ To make this information easily accessible and readable for the investors, Schedule AL

⁵² 17 C.F.R. §229.1100.

⁵³ ENGEL & MCCOY, *supra* note 21, at 214.

⁵⁴ 15 U.S.C. §77g(c).

⁵⁵ *Id.*

⁵⁶ 17 C.F.R. §229.1100.

⁵⁷ *Id.* at 1111(h).

⁵⁸ *Id.*

requires the required disclosures to be placed on EDGAR⁵⁹ in an XML format.⁶⁰ The purpose of this was simple—to give investors transparency when performing personal due diligence.

In addition to this, the disclosure of the originator would be required even where the originator originated less than 10% of the pool assets.⁶¹ This is an important disclosure since it allows investors full transparency when it comes to those who originated the assets. Moreover, and not as consequential in this analysis, is the fact that originators would be responsible for the repurchase of assets where there has been a breach of representations and warranties.⁶²

Thus, these new asset-level disclosures give investors access to information that would allow them to make better decisions on MBS offerings going forward. However, by not enforcing the rule broadly, including on the GSEs, the investor, in a private offering, is at the mercy of the issuer.⁶³ When this occurs, the sampling data all of a sudden becomes the focal point for the investor, and this is where the SEC and other regulatory bodies could and should mandate a generalized sampling methodology that would give all investors a minimum level of protection and knowledge.

⁵⁹ SEC. AND EXCH. COMM’N., IMPORTANT INFORMATION ABOUT EDGAR (2010), available at <https://www.sec.gov/edgar/aboutedgar.htm>.

⁶⁰ WIKIPEDIA, https://en.wikipedia.org/wiki/Microsoft_Excel. (Last visited Apr. 10, 2016).

⁶¹ 17 C.F.R. §§229.1110.

⁶² *Id.*

⁶³ *Id.*

B. Pool Sampling: Trying to Define a Standard

Under the revised Regulation AB II, the one thing that wasn't changed was how the pool sampling was conducted. Just like in Reg. AB I, issuers and underwriters can still use statistical models to sample a portion of the pool and then use that data in its registration and prospectuses.⁶⁴ The use of sampling of the pool-level data to determine the characteristics of the loan is not really the underlying issue here (although a recent study by Moody's disagrees with that line of thinking)⁶⁵ because to evaluate every mortgage in the pool would likely be cost prohibitive to the issuers. Where the potential problems lie, however, is in how many of the underlying loans must be sampled before a proper threshold has been reached and what sampling method was used. In other words, even though I must now disclose my sample size and my selection criteria, how can I be assured, as an investor, that the sample size is large enough to be indicative of a representative sample?⁶⁶ Or, as an underwriter or issuer, how can I be assured that I sampled enough of the pool or used the correct methodology under the circumstances to be able to assert a due diligence defense under § 11 if I need to? Obviously these questions cannot be answered with any specificity at the current time since Regulation AB II is very new and the private-labeled MBS market is stagnate and not producing securities with a high degree of underperforming loans at the moment.⁶⁷ Therefore, going

⁶⁴ *Id.*

⁶⁵ Shirish Chinchalkar & Roger M. Stein, *Comparing loan-level and pool-level mortgage portfolio analysis*, Moody's Research Labs (Nov. 14, 2010). <https://www.moody.com/sites/products/ProductAttachments/MRL%20WP%202010%2011%201.pdf>.

⁶⁶ 17 C.F.R. §§229.1110.

⁶⁷ SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, <http://www.sifma.org/blog/us-private-label-mbs-market-2015/>.

forward, it will be the duty of the SEC, other regulatory bodies, and the courts to provide guidance on what is a minimum threshold of sampling that must be done by the issuer or underwriter as to assert a due diligence defense.

So far, the SEC has established its position on aggregate sampling as one where “[e]ach subject person should evaluate the surrounding facts...and utilize techniques of investigation appropriate to the circumstances of the offering.”⁶⁸ There are many due diligence sampling methodologies, but the two that were most prevalent in MBS sampling were “random” and “adverse.”⁶⁹ Thus, the methodology chosen can only be analyzed objectively in the context of the transaction in question. For example, in the context of regulatory reviews of banking institutions (who, like RMBS aggregators, acquire and hold a large number of loans including those related to residential mortgages), the Office of the Comptroller of the Currency (“OCC”) notes in its *Sampling Methodologies Comptroller’s Handbook* that:

“[a]n examiner’s choice of a sampling method depends on the specific objectives of the supervisory activity. Sometimes, examiners may choose a sampling method that is not statistical—that is, they may want to rely on judgment or specific knowledge about a population in selecting files for review....The OCC generally does not require the use of any specific

⁶⁸ “Adoption of Integrated Disclosure System,” SEC Release No. 33-6383. 3/3/82, Fed. Sec. L. Rep. (CCH) at p. 1296 (“The important point is that each subject person should evaluate the surrounding facts, including the extent of his prior relationship with the registrant, and utilize techniques of investigation appropriate to the circumstances of the offering.... Judicial interpretations of Section 11 have confirmed the principle that what constitutes reasonable investigation and reasonable ground for belief depends upon the circumstances of each registration. The prospect of continued flexible application of that standard by the courts should provide assurance to subject persons that they will not incur unreasonable investigative burdens.”).

⁶⁹ Chad Burhance, *Mortgage Due Diligence in the Post Credit Crisis World: Controlling Underwriting Risk*, NEWOAK, <https://newoak.com/insights-news/newsletter/mortgage-due-diligence-in-the-post-credit-crisis-world-controlling-underwriting-risk/> (last visited May, 30, 2016).

sampling methodology. Unless specifically addressed in a handbook section or other policy guidance, the use of sampling in a supervisory activity, as well as the type of sampling used, is left to the discretion of the examiner-in-charge (EIC).”⁷⁰

In addition, other agencies and industry bodies agree that parties conducting due diligence should have latitude to tailor their sampling methodologies to the context of their given situation. For example, the SEC has considered and rejected⁷¹ the possibility of establishing a single sampling methodology for use in all offerings of mortgage-backed securities. Specifically, the Commission concluded that:⁷²

“Rule 193 does not specify the particular type of review an issuer is required to perform.”⁷³ We expect that the type of review of the assets an

⁷⁰ “Sampling Methodologies Comptroller’s Handbook,” Comptroller of the Currency, August 1998, at pp. 1-2.

⁷¹ The final rules adopted by the SEC on 8/27/14 did not mandate the use of any specified sampling methodology or methodologies. See “Nationally Recognized Statistical Rating Organizations,” SEC Release No. 34-72936, *available at*: <https://www.sec.gov/rules/final/2014/34-72936.pdf>.

⁷² “Issuer Review of Assets In Offerings of Asset-Backed Securities Agency: Securities and Exchange Commission (Final rule),” SEC Release No. 33-9176, 1/20/11.

⁷³ Internal Footnote: “We understand that various levels and types of review may be performed in a securitization. For example, commentators on the 2010 ABS Proposing Release have identified that the type of review conducted by a sponsor of a securitization of sub-prime mortgage loans typically falls into three general categories. First, a credit review examines the sample loans to ascertain whether they have been originated in accordance with the originator’s underwriting guidelines. This would include a review of whether the loan characteristics reported by the originator are accurate and whether the credit profile of the loans is acceptable to the sponsor. A second type of review could be a compliance review which examines whether the loans have been originated in compliance with applicable laws, including predatory lending and Truth in Lending statutes. Third, a valuation review entails a review of the accuracy of the property values reported by the originators for the underlying collateral. This could include a review of each original appraisal to assess whether it appeared to comply with the originator’s appraisal guidelines, and the appropriateness of the comparables used in the original appraisal process. See comment letter from The Commonwealth of Massachusetts Office of the Attorney General (“Massachusetts AG comment letter”) on the 2010 ABS

issuer performs may vary depending on the circumstances. For example, the nature of review may vary among different asset classes. While Rule 193 does not require a particular type of review, as described below, disclosure describing the type of review is required. The “reasonable assurance” standard is similar to language in the Foreign Corrupt Practices Act of 1977.⁷⁴ We recognize that while “reasonableness” is an objective standard, there is a range of judgments that an issuer might make as to what will provide “reasonable assurance.”⁷⁵ Thus, the term “reasonable assurance” in Rule 193 does not imply a single methodology, but encompasses the full range of reviews an issuer may perform to ensure that its review is designed and effected to provide reasonable assurance that the prospectus disclosure regarding the pool assets is accurate in all material respects. We continue to believe that the nature of review may vary depending on numerous circumstances and factors which could include, for example, the nature of the assets being securitized and the degree of continuing involvement by the sponsor.⁷⁶ We note the suggestion by several commentators that sampling should be permitted.⁷⁷ While we agree that sampling may be appropriate depending on the facts and circumstances, we believe that whether sampling is sufficient to satisfy the “reasonable assurance” standard in Rule 193 will depend on a variety of factors, such as the type of ABS being offered. For example, in offerings of residential mortgage-backed securities (“RMBS”), where the asset pool consists of a large group of loans, it may be appropriate, depending on all the facts to review a sample of loans large enough to be representative of the pool, and then conduct further review if the initial review indicates that further review is warranted in order to provide reasonable assurance that disclosure is accurate in all material respects.”

Proposing Release. The comment letters are available at <http://www.sec.gov/comments/s7-08-10/s70810.shtml>.”

⁷⁴ Internal Footnote: “Title 1 of Pub. L. 95-213 (1977). Exchange Act Section 13(b)(7) defines ‘reasonable assurance’ as ‘such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.’ 15 U.S.C. 78m(b)(7). We have long been of the view that ‘reasonableness’ is not an ‘absolute standard of exactitude for corporate records.’ Release No. 34-17500 (Jan. 29, 1981) [46 FR 11544].”

⁷⁵ Internal Footnote: “See Commission Guidance Regarding Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Release No. 34-55929, June 20, 2007.”

⁷⁶ Internal Footnote: “We agree with one commentator’s view that the review that is required is a review of the assets for purposes of the securitization and not the review conducted to originate the assets.”

⁷⁷ Internal Footnote: “See, e.g., comment letters from ABA; Fitch; Levin; SIFMA.”

In addition to the OCC and the SEC, industry groups, such as SIFMA and SFIG, have expressed their views that due diligence techniques, including sampling, should be tailored to the specific context of a given situation and that parties conducting due diligence should, as the SEC concluded, continue to have flexibility in defining which sampling protocols are most appropriate:

“While we recognize that in some transactions it may be appropriate to conduct a due diligence review of every asset, SIFMA requests that the Commission make clear in the final rule that due diligence covering every asset in the pool is not required by Rule 193. The scope of review should be determined by a variety of factors, including the nature of the pool, the number of assets in the pool and the diversity of the pool. In a large diverse pool of assets, investors do not expect that due diligence will be completed with respect to each asset. Conducting due diligence on a sampling of assets underlying residential mortgage-backed securities, for example, is the market standard and is widely accepted in the investor community. Sampling is a widely accepted practice with a solid theoretical foundation and track record of use over the course of decades in many disciplines and industries.”⁷⁸

Finally, the courts have not given much guidance so far on the issue of aggregate loan sampling. However, it seems as of the time of this writing that one case has touched on the issue of aggregate loan sampling and its role in establishing a minimum threshold of due diligence performed on RMBS. In *Federal Housing Finance Agency v. Nomura Holding America, Inc.*⁷⁹, Judge Cote, while not specifically articulating a standard, reviewed the sampling methodology and sampling size within the context of all the due diligence performed on the seven bonds in question by *Nomura* and the two bonds co-

⁷⁸ SIFMA Comment Letter to the SEC Re: Issuer Review of Assets in Offerings of Asset-Backed Securities; Release Nos. 33-9150; 34-63091; File No. S7-26-10, 11/15/10, at pp. 6-7.

⁷⁹ *Fed. Housing Finance Agency v. Nomura Holding Ame.*, 104 F.Supp.3d 441, 519 (S.D.N.Y. 2015).

underwritten by RBS to show that the sampling, and by extension the level of due diligence, was inadequate.⁸⁰ By not articulating a specific standard in regards to methodology or size, Judge Cote seemed to indirectly support the reasoning set forth by the SEC and other industry groups that sampling must be taken in context with all other due diligence performed.

