

**HOW TO PREPARE AN
INITIAL PUBLIC OFFERING:**

DUE DILIGENCE AND POTENTIAL LIABILITIES

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I. THE STATUTORY SCHEME – AN OVERVIEW¹

The civil liability provisions of the federal securities laws were intended to create an incentive for full disclosure, and to compensate purchasers who were either denied the opportunity to review an accurate registration statement or who were provided with materially misleading investment information. The Securities Act of 1933 and the Securities Exchange Act of 1934 provide aggrieved purchasers and sellers of securities with several express and implied causes of action. The Appendix compares the principal elements of the most common claims, under sections 11 and 12(a)(2) of the Securities Act and section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

A. The Securities Act of 1933

1. Section 11(a) — liability for an untrue statement of material fact or omission of a material fact *in a registration statement*.
2. Section 12(a)(2) — liability for false or misleading statement or omission, *by prospectus or oral communication*, in the offer or sale of securities.
3. Section 12(a)(1) — liability for the offer or sale of securities in violation of section 5 of the Securities Act.
4. Section 17(a) - liability for fraud in the offer or sale of securities.
5. Section 15 - liability of control persons for primary violation under other sections.

B. The Securities Exchange Act of 1934

1. Section 10(b) and SEC Rule 10b-5 – an implied private action for materially misleading statements or omissions, or manipulative and deceptive devices, in connection with the purchase or sale of a security.
2. Section 18 – liability for false or misleading statements in any application, report or document required to be filed with the SEC under the Exchange Act.
3. Section 20(a) - liability of control persons.

C. Recent Developments

1. The Supreme Court issued two significant decisions in this area during its 2006 Term.

¹ Parts of this outline have been derived in significant part from prior outlines prepared for Practising Law Institute programs, and the authors express their gratitude to William F. Alderman of Orrick, Herrington & Sutcliffe LLP and Valerie Ford Jacob of Fried, Frank, Harris, Shriver & Jacobson LLP for their permission to use those materials.

- a. In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, ___ U.S. ___, 127 S. Ct. 2499 (June 21, 2007), the Court held that the requirement to plead facts supporting a “strong inference of scienter,” imposed by the Private Securities Litigation Reform Act of 1995, was to be interpreted strictly, requiring dismissal unless the inference of fraud that could be drawn from a complaint was at least as likely as any other possible inference.

Scienter is not an element of claims under sections 11 and 12(a) of the Securities Act of 1933, and the tightening of Rule 10b-5 pleading requirements reflected in the *Tellabs* decision could raise interest in bringing such '33 Act claims when they are available.

- b. In *Credit Suisse Securities (USA) LLC v. Billing*, ___ U.S. ___, 127 S. Ct. 2383 (June 18, 2007), the Court held that implied immunity barred claims under the federal antitrust laws challenging certain underwriting practices in initial public offerings because the antitrust laws were “clearly incompatible” with securities laws governing IPOs.

2. In December 2006, the Second Circuit reversed a class certification order in the long-running *IPO Securities Litigation*, pending in the Southern District of New York. The appellate court ruled that the class certification standard applied by the district court was too lenient, and it opened the door to the possibility of significant merits arguments being presented in opposition to class certification motions in future securities class actions. See *Miles v. Merrill Lynch & Co., Inc. (In re IPO Sec. Litig.)*, 471 F.3d 24, 41-45 (2d Cir. 2006), *rehearing denied*, 483 F.3d 70 (2d Cir. 2007).

- a. Notably, in concluding that plaintiffs had failed to establish the reliance element of their class claims, the Second Circuit in *IPO* held that “the market for IPO shares is not efficient” and therefore that the “fraud on the market” presumption spelled out in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), was inapplicable in that context. *Id.* at 42.
- b. Since the Second Circuit decision, the Fifth Circuit has issued two decisions reversing class certification orders in securities class actions on the ground that plaintiffs had failed to establish the applicability of the “fraud on the market” presumption of reliance under the facts at issue, including a case arising out of the Enron litigation. See *Oscar Private Equity Investments v. Allegiance Telecom Inc.*, 487 F.3d 261 (5th Cir. 2007); *Regents of University of Calif. v. Credit Suisse First Boston (USA) Inc.*, 482 F.3d 372 (5th Cir. 2007).

