

The Securities Act, Underwriters And the **Due Diligence** Defense

Today it can be key to avoiding liability.

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BECAUSE ISSUERS typically indemnify underwriters in securities cases, underwriters often rely on the issuer's counsel to lead the defense and negotiate any settlement. In booming, or even ordinary, economic times, this can be a financially sensible strategy. Issuers will pay the underwriters' defense and settlement costs but are loathe to pay underwriters' counsel to perform the same tasks that the issuer's counsel are handling. Likewise, issuers have little appetite to pay for the underwriters' unique defenses when such cases ordinarily settle based on issuers' almost strict liability under the Securities Act.

But the recent economic downturn reveals this strategy's potential flaw. With many issuers in or near bankruptcy, some underwriters now find themselves exposed, without any real indemnification, to Securities Act claims not subject to heightened scienter pleading standards.

In these circumstances, the due diligence defense moves to the fore. Proper due diligence provides underwriters with a complete defense under §§11 and 12 and adds leverage

to negotiate a cheaper settlement than in circumstances where an issuer who is subject to strict liability supplies a deep pocket.

Thus, it is prudent for underwriters to retain their own counsel and develop a due diligence defense at the litigation's outset, even if the issuer appears financially healthy. The marginal additional cost pales compared to the underwriters' potential exposure should the issuer be unable to honor its indemnity.

For example, underwriters for bankrupt WorldCom's 2000 and 2001 debt offerings paid more than \$6 billion to settle Securities Act claims after the court denied them summary judgment on the due diligence defense.

What Is the Due Diligence Defense?

Sections 11 and 12(a)(2) make underwriters liable for misstatements or omissions in registration statements and prospectuses regardless of knowledge or intent.¹ But both sections temper this liability with a "due diligence" affirmative defense.

Section 11's due diligence defense differs depending on whether an expert prepared and certified the registration statement's challenged portions. For so-called "expertised" registration statement sections, an underwriter is not liable where it "had no *reasonable ground* to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue" or contained material omissions.²

But for non-expertised portions of a registration statement, underwriters must go further and show that "*after reasonable investigation*, [the underwriter had] 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 omitted no material facts.³

Whether a particular statement is expertised therefore is a key inquiry under the due diligence defense. Audit opinions are the most common expertised registration statement materials. But not all accountant opinions incorporated into registration statements qualify for expertised treatment. Courts will usually afford such treatment to an accountant's opinion only if it is (i) an "audit opinion," (ii) "reported in the Registration Statement," and (iii) included with the accountants' consent.⁴ Thus, unaudited interim financial statements may not qualify for the more relaxed "expertised" standard.⁵

Nor can underwriters rely, without further investigation, on accountants' comfort letters to expertise interim financial statements.

In a comfort letter, the issuer's auditor represents that nothing has come to its attention during its review of unaudited interim financials indicating that they do not comply with applicable accounting rules. But such assurances do not expertise unaudited financial statements because comfort letters are not part of the registration statement and

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do not subject the auditor to §11 liability.⁶ While a comfort letter may be important to the underwriters' reasonable investigation, courts consider it "insufficient by itself to establish the [due diligence] defense."⁷

Section 12(a)(2) does not provide a laxer due diligence standard for expertised registration statement sections but provides a single due diligence defense for underwriters who demonstrate that "[they] did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."⁸ This is "similar, if not identical," to §11's reasonable investigation requirement.⁹ Under both sections, the requisite reasonableness is "that required of a prudent man in the management of his own property."¹⁰

Where Non-Expert Materials Involved

Surprisingly few decisions address what constitutes a "reasonable investigation." *Escot v. BarChris Construction Co.*¹¹ and *Feit v. Leasco Data Processing Equipment Corp.*,¹² each approximately 40 years old, remain leading authorities within the Second Circuit on the due diligence defense.

While recognizing that "it is impossible to lay down a rigid rule suitable for every case,"¹³ the *BarChris* court held that a reasonable investigation "require[d] more effort on the part of the underwriters than the mere accurate reporting...of 'data presented' to them by the company," concluding that "the underwriters must make some reasonable attempt to verify the [issuer's] data."¹⁴ The *BarChris* underwriters failed this test because they (i) accepted at face value management's documents and information and (ii) ignored readily available corporate documents contradicting management's statements.¹⁵

Feit followed the *BarChris* standard, requiring the underwriters to play "devil's advocate" to management, but found the underwriters' due diligence sufficient.¹⁶ Among other things, the *Feit* underwriters reviewed all the issuer's available financial data, independently examined audit and actuary reports, made "searching inquiries" of the issuer's major banks, and studied the issuer's corporate minutes, records and major agreements.¹⁷