And even though this case might not have articulated a specific standard for pool-sampling moving forward, it at least provides an idea of what type of due diligence is considered inadequate where an MBS has similar characteristics as those in *Nomura*. Moving forward, the goal should be to build on these fact situations to better articulate a standard that would provide for a due diligence threshold similar to the way the case law did after the seminal *BarChris* decision some fifty years ago.⁸¹

1. Moody's provides a different and possible new way to sample

In a highly technical working paper drafted in 2010, Moody's Research Labs put forth evidence that using loan-level data instead of pool-level data can lead to drastically different conclusions about the credit risk that exists in a certain mortgage portfolio.⁸² And while the methodologies used to reach their conclusions are likely too complex and advanced for discussion in this paper, their conclusions are nonetheless worth mentioning as this kind of analysis may have an impact on what is considered an appropriate due diligence standard going forward.

⁸⁰ *Id.* at 473-74, 483-84.

⁸¹ GARY M. LAWRENCE, *DUE DILIGENCE, A SCHOLARLY STUDY* 26-27 (Alex Poor ed., 2nd ed. 2013). (describing the *Escott v. BarChris* decision that showed due diligence fell below an acceptable standard but not articulating what the standard should be).

⁸² Chinchalkar & Stein, *Supra* note 61, at 14.

In short, the analysis suggests that using loan-level analysis in forecasting credit risk on a portfolio produces default rates that differ some “20%-40%” from the pool-level analysis that is currently in effect today.⁸³ Using data from actual prime⁸⁴ RMBS pools (prime refers to borrowers with below-average credit risk), the authors ran multiple experiments that compared the loan-level analysis to both geographical pool averages and grand pool averages.⁸⁵

Using the *realized* three-year default rate from loans originated in all four quarters of 2006 and the *predicted* three-year default rate on those loans, the authors are able to show that the loan-level analysis produced results that were very similar to the actual realized results.⁸⁶ In contrast, the results for the pool-level averages performed poorly against the actual realized default rate by producing results that were well under the actual default rates realized.⁸⁷ It should be noted, however, that this type of analysis, according the authors’ knowledge, may be “among the first to address the question of the effects on mortgage analysis of loan-level vs. aggregate treatments...”⁸⁸

As such, performing loan-level analysis should not be considered dispositive in establishing a minimum standard of due diligence going forward. However, with that being said, this analysis does potentially offer a better way of analyzing MBS and other

⁸³ *Id.* at 3.

⁸⁴ INVESTOPIDA, <http://www.investopedia.com/terms/p/prime-borrower.asp>. (Last visited Apr. 14, 2016).

⁸⁵ Chinchalkar & Stein, *Supra* note 61, at 14.

⁸⁶ *Id.* at 14 (emphasis added).

⁸⁷ *Id.*

⁸⁸ *Id.* at 4.

ABS-type loans going in the future, which has the potential benefit of protecting the investors, the issuers, and the underwriters while removing a level of uncertainty.

V. CONCLUSION

While Reg. AB I and its progeny, Reg. AB II, have made appropriate strides in mandating disclosure requirements for issuers and underwriters of ABS securities, there are two main issues that are holding back the law from having a greater effect. The first of those issues is that Reg. AB II is effective only in publicly traded ABS transactions.⁸⁹ For MBS, this means that the issuer can effectively bypass Reg. AB II by simply selling the securities in a private offering. Therefore, due to the sheer dollar size of these securities, the vast majority of investors will not be your average individual investor, but rather the majority will comprise of investors who are of the institutional variety: pension funds, university endowments, etc.⁹⁰ Thus, when there is another large appetite on both sides for these kinds of products in the future, the inclination of the issuer and the investor will be to conduct a private offering,⁹¹ which could end up being a detriment to both parties.

The second issue stems from not identifying what the minimum threshold of aggregate sampling should be in terms of size and methodology. Certainly both size and methodology can be hard to quantify, as laid out previously in this paper, but it's also been shown that a new methodology might exist that can factor in all of the loan-level data and produce very consistent results that can benefit all the parties to the transaction.

⁸⁹17 C.F.R. §§229.1110.

⁹⁰ ENGEL & MCCOY, *supra* note 21, at 214.

⁹¹ *Id.*

Thus, merely accepting the status quo can lead to a wide variety of results in future litigation without some type of guidance that courts can follow.

Moreover, the articulation of a minimum standard has the potential effect of reducing the consequences of the next asset-backed related bubble. Issuers are always going to chase fees; investors will always chase yield; borrowers will continue to borrow more than they should; and lenders will lend to people they shouldn't. Those behaviors will not change, but what can change is the regulation and the transparency associated with these structured financial products so that these behaviors don't get so out of control and lead to another global financial crisis. Regulation AB is a start, but it has a long way to go before it accomplishes that goal.

The Role of Trust in Due Diligence--Does the Reasonable Person *Ever* Trust?

Hannah Mason¹

This article explores Professor Joseph K. Leahy's² notions about the reasonably prudent person and roles of trust and reliance in his or her due diligence based conduct. More specifically, it examines Professor Leahy's contention that there are times when a reasonably prudent person would not independently verify and/or investigate, but rather would rely both on information he or she has been provided, and on the investigative efforts of others. Part I overviews basic due diligence principles relevant to Professor Leahy's view. Part II examines what Professor Leahy has called the "myth of independent verification." Part III explores the current judicial and social environment in which this issue is commonly explored. And, Part IV offers a few concluding remarks recognizing the pros and cons of Professor Leahy's theory regarding its use in due diligence practice.

I. INTRODUCTION

One of the earliest cases to interpret the due diligence defenses was *Escott v. BarChris Construction Corporation* ("BarChris").³ In this case the court stated that a "reasonable investigation" requires more than accurate reporting; the underwriters must make "some reasonable attempt to verify the data submitted to them" because a prudent

¹ J.D. 2016, SMU Dedman School of Law; B.S. Human Development and Family Sciences 2013, The University of Texas at Austin.

² Associate Professor of Law, South Texas College of Law. For the substance of Professor Leahy's views in this regard, see, Joseph K. Leahy, *The Irrepressible Myths of BarChris*, 37 DEL. J. CORP. L. 411 (2012).

³ *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

man would not rely solely on the answers given.⁴ The holding of the case is often seen “as requiring independent verification of the issuer’s material statements in the registration statement.”⁵ Today, independent investigation is generally described as verification of issuer statements through outside sources.⁶ While many have simply accepted the independent verification “requirement,” Professor Leahy questions whether there are in fact circumstances under which a reasonable person would not independently verify all material information in a registration statement.

II. PART I – SELECTED DUE DILIGENCE PRINCIPLES AND THE DEVELOPMENT OF THE CONCEPT OF INDEPENDENT INVESTIGATION

While there is no statutory definition of the term “due diligence,” it is generally understood to refer to the “process and practice of using reasonable efforts appropriate under the circumstances to investigate the material aspects of a proposed transaction so that a reasonable person could make an informed decision regarding the transaction.”⁷ The process and practice is factually specific, and there is no “one size fits all” due diligence that is applicable in every circumstance and setting. Therefore, the issue of what due diligence conduct is reasonable (including any elements of reliance on others) can only be determined with reference to the specific context in which the investigation was conducted.

⁴ *Id.* at 697.

⁵ *Id.* at 429.

⁶ *Id.* at 434-35.

⁷ GARY M. LAWRENCE, *DUE DILIGENCE: A SCHOLARLY STUDY* 12 (Alex Poor, editor., 2nd ed. 2013).

A. “Reasonable Investigation” v. “Reasonable Care”

Section 11 of the Securities Act of 1933 (“Securities Act”) prohibits registration statements for a public offering from containing “an untrue statement of material fact” or omitting “a material fact required to be stated therein or necessary to make the statements therein not misleading.”⁸ Section 11 liability is strict for issuers; however, a range of non-issuer defendants may avoid liability for material misstatements or omissions if they can prove one of the affirmative defenses (“reasonable investigation” or “reasonable reliance”) set forth in the statute.⁹

With respect to non-expertised portions of a registration statement (that is, information not made on the basis of the statements of an expert), the defense requires the defendant to prove that it had, “after a reasonable investigation, reasonable ground to believe and did believe” that the statements were “true and that there was no misstatement or omission of material facts.”¹⁰ In the context of this defense, the standard of reasonableness is that of a “prudent man in the management of his own property” in a similar context.¹¹

Section 12(a)(2) on the other hand imposes liability on a seller who offers or sells a security “by means of a prospectus or oral communication” that contains an untrue statement or omission of a material fact.¹² Similar to Section 11, Section 12(a)(2) offers

⁸ 15 U.S.C. § 77k(a). Those that can be held liable are “the issuer; each signatory of the registration statement; each director or partner of the issuer; each person named as a director or officer; each accountant, engineer, appraiser or other expert; and each underwriter.” LAWRENCE, *supra* note 2 at 51.

⁹ LAWRENCE, *supra* note 7 at 52.

¹⁰ 15 U.S.C. § 77k(b)(3).

¹¹ *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 663 (S.D.N.Y. 2004).

¹² 15 U.S.C. § 771(a)(2).

an affirmative due diligence defense to a defendant who can prove that “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.”¹³ However, unlike Section 11, which states that reasonableness is that of the prudent man, Section 12 does not provide a definition of reasonableness to determine what establishes “reasonable care.”¹⁴ Nor does this statute contain a reasonable reliance defense for expertised material.

Section 11 and Section 12(a)(2) have different standards—reasonable investigation v. reasonable care. Moreover, there is at least some disagreement among courts and regulators regarding the precise relationship between the two standards. Are they the same or different, if different which is the higher standard? The SEC in Release No. 33-8591 (Securities Offering Reform)¹⁵ and Judge Cote in *WorldCom*¹⁶ have stated that reasonable care is a lower standard as compared to a reasonable investigation. However, other courts have interpreted the reasonable care defense as being comparable to the reasonable investigation defense.¹⁷ Regardless of the precise nature of the relationship, the issue of reliance vs. independent verification when measured by the prudent man standard remains.

¹³ LAWRENCE, *supra* note 7 at 91; *see also* 15 U.S.C. § 771(a)(2).

¹⁴ LAWRENCE, *supra* note 7 at 91.

¹⁵ The full text of the release may be found at <https://www.sec.gov/rules/final/33-8591.pdf>.

¹⁶ *WorldCom*, 346 F. Supp. 2d at 663.

¹⁷ William F. Alderman, *Due Diligence in the Post-Enron Era: A Litigator’s Practical Tips on Mitigating Underwriter Risk*, 1746 PLI/Corp 87, 95 (Apr. 2009).

Although the relationship between the standards is still unclear what is clear is that expectations of the reasonably prudent person have evolved over time. This evolution has led to an investigation “requirement” that may not truly be appropriate in all circumstances.¹⁸

B. The Reasonably Prudent Person and the Supposed Independent Investigation “Requirement”

The prudent person standard derives from the law of trusts and generally is interpreted as “a negligence standard—the duty to exercise ordinary care.”¹⁹ In the context of due diligence, “the reasonable prudent person is not an individual who possess exceptional or uncanny investment skill, but rather is a person of average intelligence and sound judgment when it comes to making investment related decisions.”²⁰ The prudent person reasonable investigation has developed over time through judicial decisions, regulatory pronouncements and rulings, and related literature. As noted above, a number of courts and commentators have asserted that independent investigation is nearly always a component of a reasonable investigation (Section 11) or an investigation conducted with reasonable care (Section 12(a)(2)); however, Professor Leahy has taken issue with this interpretation, raising both important and legitimate questions about its appropriateness.²¹

¹⁸ See *infra* Part II.

¹⁹ Leahy, *supra* note 2 at 455-56.

²⁰ LAWRENCE, *supra* note 7 at 14.

²¹ Leahy, *supra* note 2 at 428.

By way of background, one of the earliest cases to interpret the due diligence defenses was *Escott v. BarChris Construction Corporation* (“*BarChris*”).²² *BarChris* is still considered by many the “definitive decision concerning the scope of an underwriter’s due diligence obligation.”²³ In that case, Judge McLean asked, is it a “reasonable investigation” by a “prudent person,” if the individual asked questions, obtained satisfactory answers, and then “let it go at that, without seeking to ascertain from the records” if the answers were “true and complete?”²⁴ The court answered this question in the negative stating that a “reasonable investigation” requires more than accurate reporting; the underwriters must make “some reasonable attempt to verify the data submitted to them” because a prudent man would not rely solely on the answers given.²⁵ No authority was cited for this proposition.²⁶

The holding of the case is often seen “as requiring independent verification of the issuer’s material statements in the registration statement.”²⁷ *Feit v. Leasco* (“*Leasco*”) a few years later solidified this understanding of the “reasonable investigation.”²⁸ In that case, Judge Weinstein held that to successfully assert the due diligence defense under Section 11 one must undergo independent verification of material facts in the registration statement.²⁹ He went on to say that the investigation must be “reasonably calculated to

²² *BarChris*, 238 F. Supp. at 696.

