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CASE NOTE
IN RE SOFTWARE TOOLWORKS, INC.

Katherine Durham, J.D.*

Introduction

In 1994, the Ninth Circuit Court of Appeals handed down an opinion written by Circuit Judge Cynthia Holcomb Hall affirming in part, reversing in part, and remanding for further resolution the case of *In re Software Toolworks, Inc*. The Ninth Circuit was asked to determine whether the underwriters and accounting firm, Deloitte, (defendants in the case) established a due diligence defense sufficient for the district court to grant summary judgment in favor of the defendants. The Ninth Circuit's opinion illustrates the use of the reasonable reliance defense against claims arising under Sections 11 and 12(a)(2) of the Securities Act of 1933 ("the 1933 Act") and how successful application of that defense can be used to defeat claims arising under Sections 10(b) and 10b-5 of the Securities Exchange Act of 1934 ("the 1934 Act").

Case Background and Allegations

Software Toolworks, Inc., the issuer in this case, was "a producer of software for personal computers and Nintendo game systems."[1] In July 1990, it issued a secondary public offering and shortly after the secondary offering the price of its stock declined in value.[2] Stockholders of Software Toolworks, Inc. sought to recover damages from participants in the secondary offering, including the underwriters, Montgomery Securities and PaineWebber ("Underwriters") and accounting firm, Deloitte, on claims arising under the 1933 Act and the 1934 Act.[3]

The documents related to the secondary offering contained information about the issuer's financial statements certified by Deloitte.[4] However, plaintiffs alleged that defendants had:

> (1) falsified audited financial statements for fiscal 1990 by reporting as revenue sales to original equipment manufacturers ("OEMs") with whom Toolworks had no binding agreements, (2) fabricated large consignment sales in order for Toolworks to meet financial projections for the first quarter of fiscal 1991 ("the June quarter"),

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[1] *In re Software Toolworks Inc*., 38 F.3d 1078, 1082 (9th Cir. 1994).
[2] *Id.*
[3] *Id.*
[4] *Id.*

and (3) lied to the Securities and Exchange Commission ("SEC") in response to inquiries made before the registration statement became effective.[5]

The Underwriters and Deloitte asserted affirmative statutory due diligence defenses to avoid liability. The following analysis discusses these defenses and the court's ultimate determination that they could be sustained as a matter of law on summary judgment.

Affirmative Due Diligence Defenses Under the 1933 Act

The 1933 Act allows individual investors to bring civil actions against issuers and, by extension, other participants in public securities offerings.[6] Section 11 of the 1933 Act allows civil liability against anyone who "signed or helped prepare" the registration statement for "any misrepresentations in the registration statement."[7] Section 12(a)(2) "creates liability for any person who offers or sells a security through a prospectus or an oral communication containing a material misstatement or omission.[8]

Even if plaintiffs are able to successfully establish material misstatements or omissions under the 1933 Act, defendants may still escape liability by proving one or more of three

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[5] *Software Toolworks*, 38 F.3d 1078, 1082 (9th Cir. 1994).

[6] Cornell Law School, Legal Information Institute, https://www.law.cornell.edu/wex/securities_act_of_1933. ("[T]he Securities Act allows individual investors to bring civil actions under several provisions: 1. Section 11 makes issues strictly liable for registration statements that contain an untrue statement of a material fact or omit to state a material fact required . . . to make the statements therein not misleading. Under this provision, a purchaser of the security can bring suit under Section 11, even if he bought the security after the initial offering, on the secondary markets. As long as the purchaser can trace the purchase back to the initial offering and is within the statute of limitations, he can sue; there is no need to prove causation or reliance on the misstatements or omissions . . . Although the purchase can sue the issuer, underwriter, or subsequent seller, all defendants but the issuer have a due diligence defense that they had no grounds to believe the statement had a misstatement or omission . . . 3. Section 12(a)(2) creates liability for any person who offers or sells a security through a prospectus or an oral communication containing a material misstatement or omission. The person is liable to the purchaser for rescission of the purchase or damages, provided that the purchaser did to know about the misstatement or omission at the time of the purchase." Citations omitted).

[7] Cornell Law School, Legal Information Institute, https://www.law.cornell.edu/wex/section_11. See also 15 U.S.C. 77k ("(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated . . . any person acquiring such security . . . may . . . sue (1) every person who signed the registration statement; . . . (4) . . . any person whose profession gives authority to a statement made by him; [or] (5) every underwriter with respect to such security.").

[8] Cornell Law School, Legal Information Institute, https://www.law.cornell.edu/wex/securities_act_of_1933. See also 15 U.S.C. 77l ("(a) Any person who . . . (2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . shall be liable.").

statutory affirmative defenses—reasonable investigation, reasonable reliance, and reasonable care.[9]

The reasonable investigation defense of Section 11 relates to non-expertised statements[10] and requires the defendant to prove that it "had, after reasonable investigation, reasonable ground to believe and did believe" that there were no material misstatements or omissions in the non-expertised portions of the offering documents.[11] The reasonable reliance defense of Section 11 relates to statements made "on the authority of an expert,"[12] typically referred to as expertised material. This defense requires the defendant to prove that it "had no reasonable ground to believe and did not believe" that there were material misstatements or omissions in the expertised disclosures.[13] The reasonable care defense of Section 12(a)(2), which makes no distinction between expertised and non-expertised material, requires the defendant to prove that it "did not know, and in the exercise of reasonable care could not have known" of the material misstatements or omissions.[14] Section 11(c) states that "[i]n determining…what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."[15] Section 12(a)(2) offers no corresponding clarification.[16]

In this case, the plaintiffs challenged both the reasonable investigation and reasonable reliance defenses. First, the plaintiffs argued that the statements that the Underwriters made about Software Toolworks' business relationship with Nintendo and Walmart were not properly investigated, but the Court disagreed.[17] The Court noted the significant steps in the record that

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[9] *See In re Software Toolworks, Inc*., 38 F.3d 1087, 1083 (9th Cir. 1994) ("Underwriters, however, may absolve themselves from liability by establishing a 'due diligence' defense.").

[10] Non-expertised material is any information contained in the registration statement not purporting to be made on the authority of an expert. *See* 15 U.S.C. § 77k (a)(4).

[11] 15 U.S.C. § 77k(a).

[12] 15 U.S.C. § 77k(b)(3)(C).

[13] 15 U.S.C. § 77k.

[14] 15 U.S.C. § 77l.

[15] 15 U.S.C. § 77k(c).

[16] *See, e.g*., Catherine Masters Epstein, *"Reasonable Care" in Section 12(2) of the Securities Act of 1933*, 48 U. CHI. L. REV. 372, 377 (Spring, 1981) ("Section 12(2)'s relationship to section 11 is more complex. Like section 11, it imposes liability for misdisclosure, here on sellers whose prospectuses or other written or oral statements in connection with a sale are misleading. Like section 11, it provides an affirmative defense; but it describes the defense merely as 'reasonable care,' and unlike section 11, it does not further define the phrase."); William Douglas and George Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933) at 208 and n.205 ("[t]he standard of reasonableness is not here defined as in Section 11(c) and presumably is somewhat less exacting.").

[17] *Software Toolworks*, 38 F.3d 1083, 1084-85.

the Underwriters took to confirm information received from Software Toolworks.[18] Second, the plaintiffs argued that the statements the Underwriters made pertaining to Software Toolworks' "recognition of OEM revenue on its financial statements" were not properly investigated.[19] It was at this point where *In re Software Toolworks* solidified its place in legal history.

The court also rejected the plaintiffs' argument that the Underwriters did not reasonably investigate Software Toolworks' financial statements,[20] explaining that:

> An underwriter need not conduct due diligence into the "expertised" parts of a prospectus, such as certified financial statements. Rather, the underwriter need only show that it "had no reasonable ground to believe, and did not believe . . . that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."
>
> We recently confirmed this point in a case involving analogous facts: "[T]he defendants relied on Deloitte's accounting decisions (to recognize revenue) about the sales. Those expert decisions, which underlie the plaintiffs' attack on the financial statements, represent precisely the type of 'certified' information on which section 11 permits non-experts to rely."[21]

The Court highlighted the distinction between expertised and non-expertised materials so that Underwriters and other participants in a public offering have varying degrees of responsibility depending on the type of materials. Because the Underwriters were not accounting experts, the Court held that the Underwriters' reliance on Deloitte's financial statements was reasonable under the circumstances and sufficient to uphold summary judgment in the Underwriters' favor.[22]

Red Flags and the Due Diligence Defense

This case also confirms that a reasonable reliance defense is still sufficient even where defendants encounter red flags. There is no one-size-fits-all definition to the term red flag because, as guidance has consistently explained, its meaning can only be determined in context. However, in the context of a registered offering of securities, a red flag has been defined as "[a]ny

[18] *See id* at 1085 ("Underwriters made a substantial effort to ascertain Toolworks' return policy, both before and after the consignment sales occurred . . . Underwriters called the retailer and confirmed that the statement regarding returns was erroneous (it should have said that Walmart had an unqualified right to return defective merchandise.")
[19] *Id.*
[20] *Id.*
[21] *Software Toolworks*, 38 F.3d 1083, 1085-86.
[22] *See id* ("Given the complexity of the accounting issues, the Underwriters were entitled to rely on Deloitte's expertise.").

information that would cause a 'prudent man in the management of his own property' to question the accuracy of the registration statement."[23]

The Court affirmed summary judgment in favor of the defendants because they were able to show that they "properly followed up [on] any 'negative or questionable information [that] developed as a result of their investigation."[24] Judge Hall points out the "significant steps taken by the Underwriters after discovery of the [red flags] to ensure the accuracy of [the financial statements at issue.]"[25] Because the Underwriters did not simply "blindly rely" on the information in the financial statements, they were able to escape liability with the affirmative defense of reasonable reliance; indeed, because "the standard under which the court must measure the Underwriters' due diligence is one of reasonableness, not perfection" and "[t]he Court cannot evaluate an underwriter's due diligence defense with the benefit of hindsight."[26]

Claims Under the 1934 Act

The 1934 Act allows individual investors to bring civil actions against issuers and, by extension, other participants in the public securities offerings for "any misstatement or omission of a material fact, or one that investors would think was important to their decision to buy or sell a security."[27] To successfully raise a claim under the 1934 Act, the plaintiffs must show a "strong inference that the defendant has acted with the required 'intent to deceive, manipulate, or defraud,'" otherwise known as scienter.[28] The Court in *Software Toolworks* described the plaintiffs' burden as:

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[23] *Id*. at at 672–73; 679-80.
[24] Lawrence, G. M., *Due Diligence: Investigation, Reliance & Verification*, First Edition, Page 283 (citing Weinberger at 98, 255).
[25] *Software Toolworks*, 38 F.3d 1083, 1086
[26] *See* Lawrence, G. M., *Due Diligence: Investigation, Reliance & Verification*, First Edition, Page 283 (citing Software Toolworks, 789 F. Supp. at 1496, 1498, n. 14.
[27] Cornell Law School, Legal Information Institute, https://www.law.cornell.edu/wex/securities_exchange_act_of_1934.
[28] McLaughlin, Daniel et al., *Corporate Scienter Under Section 10(b) and Rule 10b-5*, https://www.sidley.com/-/media/files/publications/2014/05/corporate-scienter-under-section-10b-and-rule-10b5/files/view-article/fileattachment/bloomberg-bnacorporate-scienter-under-section-10__.pdf?la=en&rev=5eef87a51d704518b79c765884407508 (2014) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199, 214 (1976) ("As the Supreme Court held in *Ernst & Ernst v. Hochfelder*, by using the terms 'manipulative,' 'device,' and 'contrivance,' Congress deployed the commonly understood terminology of intentional wrongdoing—statutory language that makes unmistakable a congressional intent to proscribe a type of conduct quite different from negligence." (quotations omitted)).