More recent decisions echo these early authorities. For example, in *Phillips v. Kidder, Peabody & Co.*, the underwriters' due diligence was adequate because it included numerous discussions with outside directors, suppliers, customers, lending banks, accountants and lawyers; reviewing corporate documents (including key contracts); analyzing the issuer's industry; and investigating management and directors' backgrounds.¹⁸ But in *Ades v. Deloitte & Touche*, the court denied summary judgment where the underwriters failed to investigate independently issuers' major contracts or closely review the unaudited financial statements.¹⁹

For Financial Statements

Section 11's plain language makes clear that the registration statement's expertised sections require less rigorous due diligence than the non-expertised portions: On its face, the "expertised" defense requires no investigation. Indeed, the *BarChris* court indicated that underwriters' reliance on audited financial statements, without any affirmative investigation, was sufficient to avoid liability.²⁰

Unfortunately, the most recent Southern District decision, *In re WorldCom Inc. Securities Litigation*, may blur this distinction. Following *WorldCom*, plaintiffs' attorneys may argue that in certain instances, underwriters may be required to investigate even audited financial statements.

The *WorldCom* court rejected the underwriters' argument that they could "rely on WorldCom's audited financial statements" without further investigation unless they had "clear and direct" notice of an 'accounting' problem²¹ and held instead that "red flags" regarding audited financial statements' reliability require underwriters to do more.²² Those "red flags" could include "[a]ny information that strips a defendant of his confidence in" registration statement sections "premised on audited financial statements."²³

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The court identified two such potential red flags for WorldCom: a line-cost expense-to-earnings ratio (a key measure of a telecommunications company's financial health) that was significantly better than WorldCom's two main competitors' ratios and the absence of significant asset impairment charges that WorldCom's competitors incurred due to a general telecom sector decline.²⁴

While the court did not completely erase the distinction between audited and unaudited financial statements, plaintiffs' lawyers may seize on the opinion's broad language to argue that even seemingly insignificant issues are "red flags." Underwriters therefore may be wise to investigate even audited financial statements of an issuer whose financial performance stands out from its competition.

Best Practices for Underwriters

These judicial interpretations of the due diligence defense make it important

for underwriters' counsel, both during the transaction and in subsequent litigation, to focus closely on the underwriters' investigation. While a perfect investigation is not required,²⁵ prudent underwriters may adopt certain practices to bolster their defense.

Perform a rigorous investigation. Due diligence requirements differ for each offering. But authorities suggest that a reasonable investigation may include:

- (i) reviewing the issuer's SEC filings and other publicly available information;
- (ii) verifying management-supplied information through independent sources (such as customers, suppliers and distributors), where available;
- (iii) closely scrutinizing the issuers' corporate documents, financial statements and key contracts;
- (iv) interviewing the issuer's key employees and visiting its facilities;
- (v) discussing the issuer's accounting treatment (especially aggressive or unusual accounting) with inside and outside accountants;
- (vi) following up on issues that may require additional investigation; and
- (vii) staffing the due diligence team with experienced personnel knowledgeable about the issuer's industry.

Underwriters should apply the same standards to their due diligence investigation whether the offering is an initial public or secondary offering, a long-form, short-form, or shelf registration. While certain offerings (such as secondary offerings) may circumscribe the due diligence period, the "reasonableness" standards do not change. Short-form or shelf registration statements require underwriters to perform the same critical investigation as required for a traditional registration statement.²⁶

Underwriters who have a continuing relationship with an issuer, whether as an underwriter in a prior offering, a lender, or financial advisor, or generalized industry expertise may be able to rely on their pre-existing knowledge as part of their due diligence. The SEC has endorsed this view, suggesting that underwriters may rely on an advance "reservoir of knowledge," based on prior investigation and continuous diligence for short-form and shelf registration statements.²⁷

While no court has addressed this issue, underwriters will likely maximize their ability to rely on their knowledge reservoir if they can identify specific information they already possessed and its source, and show that due diligence personnel reviewed (and appropriately updated) the information.

Document all due diligence efforts. The most rigorous due diligence could prove worthless if not documented. Underwriters should document their efforts and consider preserving all due diligence records for at least three years after the securities are offered or sold.²⁸ Courts typically grant summary judgment only where the record "demonstrate[s] extensive

due diligence efforts,"²⁹ and a detailed written record will help meet this burden.

Underwriters must also consider the due diligence defense in crafting their discovery strategy. There is a tension between defendants' natural instinct to limit discovery and the disclosure that may show appropriate diligence. Because underwriters shoulder the burden of proof, limited discovery of diligence materials may disadvantage them more than plaintiffs. Thus, underwriters may find it prudent, although not necessary, to take a broad approach in creating their due diligence file and retain (and be prepared to produce) all notes, e-mails, memoranda and other documents concerning the offering.

Because underwriters commonly delegate portions of their investigation to their deal counsel, it may be prudent for them to assume that every document they create, mark up or review, even those ordinarily protected by attorney-client privilege, will be produced in discovery. The attorney-client privilege should safeguard privileged legal communications,³⁰ but plaintiffs' counsel may argue for a broad privilege waiver. In *RefCo*, the special master recently cautioned defense counsel that the underwriters might waive the privilege if their defense would rely on deal counsel's legal advice.³¹ Thus, separating files for legal advice and factual investigation may reduce waiver risks.