²³ Leahy, *supra* note 2 at 426.

²⁴ *BarChris*, 238 F. Supp. at 696.

²⁵ *Id.* at 697.

²⁶ Leahy, *supra* note 2 at 428.

²⁷ *Id.* at 429.

²⁸ *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971).

²⁹ *Id.* at 582.

reveal those facts which would be of interest to a reasonably prudent investor.”³⁰ Ever since these cases were decided, professionals in the industry as well as many jurists have generally agreed with and continued to champion this result without questioning the lack of authority for the proposition.³¹

While the concept of independent investigation as part of a reasonable investigation has persisted for some years, the type of investigation has changed over time.³² *BarChris* and *Leasco* both described the term “independent investigation” to mean checking the oral statements by management against the company’s own internal documents.³³ Today however, independent investigation is generally described as verification of issuer statements through outside sources.³⁴

III. PART II – THE “MYTH OF INDEPENDENT VERIFICATION”

While many have simply accepted the independent verification “requirement,” Professor Leahy questions whether there are in fact circumstances under which a reasonable person would not independently verify all material information in a registration statement.³⁵ He suggests that a *perfectly* prudent person may indeed verify all material information but a *reasonably* prudent person, which is the statutory standard,

³⁰ *Id.*

³¹ See Leahy, *supra* note 2 at 431-33; see also *WorldCom*, 346 F. Supp. at 662 (The court stated that recent Section 11 case law “shows no signs of abandoning the early courts’ demand that underwriters employ a high degree of care . . . and independent verification of the company’s representations.”).

³² Leahy, *supra* note 2 at 433.

³³ *Id.*

³⁴ *Id.* at 434-35.

³⁵ *Id.* at 455.

may not depending on the facts and circumstances.³⁶ In essence, he asks the question “what type of investigation would a reasonably prudent person investing his or her money truly employ?”³⁷ Would an independent person employ a cost benefit analysis to determine when independent verification outweighs its benefit?³⁸

Professor Leahy expands on this cost-benefit proposition³⁹ stating that there are at least two instances when the benefit of independent verification could be so low that verification would not be worthwhile.⁴⁰ “First, when there is a good, objective reason for the prudent person herself to trust the issuer’s statements, and second, when the issuer has expressly warranted its statements to the prudent person and likely will make good on that warrantee.”⁴¹ If an investor reasonably trusts the issuer, then the benefit from expending effort to check statements that they may believe are unlikely false could be low.⁴² Moreover, if the issuer has expressly warranted its statements there may be little to no benefit in investigating because the investor may not care if the statement is false if they will be reasonably made whole.⁴³

³⁶ *Id.* The standard for the due diligence defense under both Section 11 and Section 12(a)(2) “is one of reasonableness, not perfection.” *In re International Rectifier Sec. Litig.*, 1997 U.S. Dist. LEXIS 23966, 29 (C.D. Cal. Mar. 31, 1997).

³⁷ Leahy, *supra* note 2 at 458.

³⁸ *Id.* at 460.

³⁹ The *Leasco* and *Software Toolworks* cases addressed situations when the cost of independent verification was too high because the information was not readily available. See generally Leahy, *supra* note 2, notes 270-81 and accompanying text.

⁴⁰ Leahy, *supra* note 2, at 460.

⁴¹ *Id.* at 460-61.

⁴² *Id.* at 461.

⁴³ *Id.*

These two examples highlight Professor Leahy's view that the understanding and focus of a court should change to bring its understanding more in line with "reasonableness" not "perfection" and the due diligence that underwriters and other investigators actually perform or might be expected to perform in the management of their own property.⁴⁴ By Professor Leahy's lights, that there are situations where the reasonably prudent person (as opposed to perfectly prudent person) would likely trust due to their previous dealings or because they have been indemnified. This, according to Professor Leahy, is a more appropriate approach to the concepts of the reasonable person and the role of independent verification.

IV. PART III – APPLICATION TO THE CURRENT JUDICIAL AND SOCIAL ENVIRONMENT

Professor Leahy's proposed interpretation of the reasonably prudent person's mindset is compelling when viewed through the lense of everyday experience and activity. Moreover, it has the potential to significantly change the way that courts approach the role of independent verification in the context of a due diligence investigation. Those potential changes could have both positive and negative implications.

A. Pros

First, it is clear that the largest benefit of adopting Professor Leahy's approach would be the potential for enhanced efficiency in due diligence and a limitation on the explosion of due diligence based litigation.⁴⁵ Among other things, elimination of costly and, by Professor Leahy's assessment "unmerited," verification could lead to savings not

⁴⁴ *Id.* at 494.

⁴⁵ *Id.* at 499-500.

only for the parties performing the due diligence but potentially to the investors as well since the cost savings would likely trickle down stream.⁴⁶ Second, by eliminating the “requirement” that all material facts in the registration statement be independently verified, the registration statement would no longer serve as an unrealistic checklist; this would force the court’s understanding of due diligence to mirror the due diligence that is actually performed in the real world.⁴⁷ Checklists are used by due diligence professionals but they are not typically based on the registration statement.⁴⁸ There is no set checklist; the checklist depends on the specific facts and circumstances of each offering and generally includes information regarding the underwriter, the industry, customers and suppliers, and outside sources of information.⁴⁹ By bringing the courts’ interpretation of the reasonable man standard in line with what Professor Leahy sees as the real world, it would allow companies to focus their efforts more efficiently without wasting time and money on investigations that may be “perfectly” prudent but not “reasonably” prudent.

B. Cons

A potential challenge associated with following Professor Leahy’s interpretation is the fact that it runs contrary to recent judicial trends, exemplified by Judge Cote’s ruling in both *WorldCom*⁵⁰ and *Nomura*.⁵¹ For example, in the *WorldCom* case Judge

⁴⁶ Leahy, *supra* note 2 at 500.

⁴⁷ *Id.* at 495.

⁴⁸ *Id.*

⁴⁹ LAWRENCE, *supra* note 7 at 64-65; see also *Weinberger v. Jackson*, 1990 U.S. Dist. LEXIS 18394 (N.D. Cal. Oct. 11, 1990) (One of the first cases to give guidance on elements that should be included in a reasonable due diligence investigation).

⁵⁰ *WorldCom*, 346 F. Supp. 2d at 663.

⁵¹ *Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc.*, 104 F. Supp. 3d 441 (S.D.N.Y. 2015).

Cote denied the underwriters' and other defendants' motions for summary judgment regarding their due diligence and reliance defenses, claiming there were questions of fact about whether the reasonable investigation and reliance standards had been met.⁵² Judge Cote applied an especially strict view of both of the standards noting among other things (1) there is "no lesser standard of reasonableness for expedited offerings,"⁵³ (2) the issue of red flags is no longer a matter of law but one "suited to a jury determination,"⁵⁴ and (3) "due diligence for a Fortune 200 company requires the same independent verification as the due diligence in an initial public offering."⁵⁵

Going even further in her December 2014 ruling on summary judgment in the *Nomura* case, Judge Cote stated that even though the defendants conducted due diligence that was equal to or better than industry standards they still had not met the reasonableness standard.⁵⁶ More specifically, she ruled as a matter of law that defendants did not have a right to attempt to prove that their due diligence was reasonable because their due diligence was so unreasonable that no reasonable person could find that it had met the standard.⁵⁷ She went on to state that the entire industry was not doing enough due diligence.⁵⁸ As these cases show, courts will likely hold to the precedent in this area and following Professor Leahy's view may lead to negative results. However, these judicial decisions could be outliers and may have been influenced by the public cry for justice

⁵² LAWRENCE, *supra* note 7 at 71.

⁵³ *Id.* at 72.

⁵⁴ *World Com*, 346 F. Supp. 2d at 674.

⁵⁵ Leahy, *supra* note 2 at 500.

⁵⁶ *Nomura*, 68 F. Supp. 3d at 439.

⁵⁷ *Id.*

⁵⁸ *Id.*

that accompanied both of these cases because both cases dealt with large frauds that gained a lot of attention from the public and media.⁵⁹

Along the same lines, parties may not want to challenge the current judicial precedent through litigation because of the time, money, and effort that would be expended. Furthermore, the company's reputation may be harmed by coverage of the lawsuit. However, each entity would have to weigh this potential negative against the above-mentioned positive and choose what is best for them as due diligence is based on the specific facts and circumstances of each individual case.

V. CONCLUSION

While it is true that there was no authority cited for Judge McLean's statement in *BarChris* that a "reasonable investigation" requires more than accurate reporting, this landmark case has developed into precedent that may take time to overcome.⁶⁰ However Professor Leahy's new understanding of the prudent person standard has the potential to enhance efficiency in due diligence and limit the explosion of due diligence-based litigation. The elimination of costly verification could lead to savings not only for the parties performing the due diligence but potentially to investors as well. All in all, this understanding of the reasonable person/investigation has the potential to change the due diligence field for the better and while it may not lead to change immediately it is likely to lead to change in the not to distant future.

⁵⁹ LAWRENCE, *supra* note 7 at 75 (WorldCom's fraud led to massive losses for employees and small investors that could not bear the losses); *Nomura*, 68 F. Supp. at 444 (Nomura dealt with the home mortgage crisis).

⁶⁰ Leahy, *supra* note 2 at 428 (There is no authority for Judge McLean's statements in *BarChris*).

Brief Introduction to the Concept of “Red Flags” in Public Securities Offerings Due Diligence

Jennifer C. Ohn¹

I. INTRODUCTION

There is no statutory or black letter definition of the term “red flag” as applied to due diligence in the context of a public offerings of securities. Over the years, a number of sources have suggested various definitional formulations including: (1) information “that would alert a prudent person to conduct further inquiry,”² (2) “[a]ny information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements,”³ and (3) “storm warnings,”⁴ among many others. But no court so far has attempted to articulate a precise definition that may be applied in all contexts. This is understandable, since as noted jurist Judge Cote of the Federal District Court for the Southern District of New York stated in the landmark *WorldCom* case “what constitutes a red flag depends on the facts and context of a particular case.”⁵

This article briefly explores the concept of red flags in the context of due diligence investigations associated with public offerings of securities. Parts I and II offer

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² FINRA Regulatory Notice 10-22: Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings (April 2010) [hereinafter, FINRA Notice 10-22”] at 6.

³ *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 672-73 (S.D.N.Y. 2004). Accounting and financial red flags typically relate to “aggressive or unusual accounting strategies regarding significant issues.” *Id.* at 684.

⁴ *Id.* at 672.

⁵ *Id.* at 673.

a brief introduction to the concept of red flags and the most frequent contexts in which the concept arises in securities offering litigation. Part III examines Judge Cote's discussion of red flags in her opinion denying summary judgment in *WorldCom* and some scholarly objections to that ruling. Part IV examines one technique, the use of checklists, that may assist investigators in identifying and responding to information that may form the basis of a red flag allegation. Part V offers a concluding discussion.

II. OVERVIEW OF RELEVANT LAW

In securities offerings, red flags typically arise in the context of Section 11 claims under the Securities Act of 1933 (the "Securities Act")⁶ though they may also arise in the context of claims under Section 12(a)(2) of that Act and under various anti-fraud provisions of the Securities Exchange Act of 1934 (the "Exchange Act"), and/or under state Blue Sky laws. Sections 11 and 12(a)(2) of the Securities Act impose liability for misstatements or omissions of material facts made in a registration statement and prospectus.⁷ Thus, typically, the concept of red flags arises where a plaintiff alleges that the offering documents contain one or more material misstatements and/or omissions, and that these shortcomings were knowable by one or more parties conducting a due diligence investigation based on information (alleged red flags) they encountered in the course of their investigation.

Under both Sections 11 and 12(a)(2), underwriters may assert a due diligence defense.⁸ To establish a due diligence defense, the standard of reasonableness is that

⁶ 12 C.F.R. § 16.2.