> A mental state embracing intent to deceive, manipulate, or defraud. Scienter may be satisfied either by proof of actual knowledge or by proof of recklessness. The reckless conduct necessary to satisfy the scienter requirement is conduct "involving not merely simple, or inexcusable negligence, but an extreme departure from the standards of ordinary care, and which present a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[29]

Although no affirmative due diligence defense exists under the 1934 Act, a successful defense under the 1933 Act can serve to negate the critical element of scienter in establishing liability under the 1934 Act.[30] The Court in *Software Toolworks* held that "[b]ecause we conclude that the Underwriters acted with due diligence in investigating Toolworks' business . . ., we also hold that the Underwriters did not act with scienter regarding those claims."[31] The Court points out where the Underwriters and Deloitte failed to establish a due diligence defense due to a lack of verification which supported the Court's decision to reverse summary judgment in favor of the defendants, even where the defendants were not the drafters of the false statements.[32]

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[29] Lawrence, G. M., *In Search of Reasonableness: The Exercise of Professional Judgement by Underwriters and Its Implication for Judicial Determinations of Reasonableness*, https://www.americanbar.org/groups/business_law/resources/business-law-today/2022-december/the-exercise-of-professional-judgment-by-underwriters/ (2022) (citing In re Software Toolworks, Inc., 38 F.3d 1083, 1088 ("To establish liability under section 10(b), the plaintiffs must show that the defendants acted with scienter, "a mental statement embracing in intent to deceive, manipulate, or defraud." Hochfelder, 425 U.S. at 194, n.12, 96 S.Ct. at 1381, n. 12. The plaintiffs may establish scienter by proving either actual knowledge or recklessness. E.g., Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc), cert. denied, 499 U.S. 976, 111 S.Ct. 1621, 113 L.Ed.2d 719 (1991)" In this context, "recklessness" is conduct "involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Id. at 1569 (internal quotation omitted)).

[30] *See* Lawrence, G. M., *In Search of Reasonableness: The Exercise of Professional Judgement by Underwriters and Its Implication for Judicial Determinations of Reasonableness*, https://www.americanbar.org/groups/business_law/resources/business-law-today/2022-december/the-exercise-of-professional-judgment-by-underwriters/ ("Unlike Sections 11 and 12(a)(2) of the Securities Act, neither Section 10(b) nor Rule 10b-5 contains an express due diligence defense. Nonetheless, the reasonableness of a defendant's conduct may influence a court's views regarding whether scienter exists (a mandatory element of plaintiff's burden of proof." (citing generally *Software Toolworks*, 789 F. Supp. 1489; *In re Int'l Rectifier Sec. Litig*., 1997 WL 529600, 12 (C.D. Cal. Mar. 31, 1997)).

[31] *Software Toolworks*, 38 F.3d 1083, 1088

[32] *Id* at 1091 ("[T]he model agreement was false and misleading, and inclusion of the model agreement with the July 1 SEC letter gives rise to a reasonable inference that Deloitte knew or recklessly disregarded this falsehood. Deloitte claims that it did not draft, or even see the model agreement and cannot therefore be liable for it. Deloitte, however, ignores the fact that the misleading language of the model agreement was actually quoted in the body of the July 1 SEC letter itself, which Deloitte admittedly saw.").

Conclusion

The defendants in *Software Toolworks* established that their due diligence was reasonable and, more particularly, when the encountered facts or circumstances that might be considered red flags, they investigated further in accordance with guidance, but as the appellate court found, a jury might have concluded their responses to other alleged red flags were insufficient.[33] In this regard, it is important to understand that the appellate Court did not rule that the defendants' failure to investigate further into some potential red flags created liability; rather, it prevented the Court from affirming summary judgment and reversed the decision of the district court for further resolution in the courts below.[34] This cannot be read as liability (1) because it is not liability and (2) because it fails to recognize that it only gave the issue back to factfinders to determine the true reasonableness of the defendants' efforts rather than leave the decision in the hands of one district court judge.[35]

Overall, *In re Software Toolworks, Inc*. provides a vivid example of reasonable reliance in securities offering due diligence; reminding us that while a defendant may not blindly rely on information from others, it may establish reasonable reliance even in the face of red flags.[36] While the landscape of due diligence case law may be more hostile to underwriting participants in a post-*WorldCom* and *FHFA v. Nomura* world, defendants may still successfully point to Judge Hall's reasoning in *Software Toolworks* as guidance regarding factors that may assist in sustaining an affirmative due diligence defense.

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[33] *See Software Toolworks*, 38 F.3d 1083, 1089 ("The plaintiff must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.") (citing WOW II, 35 F.3d at 1426 (quotations omitted)); see also id at 1091 ("[W]e conclude that a reasonable factfinder could infer that, as members of the drafting group, [Deloitte] had access to all information that was available and deliberately chose to conceal the truth about Toolworks' poor June quarter performances. Summary judgment was inappropriate on this issue.") (quotations omitted).

[34] *See id* ("We hold that summary judgment was therefore inappropriate as to this issue.").

[35] *See id* at 1083 ("The plaintiffs first argue that due diligence and the reasonableness of the defendants' investigation is a question for the jury, even on undisputed facts. We agree, of course, that summary judgment is generally an inappropriate way to decide questions of reasonableness because the jury's unique competence in applying the reasonable man standard is thought ordinarily to preclude summary judgment. We have, however, squarely rejected the contention that reasonableness is always a question of fact which precludes summary judgment. Rather, reasonableness becomes a question of law and loses its triable character if the undisputed facts leave no room for a reasonable difference in opinion." (citing *TSC Indus v. Northway, Inc*. 426 U.S. 438, 450 n. 12 (1975); *West v. State Farm Fire & Casualty Co*., 868 F.2d 348, 350 (9th Cir. 1989) (quotations omitted)).

[36] *Software Toolworks*, 38 F.3d 1083, 1086.

CASE NOTE

IN RE INTERNATIONAL RECTIFIER SECURITIES LITIGATION

Ian D. Johnson, J.D.*

Introduction

In *In re International Rectifier Securities Litigation*, the Court held that the defendant-underwriters established affirmative due diligence defenses under Section 11 and 12(b) of the Securities Act of 1933 and were entitled to summary judgment on those defenses.[37] In this paper, I will discuss the facts of the case, the Court's legal analysis and holding, my impressions on the Court's decision, and the holding's consistency with authoritative and informative guidance.

Case Background

In re International Rectifier Securities Litigation was a securities class action brought by individuals who purchased or acquired the publicly traded securities of International Rectifier ("IR" or the "Company") between March 7, 1991, and October 18, 1991 alleging securities fraud under Sections 11 and 12(2) of the Securities Act of 1933 ("1933 Act")[38] and bringing claims under Section 10(b) and Rule 10b-5. Defendants included IR, IR directors and officers ("the Individual Defendants"), and underwriters Kidder Peabody & Co. and Montgomery Securities (the "Underwriters").

IR was founded in California in 1947 and is involved with the manufacture and sale of semiconductors.[39] IR's trademark Power MOSFET design accounted for over 65% of IR's revenue and in anticipation of an increased demand for this design, it constructed a $100m manufacturing plant in California in 1987.[40]

The issuer's industry, semiconductors, is an important element of context in the case. Among other things, the manufacture of semiconductors is very capital intensive and in order to

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[37] In re Int'l Rectifier Sec. Litig., No. CV91-3357-RMT(BQRX), 1997 WL 529600 (C.D. Cal. Mar. 31, 1997).

[38] *Id.*

[39] *Id.*

[40] *Id.*

meet increasing demand, IR needed to expand its assembly capacity through the purchasing and installation of new equipment at the new plant in California.[41] Having realized the rapid need for additional capital, the Underwriters began assisting IR in its plan to raise funds.[42] IR retained Kidder as the lead underwriter for the stock offering and Montgomery as a joint bookrunner.[43]

The Underwriters, in compliance with Securities and Exchange Commission ("SEC") and Financial Industry Regulatory Authority ("FINRA") requirements, conducted due diligence into IR's operations and business which included, among other activities and undertakings, holding an organizational meeting attended by Kidder, Montgomery, Underwriter's attorneys, IR's attorneys, and IR's outside accountants.[44] To begin, the Underwriters interviewed eleven senior and middle management employees regarding IR's management, operations, customer-base, technology, expenditures, and growth potential.[45] Moreover, they interviewed IR's major customers, outside consultants and accountants, and IR's patent attorney and environmental counsel.[46] Along with these interviews, they conducted site visits to IR's major factories, reviewed the issuer's financial projections, and with the aid of counsel, reviewed documents they considered material.[47] Moreover, the Underwriters, again aided by counsel, reviewed the offering documents and participated in drafting sessions.[48] In addition, the Underwriter's conducted their own independent analysis of IR through financial modeling which indicated IR's own projections were in fact conservative.[49] Finally, the Underwriters bolstered their independent investigation with representations and warranties from IR and IR's management stating that the offering documents did not contain material misstatements and omissions, negative assurance letters from issuer and Underwriter counsel, and a comfort letter and circle-up from IR's independent auditor.[50]

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[41] *Id.* at 3.
[42] *Id.*
[43] *Id*.
[44] *Id*. at 4.
[45] *Id*.
[46] *Id*.
[47] *Id*.
[48] *Id*.
[49] *Id*.
[50] *Id*.