- c. At least one district court also has applied the *IPO* holding to dismiss Rule 10b-5 claims based on an IPO registration statement, concluding that plaintiffs had failed to allege facts that would give rise to the “fraud on the market” presumption of reliance. *See In re Converium Holding AG Sec. Litig.*, No. 04 Civ. 7897 (DLC), 2006 WL 3804619 (S.D.N.Y. Dec. 28, 2006). The court later clarified that 10b-5 claims could proceed on behalf of investors who purchased their shares in the aftermarket, however.
3. In March 2007, the Supreme Court granted certiorari to review the 8th Circuit’s decision in *Charter Communications*, in which the appellate court dismissed securities fraud claims against third-party equipment vendors that were based on a “scheme liability” theory that had been applied by some courts as a way around the prohibition on private claims for aiding and abetting securities fraud that was articulated by the Supreme Court in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). The case will provide the Court an opportunity to resolve an important issue for investment banks and other third parties who, since *Central Bank*, have been sued as alleged “primary violators” under the securities laws for conduct that has many hallmarks of “aiding and abetting” another person’s fraud. *See Stoneridge Investment Partners LLC v. Scientific Atlanta Inc.*, 127 S. Ct. 1873 (Mar. 26, 2007).
4. Since 2002, decisions in cases concerning noteworthy corporate scandals have reexamined and, in the view of some commentators, redefined standards of liability for issuers, underwriters and their professional advisors under the Securities Act and the Exchange Act, perhaps most notably in the *Enron* and *WorldCom* cases.
5. In its 2005 decision in *Dura Pharmaceuticals*, the Supreme Court strongly reemphasized the importance of “loss causation” to claims of securities fraud under the Exchange Act. Since that decision, “loss causation” arguments have been considered in dozens of securities class actions, with varying results.
6. In December 2005, the Securities and Exchange Commission’s securities offering reform rules became effective. *See* SEC Release Nos. 33-8591, 34-52056, 70 Fed. Reg. 44722 (Aug. 3, 2005). The rules impact potential liabilities for offering participants in a number of ways.

II. THE DUE DILIGENCE PROCESS: A PRACTICAL GUIDE²

The term “due diligence” is used generally in the corporate finance context to refer to the process of investigating a company’s business, legal and financial affairs – in preparation for a

² *See* Valerie Ford Jacob, “The Due Diligence Process from the Underwriters’ Perspective,” Practising Law Institute, June 2007.

possible transaction. In securities offerings, the due diligence investigation enables the underwriters to gain a clear understanding of the issuer and its business, to assess the risks associated with the proposed transaction and, perhaps most importantly, to confirm the statements made in the offering document in order to avoid liabilities under the securities laws based on incorrect, incomplete or misleading disclosure.

A thorough due diligence investigation is particularly important in the case of an initial public offering in view of the lack of a substantial body of publicly available information about the issuer. Thorough due diligence before an initial public offering also can provide underwriters with significant defenses.

It is difficult to establish a uniform set of due diligence procedures for all transactions. The determination of how much diligence is necessary or appropriate or what constitutes a “reasonable investigation” will generally vary depending on the specific facts and circumstances of each offering and each issuer. Steps that are appropriate for one offering may not be appropriate for another. This set of guidelines is intended to provide a general introduction to the due diligence process. In any particular situation though, the due diligence investigation must be designed to accomplish the identified objectives while taking into account the specifics of the proposed transaction. Although the due diligence process often begins as a “standardized” process, due diligence is, by its nature, a constantly evolving process and is largely driven by facts and circumstances. On any given transaction, certain areas may expand in importance while others become of lesser concern.

The due diligence process will generally include the following elements:

- background due diligence,
- business due diligence,
- financial due diligence,
- accounting due diligence,
- legal due diligence, and
- corporate governance/Sarbanes-Oxley due diligence, if appropriate.