⁷ 15 U.S.C.A. § 77k.

⁸ *See id.*

which is “required of a prudent man in the management of his own property.”⁹ To determine whether this standard is met. Several factors have been deemed relevant. For instance, SEC Rule 176 sets out a number of general factors courts may consider in determining reasonableness. For purposes of the due diligence defense, a defendant’s actions will be typically be found reasonable when efforts included: (1) contacting customers and suppliers; (2) inspecting an issuer’s factory; (3) reviewing an issuer’s financial statements with its auditors; (4) obtaining written representations from the issuer and selling stockholder that information in the registration was accurate; and (5) having underwriter’s counsel conduct a separate review of the issuer’s records.¹⁰ Further, in *Weinberger v. Jackson*, the court reinforced that these kinds of factors may help to determine reasonableness. In that case, the underwriters conducted efforts similar to those laid out in Rule 176, which led the court to determine that the investigation was reasonable.

On the other hand, defendants are unable to establish a due diligence defense when there were deficiencies in their investigations.¹¹ Specifically, underwriters seeking to establish a due diligence defense as to “expertised” portions of the registration statement (that is, those portions made on the authority of an expert) must prove that they “had no reasonable ground to believe and did not believe” that such portions of the registration statement contained misstatements or omissions of material facts.¹²

⁹ 15 U.S.C §77k(c) (1988).

¹⁰ *In re Software Toolworks Inc.*, 50 F.3d 615, 624 (9th Cir. 1994).

¹¹ See *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968); *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 362 (2d Cir. 1973); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 568 (E.D.N.Y. 1971).

¹² *WorldCom*, 346 F. Supp. 2d at 601.

Conversely, underwriters seeking to establish a due diligence defense as to “non-expertised” portions of the registration statement must prove that they “had, after reasonable investigation, reasonable ground to believe and did believe” there were no misstatements or omissions of material facts.¹³ One consideration in a court’s determination of whether the defendant has met these burdens of proof, is whether it encountered any red flags in the course of its investigation and, if so, how it responded to them.

In addition to a due diligence defense, Section 11 provides a reliance defense. In order to be entitled to the reliance defense under Section 11, a defendant must show that he or she had “no reasonable ground to believe and did not believe” that the statements within the registration statement that were made on an expert’s authority were untrue. However, “neither “the Supreme Court nor the Second Circuit had explored this area of law in any significant way.”¹⁴ The *WorldCom* court announced the general rule when it explained that “reliance on audited financial statements may not be blind.”¹⁵

The most common claims presented in such litigation are those against underwriters. Issuers employ underwriters, typically investment banks, to facilitate the sale of securities to the public.¹⁶ Underwriters have been defined as having a “moral responsibility to the public [that] is particularly heavy,”¹⁷ and have been held to the

¹³ *See id at 572.*

¹⁴ *Id. at 671* (citing *Escott v. BarChris Constr. Corp.*, 283 F.Supp. 643, 683 (S.D.N.Y.1968)).

¹⁵ *Id at 672.*

¹⁶ Christian A. Young, *Looking Back on Worldcom: Addressing Underwriters' Due Diligence in Shelf Registration Offerings and the Need for Reform.*, 40 Suffolk U.L. Rev. 521, 527 (2007).

¹⁷ *In re WorldCom, Inc.*, 346 F. Supp. 2d at 657.

standard of exercising “a high degree of care in investigation and independent verification of the company's representations.”¹⁸ Indeed one court has gone so far as to observe that, “[n]o greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter.”¹⁹ This high level of responsibility associated with underwriters has led to their increased liability for ignoring red flags in an investigation. In an underwriter claim, red flags typically arise when a plaintiff has alleged that, in the course of its due diligence investigation, the underwriter encountered red flags in reviewing the offering documents that would have led to discovery of material misstatements and/or omissions. More specifically, the plaintiff typically alleges that the underwriter failed to properly investigate the red flags, and that if it had, it would have discovered the alleged misstatements and/or omissions. This increased responsibility has been reflected in many recent decisions, including the *WorldCom* decision discussed below.

III. IN RE WORLDCOM, INC. SECURITIES LITIGATION

A. Overview

One of the first most significant cases exploring the concept of red flags is *In re WorldCom, Inc. Secs. Litig.* (“*WorldCom*”), involving a consolidated securities fraud litigation against telecommunications giant WorldCom, Inc.²⁰ The plaintiffs alleged that WorldCom’s registration statements contained material misstatements and omissions and that the underwriters and others failed to properly recognize and respond to red flags in

¹⁸ *In re WorldCom, Inc.*, 346 F. Supp. 2d at 662 (citing *Feit v. Leasco Data Processing Equip. Corp.*, 332 F.Supp. 544, 582 (E.D.N.Y.1971)).

¹⁹ *Id.* (citing *Chris-Craft*, 480 F.2d at 370).

²⁰ *See WorldCom*, 346 F. Supp. 2d 628 at 673.

the issuer's audited financial statements in violation of Sections 11 and 12(a)(2) of the Securities Act. Notably, the *WorldCom* Court "elaborated on the concept of 'red flags' making reliance on expertized portions unreasonable [when red flags are present]."²¹ The Court defined a red flag as "[a]ny information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements."²² Moreover, the court found that "what constitutes a red flag depends on the facts and context of a particular case."²³ The court also decided that red flags should be held to a "prudent man" standard, to be determined by a jury."²⁴

The court denied the underwriter defendants' motion for summary judgment on their affirmative defenses of due diligence and reliance.²⁵ In this opinion, Judge Cote held that mere reliance on comfort letters and unaudited financial statements (non-expertised material) did not establish a due diligence defense.²⁶ Further, she held that the underwriter defendants' reliance on audited financial statements (expertised material), where the underwriter faces a red flag concerning the accuracy of those statements, did not establish a reliance defense because the red flags triggered a duty to investigate further.

²¹ *Id.* at 604.

²² *Id.*

²³ *WorldCom*, 346 F. Supp. 2d 628 at 673.

²⁴ *See id.* at 674. (citing *Mosesian*, 727 F.2d at 879).

²⁵ *See id.* at 678.

²⁶ *See* William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 592 (2006).

Additionally, the underwriters' motion for summary judgment on the reliance defense was denied.²⁷ While underwriters can rely on an accountant's audit opinion, underwriters may not rely on an accountant's comfort letters for interim financial statements.²⁸ This is because "[c]omfort letters do not expertise any portion of the registration statement that is otherwise non-expertised."²⁹ If an initial investigation leads an underwriter to question the accuracy of financial reporting, then the existence of an audit or a comfort letter does not excuse the failure to follow through with a subsequent investigation of the matter. Further "[i]f red flags arise from a reasonable investigation, underwriters will have to make sufficient inquiry to satisfy themselves as to the accuracy of the financial statements, and if unsatisfied, they must demand disclosure, withdraw from the underwriting process, or bear the risk of liability."³⁰

WorldCom addressed several issues related to an underwriter's due diligence obligations.³¹ In *WorldCom*, the lead plaintiff pointed to three key red flags: (1) the discrepancy between WorldCom's E/R (expense to revenue) ratio and that of its competitors; (2) the deterioration in the MCI long-distance business (WorldCom acquired MCI for \$47 billion³²), and (3) the personal financial situation of WorldCom's CEO.³³ The Court recognized these issues in denying the underwriters' motion for summary

²⁷ See *WorldCom*, 346 F. Supp. 2d 628 at 678.

²⁸ See *id.* at 666.

²⁹ *Id.*

³⁰ *Id.* at 684.

³¹ *Id.* at 634.

³² *Id.* at 680.

³³ *Id.* at 680.

judgment on the due diligence defense.³⁴ First, the Court found that there were a genuine issues of material fact related to the discrepancy between WorldCom’s E/R ratio and that of its competitors and in comparison to WorldCom’s statement of assets.³⁵ WorldCom reported an E/R ratio that was significantly lower than that of its two closest competitors.³⁶ Although the difference in E/R ratios was “publicly available information,” it is up to a jury, applying the “prudent man” standard “to find that this difference [in E/R ratios] was of sufficient importance to have triggered a duty to investigate the reliability of the figures on which the ratio was based even though the figures had been audited.”³⁷ Thus, the difference in E/R ratios and WorldCom’s statement of assets were issues of fact “that a jury may find raised a red flag and imposed upon the Underwriter Defendants the obligation to inquire.”³⁸ Second, the Court found that the decline in WorldCom’s MCI long-distance business raised a red flag concerning the assets reported in WorldCom's financial statements. An identified omission from the 2000 Registration Statement was a failure to disclose adequately that WorldCom was experiencing continued difficulty with its MCI long-distance business segment. Regarding this issue, the court held that there were “issues of fact regarding WorldCom's statement of its assets that a jury may find raised a red flag and imposed upon the Underwriter Defendants the obligation to inquire.”³⁹

³⁴ *See id.*

³⁵ *See id.* at 678.

³⁶ *See id.*

³⁷ *Id.* at 679.

³⁸ *Id.* at 681.

³⁹ *Id.*

Thus, to prevail on their due diligence defense, the underwriters had to “show that they conducted a reasonable investigation and that after such an investigation that they had reasonable ground to believe that the statements in the registration statements, including the information in the unaudited interim financial statements, were true.”⁴⁰ Here, there were questions of fact as to whether the underwriters conducted a reasonable investigation. Evidence indicated that the “limited number of conversations with the issuer or its auditor, the cursory nature of the inquiries, the failure to go behind any of the almost formulaic answers given to questions, and the failure to inquire into issues of particular prominence in the Underwriter Defendants' own internal evaluations of the financial condition of the issuer or in the financial press.”⁴¹

On the other hand, Judge Cote also gave guidance which situations don't rise to the level of a red flag.⁴² These situations generally involve “recklessness” and “motive and opportunity” that arise under Section 10(b) of the Exchange Act.⁴³ In this line of cases, the issue is “whether a plaintiff has adequately pleaded an officer's motive and opportunity to engage in fraud such that the defendant's scienter has been adequately alleged.”⁴⁴ For instance, in some situations, extraordinary dependence on an issuer's officer regarding the financial condition of the issuer is not a red flag absent a reason to believe that the officer was untrustworthy.⁴⁵ In *WorldCom*, the issue of the CEO's

⁴⁰ *Id.* at 682.

⁴¹ *Id.* at 683.

⁴² *Id.* at 681.

⁴³ *Id.* at 672.

⁴⁴ *Id.* at 681.

⁴⁵ *See id.*

personal financial situation did not constitute a red flag.⁴⁶ There was no reason to believe that the CEO was untrustworthy and the CEO's "dependence on WorldCom's financial health, even though extraordinary, [was] insufficient to constitute a red flag that he may have caused a manipulation of WorldCom's financial statements."⁴⁷

B. Scholarly Criticisms of WorldCom

A number of informative sources have criticized the *WorldCom* decision, especially as it relates to its interpretation of red flags and the ruling that "the existence of red flags can create a duty to investigate even audited financial statements."⁴⁸ Although not binding on every federal court, *WorldCom* set precedent and had a profound effect on securities underwriting. Some studies even suggest that *WorldCom* led to an increase in Section 11 filings relative to Rule 10b-5 filings.⁴⁹

As noted by Gideon A. Schor, former staff member of the U.S. Attorney's Office for the Southern District of New York and former law clerk to the Honorable J. Edward Lumbard of the U.S. Court of Appeals for the Second Circuit, "the decision's frailties have become evident."⁵⁰ *WorldCom* left many questions unanswered, as Professor Schor believes that *WorldCom* offered "little concrete guidance" as to "where an ordinary business event ends and a red flag begins."⁵¹ Professor Schor stated that "[m]ore

⁴⁶ *See id*

⁴⁷ *Id.*

⁴⁸ *Id.* at 679.

⁴⁹ David I. Michaels, *An Empirical Study of Securities Litigation After Worldcom*, 40 RUTGERS L.J. 319, 352 (2009).

⁵⁰ Schor, *The Due Diligence and Reliance Defenses in WorldCom: Retrospect and Prospect* at *8 (2006), available at https://www.wsgr.com/PDFSearch/Due_Diligence_after_WorldCom.pdf.