During the process, IR filed a Registration Statement with the SEC for the offering of 4.2 million shares of stock.[51] After the successful stock offering, Kidder recommended a debenture conversion where IR's debenture holders were given the option to convert their debentures into common stock at $16,375 per share or redeeming the debentures at $1,045 per each $1,000 of face value.[52] Kidder was the sole underwriter for the debenture conversion and assisted IR in a similar manner to the above-referenced offering.[53]

On June 19, 1991, IR publicly announced the completion of its debenture conversion but, simultaneously, a Kidder analyst, issued a report that lowered the earnings estimates of IR's June 1991 quarter and recommended a change from "buy" to "hold" on IR's stock. Thereafter, the trading value of IR's stock declined.[54] Thereafter, Plaintiffs filed a putative class action alleging violation of various federal securities laws including under Sections 11 and 12(2) of the 1933 Act.[55]

Eight days after issuing his "hold" report, Whittington reinstated his "buy" recommendation[56] and stating his opinion that long-term, IR was an excellent investment, but in the short-term, there were some earning concerns.[57] Of these concerns, he cited that testing and assembly at an IR manufacturing facility was slower than anticipated, demand for lower margin IR products was weakened by a slower European economy, and there was demand concerns for IR's Electronics Products Division.[58] In retrospect, Whittington's analysis of IR's earnings estimates was incorrect as evidenced by his own concession of poor recommendation and IR's stock trading at approximately $46 in November of 1995.[59]

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[51] *Id*.
[52] *Id*.
[53] *Id*.
[54] *Id*.
[55] *Id*. at 5.
[56] *Id*.
[57] *Id*.
[58] *Id*.
[59] *Id*.

Plaintiffs argued that the information in Whittington's report was material, known to IR, and not publicly available to the market. Moreover, they asserted that IR's alleged concealment of this information amounted to violations of Sections 11 and 12 of the 1933 Act.[60]

Due Diligence Defenses Involved

Under Section 11 of the 1933 Act, any person who purchases a security issued pursuant to public offering documents that contain a material misstatement or omission has a private cause of action.[61] Persons who may be liable include: (i) the issue, (ii) signatories of the registration statement, (iii) directors or partners of the issuer, (iv) named or near future directors or officers, (v) accountants, engineers, appraisers or other experts and (vi) underwriters.[62] Under Section 12(a)(2) of the 1933 Act, sellers of publicly registered securities are prohibited from making materially false or misleading statements in a prospectus or oral communication related to the sale.[63] Potential plaintiffs include any person who purchases a security pursuant to public offering documents that contain material misstatements or omissions.[64]

However, underwriters are able to avoid liability under both Section 11 and 12(a)(2) of the 1933 Act through affirmative due diligence defenses.[65] Under the reasonable investigation defense of Section 11, a defendant can avoid liability if he can establish that "he conducted a reasonable investigation and that after such investigation he had reasonable grounds 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." The main focus of this inquiry with respect to non-expertised material, which is material not purported to be made on behalf of an expert, is the reasonableness of the party's investigation.[66] Under Section 12(a)(2), a defendant can avoid liability if they exercised

[60] *Id*.
[61] Gary M. Lawrence, Due Diligence: Investigation, Reliance & Verification 55 (2018).
[62] *Id*. at 57.
[63] *Id*.
[64] *Id*.
[65] *Id*. at 65.
[66] *Id*.

reasonable care which requires showing that the defendant did not know, and in the exercise of reasonable care, could not have known of the truth or omission.[67]

The Court's Ruling

As a preliminary matter, the *International Rectifier* Court found that IR's prospectuses were not false nor misleading.[68] While the Plaintiff's argued that the Whittington report contained new information and IR concealed it, the Court found that the information was either fully disclosed in the prospectus and that some information was merely an expression of the analyst's opinion as opposed to factual information related to IR.[69]

Regarding the due diligence defenses, the Court began its analysis by exploring the meaning of a reasonable investigation and reasonable care[70] and examining a variety of factors from precedent rulings it considered relevant in the determination of reasonableness.[71] Among others, it cited *In re Software Toolworks, Inc.* in which the court found that the reasonable investigation and reasonable care standards set for in Section 11 and Section 12 respectively were "similar, if not identical,"[72] that the applicable standard is "that required of a prudent man in the management in his own property,"[73] and that context is an essential consideration in the assessment of affirmative due diligence defenses.[74] The Court also referenced *Weinberger v. Jackson*, *Competitive Associates, Inc. v. International Health Sciences*, and *Leasco Data Processing Equipment Corp.* After considering these rulings and the light they shed on the concept of reasonableness in due diligence, the Court determined the following factors (among others) were relevant in the instant case:

> (1) whether the Underwriters were familiar with IR's finances, management, and operations;

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[67] *Id*. at 67.

[68] In re Int'l Rectifier Sec. Litig., 1997 WL 529600 at 6.

[69] *Id*.

[70] See id.

[71] In re Int'l Rectifier Sec. Litig., 1997 WL 529600 at 7.

[72] *Id*.

[73] *Id*.

[74] *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971).

> (2) whether the Underwriters possessed knowledge of the industry in which IR is involved;
>
> (3) whether the Underwriters conducted interviews of IR's employees;
>
> (4) whether the Underwriters conducted interviews of and/or confirmed data with IR's customers or other third parties; [and]
>
> (5) whether the Underwriters obtained written verification from IR and/or outside accountants that the information contained in the prospectus was accurate.[75]

The Court then observed that the Underwriters:

> (1) reviewed IR's internal financial forecasts, contracts, and other important documents, and inspected IR's major facilities;
>
> (2) employed analysts who were knowledgeable of the semiconductor industry;
>
> (3) conducted interviews with eleven of IR's senior and middle management employees, inquiring about numerous aspects of IR's operations;
>
> (4) conducted interviews with IR's major customers, IR's outside quality consultants, the public accounting firm responsible for auditing IR, IR's patent attorney, and IR's outside environmental counsel; [and]
>
> (5) obtained written verification from IR's management that the information in the prospectus was correct and a "cold comfort" letter from IR's outside accountants indicating that there had been no material changes in IR's financial position since its last audit.[76]

As is common in such cases, the Plaintiffs presented expert testimony, in this case from Dr. Richard Smith, a finance professor,[77] that the Underwriters' due diligence was "inadequate."[78][79]

Dr. Smith's opinions were based on the following:

> (1) The Underwriters failed to examine quarterly as opposed to annual production and sales data. Such data, opines Dr. Smith, would have revealed IR's declining market share and decreasing output from the HexAm plant.
>
> (2) The Underwriters failed to read reports from Andersen Consulting, IR's outside consultants, concerning issues such as plant capacity, growth potential and customer satisfaction. Dr. Smith asserts that these reports would have been a "red flag" to the Underwriters that the market had been misled about IR's ability to expand output.

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[75] *Id*. at 8.

[76] *Id*.

[77] The Underwriters questioned Dr. Smith's credentials, noting among other things, that he had no experience in securities law, let alone due diligence case law, and he had never published regarding underwriter due diligence.

[78] *Id*.

[79] *Id*. at 9.

> Acknowledging that a member of the underwriting team spoke by telephone with an Andersen consultant, presumably about the reports, Dr. Smith contends that "a conversation is not an adequate substitute for first-hand examination of the reports."
>
> (3) The Underwriters, upon interviewing IR's employees, neglected to speak to plant employees, focusing instead on upper-level management. Dr. Smith asserts that "[i]t is not sufficient simply to speak with senior management since it is the representations of senior management that need to be tested."
>
> (4) The Underwriters interviewed only IR's largest customers, rather than selecting customers at random or by a stratified sampling. Dr. Smith contends that "[g]iven the size of IR backlog and the fact that IR output was being rationed, it would have been important to determine whether these customers were receiving priority treatment or were representative of the other customers."[80]

While the Court acknowledged that at first glance these issues would raise legitimate concerns, upon a closer examination it found these concerns to lack legitimacy.[81] Regarding Dr. Smith's first criticism, the Court found that the Underwriters had no other option than to examine annual production and sales data rather than quarterly because the quarterly reports were not yet available.[82] Next, the Court found Dr. Smith's assertion that the Underwriters should have read the Anderson Consulting reports to be unconvincing.[83] The Court reasoned that the Underwriters had no reason to believe the oral communication with Anderson Consulting would be anything less than genuine.[84] Furthermore, due to the Underwriters limited time and resources, the oral summation they received was reasonable in the context.[85] In regard to Dr. Smith's contention that the Underwriters should have interviewed lower-level employees, the Court found that there was no particular reason that the Underwriters should have contacted lower-level employees as opposed to middle and senior management.[86] Finally, the Court did agree with Dr. Smith's argument that the Underwriters should have interviewed IR's customers at random, as opposed to only IR's largest customers.[87] While the Court did acknowledge that smaller customers collectively do have a material impact on revenue and the Underwriters should have interviewed

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[80] *Id*.
[81] *Id*. at 10.
[82] *Id*.
[83] *Id*.
[84] *Id*.
[85] *Id*.
[86] *Id*. at 11.
[87] *Id*.

them, it found this one judgmental error to not overcome the overall reasonableness of the due diligence process as a whole.[88]

Plaintiffs also brought Section 10(b) and Rule 10b-5 claims against the Underwriters which requires scienter on behalf of defendants for liability.[89] The Court's analysis of these claims was simple in light of its analysis of the Section 11 and Section 12(2) 1993 Act claims.[90] By finding that the Underwriters reasonably believed in the statements put forth in the prospectuses, there was no mental state embracing the intent to deceive, manipulate, or defraud.[91]

In light of finding that these measures were reasonable in the context of the proposed offering, the Court held that the Underwriters were entitled to summary judgment with respect to all the claims asserted against them, and IR and the Individual Defendants were entitled to partial summary judgment on the Section 11 and 12(b) claims as to the common law fraud and negligent misrepresentation claims surrounding the representation claims contained in the prospectuses.[92]

Impressions of the Court's Reasoning

The Court's reasoning in *International Rectifier* is well supported and does not stray from the precedent of due diligence cases.[93] While the grant of summary judgment on due diligence defenses is rare because of the fact intensive inquiry surrounding securities contexts, it is my opinion that the Court exercised proper judgment. Congress enacted the 1933 Act with the aim to protect investors due to the recent stock market crash at the time.[94] This protection entails providing investors with full disclosure of material information pertinent to public offerings and preventing fraud.[95] This caused underwriters and parties associated with securities offering processes to increase their documentation during due diligence and act with more caution

[88] *Id*.
[89] *Id*. at 2.
[90] *Id*. at 12.
[91] *Id*.
[92] *Id*. at 12.
[93] *See* In re Int'l Rectifier Sec. Litig., 1997 WL 529600.
[94] William K. Sjostrom, Jr., The Due Diligence Defense Under Section 11 of the Securities Act of 1933, 44 Brandeis Law Journal 2 (2006).
[95] *Id*. at 3.

throughout the offering process.[96] While the aims of the 1933 Act are undoubtedly important and has served its purpose of protecting investors, Underwriters and companies seeking to sell securities in the public market can face unnecessary scrutiny in their sale process when company valuations decline post-offering.[97] This is one of the reasons Section 11 and Section 12(b) provide an affirmative due diligence defense for underwriters and other parties involved in the securities offering process.[98] These defenses acknowledge that even if underwriters tailor their due diligence with reasonable caution, things may still go awry post-offering.