A. Background Due Diligence

Before starting any due diligence investigation, it is important to be well informed about both the transaction and the issuer that is being reviewed. A good starting point for conducting due diligence is to tap into public sources of information. Lexis/Nexis or Westlaw searches of newspaper and magazine articles about the company, its management and its industry, as well as Google or similar searches should be done as early as possible in the timeframe for an offering. In addition, underwriters and their counsel should review other public sources of information about a company and its industry such as:

- Analyst and rating agency reports on the company or industry sector
- The company's web site (which may include archived press releases and investor presentations)
- For secondary offerings, the company's SEC filings (10-K's, 10-Q's, 8-K's and prior

- registration statements and comment letters), and prospectuses and SEC filings of companies in the same industry
- Other public regulatory filings
 - Press releases or articles regarding the company or the industry
 - Public information about the country in which the company conducts most of its business if outside the United States
 - Industry-specific magazines and trade journals

B. Business Due Diligence

The underwriters will also engage in a formal business due diligence process. In general, the underwriters and their counsel should regularly communicate with each other about issues they each uncover during the due diligence process. Business due diligence may include some or all of the following elements:

- interviews with senior management of the company (and former officers, if applicable)
- background checks of management
- interviews with the company's middle management, such as officers in charge of marketing, sales, human resources, production, manufacturing or other core areas
- site tours of the company's principal facilities or retail locations
- interviews with the company's principal customers, suppliers, lenders or other business partners

An important part of the business due diligence process is the opportunity to ask the company's management specific questions about different aspects of the business. These questions may include issues related to the company's background and history, products and services, the market in which the company competes, research and development, sales and marketing and information systems, in addition to a wide range of other items. As part of this process, it is often a good idea to ask the same question to different people at different levels of management. (You will surprisingly often get different answers to the same questions.) Interviews with the company's customers, suppliers, lenders and other business partners are also an important part of the due diligence process and should ideally be conducted outside of the presence of management.

In some transactions the underwriters may retain specialized consultants to assist with the investigation of particularly specialized matters. For example, the underwriters may retain retail consultants to tour and evaluate a new distribution center, information systems consultants to evaluate the company's systems or environmental consultants to evaluate potential clean-up sites. The underwriters and their counsel should follow up with the company or other appropriate persons on issues raised by outside consultants.

Another important part of the due diligence process is making sure that the underwriters and underwriters' counsel have received adequate backup for industry statistics, market share and similar data included in the prospectus. The underwriters' counsel should distribute a "backup request" to the issuer and issuer's counsel asking for backup for particular numbers and qualitative phrases such as statements regarding the company's market share or leading position in a particular area. This information will enable the deal team to draft more accurate disclosure. In addition, the SEC frequently asks for backup support for statements in the prospectus, and therefore it is helpful to have gathered this information prior to the initial filing.

C. Financial Due Diligence

Financial due diligence is often conducted by investment bankers and the in-house financial staff. It is also important for lawyers to participate in this process and understand the financial status of the company and the major issues presented by the company's financial statements. This is particularly true in the context of a securities offering, where lawyers often become involved in drafting and understanding the management's discussion and analysis section of the offering document in which the company explains its financial results for the prior periods and also discusses any items that could have a material impact on future results.

Financial due diligence typically includes:

- a review of the company's historical and pro forma financial statements (including all footnotes), including
 - any material changes from the previous year's reporting period (including any changes in accounting principles), and the reasons for these changes
 - significant items on the financial statements
 - any recent or anticipated restatements, impairments or other charges
 - unusual or non-recurring items
 - acquisitions and divestitures and any related goodwill amortization
 - contingencies / contractual obligations
 - litigation / legal matters
 - derivatives and hedging
 - reserves and significant estimates
 - potential compensation charges as a result of cheap stock issues and other issues
 - reversals of accrued liabilities.
 - off-balance sheet or under-recorded liabilities and contingencies, including in particular potential employee benefit plan liabilities (unfunded pension plans) and worker's compensation liabilities.
- Management's Discussion & Analysis ("MD&A")
 - known trends and projections
 - critical accounting policies
 - results of operations and factors for material changes from period to period
 - related party transactions

- a review of the company's projections, including current and past internal budgets
- a review of credit facilities and a determination of whether the offering will violate any of the issuer's existing financial covenants

As part of the financial due diligence process, particularly in the case of an initial public offering, bankers will review in detail the company's projections and business model with the company's CFO and financial management. Underwriters' counsel should also be involved in the process given the importance of these data points to understanding the future growth and direction of the company. Bankers should analyze the reasonableness of the assumptions underlying the projections in order to determine whether the business model is realistic. As part of this process, bankers will often review a base case model, a best case model and a worst case model. Review of projections will frequently result in modifications or enhancements to the description of the company's business strategy and MD&A in the prospectus.