⁵¹ *Id.* at 8 (citing *WorldCom*, 346 F. Supp. 2d at 679).

alarmingly, the opinion effectively states that, in a competitive industry, any meaningful superiority of one company over another in any financial category could raise a red flag.”⁵² Professor Schor also takes issue with the fact that “it appears likely that *WorldCom* will make summary judgment more difficult to obtain and that underwriters will face greater settlement pressure as a result.”⁵³ Professor Schor believes that as a result of *Worldcom*, underwriters will be encouraged to retain accountants to investigate the accuracy of financial statements.⁵⁴ Professor Schor also believes that the opinion will discourage shelf registration.⁵⁵ He worries that comfort letters have become obsolete since “they are insufficient by themselves to establish a due diligence defense.”⁵⁶ He also argues that *WorldCom* will significantly change how underwriters document their diligence. He notes that it was “remarkable . . . that the memorandum describing the diligence for WorldCom’s 2000 offering did not even identify who participated in the call with WorldCom.”⁵⁷ Professor Schor believes that co-managing underwriters (non-lead underwriters) are doubly at risk of losing their diligence defense because “[i]f the teaching of *WorldCom* is that leads may not rely blindly on auditors, then *a fortiori* non-leads may not rely blindly on leads.”⁵⁸ Professor Schor ultimately argues that due to

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *See id.*

⁵⁵ *Id.* at *9.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

WorldCom, diligence sessions may become interrogations and that “the days of gentlemanly exchanges and honor-code examinations may be over.”⁵⁹

Similarly, Professor William J. Sjostrom, Professor of Law at the James E. Rogers College of Law of the University of Arizona, believes that the *WorldCom* court erred on several counts.⁶⁰ According to Professor Sjostrom, *WorldCom* made reliance on expertized information unreasonable.⁶¹ He states that “[o]ne could argue that the market did not see WorldCom's lower E/R ratio as a red flag indicating the unreliability of WorldCom's financials.”⁶² According to Professor Sjostrom, if WorldCom’s E/R ratio was a red flag, “its stock would have been trading at much lower than the \$35 to \$45 per share range it was trading in May 2000 and the \$17 to \$22 per share range it was trading in May 2001.”⁶³ He further states that, “if the market did not see the ratio as a red flag, it follows that a “prudent man in the management of his own property” would not see it as a red flag either.”⁶⁴ Thus, “*WorldCom* misapplie[d] the ‘prudent man in the management of his own property’ standard in the context of audited financial statements.”⁶⁵ Professor Sjostrom’s theory suggests that it is reasonable to rely on financial statements certified by public accountants.⁶⁶ He argues that underwriters are not considered experts in accounting and are not qualified to perform audits since “accounting issues can be

⁵⁹ *Id.*

⁶⁰ See William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549 (2006).

⁶¹ *Id.* at 604.

⁶² *Id.*

⁶³ *Id.* at 606.

⁶⁴ *Id.*

⁶⁵ *Id.* at 607.

⁶⁶ See *id.*

enormously complex, and in such situations it is absurd for non-accountants to be expected to spot accounting mistakes.”⁶⁷ Overall, Professor Sjoström prefers use of the narrower “smoking gun” standard be used with respect to determining reasonable reliance on audited financial statements rather than whether a red flag makes reliance unreasonable.

Moreover, former Assistant District Attorney Christian A. Young believes that *WorldCom* “significantly raised the level of due diligence an underwriter must perform.”⁶⁸ Young states that, “red flags, which Judge Cote did not explicitly define, extend beyond the obvious financial misstatements and reach to external factors, such as competitors' financial situations and hidden corporate malfeasance.”⁶⁹ Young further suggests that the “*WorldCom* court's definition of red flags denotes the end of underwriter reliance on audited financial statements.”⁷⁰ Given the vast criticism of where *WorldCom* has left underwriters, various solutions have been posed. Below, checklists are explored as a potential aid to underwriters in facing the *WorldCom* definition of red flags.

IV. THE USE OF CHECKLISTS IN DUE DILIGENCE INVESTIGATIONS

Checklists are a useful tool to assist investigators in identifying and responding to information that may form the basis of a red flag allegation. There is no definitive checklist for red flags in due diligence investigations, but “some underwriters rely on internal checklists to assure that important issues are not overlooked in the conduct of due

⁶⁷ *Id.* at 608.

⁶⁸ Christian A. Young, *Looking Back on Worldcom: Addressing Underwriters' Due Diligence in Shelf Registration Offerings and the Need for Reform.*, 40 SUFFOLK U.L. REV. 521, 543 (2007)

⁶⁹ *Id.*

⁷⁰ *Id.*

diligence investigations.”⁷¹ Checklists can either be a “valuable asset” or a “major hindrance” to due diligence.⁷² It is important to recognize that “[f]ollowed blindly, they often lead the attorney to miss essential information. However, followed rigidly, they can cause a waste of valuable time.”⁷³ As a result, creating a checklist is a flexible process that should be adapted to the facts and circumstances surrounding an offering. A typical checklist “includes organizational documents, financial statements, product advertising, governmental filings, the business plan, management questionnaires, and litigation.”⁷⁴ But even the best checklist is not a substitute for awareness.⁷⁵

The SEC introduced Rule 176 as a response to short-form registration and the expansion of shelf registration. The purpose of Rule 176 was “to make explicit what circumstances may bear upon the determination of what constitutes a reasonable investigation and reasonable ground for belief as these terms are used in Section 11(b) of the Securities Act.”⁷⁶ Rule 176 sets forth “circumstances affecting the determination of what constitutes reasonable investigation and reasonable grounds for belief under section 11 of the Securities Act.”⁷⁷

Rule 176 states:

⁷¹ 4A Tax-Advantaged Securities § 8:19.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ CONSIDERATIONS IN APPROACHING DUE DILIGENCE, SW017 ALI-CLE 341.

⁷⁵ *Id.*

⁷⁶ *Circumstances Affecting the Determination of What Constitutes Reasonable Investigation & Reasonable Grounds for Belief Under Section 11 of the Sec. Act Treatment of Info. Inc. by Reference Into Registration Statements*, Release No. 6335 (S.E.C. Release No. Aug. 6, 1981) *proposed rule adopted by Adoption of Integrated Disclosure Sys.*, Release No. AS-306 (S.E.C. Release No. Mar. 3, 1982)

⁷⁷ 17 C.F.R. § 230.176.

“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 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.”⁷⁸

The SEC did not intend for Rule 176 to alter underwriters’ due diligence obligations.⁷⁹ Rule 176 is in no way an exhaustive list of considerations. Only a court can determine whether a defendant’s conduct was reasonable under all the circumstances of a particular offering but elements of Rule 176 offer some guidance as to what should be incorporated in a due diligence checklist.⁸⁰

In November of 1998, the SEC issued its Aircraft Carrier release in an attempt to provide courts with more comprehensive guidance as to whether an underwriter has established a due diligence in the context of expedited offerings.⁸¹ The Aircraft Carrier proposed amendments to Rule 176 articulated six due diligence “positive practices” that

⁷⁸ *Id.*

⁷⁹ *WorldCom*, 346 F. Supp. 2d 628 at 669.

⁸⁰ *See id* at 670 (citing SEC Rel. 6335, 1981 WL 31062, at *13)

⁸¹ Aircraft Carrier release, Fed. Sec. L. Rep. at 81,547.

are viewed as favorable by courts.⁸² Significantly, one of these factors is whether an underwriter conducted reasonable inquiry into any red flags.⁸³ This guidance by the SEC indicates that courts regard the detection and investigation of red flags as a positive practice.

V. CONCLUSION

In order to explain the concept of red flags in the context of due diligence investigations, particularly in the public offerings of securities, this article highlights frequent contexts in which red flags arise. It further explores responses to Judge Cote's denial of summary judgment in the *WorldCom* case, including scholarly objections to that ruling, and the use of checklists in identifying and responding to information that may form the basis of a red flag allegation. Red flags often arise in the underwriter context under Sections 11 and 12(a)(2) of the Securities Act, under various anti-fraud provisions of the Exchange Act and under state Blue Sky laws. As such, defendants in red flag litigation are oftentimes lead and co-underwriters. As the Southern District Court of New York recognized in *WorldCom*, red flags create an obligation to investigate further.⁸⁴ *WorldCom* marked a significant deviation from the jurisprudence covering Section 11's due diligence and reliance defenses, which a number of courts and scholars have criticized, particularly its interpretation of red flags. Many criticisms center around the belief that in the context of red flags, *WorldCom* set precedent that may cause even minimal financial discrepancies to raise a red flag, regardless of whether the reported information is expertised or non-expertised. Thus, an audited figure can be a red flag and

⁸² *See id.*

⁸³ *See id.*

⁸⁴ *WorldCom*, 346 F. Supp. 2d 628 at 679.

impose a duty to investigate. Thus, *WorldCom* has discouraged short-form registration and the expansion of shelf registration. Further, underwriters have begun to rely on checklists and SEC Rule 176 more heavily to determine due diligence obligations in regards to red flags. However, checklists are not exhaustive and may even hinder discovery of red flags if used improperly. Context is key in assessing whether red flags invoke a duty to investigate and, thus, eliminate the due diligence defense.

Case Note: *In re International Rectifier and Weinberger v. Jackson*

Meron Elias Squires¹

I. INTRODUCTION

Over the years courts have tackled the difficult issue of defining reasonable due diligence in a business transaction. Without a statutory definition clarifying what is required of directors, underwriters and other defendants, courts have been forced to articulate their own approaches to determine whether the investigation performed or reliance placed was reasonable and therefore satisfied the statutory standard of the applicable due diligence defense.

While courts may pursue different forms of analysis, there has been a consensus: context is the key, as there is not a “one size fits all approach” to due diligence. Therefore, decisions regarding “reasonableness” must be made on a case-by-case basis, with heavy reliance placed on the specific elements of context involved in a given situation. Regulatory bodies, such as the Securities Exchange Commission (“SEC”) and the Financial Industry Regulatory Authority (“FINRA,” formerly the National Association of Securities Dealers (“NASD”)) have followed the same approach, underscoring the importance of context in determining “reasonableness” in a due diligence investigation.

History has shown that the standard of “reasonable investigation,” “reasonable reliance” or “reasonable care” defense under Sections 11 and 12(a)(2) respectively, has increased, as the “degree of informational access and influence” has increased for both

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officers and directors.² Moreover, case law has also shown that outside directors and inside directors differ with regard to the amount of due diligence required by the courts, as an outside director's standard is much lower than an inside director.³ The type of underwriter, is also a relevant element of context with members of the syndicate, other than the lead underwriter, relying "entirely upon the managing underwriter" to conduct the investigation.⁴

II. RELEVANT BACKGROUND: SEC AND FINRA⁵ VIEWS

To determine what constitutes as "reasonable investigation," under § 11 and "reasonable care" under § 12 of the Securities Act, the SEC in § 230 of 17 CFR indicates that the "variation in the nature of duty owed to the investing public," is based on the context of the situation.⁶ The eight types of context⁷ to consider include: type of issuer; type of security; type of person; the office held when the person is an officer; presence or absence of another and relationship between director and issuer; reasonable reliance on

² Gary M. Lawrence, Due Diligence: Law, Standards and Practice. Southern Methodist University. CADDIS Scholars Press. 36 (2015), [hereinafter "Lawrence"]

³ See *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 577-78 (E.D.N.Y. 1971), [hereinafter "Leasco."]

⁴ Issuers, unlike underwriters and directors do not have a due diligence defense under §11 of the Securities Act, and are thus strictly liable for material misstatements and omissions. Lawrence at 55.

⁵ The term FINRA as used herein also applies to its predecessor the NASD.

⁶ Circumstances Affecting the Determ. of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Sec. 11 of the Securities Act Treatment of Info. Inc. by Ref. into Registration Statements, Release No. 6335, 1981 WL 31062 at *13 (Aug. 6, 1981), [hereinafter "SEC Publication"].