The Court also appropriately applied the principle of requiring the due diligence to be reasonable, but not perfect.[99] This echoes the fact that hindsight bias makes it easy to critique a securities offering retrospectively so courts must look at the due diligence prospectively.[100] The Underwriters properly conducted their due diligence process consistent with prior case law and made consistent efforts to turn over nearly every leaf leading up to the public offering.[101] This is evidence by their (1) review of IR's internal important documents (2) inspection of IR's major facilities (3) employment of analysts specializing in the semiconductor industry, (4) interviewing of senior and middle management about pertinent aspects of IR's operations, (5) interviewing of IR's major customers, IR's quality consultants, IR's audit accounting firm, IR's patent attorney, and IR's environmental counsel, and (6) acquisition of written verification from IR's management concerning the accuracy of the prospectus and a "cold comfort" letter from IR's outside consultants ensuring no material changes in IR's financial position.[102] All of these actions indicate that the Underwriters were cautious throughout the offering process ensuring that they conducted their investigation in a reasonable manner.[103]

Finally, the Court concluded that Plaintiffs were unable to point to any material flaws in the Underwriters overall due diligence, noting among other things that the information in the

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[96] Rodrigues, Tony & Petroski, Karen. The Section 11 Due Diligence Defense for Director Defendants. Securities Litigation Journal, Summer 2007.

[97] *See* In re Int'l Rectifier Sec. Litig., 1997 WL 529600.

[98] *See id*.

[99] *See id*.

[100] In re Software Toolworks, Inc. Sec. Litig., 789 F. Supp. 1489, 1498 (N.D.Cal.1992).

[101] *See* In re Int'l Rectifier Sec. Litig., 1997 WL 529600 at 8.

[102] *Id*.

[103] *See id.*

Whittington report was either disclosed in the prospectus or was pure opinion which IR was unaware of,[104] and that Dr. Smith's attempt to critique the Underwriters' due diligence were unpersuasive, even with the benefit of hindsight.[105] Overall, the *International Rectifier* Court properly adhered to the principle that due diligence need only be reasonable in the context and not perfect.

Consistency with Authoritative and Informative Guidance

The *International Rectifier* Court's ruling is consistent with the existing case law at the time of its ruling.[106] Regarding authoritative guidance, the Court followed the landmark due diligence cases in establishing factors to use when evaluating the Underwriters' due diligence.[107] Like the underwriters in *Software Toolworks*, the Underwriters received written confirmation from senior management that the prospectus was accurate and consulted with the Company's major customers.[108] Moreover, similar to *Weinberger* and *Leasco Data Processing*, the Underwriters reviewed Company documents, conducted meetings throughout the diligence process with senior management, interviewed employees and inspected IR's major facilities.[109] Finally, like *Competitive Associates, Inc.*, the Underwriters undertook a complete analysis of the Company from a financial and operational perspective along with an analysis of the semiconductor industry.[110] As evidenced by the Underwriters' due diligence process, they carefully adhered to due diligence practices found reasonable in important cases.[111] Moreover, they were broadly covered all three silos of due diligence to ensure an accurate prospectus for potential investors.[112] The Underwriters also satisfied themselves reasonably that the offering

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[104] *Id*.

[105] *Id*.

[106] *See* In re Software Toolworks Inc., 50 F.3d 615; Weinberger, 1990 WL 260676; Leasco Data Processing Equip. Corp., 332 F. Supp. 544; Competitive Assocs., Inc. v. Int'l Health Scis., Inc., No. 72 CIV. 1848-CLB, 1975 WL 349 (S.D.N.Y Jan. 22, 1975).

[107] *See* In re Int'l Rectifier Sec. Litig., 1997 WL 529600.

[108] *See* Toolworks II, 50 F.3d at 623.

[109] *See* Weinberger, 1990 WL at *3; Leasco Data Processing Equip. Corp., 332 F. Supp. 544.

[110] *See* Competitive Assocs., Inc., 1975 WL 349.

[111] *See* In re Int'l Rectifier Sec. Litig., 1997 WL 529600.

[112] *See* Lawrence, *supra* note 31, at 25.

documents contained adequate disclosures about the issuer and were not materially misstated or misleading.[113]

It is no mystery that courts analyze underwriter due diligence in the context of the transaction. While this may seem like there is a lack of guidance for underwriters on the subject, there is an ample amount of authoritative guidance and informative guidance to shed light on what is reasonable in the context.[114] Through analyzing past cases and looking at the present case without hindsight bias, the *International Rectifier* Court properly found the Underwriters' acted reasonable and set a good precedent for future guidance on due diligence practices in the securities offering context.

[113] *See* In re Int'l Rectifier Sec. Litig., 1997 WL 529600 at 6.

[114] Lawrence, *supra* note 31, at 95.

CASE NOTE
LAVEN V. FLANAGAN

Kaitlin Schleich*

Introduction

In the case of *Laven v. Flanagan*, purchasers of Western Union stock sued three outside directors for violations of securities laws related to alleged misstatements and omissions in the offering documents. In a rare occurrence in securities litigation, the court granted summary judgment to the outside directors on all claims against them, concluding that as a matter of law they had met the burden of proving their affirmative due diligence defenses. The court considered a number of factors in making its determination, and the decision was in accord with authoritative and informative due diligence guidance. All of these matters are addressed in more detail in this case note.

Overview of Securities Law & Its Due Diligence Defenses

Securities offerings (and related matters) in the United States are primarily governed by the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").[115] The Securities Act generally regulates the sale of securities in the primary market, and the Exchange Act is broader but mostly regulates securities in the secondary market.[116] A common goal of both Acts is to protect investors and prohibit fraud and deceit.[117]

The Securities Act is the primary legislation governing the offering and sale of securities to the public.[118] Section 11 of the Act provides a civil remedy to buyers of securities who were harmed by material misstatements and omissions in an issuing company's registration

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[115] *The Laws That Govern the Securities Industry*, U.S. SECURITIES AND EXCHANGE COMMISSION (Oct. 1, 2013), https://www.sec.gov/about/about-securities-laws#:~:text=Often%20referred%20to%20as%20the,in%20the%20sale%20of%20securities.

[116] *Id.*; *see also Securities Exchange Act of 1934*, CORNELL LAW SCHOOL LEGAL INFORMATION INSTITUTE, https://www.law.cornell.edu/wex/securities_exchange_act_of_1934 (last visited April 05, 2024).

[117] *Id.*

[118] *The Laws That Govern the Securities Industry*, U.S. SECURITIES AND EXCHANGE COMMISSION (Oct. 1, 2013), https://www.sec.gov/about/about-securities-laws#:~:text=Often%20referred%20to%20as%20the,in%20the%20sale%20of%20securities.

statement.[119] Under Section 11, an issuer is strictly liable for material misstatements and omissions, and other possible defendants include anyone who signed the registration statement, every partner or director of the issuer, the underwriters, and experts who participated in the offering, such as accountants, engineers, and appraisers.[120] These defendants are not strictly liable because, under Section 11, they are afforded the opportunity to prove two affirmative due diligence defenses: reasonable investigation and reasonable reliance.[121]

Section 11 categorizes statements in the registration statement as either "expertised" or "non-expertised".[122] Expertised statements are those "prepared or certified" by experts, such as audited financial statements.[123] Under the reasonable investigation defense, the defendant has the burden of proving that "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[124] The reasonable reliance defense requires the defendant to prove that "he had no reasonable ground to believe and did not believe…that the statements [in the expertised portions] were untrue or that there as an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[125] Thus, for the reasonable reliance defense, there is no obligation for the defendant to have conducted an independent investigation of the expertised portions, but they still had to have verified the information in some way.[126]

Section 12(a)(2) of the Securities Act similarly imposes liability for material misstatements and omission, but for the prospectus and oral communications rather than the registration statement.[127] Section 12(a)(2) offers another affirmative defense for sellers of securities, known

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[119] 15 U.S. Code § 77k.

[120] *Id.*

[121] *Id.*

[122] *Id.*

[123] *Id.*

[124] *Id.* (when experts are defendants, they will only be liable for the expertised portions that they prepared and will only have to prove a reasonable investigation for the expertised portion).

[125] 15 U.S. Code § 77k.

[126] Gary M. Lawrence, *In Search of Reasonableness: The Exercise of Professional Judgment by Underwriters and Its Implication for Judicial Determinations of Reasonableness*, ABA BUSINESS LAW SECTION (Dec. 02, 2022), https://www.americanbar.org/groups/business_law/resources/business-law-today/2022-december/the-exercise-of-professional-judgment-by-underwriters/.

[127] 15 U.S. Code § 77l.

as the reasonable care defense, which states that the defendant must prove "that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission…"[128] The reasonable care defense does not distinguish between expertised and non-expertised statements.[129] In general, guidance equated the standard to satisfy the reasonable care defense with that of the reasonable investigation defense in Section 11, though some sources (the minority) disagree.[130]

The Exchange Act creates and empowers the SEC, imposes continuous disclosure requirements, oversees the players in the securities market.[131] Section 10(b) of the Exchange Act prohibits any person "to use or employ, in connection with the purchase or sale of any security…any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[132] It is essentially the anti-fraud section of the Exchange Act.[133] Rule 10b-5, promulgated thereunder, states that it is unlawful for any person "(a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made…not misleading…in connection with the purchase or sale of any security."[134] In order for a defendant to be liable under Section 10(b) and Rule 10b-5, the plaintiff must prove that the defendant acted with scienter, "a mental state embracing intent to deceive, manipulate, or defraud."[135] While there is no express affirmative due diligence defense in the Exchange Act, courts often hold that when a defendant has proved an affirmative defense under Sections 11 and 12 of the Securities Act, that amounts to a negation of scienter.[136] Thus, if an affirmative defense was proved under the

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[128] *Id.*

[129] Gary M. Lawrence, *In Search of Reasonableness: The Exercise of Professional Judgment by Underwriters and Its Implication for Judicial Determinations of Reasonableness*, ABA BUSINESS LAW SECTION (Dec. 02, 2022), https://www.americanbar.org/groups/business_law/resources/business-law-today/2022-december/the-exercise-of-professional-judgment-by-underwriters/.