Bankers should also review the company's capital expenditure plans (for maintenance and for growth) and consider when any large cash outlays by the company may be required. Both bankers and lawyers should verify whether the company's credit facilities need to be amended in order to allow the company to achieve its business plan. The capital expenditures covenants may limit the company's expansion plans. Bankers should also calculate whether the offering will cause the company to violate any financial covenants in the company's financing documents and thereby require amendment as a condition to closing.

When dealing with non-U.S. issuers, bankers should also focus on differences between U.S. and non-U.S. GAAP. Significant differences may involve:

- revenue recognition
- goodwill
- pension accounting
- accounting for stock options
- treatment of derivatives

D. Accounting Due Diligence

The bankers and lawyers should interview the company's principal accountants and, where material, accountants of acquired entities. Principal topics of discussion may include:

- the company's accounting policies generally,
- the company's revenue recognition and capital expenditures policies,
- potential disagreements with the company,
- consistency of the company's accounting policies with industry norms,
- issues regarding any material weaknesses or significant deficiencies,
- off-balance sheet liabilities, if any,
- the company's liquidity position,
- significant write-offs, if any, and
- proposed changes in the accounting rules or accounting literature which could impact the company's financial statements.

Accountants will also provide a comfort letter to the underwriters which is an important part of the underwriter's due diligence defense. The principal purpose of a comfort letter is to provide assurance that the financial information in an offering document is accurate and has been independently verified. The contents of the comfort letter are governed by Statement of Auditing Standards No. 72 ("SAS 72"). One significant part of the comfort letter is the bring-down of the company's income statement and balance sheet since the most recent balance sheet date included in the registration statement. This is an important mechanism for verifying how the company is doing in the most recent months. It is extremely important for the underwriters and their counsel to consult prior to the pricing on any negative information which emerges in the accountants' bring-down of the financial statements in the comfort letter.

Underwriters should also consider having a discussion with the chairman or a member of the audit committee. Any such discussion may include the following topics:

- the structure of the audit committee,
- the audit committee's meeting process, review of financial data and line of communication with the company,
- any significant issues encountered by the audit committee,
- the audit committee's review process for periodic reports and monthly statements,
- the audit committee's review of internal controls,
- the audit committee's review of any off-balance sheet liabilities and contingencies,
- the mechanism used by the audit committee to select the auditors,
- any process for meeting with auditors without management,
- the company's critical accounting policies,
- any related party transactions,
- the impact of any new accounting or SEC pronouncements on the company's financial statements,
- any issues relating to options backdating,
- the level of communication between management and the audit team,
- any significant accounting issues that have arisen in connection with the most recent periodic reports,
- any material issues discussed at the most recent meetings,
- the audit committee's review of compensation-related matters including stock options backdating,
- the audit committee's review of taxes and tax reserves and
- any significant disagreements between the audit committee and the auditors or between the audit committee and management.

E. Legal Due Diligence

Legal due diligence is generally led by the underwriters' counsel and closely monitored by the banking team. It is a document intensive process that is framed by a legal due diligence request list that is normally generated by underwriters' counsel. The due diligence request list may include and require review of some or all of the following:

- minutes of board of directors (and any subcommittees) of the company and principal subsidiaries
- lawyers' letters to accountants
- any reports to management or the audit committee from accountants
- charters and bylaws
- stockholders agreements, registration rights agreements, warrants, preferred stock and other documents relating to the company's outstanding securities
- indentures, loan agreements and credit facilities
- other material business contracts
- employment agreements, stock option plans and stock purchase plans
- D&O questionnaires
- Correspondence with the SEC or other regulators (including comment letters and responses)

Attorneys also typically review the company's outstanding litigation and, where necessary, will interview outside counsel handling any principal litigation. Other areas where attorneys may provide particular expertise in due diligence include:

- tax diligence, particularly involving IRS investigations,
- intellectual property and a review of the company's licensing agreements,
- employee benefit plans and stock option plans,
- special regulatory issues, involving telecommunications, environmental or other areas, and
- government, antitrust, SEC or other investigations of the company's business.