⁷ 17 C.F.R. §230.176

officers, employees, and others with heightened duties; role of the underwriters; and the responsibility of individual at time of registration filing.⁸

The SEC points out that identifying the type of issuer is significant to an analysis because it uncovers “potentially important disclosure issues.”⁹ For example, a limited partnership analysis would differ greatly from a corporation analysis, simply based on the terms of the “legal relationship,” between the parties. The type of security is also essential in an analysis, as the investigation would differ based on whether the security involves a short-term debt or a long-term debt. As stated earlier, the role of the defendant, as well as the type of office the defendant held in the investigation, are important in an analysis, specifically to determine what is required from them under §11. For example, there is a heightened responsibility for underwriters, as they are required to verify all submitted data.¹⁰ Further, if an underwriter becomes aware of any material misstatement or omission, an amendment must be made.¹¹ In the second part of the analysis, the SEC advises the courts to look at the relationship between the issuer and the director.¹²

As case law points out, a director will be held to a higher standard if the record shows that the issuer and the particular director had a close relationship, involving “expertise, knowledge or responsibility” related to an omission or misstatement.¹³ In addition to looking at the relationship between the defendants, the SEC advises the court

⁸ *Id.*

⁹ SEC Publication, page *14, *supra* note 5.

¹⁰

¹¹ SEC Publication, page *14, *supra* note 5.

¹² *Id.*

¹³ *Id.*

to look at whether there was a reliance on specific members within the due diligence team, and whether that reliance was reasonable. Lastly, and often most importantly, the SEC advises the courts to take a close examination into the role and responsibility of each defendant.¹⁴ For example, if a person is described as an underwriter, the courts will look at the type of the underwriter (i.e. traditional underwriter, selling shareholder, etc.), as this would affect the role they would play in the registration statement.

In a special report focusing on “standards on the street,” the NASD also reiterates the importance of context in an analysis, indicating that, “[t]he standard of reasonableness is not an absolute standard that never changes...[as] due diligence should depend on what constitutes commonly accepted commercial practice.”¹⁵

Focusing more on trends in the specific industry, the NASD advises courts to draw links to similar transactions in their analysis. The NASD argues that a “standard on the street,” can be more important than other aspects of an analysis, because a “prudent man” will be “reluctant to do anything that varies from street practice,” as this will almost always trigger liability.¹⁶ For example, if the court finds that all underwriters review accountant records and meet with various members of management, an unspoken standard will be created, and future underwriters may be subject to liability if they choose not to engage in the practice.¹⁷

¹⁴ *Id.* at *15. For example, distinguishing between different types of underwriters is essential (i.e. traditional underwriter versus a technical underwriter), as there are different requirements for each respective type.

¹⁵ National Association of Securities Dealers, Inc., Special Report: Due Diligence Seminars (July 1981), [hereinafter "NASD Special Report"].

¹⁶ *Id.*

¹⁷ *Id.* at 5-6.

Context may be thought of as having four dimensions: transactional, situational, temporal and positional.¹⁸ In a transactional analysis the court will consider the type of transaction, such as whether the deal involved a public or private placement of securities. A situational analysis will consider the size of the transaction and the sophistication of the parties, as this will affect the budget/time of the diligence, as well as the nature of the issuer or offering. In a temporal analysis, the court will rely on case law on providing guidance on whether the due diligence in that field has evolved over time, similar to the “Standards on the Street,” in the NASD report cited above. Lastly, in a positional analysis, courts should consider whether the party is a buyer, seller, borrower, or other participant, as this would determine the requisite amount of diligence required.¹⁹ Positional context was the central theme in *Weinberger v. Jackson*, and *In re Intl. Rectifier Securities Litig.*, as both courts tied the role of the defendant to the amount of diligence needed to succeed in a due diligence defense. For example, in *Weinberger*, the court lessened liability of an outside director, in respect to the other defendants, allowing them to rely on statements made by other members of the due diligence team. Both cases stood apart from precedent, as they both conducted a positional context analysis, focusing almost entirely on the role of defendant in the transaction.

III. ANALYSIS OF THE WEINBERGER AND INTERNATIONAL RECTIFICER CASES

1) Weinberger v. Jackson

¹⁸ Lawrence at 48.

¹⁹ Lawrence at 48. *See Escott v. BarChris Const. Corp.*, 283 F. Supp. 643, 682-701 (S.D.N.Y. 1968), [hereinafter “*BarChris*”]; *Leasco* at 577. *Weinberger v. Jackson*, No. C-89-2301-CAL, 1990 WL 260676 (N.D. Cal. Oct. 11, 1990), [hereinafter “*Weinberger*”]; *Laven v. Flanagan*, 695 F. Supp. 800, 811-12 (D.N.J. 1988), [hereinafter “*Laven*”].

Parties/Facts

The parties in this case are plaintiff, William Weinberger, who purchased shares of the defendant's common stock at \$21 per share, and the defendants, include the issuer, officer, underwriter and directors.²⁰ In advertising the company's, projected revenue, the defendants launched a "road show," in which they presented figures to investment banks.²¹ The investment community was advised that the revenues for the following year would be between 75-90 million,²² which was not part of the prospectus, and was not distributed to the public.²³ After shipping difficulties due to power outages later in the year, the company revised its projections to \$72-78 million.²⁴ These revisions were made after the issuance of the prospectus. Weinberger claimed that stock price was exaggerated because of material misstatements and omission in the registration and prospectus, and argued that the plaintiffs purposely omitted difficulties in production effect on shipments and the company's software problems.²⁵ The company raised objections to these claims, indicating that the due diligence team genuinely believed the prospectus, and that opinions/projections are "constantly changing."²⁶ Accordingly, the defendants argued that they conducted reasonable investigation under § 11 and reasonable care under § 12(2).²⁷

²⁰ *Weinberger* at •1.

²¹ *Id.* at *8.

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.* at *2

²⁷ *Id.*

Due Diligence

The court notes that the issuer, officer, inside director and underwriter performed the following activities²⁸ during the investigation: conducted an “ongoing analysis,” which was “flexible, constantly changing,” due to the multiple variables that could change the projections; performed extensive research on the industry and the company and its management; conducted several meetings with different levels of management ranging from company personnel to upper level management; contacted the company’s customers and distributors who were asked about the health of the organization. In addition, the record shows the above defendants inspected important documents, including corporate records, contracts and financials; researched industry trends and competitive information; physically inspected the company’s facilities; thoroughly researched red flags, ensuring that the questionable items were discussed with the appropriate parties; and obtained “written documentation” from the company and shareholders that there were “no misstatements or omissions,” as of the public offering closing date.

The record also shows that the outside director, Valentine engaged in the following activities²⁹: became reasonably familiar with the company’s business operations; regularly attended board meetings; reviewed the company’s financial statements; became involved in various discussions concerning decisions that affected the company; and reviewed several drafts of the registration statement and saw nothing suspicious.

²⁸ *Id.* at *3.

²⁹ *Id.*

Cited Case Law

While the process for determining what constitutes as “sufficient due diligence” has been somewhat ambiguous in nature, the court turned to case law for guidance. In *Feit v. Leasco*, the court set the standard in determining whether the defendants were liable under §§ 11 and 12(2).³⁰

The court created two criteria³¹, which would assist in making that determination:

- (1) The importance of the role played by each participant in the scheme of distribution, and
- (2) The reliance that the investor is justified in placing upon each participant.³²

The court’s focus on these two points, reiterates the importance of the party’s role in the transaction. The *Leasco* court acknowledged that “the less the [defendant] relied on management, the more the investor would rely on the participant in the registration process.”³³

In a de facto positional context analysis, the court concluded that insiders, like issuers, have a higher burden because the position has an “intimate knowledge of corporate affairs.”³⁴ Thus, the court will expect a complete investigation “supporting and contradicting” the registration.³⁵ According to the record, the court rejected the inside directors defense as they only reviewed Leasco’s audit statements, and examined

³⁰ *Leasco* at 577.

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Id.* at 578

³⁵ *Id.*

corporate records,³⁶ but failed to verify the estimates that had been provided to them by other members of the due diligence team. The court indicated that by neglecting to inquire about the estimates, the issuers did not fulfill their responsibility to disclose all facts, which may “affect the value of the corporation’s stock or securities.”³⁷

In discussing the duties of an outside director, the *Weinberger* court cites *Laven v. Flanagan*. The *Laven* court held that outside directors were under a “lesser obligation to conduct a thorough investigation than an inside director,”³⁸ who often has a more intimate relationship with the corporation. While the court lowered the standard for the outside director, it concluded that the reliance placed on the outside directors was not unreasonable, as they were provided information from the nation’s top underwriters, Price Waterhouse and Merrill Lynch.³⁹ Thus, the *Laven* court engaged in an individualistic analysis, focusing more on the particular defendant’s relationship to the corporation, rather than what was typically required of an outside director. Lastly, in discussing the liability of an outside director, the *Weinberger* court pointed to *Escott v. BarChris Const. Corp.*, which reiterated that an inside director is always held to “higher standard of investigation,” than an outside director, who is generally regarded to have “no special knowledge or additional responsibility” to the plaintiff.⁴⁰

Holding

The inside directors, officers, issuer and underwriters were all held to the same high standard of reasonableness, due to the investors’ high level of reliance on these

³⁶ *Id.* at 561.

³⁷ *Id.* at 569.

³⁸ *Laven* at 812.

³⁹ *Id.*

⁴⁰ *BarChris* at 682.

types of defendants. According to the facts, the defendants remained flexible throughout the investigation, often stopping to analyze red flags and conducting independent investigations. The record also notes that during this “ongoing process,” the defendants remained transparent throughout the investigation, and were in constant communication with the investors.⁴¹ In addition, unlike in *Leasco*, the defendants in *Weinberger* not only inspected audit statements and contracts, but “thoroughly researched red flags,” and followed up with the items of concern. The court ultimately ruled in favor of the defendants, concluding that the investigation met the reasonableness standard required under §§ 11 and 12,⁴² and as a result the court further held that the defendants reasonably believed the prospectus’ accuracy.⁴³

For the outside director, Valentine, the court held that as long as the prospectus was in alignment with his own personal knowledge he acquired as a director, he was not required to conduct independent investigations.⁴⁴ The court ruled in this manner because unlike the outside director in *Laven*, Valentine was not provided intimate knowledge, and only became “reasonably familiar” with the operations of the company. Thus, due to his lack of intimate knowledge, the court concluded that Valentine had made a reasonable effort to seek “verification of the truth,” in reviewing the financial registration statement for red flags, as this was all what was required.⁴⁵

2) *In re International Rectifier Corporation Securities Litigation*

⁴¹ *Id.*

⁴² *Weinberger* at *3.

⁴³ *Id.* at *3.

⁴⁴ See *Laven* at 800. *Goldstein v. Alodex Corp.*, 409 F.Supp. 1201 (E.D.Pa.1976); *Weinberger* at *4.

⁴⁵ *Id.*

Parties/Facts

The plaintiffs include individuals who purchased or acquired the “publicly traded securities” during a “conversion” period. The defendants are members of the extensive due diligence team, the “Working Group,” who include the issuer, officers, directors, underwriters, and legal counsel of both the company and the underwriters. International Rectifier (“IR”), manufacturer of semi-conductors, went public shortly after investment banks approached IR with a proposal for a stock offering.⁴⁶ IR agreed to the offering and formed the Working Group to conduct the due diligence. An analyst for one of the underwriters, Richard Whittington, who had previously rated IR’s stock as “hold” soon changed his rating to “buy,” and Whittington was retained as lead underwriter for the offering.⁴⁷

Prior to filing a registration statement with the SEC, the “Working Group” received oral verification IR’s management that the prospectus was correct and a comfort letter that reaffirmed “no material changes in IR’s financial position.”⁴⁸ Due to the successful stock offering, the underwriters suggested IR perform a “debenture conversion,” which would give stockholders the option of converting their debentures into common stock. However, on the same day that this conversion took place, Whittington released a second report, changing the rating of IR from “buy” to “hold,” which caused the stock to drop dramatically.⁴⁹ In his report, Whittington attributes the

⁴⁶ *Intl. Rectifier* at *3.

⁴⁷ *Id.*

⁴⁸ *Id.* at *4.

⁴⁹ *Id.*

downgrade to his poor performance in his previous report as well as a “general decline” in the semiconductor industry.⁵⁰

The plaintiffs contend that the “Working Group” must have known about what was contained in the report prior to the offering, and that even if the team did not know, the due diligence could not have been reasonable, as it should have uncovered the discrepancy.⁵¹ However, the court reiterates that the standard to measure the defendant’s due diligence is “one of reasonableness, not perfection.”⁵²

Due Diligence

The record shows that the “Working Group” conducted a thorough investigation, which consisted of eight key actions⁵³: completed a review of important documents, including financial forecasts and contracts; inspected the issuer’s major facilities; utilized analysts’ semiconductor knowledge, interviewed issuer’s management; interviewed major customers, auditing firm and legal counsel; received verbal confirmation from management that the prospectus was correct; received a comfort letter from issuer on accuracy of the prospectus; and obtained “cold comfort” letter from auditors, guaranteeing no material changes in financial position since last audit.