[130] *Id.*

[131] *The Laws That Govern the Securities Industry*, U.S. SECURITIES AND EXCHANGE COMMISSION (Oct. 1, 2013), https://www.sec.gov/about/about-securities-laws#:~:text=Often%20referred%20to%20as%20the,in%20the%20sale%20of%20securities.

[132] 15 U.S. Code § 78j

[133] *See Id.*

[134] 17 CFR § 240.10b-5

[135] In re Software Toolworks Inc., 50 F.3d 615, 626 (9th Cir. 1994).

[136] *Id.* at 626-627.

Securities Act, then the Section 10(b) and Rule 10b-5 claims will also fail because the element of scienter would not have been proven.[137]

Regardless of the statutory basis of a plaintiff's claims or a defendants assertion of affirmative due diligence defenses, the standard of reasonableness in determining what constitutes a reasonable investigation and reasonable ground for belief is "that required of a prudent man in the management of his own property."[138] What composes a reasonable investigation or reasonable reliance depends on the context, therefore implicit in the definition above are the words "in the same or a similar context."[139] Accordingly, what may be reasonable in one context may not always be reasonable in another, thus there is no specific set of actions one must do in order to conduct a reasonable investigation in every context, and courts will engage in a factual analysis in each case taking into account the context of each offering.[140] While there is no universal checklist, various courts, government organizations and non-government organizations—including the SEC itself—have issued guidance regarding the concept of reasonableness in due diligence, which in turn has influenced the custom and practice of due diligence.[141]

Factual Background

Between July 1981 and August 1982, Curtiss-Wright Corporation purchased 20.5% of Western Union's total number of voting shares, because Curtiss-Wright believed "Western Union was 'the most undervalued telecommunications company in the market.'"[142] When Western Union acquired another company in 1982, Curtiss-Wright's interest was diluted to 17.5%, though they remained as Western Union's largest shareholder.[143]

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[137] *See Id.*

[138] 15 U.S. Code § 77k.

[139] Gary M. Lawrence, *In Search of Reasonableness: The Exercise of Professional Judgment by Underwriters and Its Implication for Judicial Determinations of Reasonableness*, ABA BUSINESS LAW SECTION (Dec. 02, 2022), https://www.americanbar.org/groups/business_law/resources/business-law-today/2022-december/the-exercise-of-professional-judgment-by-underwriters/.

[140] *Id.*

[141] *See* Securities Exchange Act Release No. 33-7606A (November 17, 1998; *See also* NASD Notice 73-17 (1973); *See also* NASD Special Report: Due Diligence Seminars (1981).

[142] Laven v. Flanagan, 695 F. Supp. 800, 804 (D.N.J. 1988).

[143] *Id.*

In the fall of 1983, Western Union and Curtiss-Wright entered into a standstill agreement, the terms of which gave Curtiss-Wright the right to name three directors on Western Union's sixteen person board of directors in exchange for Curtiss-Wright preclusion from purchasing more than twenty-five percent of Western Union stock.[144] Pursuant to this standstill agreement, three Curtiss-Wright officers joined Western Union's board of directors on November 22, 1983.[145] One of these three was T. Roland Berner, the chairman and president of Curtiss-Wright.[146] The other two were Charles E. Ehinger and Richard P. Sprigle, both executive vice presidents of Curtiss-Wright.[147]

In December of 1983, "Western Union announced a multi-million-dollar write-down of its plant and equipment," which was proposed before Berner, Ehinger, and Sprigle joined the board days prior.[148] Additionally, Berner, Ehinger, and Sprigle did not serve on the Audit Committee during the time the write-down was discussed.[149] Importantly, "[t]he board was assured by both management and the Price Waterhouse accounting firm that the write-down was proper and would insure an accurate statement of Western Union's assets."[150] In a board meeting in February 1984, the Western Union board of directors approved increased expenditure to market its EasyLink service.[151]

In March of 1984, the board discussed an offer from Merrill Lynch, Pierce, Fenner Smith "to purchase and underwrite a public offering of $50 million in Western Union preferred shares," to which Berner objected, stating that the dividend rate and redemption premium were too high.[152] Berner proposed two different offers, first an offering that common stock with Curtiss-Wright

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[144] *Id.*; Adam Hayes, *Standstill Agreement: Definition, How Contract Works, and Example*, Investopedia (March 31, 2024), https://www.investopedia.com/terms/s/standstill_agreement.asp#:~:text=A%20standstill%20agreement%20is%20a,cannot%20negotiate%20a%20friendly%20deal (explaining, "A standstill agreement is a contract that contains provisions that govern how a bidder of a company can purchase, dispose of, or vote stock of the target company. A standstill agreement can effectively stall or stop the process of a hostile takeover if the parties cannot negotiate a friendly deal.").

[145] Laven v. Flanagan, 695 F. Supp. 800, 804 (D.N.J. 1988).

[146] *Id.* at 803-804.

[147] *Id.*

[148] *Id.*

[149] *Id.*

[150] *Id.*

[151] Laven v. Flanagan, 695 F. Supp. 800, 804 (D.N.J. 1988).

[152] *Id.*

purchasing its proportionate share, and later offering Curtiss-Wright to buy the entire amount of preferred shares without the redemption premium, thereby lowering Western Union's costs.[153] Both of Berner's proposals were rejected, and the Finance Committee voted to proceed with Merrill Lynch's offer.[154] Merrill Lynch then underwrote the offering and sold the preferred shares to the public in April of 1984.[155]

Accompanying the offering was a registration statement and prospectus, which were signed by all of Western Union's directors, including Berner, Sprigle, and Ehinger.[156] For the purposes of the motion for summary judgment, the Court presumed the prospectus "constituted a deception of the potential investor, in that it presented a 'generally rosy picture of Western Union as a company poised to take a leadership role in the telecommunications industry [while] the truth is that it was on the verge of collapse.'"[157] The marketing strategies stated were "'high risk'" and would only have been able to succeed with external financing.[158] In November of 1984, a $100 million line of credit was cancelled by Western Union's banks, leading to a sudden decrease in cash, which led Western Union to cancel dividend payments.[159] After this, "[t]he price of the company's stock began a swift decline," thus, leading to the litigation at issue in this case.[160]

Discussion of Case

The defendants in *Laven v. Flanagan* were Curtiss-Wright, Berner, Ehinger, and Sprigle.[161] The lead plaintiffs in the case were representatives of classes of persons who purchased some of the preferred shares Western Union issued pursuant to the accompanying registration statement, prospectus, and two prospectus supplements, and from Merrill Lynch.[162]

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[153] *Id.*
[154] *Id.* at 805.
[155] *Id.*
[156] *Id.*
[157] Laven v. Flanagan, 695 F. Supp. 800, 805 (D.N.J. 1988).
[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] *Id.* at 803.
[162] *Id.*

The plaintiffs alleged violations of Section 11 of the Securities Act and Section 15 of the Securities Act, "based upon the contention that Western Union's prospectus contained untruths and omissions on matters of material fact and that defendants were controlling persons of Western Union"; a violation of Section 12(2) of the Securities Act "by aiding and abetting Merrill Lynch's violations of the same section"; and violations of Section 10(b), Section 20, and Rule 10b-5 of the Exchange Act, alleging "defendants both aided and abetted, and are primarily liable for" those violations.[163] The defendants moved for summary judgment on all claims, and the Court granted the motion, finding that the defendants were entitled to judgment as a matter of law.[164]

In addressing the director's summary judgment motion, the Court considered several factors. First, all three directors were outside directors, and thus, they were under a "lesser obligation to conduct a painstaking investigation than an inside director with an intimate knowledge of the corporation."[165] Even though Berner served as chairman for a brief time, the court noted that his time in the position "suggests powerlessness," noting that who he suggested to take his place was rejected, the three Curtiss-Wright directors were increasingly excluded, and even the plaintiffs brief stating that they were "'hounds' to be kept at bay," showed how he was really an outsider.[166] The Court noted that in order to avoid liability under Section 11, the outside directors, Berner, Sprigle, and Ehinger, had to prove that they conducted a reasonable investigation.[167] However, as the Court explained, they were allowed to reasonably rely on representations from management, but also cautioned that "it is not good enough for a defendant to possess a good faith belief in the truth of a registration statement. That belief must be found reasonable by an objective standard."[168] From the directors' affidavits and their actions, such as Berner personally buying 1000 shares of Western Union stock two months after the offering and their objections to the original Merrill Lynch proposal, it was clear to the Court that they believed in the truth of the registration statement.[169]

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[163] *Id.*
[164] *Id.* at 803-806.
[165] *Id.* at 812.
[166] *Id.* at 808.
[167] *Id.* at 811.
[168] *Id.*
[169] *Id.* at 805-811.

To prove a reasonable belief, the defendants pointed to their review of the offering documents and their reliance on Merrill Lynch, Salomon Brothers, independent audits from Price Waterhouse, and assurances from management at Western Union.[170] Specifically, they relied on Western Union management's representations "concerning production schedules for Western Union products such as EasyLink and Airfone."[171] The plaintiffs in the case argued that implementing EasyLink and Airfone was high risk, and that delays in their production should have put the directors on notice—essentially claiming there was a red flag.[172] However, the Court found that the directors did not merely place blind reliance on management's statements.[173] The representations were confirmed by Price Waterhouse and Merrill Lynch, and the three directors, as the court stated, "actively worked to bring their knowledge of Western Union activities up to speed in the months between their accession to the Western Union board and the Merrill Lynch offering."[174] Thus, the Court concluded the directors were reasonable in their efforts to verify the truth of the registration statement and prospectus, thereby satisfying their burden to prove an affirmative due diligence defense.[175] The Court also noted that while their investigation was imperfect, perfection is not required, only reasonableness.[176]

As for the other claims, the Court found that the evidence did not lead to a finding of imposing control liability on Curtiss-Wright nor Berner, Sprigle, and Ehinger (Section 15 of the Securities Act and Section 20 of the Exchange Act); Curtiss-Wright and the three directors were not liable for aiding and abetting nor culpable participation (Rule 10b-5, Section 10(b) and Section 20 of the Exchange Act, Section 15 of the Securities Act); and that Curtiss-Wright was not an aider and abettor of Merrill Lynch (Section 12(2) of the Securities Act).[177]

Conclusions

The granting of summary judgment in *Laven v. Flanagan* is consistent with the authoritative and informative guidance regarding reasonable due diligence by outside directors. The positional

[170] *Id.*
[171] *Id.* at 811-812.
[172] *Id.*
[173] *Id.*
[174] *Id.* at 812.
[175] Laven v. Flanagan, 695 F. Supp. 800, 812 (D.N.J. 1988).
[176] *Id.*
[177] *Id.* at 806-813.