Carefully review financial statements. *WorldCom* suggests that underwriters should carefully review both audited and unaudited financial statements to identify aggressive or unusual accounting strategies and discrepancies between the issuer and its competitors. While these distinctions may not appear significant during the offering, they may seem more important in hindsight when a court evaluates the underwriters' diligence efforts. Underwriters should investigate potential "red flags" and verify that any accounting treatment is appropriate and the underlying information is correct.

Check for potential internal conflicts. Underwriters should check internally for any actions that, in hindsight, a court could view as inconsistent with the registration statement (such as short-selling securities of an issuer whose offering they are underwriting). If any such circumstances exist, the underwriters should determine whether additional disclosures or investigation are required.

Failing to address potential internal conflicts before an offering may weaken the due diligence defense. In *WorldCom*, the court denied summary judgment, in part, because several underwriters had internally downgraded *WorldCom*'s credit rating and were secretly reducing their *WorldCom* debt exposure while simultaneously underwriting *WorldCom* debt.³²

All underwriters should closely monitor due diligence efforts. Industry practice is for participating underwriters to rely on a lead

underwriter's due diligence. While the SEC has recognized that participating underwriters may delegate due diligence to a lead underwriter, it has cautioned that they first "must satisfy [themselves] that the managing underwriter makes the kind of investigation [they] would have performed if [they] were the manager" and "that the manager's...investigation...[is] adequate."³³

Indeed, §11 makes no distinction between participating and lead underwriters. If the lead underwriter's investigation is inadequate, all participating underwriters are potentially liable.³⁴

Consider retaining an accounting expert. Although *WorldCom* stopped short of requiring experts, the court observed that "a prudent underwriter may choose to consult with accounting experts to confirm that the [aggressive or unusual] accounting treatment is appropriate."³⁵ And courts have granted summary judgment to underwriters who both obtained a comfort letter and confirmed the issuer's accounting treatment with their own accounting expert.³⁶

Conclusion

In difficult economic times, underwriters may find that their due diligence defense is the only shield warding off §11 and 12 liability. Underwriters can strengthen their defense by working with counsel to implement prudent practices during the offering and developing a due diligence strategy at the litigation's outset.



1. See 15 U.S.C. §§77k, 77l(a)(2) (2009).
2. 15 U.S.C. §77k(b)(3)(C) (emphasis added).
3. 15 U.S.C. §77k(b)(3)(A) (emphasis added).
4. *In re WorldCom Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 664-65 (S.D.N.Y. Dec. 15, 2004).
5. *Id.* at 664.
6. *Id.* at 665-66 (internal quotation marks omitted).
7. *Id.* at 683.
8. 15 U.S.C. § 77l(a)(2) (emphasis added).
9. *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 621 (9th Cir. 1994).
10. 15 U.S.C. §77k(c).
11. 283 F. Supp. 643 (S.D.N.Y. 1968).
12. 332 F. Supp. 544 (E.D.N.Y. 1971).
13. *BarChris*, 283 F. Supp. at 697.
14. *Id.*
15. *Id.* at 694-696.
16. *Feit*, 332 F. Supp. at 582.
17. *Id.* at 582-83.
18. 933 F. Supp. 303, 318-19 (S.D.N.Y. 1996).
19. No. 90 Civ. 4959 (RWS), 1993 WL 362364, **20-21 (S.D.N.Y. Sep. 17, 1993).
20. *BarChris*, 283 F. Supp. at 697.
21. *WorldCom*, 346 F. Supp. 2d at 661, 679.
22. *Id.* at 672.
23. *Id.*
24. *Id.* at 679-80.
25. See *Feit*, 332 F. Supp. at 583.
26. *WorldCom*, 346 F. Supp. 2d at 669.
27. "Treatment of Information Incorporated by Reference into Registration Statements," Securities Act Release No. 33-6335, 1981 WL 31062, at *11-12 (Aug. 6, 1981).
28. See 15 U.S.C. §77m.
29. *WorldCom*, 346 F. Supp. 2d at 676-77 (discussing three cases granting underwriters summary judgment).
30. See Opinion, at 2-3, *In re RefCo Inc. Sec. Litig.*, No. 05 Civ. 8626 (JSR) (Jan. 4, 2010).
31. *Id.* at 3.
32. *WorldCom*, 346 F. Supp. at 649, 651.
33. "New High Risk Ventures," Exchange Act Release No. 34, 9671, 1972 WL 125474, at *6 (July 27, 1972).
34. *BarChris*, 283 F. Supp. at 697 (participating underwriters "who did nothing and relied solely on [lead underwriter]" were bound by their failure to conduct a reasonable investigation).
35. *WorldCom*, 346 F. Supp. 2d at 684.
36. *Toolworks*, 50 F.3d at 624.