Cited Case Law

The court first points to the due diligence performed in *Weinberger*, where the defendants obtained written representations regarding the prospectus, became familiar with the company’s finances and operations, possessed knowledge of the industry, and

⁵⁰ *Id.* at *5.

⁵¹ *Id.* at *6

⁵² *Id.* at *11.

⁵³ *Id.* at* 4

conducted interviews with the company's customers, and confirmed data with the appropriate parties. The *Weinberger* court concluded that the diligence conducted by the defendants satisfied the requirements under the Securities Act, and were thus successful in their due diligence defense.⁵⁴

In addition to *Weinberger*, the *BarChris* court engaged in an analysis considering the positional context of the defendants, concluding that officers, insiders and lead underwriters may have a higher standard if they have substantial access to information. In addition, participating underwriters may rely on the leads in an investigation, as to not duplicate the work.⁵⁵ Lastly, in *Competitive Associates, Inc. v. International Health Sciences, Inc.*, the court held that the underwriters' due diligence, which consisted of a review of industry publications and company documents, inspection of the facilities, interviews with personnel and customers, and written representations that the prepared prospectus was accurate, was reasonable under §§ 11 and 12 of the Securities Act.⁵⁶

Holding

In a similar analysis, the court looked at the defendants' role in the investigation in determining what constituted as "reasonable" due diligence. First, the court examined the record, which showed that the underwriter's report did not reveal any "new, material information" in the registration statements."⁵⁷ The court determined that the analysts' comment that a "mix shift" could "dampen demand," was only an opinion, and thus "no

⁵⁴ *Weinberger* at *3; *Intl. Rectifier* at *7.

⁵⁵ *BarChris* at 703.

⁵⁶ *Competitive Associates, Inc. v. International Health Sciences, Inc.*, 1975 WL 349 at *18, Fed.Sec.L.Rep. ¶ 94,966 (S.D.N.Y. Jan. 22, 1975), [hereinafter "*Competitive Associates*"]; *Intl. Rectifier* at *7.

⁵⁷ *Id.* at *1.

liability could be premised,” on the underwriter.⁵⁸ The court also held that the plaintiff’s reliance on the initial Whittington Report was misguided, as it was merely an “opinion”, and not a fact.⁵⁹ The court further noted that even if the report was regarded as fact, the defendants were not aware of either, and thus were not liable.

The court also discredited the plaintiff’s due diligence expert, “Dr. Smith,” who asserted that the diligence performed by the underwriters was inadequate. The court concluded that because he had no first-hand knowledge or background in securities law, he was “not qualified to opine.”⁶⁰ Dr. Smith took issue with the diligence on four points: examining the sales and production data on an annual basis rather than a quarterly basis; reliance on a phone conversation with IR’s outside consultants regarding possible “red flags,” rather than engaging in “first hand examination”; focusing on upper-level management during interviews rather than plant employees; and focusing on IR’s largest customers, rather than a random “sampling.”⁶¹

In response to Dr. Smith’s conclusions, the court pointed out that the quarterly reports were unavailable, which is why the defendants relied on annual reports. Second, there was no need to speculate that the consultant “misrepresented” the data in the phone conversation, as the reliance was reasonable. Next, there was no evidence that lower employees would possess greater knowledge than senior level management, thus focusing solely on upper management was sufficient. Lastly, neglecting to consider “smaller customers,” was an insignificant point, and did not, on its own, force the court to

⁵⁸ *Weinberger* at *1.

⁵⁹ *Intl. Rectifier* at *6.

⁶⁰ *Id.*

⁶¹ *Id.* at *10.

question whether the defendants acted reasonably.⁶² Using positional context analysis, the court ultimately held that the investigation conducted by the defendants was “reasonable.” *Intl. Rectifier* thus further solidifies the requirements of what is required under the standard of “reasonable care” and “reasonable investigation” under §§ 11 and 12(2) of the Securities Act by focusing on the role of each defendant.

IV. CONCLUSION

Regardless of the subject matter, context is important in any analysis lacking statutory guidance. Of the several types of contextual analyses it appears that positional context often is the most influential and strongest element in determining whether an investigation was sufficient. For example, in a congressional hearing, a court will place a higher standard of liability on a high-ranking cabinet official than a soldier, simply due to the former’s access to insider knowledge. The same is true in an analysis of a due diligence investigation, where the standard of reasonableness is higher for an underwriter than an outside director. Recognizing the importance of positional context, the courts of *Weinberger* and *Int’l Rectifier* tailored their analysis based solely on the role each defendant played in the respective investigation, which allowed the courts to conclude that the due diligence conducted was “reasonable,” under Sections 11 and 12(a)(2) of the Securities Act.

⁶² *Id.* at *11.

CASE NOTE: *PHILLIPS V. KIDDER, PEABODY & CO.* AS A GUIDE TO THE DUE DILIGENCE
REQUIREMENTS OF UNDERWRITING AN INITIAL PUBLIC OFFERING

*Christopher Cornell*¹

I. Introduction

This article explores the due diligence implications of *Phillips v. Kidder, Peabody & Co.* (“*Phillips*”), a 1996 case from the U.S. District Court for the Southern District of New York.² *Phillips* is an important due diligence ruling because it discusses in detail many of the issues and elements that arise in conduct of due diligence.³ Part II of this article provides background information on the case itself, Part III discusses the claims and issues in the case under Sections 11 and 12 of the Securities Act of 1933 (the “Securities Act”), and Section 10 the Securities Exchange Act of 1934 (the “Exchange Act”), while Part IV concludes.

II. Background and Overview of the Case

Phillips was a shareholder lawsuit against an underwriter for alleged violations of federal securities law and common law fraud.⁴ The case centered around claims that alleged material misstatements and omissions in the offering documents for a public

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² *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303 (S.D.N.Y. 1996) *aff'd sub nom.* *Phillips v. Kidder Peabody & Co.*, 108 F.3d 1370 (2d Cir. 1997).

³ This case focuses on underwriter due diligence, but many of its conclusions offer informative guidance for other defendants as well regarding some of the constituent elements of reasonable due diligence.

⁴ *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. at 307.

offering of stock had led to shareholder losses.⁵ Specifically, in 1984, Kidder, Peabody & Co. (“Kidder”) had served as the lead underwriter for a public offering of stock by Computer Depot, Inc. (“CDI”).⁶ As the lead underwriter, Kidder had issued a prospectus for the CDI stock offering of July 12, 1984.⁷ Later CDI’s stock price fell and litigation ensued, starting in the federal district court for the District of Minnesota, a case where class action certification was denied⁸ and in which Robert D. Phillips (“Phillips”) was not allowed to intervene, prompting him to instead sue Kidder in the federal district court for the Southern District of New York.⁹ Phillips claimed that he had relied on the information stated in the prospectus when he bought 300 shares of CDI stock on the date of the initial public offering and 100 additional shares eleven months later.¹⁰

A. PHILLIPS’ CLAIMS

Phillips asserted that in the prospectus Kidder had presented a “falsely optimistic picture of CDI’s future growth, expansion, business products, and probability.”¹¹ Phillips alleged that the prospectus contained several specific “false or misleading representations” including (1) overly optimistic claims that a new computer center would quickly achieve profitability, (2) that large volume purchases would drive down CDI’s costs and keep its prices competitive, (3) that subject to obtaining financing CDI planned

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ *See also* *Kassover v. Computer Depot, Inc.*, 691 F. Supp. 1205 (D. Minn. 1987) *aff’d*, 902 F.2d 1571 (8th Cir. 1990) (for more detail on the earlier case in the federal district court for the District of Minnesota).

⁹ *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. at 307.

¹⁰ *Id.* at 307-08.

¹¹ *Id.* at 308.

on opening 90 new outlets in 1985, and (4) that CDI would “approximately break even” in the second financial quarter of 1984.¹² Phillips further claimed that in the prospectus Kidder failed to disclose: (1) adverse changes in the personal computer industry had led to decreased prices and increased competition, (2) that CDI had incurred substantial losses in the thirteen weeks before the initial public offering, and (3) that CDI had experienced significant inventory shrinkage and lacked adequate inventory controls.¹³

B. KIDDER’S RESPONSE

In response to Phillips’ claims, Kidder moved for summary judgement on the basis that: (1) the statute of limitations barred Phillips’ claims regarding CDI’s inventory shrinkage¹⁴, (2) the accuracy of the entirety of the prospectus is backed up by undisputed facts, (3) the prospectus had disclosed information about falling computer prices and increased industry competition, and (4) Kidder had backed up CDI’s statements in the prospectus based on extensive due diligence, and based on that due diligence had a reasonable basis for its adoption of CDI’s future projections.¹⁵

III. The District Court’s Due Diligence Related Rulings

A large part of the reason why *Phillips* is useful for illustrating due diligence requirements, both specifically in the case of underwriters and in general, is the clear way

¹² *Id.*

¹³ *Id.*

¹⁴ While there is some discussion at length in the opinion regarding claims and counterclaims on civil procedure aspects of statute of limitations matters, essentially, the court ruled that the individual claim by Phillips had been tolled while another case had been proceeding and therefore, though he had missed a filing deadline, when the tolled time was factored in the filing of Phillips’ case was timely for statute of limitations purposes. However, no such tolling had occurred or been permissible for class actions purposes and therefore Phillips’ attempt to achieve class action status was barred by the statute of limitations. *Id.* at 309-14.

¹⁵ *Id.* at 308.

Judge Francis breaks down the statutory and procedural claims in his opinion. Following Judge Francis' example, a similar approach will be taken throughout this section.

A. CLAIMS UNDER SECTIONS 11 AND 12 OF THE SECURITIES ACT OF 1933

Judge Francis in his analysis provided a detailed and clear breakdown of Phillips' claims, including the alleged omissions and misrepresentations under Sections 11 and 12(2) (now Section 12(a)(2))¹⁶ of the Securities Act of 1933. It should be noted that while in *Phillips* the claims under both sections were handled together, Section 11 provides liability exemptions for those who, in their duties relating to the issuance of registration statements for securities, conduct a reasonable investigation¹⁷, while Section 12(a)(2) provides a liability exemption for anyone who did not know and should not have known of untrue statements in a prospectus for a securities offering¹⁸ while exercising reasonable care.¹⁹

1. Claims of Alleged Omissions

Judge Francis began his analysis by pointing out that an omission from a prospectus becomes material when—if it had been included—it would have resulted in a reasonable investor significantly altering the way he saw the totality of the available

¹⁶ What was Section 12(2) when *Phillips* was decided was subsequently renumbered to its current designation as Section 12(a)(2). 15 U.S.C. § 77l.

¹⁷ 15 U.S.C. § 77k.

¹⁸ 15 U.S.C. § 77l.

¹⁹ It also should be noted that the SEC is of the opinion that the reasonable care standard is a lower one than the reasonable investigation standard, and that while some courts have taken that position, some have treated the two standards as roughly equivalent and others have taken a view that the reasonable care standard is higher than the reasonable investigation one. *See, e.g.*, MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 233-36 (5th ed. 2009).

information, and the court can award summary judgement if it finds that the allegedly omitted information was actually disclosed in the prospectus.²⁰

a. Market Shakeout: Decreases in Market Prices and Increased Competition

Phillips first complained that Kidder failed to adequately disclose the changing circumstances in the personal computer market (i.e. price cutting and increased competition), and that CDI failed to adequately disclose the negative effects of this increased competition.²¹ Judge Francis dismissed those claims, as well as the allegation that investors had not been advised about the effects of price cutting on CDI's profitability and the probability of new stores opening.²² In the opinion, Judge Francis pointed to language in the prospectus that clearly warns about market volatility, increased market competition, and decreases in personal computer prices.²³ Further, the opinion made clear that, even if Kidder had not explicitly pointed out the volatility in the personal computer market, it could not be liable, because precedent establishes that Kidder had no obligation to report on readily available industry trends.²⁴ In addressing a further claim that Kidder was obligated to disclose both industry trend information and the effect of those trends on CDI, Judge Francis dismissed the claim by again citing precedent that, although an underwriter must disclose firm-specific information, they are only liable if they fail to disclose information that typically would be used to make a forecast about a

²⁰ *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. at 321.