context of the directors was one of the most important factors the court considered in *Laven*. The Court considered Berner, Sprigle, and Ehinger's positions as outside directors, and noted how outside directors have a "lesser obligation to conduct a painstaking investigation than an inside director with an intimate knowledge of the corporation."[178] The Court also took into account how the directors were also officers at Curtiss-Wright corporation, who was the largest shareholder at Western Union, thus creating hostility between the Curtiss-Wright directors and the rest of Western Union's board, leading towards the three Curtiss-Wright directors being excluded and Western Union management being told not to communicate with them.[179] The directors situation of being not only directors but also officers of a company Western Union had animosity towards directly affected their control and access to candid information.[180]

Finally, the *Laven* decision was also in line with other cases involving due diligence by outside directors. In *In re Avant-Garde Computing Inc. Sec. Litig.*, the court granted an outside director's motion for summary judgment.[181] Some of the factors considered, among other things, were the director attending board meetings discussing the offering, verifying the financial statements with an independent auditor, and reviewing the drafts and final copy of the prospectus.[182] The three directors in *Laven* also did those things. They attended multiple board meetings, received external verification from the accounting firm, and examined both the registration statement and prospectus before signing them.[183] Additionally, in *Weinberger v. Jackson*, the court also granted summary judgment for an outside director.[184] The court stated, "[the outside director defendant] was reasonably familiar with the company's business and operations. He regularly attended board meetings...He was familiar with the company's development of its new product lines. He was involved with various company decisions."[185] Like the director in *Weinberger*, the directors in *Laven* similarly attended board meetings, besides the ones that were held in "secret" without them.[186] They were familiar with the development of

[178] Laven v. Flanagan, 695 F. Supp. 800, 812 (D.N.J. 1988).
[179] *Id.* at 805.
[180] *See Id.*
[181] In re Avant-Garde Computing Inc. Sec. Litig., No. CIV. 85-4149(AET), 1989 WL 103625 (D.N.J. Sept. 5, 1989).
[182] *Id.*
[183] Laven v. Flanagan, 695 F. Supp. 800, 804 (D.N.J. 1988).
[184] Weinberger v. Jackson, No. C-89-2301-CAL, 1990 WL 260676 (N.D. Cal. Oct. 11, 1990).
[185] *Id.*
[186] Laven v. Flanagan, 695 F. Supp. 800, 805 (D.N.J. 1988).

Western Union's EasyLink and Airfone services, and the amount of external financing needed to successfully complete a takeover discussed at a board meeting.[187] While the plaintiffs argued that the delay in EasyLink and Airfone production should have put the directors on notice that the prospectus was not entirely accurate, as the court said in *Weinberger*, "[the director] had no duty to [make specific inquiries] as long as the prospectus statements were consistent with the knowledge of the company which he had reasonably acquired in his position as director."[188] Since the directors in *Laven* reasonably believed Western Union was undervalued, their actions were consistent with that view.[189]

In light of the above, the Court's ruling in *Laven* is consistent with other judicial decisions and authoritative and informative guidance including from the SEC and FINRA. Thus, the Court correctly determined that the actions the three directors took were enough, as a matter of law, to prove their affirmative due diligence defense under the Securities Act.

[187] *Id.* at 810.

[188] Weinberger v. Jackson, No. C-89-2301-CAL, 1990 WL 260676 (N.D. Cal. Oct. 11, 1990).

[189] Laven v. Flanagan, 695 F. Supp. 800, 810 (D.N.J. 1988).

CASE NOTE
FEYKO V. YUHE INT'L

Bailey White*

Introduction

Underwriter due diligence is often subject to judicial scrutiny in class action lawsuits alleging violations of US securities law. Moreover, recent due diligence case law suggests that courts are hesitant to find that underwriters have met the reasonableness standard required under the affirmative due diligence defenses available in the Securities Act of 1933 ("Securities Act").[190] This Case Note details and analyzes a rare occasion where underwriters successfully pled an affirmative due diligence defense as a matter of law in *Feyko v. Yuhe Int'l* ("*Feyko"*).[191] Part I overviews Section 11 and the affirmative reasonable reliance defense available therein. Part I additionally identifies key considerations affecting the determination of reasonableness in due diligence. Part II discusses *Feyko,* and its holdings related to an underwriter's reliance on auditor financial statements and certified expert opinions. Part III compares the court's reasoning in *Feyko* with traditional authoritative and informative due diligence guidance. Lastly, Part IV overviews the ultimate result for the underwriters in *Feyko* and reemphasizes the importance of *Feyko* in due diligence case law.

Overview of Section 11 and Due Diligence Defenses

Underwriters are subject to liability under the Securities Act and the Securities Exchange Act ("Exchange Act") of 1934.[192] Essential to the scope of this Case Note is the Securities Act, which governs public offerings and "prohibits material misstatements or omissions in the offering

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[190] *See generally* In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 672 (S.D.N.Y. 2004)(scrutinizing the defendants' due diligence to an unprecedented degree).

[191] *See* Feyko v. Yuhe Intern., Inc., No. CV 11-05511 DDP (PJWX), 2013 WL 816409, at *8-9. (C.D. Cal. Mar. 5, 2013).

[192] 15 U.S.C. §§ 77a-77z; 15 U.S.C. § 78a.

documents."[193] Specifically, this Case Note focuses on Section 11 of the Securities Act and the affirmative due diligence defenses available therein.

Section 11 Liability

Under Section 11 of the Securities Act, "any person who purchases a security issued pursuant to public offering documents that contain a material misstatement or omission has a private cause of action."[194] Numerous parties to a public offering fall under the scope of Section 11, including the issuer and its directors and officers, underwriters, experts,[195] and all "signatories of the registration statement."[196] Importantly, plaintiffs to a Section 11 lawsuit need not prove that the defendants had a "culpable state of mind" or scienter.[197] In other words, Section 11 plaintiffs must only prove that the issuer's public offering documents contained material misstatements or omissions.[198]

Section 11 Due Diligence Defenses

Section 11 provides all defendants (except the issuer) with two affirmative due diligence defenses.[199] First is the reasonable investigation defense, which negates liability for underwriters, experts, directors, officers, partners of the issuer, and signatories of the registration statement regarding non-expertised portions of offering documents.[200] Under the reasonable investigation defense, defendants must prove that they "had, after reasonable investigation, reasonable grounds

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[193] G.M. LAWRENCE, DUE DILIGENCE: INVESTIGATION, RELIANCE & VERIFICATION: CASES, GUIDANCE AND CONTEXTS 49 (CADDS Scholars Press, 1st ed. 2018) (describing 15 U.S.C. §§ 77a-77z) [hereinafter "DUE DILIGENCE: INVESTIGATION, RELIANCE & VERIFICATION"].

[194] Gary M. Lawrence, *In Search of Reasonableness: The Exercise of Professional Judgment by Underwriters and its Implications for Judicial Determinations of Reasonableness,* BUS. L. TODAY 37, 33 (Dec. 2022).

[195] *Id.* at 66 (explaining that Section 11's defines experts as "accountants, engineers, appraisers, "or any person whose profession gives them authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him").

[196] *Id.* at 55.

[197] *Id.*

[198] Gary M. Lawrence, *In Search of Reasonableness: Director & Underwriter Due Diligence in Securities Offerings,* 47 SEC. REG. L. J. (2019) [hereinafter "*Director & Underwriter Due Diligence in Securities Offerings*"].

[199] *See* § 77k(b)(3).

[200] *Director & Underwriter Due Diligence in Securities Offerings, supra* note 9.

to believe and did believe" that the offering documents contained factual statements and that there were no omissions of material facts that would make the statements misleading.[201]

The second defense is the reasonable reliance defense, which is the focus of *Feyko* and this Case Note.[202] Under the reasonable reliance defense, "[n]on-issuer, non-experts, such as directors and underwriters, can establish a reasonable reliance defense as to expertised material by demonstrating that they had 'no reasonable ground to believe and did not believe . . . that the statements [contained in the expertised portion] were untrue or that [they omitted] a material fact.'"[203] Thus, the reasonable reliance defense is only available to those who rely on expertised material such as audited financial statements.[204] Reasonable reliance does not require a reasonable investigation into expertised material except when red flags are present.[205] While no clear-cut definition of red flags exists, the Financial Industry Regulatory Authority ("FINRA") defines red flags generally as "information 'that would alert a prudent person to conduct further inquiry.'"[206]

Reasonableness in Due Diligence

The core of Section 11's two affirmative due diligence defenses is "reasonableness."[207] Under the Securities Act, the reasonableness standard is that of what a prudent person in a similar situation would do in the management of his or her own property.[208] This standard, however, is difficult for courts to apply consistently with each other and thus varies case by case.[209] Moreover, the reasonableness of one's actions greatly depends on context.[210] Various authoritative and informative actors have tried and failed crafting set standards for the reasonableness inquiry under

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[201] *Id.*

[202] *See infra*-Part III.

[203] *Director & Underwriter Due Diligence in Securities Offerings, supra* note 9(quoting 15 U.S.C. § 77k).

[204] *See id*; DUE DILIGENCE: INVESTIGATION, RELIANCE & VERIFICATION, *supra* note 4 at 66 (explaining that "not every statement of an expert constitutes expertised material").

[205] *See* DUE DILIGENCE: INVESTIGATION, RELIANCE & VERIFICATION, *supra* note 4 at 67 n.94 (referencing In re WorldCom, 346 F.Supp.2d at 672) (explaining Judge Cote's opinion in *Worldcom* stating that expertised material containing red flags must be investigated).

[206] *See* DUE DILIGENCE: INVESTIGATION, RELIANCE & VERIFICATION, *supra* note 4 (quoting FINRA Regulatory Notice 10-22: Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings (April 10) at 6).

[207] *See Director & Underwriter Due Diligence in Securities Offerings, supra* note 9.

[208] 15 U.S.C. § 77k; Lawrence, *supra* note 5.

[209] *See* Lawrence, *supra* note 5.

[210] *Id.*

the Section 11 due diligence defenses, showcasing that reasonableness cannot be confined to a definitional box.[211] Thus, courts analyze reasonableness pursuant to a flexible "sliding scale that varies with transactional context, positional context, situational context, and temporal context."[212] Some courts additionally look at "industry custom and practice."[213]

Feyko v. Yuhe Int'l

Feyko v. Yuhe Int'l, decided by Federal District Court for the Central District of California in 2013, is one of the few due diligence cases that granted an underwriter's motion to dismiss a Section 11 claim, stating that underwriters "occupy a special place in Section 11 jurisprudence because they are allowed to rely on auditors' work, absent red flags."[214]

A. Facts and Background

This case involved Yuhe International, Inc. ("Yuhe"), a Chinese supplier of broiler chickens and its various SEC filings mentioning an acquisition of thirteen broiler farms.[215] Between December of 2009 and May 2011, Yuhe filed numerous SEC documents (many of which were signed by Yuhe's CEO, CFO, and Chief Accounting Officer[216]) publicizing its 2009 purchase of thirteen chicken breeding farms from Waifang Dajiang ("Dajiang).[217] In early 2010, Yuhe's CEO, Chairman of the Board and largest shareholder, Zhentao Gao ("Gao"), specifically cited the

[211] *Id.* (noting that "legislators, regulators, courts, and other authoritative and informative sources have offered guidance regarding the reasonableness of underwriter conduct in certain contexts, no authoritative source has successfully developed a one-size-fits-all checklist of reasonableness appropriate to all contexts").