The underwriters' counsel is usually responsible for negotiating the representations and warranties in the underwriting agreement. These negotiations will often raise due diligence issues and lead to further discussions if the company is unable to make standard representations.

The underwriters' counsel also typically provides a 10b-5 opinion to the underwriters that states that counsel is not aware of any material misstatement or material omissions in the time of sale information package (i.e., generally the preliminary prospectus together with a final term sheet or oral conveyance of final terms) as well as the final prospectus. The underwriters will receive a similar opinion from the issuer's counsel. The receipt of these opinions is a critical part of the underwriters' due diligence record.

F. Corporate Governance/Sarbanes-Oxley

In light of the passage of Sarbanes-Oxley Act and the SEC rules promulgated thereunder, underwriters may also consider engaging in a due diligence review of the corporate governance

policies of the company. Underwriters could focus on, among other things, the following topics in discussions with the company:

- filing of CEO/CFO certifications under Section 302 and Section 906 of the Sarbanes-Oxley Act,
- the company's disclosure controls and procedures and internal controls,
- the company's code of ethics and any exemptions to the code,
- the company's whistleblowing procedures,
- any loans from the company to management,
- the composition of the audit committee and whether there is a "financial expert" on the audit committee,
- the composition of a nominating committee, if applicable,
- the independence of the members of the Board in general
- the company's internal audit function,
- the company's document retention policy,
- any non-audit services provided by the company's independent auditors,
- any restatements of the company's financial statements,
- any unresolved comments from the SEC in connection with any filing,
- any off-balance sheet transactions, and
- any non-GAAP financial information in its '34 Act reports or press releases.

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Underwriters should participate in the offering process with a healthy amount of "skepticism" about the claims of management. In evaluating underwriter due diligence, courts have in general looked favorably on underwriters that followed up on red flags when they were detected. It is important to not simply rely on the statements of management but to verify those statements as part of the due diligence process. The underwriters should explain to the company in advance of the offering that the due diligence effort is aimed at creating a more accurate disclosure document (which benefits the company as well as the underwriters) in addition to helping the underwriters establish a sufficient due diligence defense.

III. THE PRINCIPAL CLAIMS IN IPO SECURITIES LITIGATION

A. Section 11 of the Securities Act

Section 11 imposes a "stringent standard of liability" on parties directly involved with a registered offering. *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 657 (S.D.N.Y. 2004) (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983)). It provides that signers of a registration statement, directors, accountants, experts and underwriters may be held liable for any materially misleading statement or omission in that registration statement. 15 U.S.C. § 77k.

For purposes of section 11, a "registration statement" includes the prospectus and other information required by section 7 of the Securities Act and the regulations promulgated thereunder. *See* 12 C.F.R. § 16.2(m); 17 C.F.R. §§ 210 *et seq.* (Regulation S-X); 17 C.F.R.

§§ 229 *et seq.* (Regulation S-K). Liability under section 11 arises only for statements that were false or misleading at the time the registration statement became effective. 15 U.S.C. § 77(a).

Section 11 does not apply to oral communications or preliminary prospectuses. *In re Lyondell Petrochemical Co. Sec. Litig.*, 984 F.2d 1050 (9th Cir. 1993); *In re Sterling Foster & Co., Inc. Securities Litigation*, 222 F. Supp. 2d 216, 267 (E.D.N.Y. 2002). Aftermarket statements, which include “roadshow” presentations, analyst reports, and statements to institutional investors during conference calls, also generally are outside the reach of section 11. *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1405 (9th Cir. 1996); *Castlerock Mgmt., Ltd. v. Ultralife Batteries, Inc.*, 68 F. Supp. 2d 480, 484 (D.N.J. 1999); *Rhodes v. Omega Research, Inc.*, 38 F. Supp. 2d 1353, 1360 n.8 (S.D. Fla. 1999).