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.*

company's future.²⁵ Further, such liability does not arise when an underwriter fails to disclose the potential harm to a business from market vitality when the volatility would be apparent to all informed observers as well as most casual ones.²⁶ In addressing the claim of failure to disclose the potential effects of increased competition on CDI's probability and expansion, Judge Francis dismissed the claim by citing to sections of the prospectus that, amongst other things: (1) discussed volatility in the market, (2) provided a list of competitors, and (3) made clear that increased sales of computers by department stores and through other sales channels could undercut CDI.²⁷

b. Expansion and Costs of Opening New Stores

Phillips' claims that Kidder failed to disclose the effects of CDI's increased expenses in setting up new stores was dismissed because that risk had been disclosed.²⁸ Specifically, Judge Francis cited a section of the prospectus that made clear that new store setup expenses could negatively affect CDI's profitability in future quarters.²⁹ A further complaint that new stores sites had been: (1) chosen haphazardly, (2) were becoming drains on corporate assets, and (3) could eventually force CDI into using bankruptcy protections, was dismissed because Kidder was able to show that the new stores had in fact quickly become profitable.³⁰

c. Losses Immediately Before the Initial Public Offering

²⁵ *Id.* at 321-22.

²⁶ *Id.* at 322.

²⁷ *Id.*

²⁸ *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. at 322.

²⁹ *Id.* at 322-23.

³⁰ *Id.*

Phillips complained that Kidder had failed to disclose the substantial financial losses CDI experienced during the thirteen weeks before its initial public offering.³¹ However Kidder was able to provide sworn testimony proving that there were in fact no such losses.³² While an incorrect inventory count resulted in CDI briefly having a write-down of \$719,000 and a reported loss of \$420,000, Kidder proved that the subsequent inventory recount revealed that the loss was due to an inventory counting error and the associated figures had been promptly corrected with an upward adjustment of \$819,000.³³ Consequently, Phillips further argued that there was an issue of material fact as to whether or not a loss had occurred and thus that summary judgement was not appropriate.³⁴ However, Kidder demonstrated that there was no such loss and Phillips could only produce one document that merely suggested that CDI should make improvements to its internal accounting procedure to prevent inventory miscounts.³⁵ Therefore, Judge Francis dismissed Phillips' claim of that undisclosed losses had been sustained in the thirteen weeks before the offering as mere speculation.³⁶

d. Internal Controls

Phillips' also alleged that Kidder failed to disclose that CDI lacked the ability to accurately value its inventory, report its financial outcomes, and make future forecasts.³⁷ In this regard, Judge Francis pointed out it was not for the court to determine if the

³¹ *Id.* at 323.

³² *Id.*

³³ *Id.*

³⁴ *See Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. at 323.

³⁵ *See id.*

³⁶ *See id.*

³⁷ *Id.*

allegation was true, but rather if Kidder as the underwriter could reasonably have affirmed the information in the prospectus given what it knew about CDI.³⁸ The opinion noted that even if assuming Phillips' claim is true, an underwriter is entitled to a due diligence defense if: (1) they can demonstrate that they conducted a reasonable investigation, (2) that they had reason to believe the information in the prospectus was accurate.³⁹ Further, Judge Francis noted that the question of adequacy of the due diligence can be decided on summary judgement.⁴⁰ Therefore, summary judgement for Kidder was appropriate since Kidder could demonstrate: (1) that it carried out "extensive due diligence", (2) that it had reasonably affirmed the prospectus by relying on a cold comfort letter from the accounting firm of Arthur Andersen stating that CDI's internal accounting was adequate, and (3) had no knowledge of any misrepresentations or omissions.⁴¹

2. Claims of Alleged Misrepresentations

Phillips alleged a number of misrepresentations regarding CDI's financial outlook, its expansion plans, and the effects of market trends on the company's future, or as Judge Francis put it, "[e]ssentially...reiterate[ing] its argument that the above statements in the Prospectus are false or misleading in light of the weakness in CDI's internal accounting and its susceptibility to the market shakeout".⁴² In response, Kidder

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.* See also *Weinberger v. Jackson*, No. C-89-2301-CAL, 1990 WL 260676, at *3 (N.D. Cal. Oct. 11, 1990) (this case as cited by Judge Francis provides more information regarding the lack of underwriter liability when an underwriter can demonstrate that they performed reasonable due diligence).

⁴² *Id.* at 324.

asserted that the alleged misrepresentations were not actionable, because in each case they were forward-looking statements, rather than false or misleading guarantees.⁴³ In particular, Kidder argued that under the “bespeaks caution” doctrine, if the court determined that it had provided sufficient cautionary language in the prospectus, the statements had to be treated as general forward-looking projections, and Phillips’ claim should be dismissed on summary judgement.⁴⁴ As a means of helping potential investors carefully evaluate an investment in CDI, Kidder had provided specific warning and risk factors regarding CDI’s expansion plans, personal computer market volatility, and potential supply chain issues.⁴⁵ That cautionary language, combined with evidence of an extensive and sufficient due diligence investigation, plus Phillips’ inability to show that Kidder did not have a reasonable basis for affirming the prospectus, together led Judge Francis to grant summary judgement for Kidder on all of the Section 11 and 12 claims in this case.⁴⁶

B. CLAIMS UNDER SECTION 10 OF THE SECURITIES EXCHANGE ACT OF 1934

Under Section 10(b) of the Exchange Act, it is unlawful for anyone to violate the rules and regulations of the Securities and Exchange Commission (“SEC”) by any means⁴⁷, and also under this section’s Rule 10b-5 acts of fraud or deceit and attempts to defraud are prohibited⁴⁸.

1. Primary Liability

⁴³ *Id.*

⁴⁴ *Id.* at 324-25.

⁴⁵ *Id.*

⁴⁶ *Id.* at 325.

⁴⁷ 15 U.S.C. § 78j(b).

⁴⁸ 17 C.F.R. § 240.10b-5.

Kidder tried to argue that the then recent Supreme Court decision in *Cent. Bank of Denver v. First Interstate Bank of Denver*⁴⁹, had abolished aiding and abetting liability under Section 10(b).⁵⁰ The court however disagreed, by citing to both *Central Bank* and lower court holdings that professionals, such as underwriters, can be just as liable as a primary violator under Rule 10b-5, if all of the requirements for primary liability under the rule are met.⁵¹ Judge Francis then determined that, even though the prospectus had been issued in CDI's name, based on Kidder's role in producing the prospectus, Kidder had *made* the "allegedly misleading statements" on which Phillips claimed to have detrimentally relied.⁵² Kidder in turn argued that, under *Central Bank*, as an underwriter, it should only be potentially liable for statements directly attributable to (i.e. signed by) it.⁵³ However, Judge Francis rejected this argument because this would almost always lead to absolving underwriters of liability under Rule 10b-5, a result not contemplated by the Supreme Court in *Central Bank*.⁵⁴ As such, summary judgement dismissing Phillips' Exchange Act claims on the grounds that underwriters cannot make (or that in this case Kidder had not made) statements that were allegedly misleading, was not warranted.⁵⁵

2. *Scienter*

⁴⁹ *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, (1994).

⁵⁰ *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. at 314.

⁵¹ *Id.*

⁵² *Id.* at 316.

⁵³ *Id.* at 316-17.

⁵⁴ *Id.*

⁵⁵ *Id.* However, Judge Francis did note that if Phillips had failed to allege that Kidder had *made* any of the allegedly misleading statements then summary judgement in Kidder's favor would have been appropriate as there would not have been any alleged Rule 10b-5 violation. *See id.* at 316.

Kidder claimed that Phillips had failed to prove the required scienter, an essential element, the lack of which would result in summary judgement being granted for the defendant.⁵⁶ Scienter can be found either by demonstrating specific facts showing defendants had a motive for committing fraud and a clear opportunity to do so, or by demonstrating “conscious or reckless” behavior by the defendant.⁵⁷

a. Motive

Phillips alleged that Kidder’s motive to commit fraud was to avoid losing the offering and the fees it would earn for the associated work.⁵⁸ However, Second Circuit precedent establishes that the receipt of or desire to earn the regular standard compensation for underwriting work does not establish motive for scienter per se.⁵⁹ Therefore, Judge Francis ruled that Phillips failed to demonstrate scienter, due to his failure to demonstrate that Kidder had derived any benefit other than its standard underwriting fee.⁶⁰

b. Recklessness

In his complaint Phillips listed numerous allegations of reckless behavior by Kidder, which Judge Francis boiled down to two categories. First, alleged failure to

⁵⁶ *Id.* at 317.

⁵⁷ *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. at 317.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

review CDI's board minutes and other records regarding its internal accounting controls and their possible inadequacies; Second, a question as to whether or not Kidder was reckless in affirming the prospectus in light of the then-developing trends in the personal computer market.⁶¹

Because Phillips could not refute Kidder's proof that it, its legal counsel, and Arthur Andersen, CDI's external auditor, had reviewed the board minutes and was unable to find any material weaknesses in CDI and its accounting controls, the only way Phillips could prove scienter would be to prove: (1) Kidder's actual knowledge of information in the minutes which called some of CDI's accounting practices into question and who (2) recklessly disregarded it.⁶² However, Kidder was able to demonstrate that it had carried out extensive due diligence on a wide variety of issues that could affect CDI, for instances, interviews throughout the company and with its suppliers; and that it had received reports from Arthur Andersen that CDI's accounting procedures were in fact adequate, and had even withdrawn an earlier offering of CDI stock so it could evaluate newly available information.⁶³ Looking at the totality of these actions, Judge Francis ruled that Kidder's due diligence had been sufficient, and Phillips had not demonstrated recklessness by Kidder and thus could not prove scienter.⁶⁴

Similarly, Kidder offered sworn testimony that based on several factors, such as its review of the personal computer industry (including developing trends) and CDI's unique competitive advantages therein, it did not believe CDI's prospects would be

⁶¹ *Id.*

⁶² *Id.* at 318-20.

⁶³ *Id.*

⁶⁴ *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. at 320.

negatively affected.⁶⁵ To counter Kidder, Phillips was only able to cite two newspaper articles indicating a slowdown in the personal computer market and a section of board minutes which Judge Francis described as being “taken out of context.”⁶⁶ Phillips had only cited to limited general evidence of a trending decline in the personal computer market, and as a matter of law Kidder could not be reckless on that ground as it had no duty to report on readily available industry trends.⁶⁷ Because Phillips failed to prove recklessness or motive—and thus failed to prove scienter—Judge Francis granted summary judgement for Kidder on all of Phillip’s Section 10(b) and Rule 10b-5 claims.⁶⁸

IV. Conclusion

On appeal, the U.S. Court of Appeals for the Second Circuit reviewed Judge Francis’ opinion and upheld it, having found no errors and ruled that Phillips’ claims lacked merits.⁶⁹ At its core, *Phillips* is an important case in the study of due diligence, because it sets out in clear language and in detail a number of factors affecting the determination of the sufficiency of an underwriter’s due diligence in preparing a security issuance. In particular, *Phillips* provides guidance to both fiduciaries and potential litigants as to what is (and is not) required for an underwriter to prove sufficiency of its due diligence in terms of both Sections 11 and 12 of the Securities Act, as well as Section 10 of the Exchange Act, and the related Rule 10b-5. Essentially, in terms of Sections 11 and 12 of the Securities Act, *Phillips* establishes that, underwriters can prove that their

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.* at 321.

⁶⁹ *Phillips v. Kidder Peabody & Co.*, 108 F.3d 1370 (2d Cir. 1997).

due diligence was sufficient, by showing that (1) they conducted thorough investigations, (2) they relied on the opinions of experts (such as external auditors), and (3) by including cautionary warnings to prospective investors in the offering prospectus.⁷⁰ Similarly, for purposes of Section 10 of the Exchange Act and Rule 10b-5, although underwriters can be liable for statements they *make* in a prospectus and for the purpose of such liability will probably be assumed to have *made* the entirety of a prospectus, underwriters can still get cases dismissed on summary judgment, if they can demonstrate the lack of scienter by showing that they did not have motive to commit fraud and were not reckless in their investigations.⁷¹

⁷⁰ *Supra* Part III(A).

⁷¹ *Supra* Part III(B).