[212] For an in-depth discussion over the four contexts of the reasonableness inquiry, *see* Lawrence, *supra* note 5 at 43-46.

[213] *Id.* (noting that industry customs and practices are also referred to as "standards of the street," or "a standard that depends to some extent on what constitutes commonly accepted commercial practice").

[214] *Feyko,* 2013 WL 816409 at *8.

[215] *Id.* at *1 (C.D. Cal. Mar. 5, 2013).

[216] *See Feyko,* 2013 WL 816409 at *1(naming Zhentao Gao as Yuhe's CEO, Chairman of the Board, and largest shareholder Hu Gang as Yuhe's CFO, and Jiang Yingjun as Yuhe's Chief Accounting Officer) (noting that "Gao, Gang, and Yingjun signed the Form 10-K" at issue, and "Gao and Gang signed its Sarbanes-Oxley certification" as well as the Sarbanes-Oxley certifications associated with the May 2011 Form 10-Q filing).

[217] *Feyko,* 2013 WL 816409 at *1-2(stating that Yuhe filed two Form 8-Ks, one From-10k Annual Report, one Prospectus Supplement, and a 10-Q over the two-year period in controversy affirming the acquisition of thirteen breeder farms).

acquisition as boosting Yuhe's broiler production capacity by over fifty percent.[218] Shortly thereafter, Yuhe's independent auditor resigned.[219]

Nevertheless, from October 20, 2010, to November 2, 2010, "Yuhe sold $4,140,000 newly-issued shares at $7 each pursuant to its second offering."[220] The prospectus supplement included prior statements about the Dajiang acquisition as well as auditor opinions from Yuhe's new auditing firm, Child, Van Wagoner & Bradshaw ("CVB").[221] The public offering was underwritten by a syndicate comprised of lead underwriter Roth Capital Partners and participating firms Brean Murray, Carret & Co. and Global Hunter Securities ("underwriters"). All underwriters received Yuhe shares pursuant to the public offering.[222]

The promotion of the Dajiang acquisition in Yuhe's SEC filings and related press releases prompted a response from Xuejing Zheng ("Zheng"), Chairman and General Manager of Dajiang.[223] On June 13, 2011, GeoInvesting reported Zheng's statement that Yuhe never purchased breeding farms from Dajiang.[224] Shortly thereafter, Yuhe's stock price plummeted to $1.96 and CVB resigned.[225] A securities class action suit was filed shortly thereafter.[226]

The plaintiffs (a class led by aAD Partners LP on behalf of various Yuhe common stock shareholders) filed a complaint alleging four main claims.[227] First, plaintiffs alleged that Yuhe, as well as Yuhe's CEO, CFO, and Chief Accounting Officer ("Yuhe officers"), violated Section 10(b)

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[218] *Feyko,* 2013 WL 816409 at *1.

[219] *Feyko,* 2013 WL 816409 at *1(identifying Yuhe's independent auditor as Grant Thornton).

[220] *Feyko,* 2013 WL 816409 at *1.

[221] *Feyko,* 2013 WL 816409 at *1.

[222] *Feyko,* 2013 WL 816409 at *1.

[223] *Feyko,* 2013 WL 816409 at *2.

[224] *Feyko,* 2013 WL 816409 at *1-2(describing the various conversations between Zheng and GeoInvesting representatives where Zheng initially claimed that Dajiang and Yuhe had never discussed the acquisition, but admitted a day later that the two did talk but Dajiang "did not proceed with this deal," alleging that the deal was actually a "fake deal" for Yuhe's U.S. listings).

[225] *Feyko,* 2013 WL 816409 at *3(citing the "Company's management's misrepresentation and failure to disclose material facts surrounding certain acquisition transactions and off-balance sheet related party transactions" as reason for resignation).

[226] *Id.* at *1.

[227] *Id.*

of the Exchange Act.[228] The plaintiffs then alleged that Yuhe's officers violated Section 20 of the Exchange Act.[229] Next, plaintiffs claimed that the underwriters violated Section 12(a)(2) of the Securities Act.[230] Lastly, the plaintiffs claimed that all defendants—Yuhe, Yuhe's officers, CVB, and the underwriters—violated Section 11 and 15 of the Securities Act.[231] Specifically, plaintiffs alleged that the fraudulent statements regarding the broiler farm acquisitions contained in Yuhe's SEC filings from December 31, 2009 to June 17, 2011 and resulting stock price drop "result[ed] in millions of dollars in investor losses."[232] The defendants moved to dismiss all claims, and Yuhe and its officers and underwriters moved to strike the plaintiff's class action complaint.[233]

B. Relevant Holdings

The court in *Feyko* denied and granted in part the defendant's motion to dismiss.[234] Specifically, the court rejected all of the defendant's motions except for the Section 10(b) claim against Yuhe's CFO, the Section 12(a)(2)[235] and Section 11 claims "of all subclass members whose Yuhe shares are only traceable to the second offering," and the Section 11 claim against the underwriters.[236] This Section focuses solely on the court's motion to dismiss the Section 11 claim against the underwriters. Specifically, this Section overviews at the court's (1) analysis of the underwriters' reasonable reliance defense, (2) justification for early dismissal, and (3) discussion of the plaintiff's characterization of certain facts as red flags.

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[228] *Id.*;15 U.S.C. § 78j (prohibiting fraudulent statements in the offer and sale of securities and requiring that defendants have a requisite "culpable state of mind," or scienter, to qualify for 10(b) liability).

[229] *Feyko,* 2013 WL 816409 at *1; 15 U.S.C. § 78t (providing for joint and several liability for defendants "who control or abet violators of the Exchange Act").

[230] *Feyko,* 2013 WL 816409 at *1; 15 U.S.C. § 77l (prohibiting all sellers of publicly registered securities from including false or misleading statements in offering documents or oral communications related to the sale of the securities at issue).

[231] *Feyko,* 2013 WL 816409 at *1; 15 U.S.C. §77k (*see* discussion *supra* Section II); 15 U.S.C. § 77o (providing for joint and several liability for "control persons" of defendants liable under §§ 77k, 77l).

[232] David McAfee, *Yuhe to Pay $2.7M to Settle $40M Stock Offering Row,* LAW360 (Jan. 6, 2014), https://www.law360.com/articles/499106.

[233] *Feyko,* 2013 WL 816409 at *1.

[234] *See Id.*

[235] *Id.*

[236] *Id.* (specifically stating that the 12(a)(2) claim of all subclass members are dismissed *with* prejudice).

The court in *Feyko* held that the underwriters met their burden of proving that they reasonably relied on expertised material during their due diligence.[237] In response to the plaintiff's Section 11 claim, the underwriters argued that the face of the complaint established their affirmative due diligence defense because it showcased that the underwriters' "work on the offering and prospectus relied on the auditors' financial statements and certified expert opinions."[238] Specifically, the underwriters pointed to the complaint's admittance that the 2009 10-K statements about the Dajiang acquisition incorporated in the prospectus supplement at issue were financial statements.[239] The complaint alleged that CVB audited the financial statements and that CVB "certified its expert opinion confirming that the financial statements contained no material misstatements."[240] The court found the underwriters' argument persuasive because the Section 11 reasonable reliance defense protects underwriters who reasonably rely on expertised material in due diligence, and affirmative defenses that clearly "appear on the face of the pleading" are entitled to dismissal.[241]

The court relied on the Ninth Circuit's *Software Toolworks* decision, stating that "an underwriter need not conduct due diligence into the 'expertised' parts of a prospectus, such as certified financial statements."[242] Furthermore, the court followed *Software Toolworks'* approach to determining whether an underwriter's reliance was reasonable or not, stating that an underwriter must only show that there was "no reasonable ground to believe, and did not believe" that the issuer's statements were untrue or contained an omission of material fact "necessary to make the statements therein not misleading."[243] Here, the court agreed with the underwriters that the plaintiffs did not plead any facts that would negate the underwriter's reasonable belief that CVB's statements about the Dajiang acquisition were correct.[244]

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[237] *See id.* at *8.

[238] Notice of Motion and Motion to Dismiss for Underwriters at *14 , *Feyko,* 2013 WL 816409 ("The Complaint reveals on its face that the Dajiang Acquisition – the sole misstatement allegedly contained in the Prospectus Supplement – was substantiated by CVB's audited and thus expertised financial statements").

[239] Notice of Motion and Motion to Dismiss for Underwriters at *14 , *Feyko,* 2013 WL 816409.

[240] *Id.* at *13.

[241] *Feyko,* 2013 WL 816409 at *8.

[242] *Id.* (quoting *In re Software Toolworks Inc.,* 50 F.3d 615, 623 (9th Cir.1994)).

[243] *Id.*; *In Re Software Toolworks,* 50 F.3d at 623.

[244] *Feyko,* 2013 WL 816409 at *8.

Although *Software Toolworks* analyzed an underwriters' due diligence defense at the motion for summary judgment phase of litigation, the court here nonetheless held that underwriters can establish Section 11 due diligence defenses at the motion to dismiss phase pursuant to the Federal District Court for the Central District of California's decision in *In Re Countrywide.*[245] The court explained that the tribunal in *In Re Countrywide* thought it appropriate for an underwriter to establish such a due diligence defense at this early stage of litigation because "underwriters may reasonably rely on auditors' statements, absent red flags that the underwriters were in a position to see."[246] And, while one recent decision[247] in the Federal District Court for the Central District of California's disagreed with *In Re Countrywide*, the *Feyko* court nonetheless agreed with *In Re Countrywide*'s opinion that underwriters have a "special place in Section 11 jurisprudence."[248]

While underwriter defendants have the burden of proving their due diligence defenses, the *Feyko* court held that plaintiffs carry the burden of pointing to red flags "that should have indicated to the underwriter that the financial statements were not trustworthy."[249] While the plaintiffs argue that "various red flags" existed, the court disagreed, stating that the complaint was "essentially silent about the underwriters."[250] The plaintiffs argued that two "red flag" situations should have notified the underwriters of the misleading statements included in the offering documents.[251] First, the plaintiffs argued that the resignation of Yuhe's previous auditor, Grant Thornton, was a red flag.[252] The court was unpersuaded by this argument, holding that "nothing in the disclosure

[245] *Feyko,* 2013 WL 816409 at *8 (quoting and agreeing with *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F.Supp.2d 1132, 1175 (C.D.Cal.2008)).

[246] *Feyko,* 2013 WL 816409 at *8 (quoting and agreeing with *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F.Supp.2d 1132, 1175 (C.D.Cal.2008))(holding that a defendant established its due diligence defense in the motion to dismiss phase)(disagreeing with *In re China Intelligent Lighting and Electronics, Inc. Sec. Litig.,* No. CV–112768– PSG (SSx), at * 11)(disagreeing with *In re Countrywide's* analysis on due diligence defenses in the motion to dismiss stage of litigation).

[247] *See In re China Intelligent Lighting and Electronics, Inc. Sec. Litig.,* No. CV–112768– PSG (SSx), at * 11.

[248] *Feyko,* 2013 WL 816409 at *8.

[249] *Id*; *In re Software Toolworks,* 50 F.3d at 623-24.

[250] *Id.* at 9.

[251] *See id.*

[252] *Id.*

regarding Grant Thornton's resignation would have alerted the Underwriter Defendants to the Dajiang deal being fraudulent"[253]

Second, the plaintiff argued that CVB's production of an audit opinion twenty-two days after Grant Thornton's resignation was a red flag.[254] The court disagreed, emphasizing that there was no evidence suggesting that twenty-two days is too quick a turnaround time for an audit opinion.[255] The court stated that whether twenty-two days was too quick depends on various factors like "how much information the auditors had to analyze, and how many auditors they devoted to the audit," which the plaintiffs did not allege.[256] Finally, the court emphasized that the 22-day period was "not particularly probative" because CVB worked for Yuhe for over a year before Grant Thornton's three-month stint as Yuhe's auditor.[257] Thus, the court held that CVB's long-term relationship with Yuhe indicated that the quick performance of an audit opinion was not a red flag.[258]

C. **Analysis**

This Section analyzes and critiques in part the holding in *Feyko* based on traditional informative and authoritative due diligence guidance. Specifically, this Section breaks the discussion of *Feyko* into three parts: (1) the court's assessment of the reasonableness of the underwriters' reliance (2) the court's finding of no red flags, and (3) the absence of verification considerations in the court's reasonable reliance analysis.

The court in *Feyko* correctly held that underwriters relying on audited financial statements contained in a registration statement do so reasonably as a matter of law, absent any red flags. First, the court correctly labeled audited financial statements as "expertised material" under Section 11.[259] Second, the court's deferential view of underwriters' reliance on expertised material in the

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[253] *Feyko,* 2013 WL 816409 at *9; *but see* cite P's response in n.6 (The Underwriter Defendants were fully cognizant of Grant Thornton's withdrawal and its accompanying explanation, i.e., the inability of Yuhe to comply with the Sarbanes-Oxley Act of 2002 and lack of internal accounting control, a conclusion Yuhe agreed with, yet which was missing from CVB's audit opinion"

[254] *See id.*

[255] *See id.*

[256] *Id.*

[257] *Id.*

[258] *Id.*

[259] *See* William K. Sjostrom, Jr., *The Due Diligence Defense under Section 11 of the Securities Act of 1933,* 44 BRANDEIS L. J. 17 (2006).

registration statement is consistent with authoritative judicial decisions like *Software Toolworks, In Re Countrywide,* and *In Re Worlds of Wonder Securities Litigation.*[260] Importantly, this holding aligns with policy considerations best expressed by Justice Powell in his dissenting opinion on the Supreme Court's denial of *certiorari* in *Sanders v. John Nuveen:* It is the experts—and "not those who rely in good faith on their professional expertise—who are at fault and who should be held responsible."[261] Speaking specifically about underwriters relying on certified financial statements like the underwriters in *Feyko,* Justice Powell emphasized that this kind of reliance is "essential to the proper functioning of securities marketing."[262] This view of reliance by underwriters on expertised material presumes that underwriters are not "customarily equipped to conduct granular due diligence into an issuer's quantitative and qualitative financial information," thus confirming the reasonableness of relying on experts.[263] Hence, the holding in *Feyko* is consistent with authoritative judicial guidance concerning reliance on audited financial information.

An analysis of informative academic commentary is also consistent with the holding in *Feyko.*[264] For example, Professor William K. Sjostrom, Jr.'s commentary on the reasonableness of an auditor's reliance on audited opinions echoes the policy promulgated by Justice Powell in *Sanders,* stating that it's the "auditors, not the underwriters, that have the expertise, resources and constant access to company information that are in the best position to uncover material omissions or misstatements in the financial statements."[265] Additional scholarship supports the holding in *Feyko,* stating that "[r]eliance on audited financial statements included in the registration statement will usually be reasonable as a matter of law, unless these statements contain serious "red flags" or discrepancies."[266]

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[260] *Id.* at 54-56; *See generally In re Software Toolworks,* 50 F.3d at 624(noting that underwriters were right to not question—and instead rely—on Deloitte's expertised material); *In re Countrywide,* 588 F.Supp.2d at 1175 (holding that underwriters may reasonably rely on on auditor's statements absent red flags); *In re Worlds of Wonder Sec. Lit.,* 814 F. Supp. at 850 (N.D. Cal. 1993).

[261] *See* Sanders v. John Nuveen, 450 U.S. 1005 at 1010 n. 4 (1981) (Powell, J. dissenting).

[262] *Id.*

[263] *Director & Underwriter Due Diligence in Securities Offerings, supra* note 9.

[264] *See* Sjostrom, *supra* note 70.

[265] *Id.* at 60.

[266] *See* Tony Rodriguez & Karen Petroski, *The Section 11 Due Diligence Defense for Director Defendants,* SEC. LIT. J., 13, 13-15 (2007), https://scholarship.law.slu.edu/cgi/viewcontent.cgi?article=1195&context=faculty.

However, the *Feyko* holding lacks meaningful analysis of the contextual factors that traditionally impact a finding of reasonableness. Informative guidance such as reports by the American Bar Association's Committee on Federal Regulation of Securities Task Force emphasizes that "'reasonableness' is meaningless except in a specific factual context."[267] The *Feyko* case is relatively quiet about the case-specific circumstances (beyond the physical location of the material misstatement in the audit opinion) affecting their determination of reasonable reliance.[268]

While situational context[269] supports the court's holding that the short turnaround time for CVB's audit opinion was not a red flag, the court's rejection of the plaintiff's argument that Grant Thornton's resignation was a red flag is inconsistent with recent due diligence guidance.[270] What is considered a "red flag" is unique to the context presented.[271] In *Feyko*, Grant Thornton's resignation came after only ninety days as Yuhe's independent auditor and less than a month before Yuhe filed its Form 10-k Annual Report.[272] Thornton's resignation was publicly disclosed, which put the underwriters "in a position to see."[273] Moreover, according to an early filing, Grant Thornton's resignation announcement had an accompanying explanation that allegedly cited Yuhe's failure "to comply with the Sarbanes-Oxley Act of 2002 and lack of internal accounting control" as reasons for resignation."[274]

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[267] Lawrence, *supra* note 4 (quoting the Committee on Federal Regulation of Securities, *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, BUS. L., Vol. 48 (May 1993) ("ABA Due Diligence Task Force Report") at 1232);

[268] *See Feyko,* 2013 WL 816409 at *8-9.

[269] *See* Lawrence, *supra* note 4 (describing situational context as "the size and complexity of the issuer and its business, the experience and skills of the persons involved, and the reservoir of knowledge already possessed by those engaged in the due diligence"); The situational context here is that CBV and Yuhe worked together for some time before Grant Thornton stepped in for three months. The court was sound in assuming that the past relationship between CBV and Yuhe may have created a "reservoir of knowledge already possessed" by CBV that could have reasonably expedited CBV's audit opinion timeline.

[270] *See How to Read an 8-K,* SEC: INVESTOR ALERTS & BULLETINS (Jan. 26, 2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/how-read-an8-k. (explaining that many situations involving a change in the issuer's independent auditor are "a cause for concern" or are "widely seen as red flags").

[271] *See Director & Underwriter Due Diligence in Securities Offerings, supra* note 9.

[272] *See Feyko,* 2013 WL 816409 at *1-2.

[273] *Id.* at *1, 8.

[274] *See* Lead Plaintiff's Memorandum in Opposition to Underwriters' Motion to Dismiss, *Feyko,* 2013 WL 816409 at n4.

Due diligence case law supports a finding that Grant Thornton's resignation was a red flag. In *Refco,* the bankruptcy examiner cited a CFO's resignation as a red flag that a defendant failed to look into.[275] Furthermore, the informative 1973 NASD Notice 73-17 lists the "[r]eview of all changes in auditors within the proceeding ten-year period if applicable and the reasons therefore" as a critical due diligence procedure.[276] In sum, the auditor's resignation in *Feyko* may be considered a red flag by some due diligence authority, and thus should have invited a factual inquiry beyond a motion to dismiss.

Conclusion

In sum, *Feyko* illustrates a rare decision[277] where underwriters successfully established a Section 11 reasonable reliance defense in the motion to dismiss phase of litigation.[278] The court's ruling discusses, among other things, the viability of an underwriter's due diligence defense in the motion to dismiss phase and offers guidance on what a court may not consider a red flag.[279] While the underwriters in *Feyko* were ultimately unsuccessful, the Section 11 motion to dismiss studied in this Case Note supports the idea that it is reasonable for underwriters to rely on audited opinions contained in a registration statement as a matter of law.

[275] *See* Final Report of Examiner, *In re Refco, Inc.,* Case No. 05-600006.

[276] NASD, Notice to Members 73-17, Proposed New Article III, Section 35 of the Rules of Fair Practice Concerning Underwriter Inquiry Standards Respecting Distributions of Issues of Securities to the Public (1973).

[277] While the Feyko court granted the underwriters motion to dismiss the Section 11 claims in March of 2013, the plaintiffs filed a new complaint against the underwriters. *See* Second Consolidated Amended Class Action Complaint, Feyko v. Yuhe Int'l, Inc., 2013 WL 3467067 (C.D. Cal. July 10, 2013). In July of 2013, a U.S. District Court denied the underwriters' new motion to dismiss, holding that the plaintiffs "adequately pled that the underwriters missed Yuhe's alleged false statements" about the breeder farms. McAfee, *supra* note 43. In 2014, the underwriters and CVB agreed to settle the claims for $2.7 million. *Id*.

[278] *See Feyko* 2013 WL 816409 at *8-9.

[279] *See id.*