1. Elements of Section 11 Claims

- a. **Misstatement or Omission.** The central element of a section 11 claim is a misrepresentation of material fact in a registration statement, or the omission of a material fact necessary to make the statements therein not misleading. 15 U.S.C. § 77k.
 - (1) As discussed further in other outlines, the SEC has issued regulations concerning the information that must be included in registration statements. Regulation S-X, 17 C.F.R. §§ 210 *et seq.*, governs the form and content of financial statements that must be included with a registration statement and Regulation S-K, 17 C.F.R. §§ 229 *et seq.*, specifies the non-financial information that must be included in a registration statement. In addition, the SEC’s general regulations state that in addition to the information specifically required to be included in a registration statement, further material information shall be added as necessary to make the required statements not misleading. 17 C.F.R. §§ 230.408.
 - (2) SEC regulations and the expressed views of the SEC are not dispositive of issues that a private plaintiff must establish to recover under the securities laws. However, in assessing liability under section 11, courts have looked to these SEC regulations (among other sources) to determine whether a registration statement contains misstatements or omissions. *See DeMaria v. Andersen*, 318 F.3d 170, 180 (2d Cir. 2003) (the fact that the defendant had complied with a specific section of Regulation S-X did not end inquiry for liability under section 11; disclosure had to be evaluated under catch-all provision of 17 C.F.R. §230.408); *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1297-98 (9th Cir. 1998) (“any omission of facts ‘required to be stated’ under Item 303 will produce liability under section 11.”); *In re N2K, Inc. Securities Litigation*, 82 F.

Supp. 2d 204, 207 (S.D.N.Y. 2000) (the “relevant SEC regulations answer the question as to what material facts are required to be stated in an issuer’s registration statement and prospectus”).

(3) In the securities offering reform rules, the SEC adopted Rules 430B and 430C governing the filing of prospectus supplements. Under these rules, information included in a prospectus supplement will be deemed to be part of the registration statement for purposes of liability under section 11 in certain circumstances:

a. The general rule: all information included in a prospectus supplement will be deemed part of the registration statement as of the date that the prospectus supplement is first used, *see* 17 C.F.R. § 230.430C(a);

b. Exception: For prospectus supplements filed in connection with a shelf registration takedown, all information in the prospectus supplement will be deemed part of the registration statement as of the earlier of the date it is first used or the time of the first contract of sale of securities in the offering to which the prospectus supplement relates, *see* 17 C.F.R. § 230.430B(f).

b. ***Standing.*** Plaintiffs who acquire shares in an IPO have standing to sue under section 11 for false or misleading statements in the registration statement. The standing of aftermarket purchasers, however, has been a subject of significant debate over the last 10 years.

(1) Before 1995, plaintiffs who could show that their securities were directly traceable to the challenged offering could state a claim under section 11. *See, e.g., Kirkwood v. Taylor*, 590 F. Supp. 1375, 1378-83 (D. Minn. 1984). Beginning in 1995, some question was raised about whether “tracing” was available under section 11 because of the decision of the Supreme Court in *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), which considered who had standing under section 12(a)(2) of the Securities Act.

(2) More recently, however, courts have come to agree that *Gustafson* does not bar section 11 claims by aftermarket purchasers and that a section 11 plaintiff can establish standing by tracing. *DeMaria v. Andersen*, 318 F.3d 170,

178 (2d Cir. 2003); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 873 (5th Cir. 2003); *Lee v. Ernst & Young, LLP*, 294 F.3d 969, 974-75 (8th Cir. 2002); *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999).

- (3) While it now appears to be settled that “tracing” will be allowed for certain aftermarket purchasers, the standard of proof required for a given plaintiff or class of plaintiffs to trace their shares to an allegedly misleading registration statement remains the subject of significant litigation. In *Krim v. pcOrder.com, Inc.*, 402 F.3d 489 (5th Cir. 2005), the Fifth Circuit affirmed the dismissal of a class action asserting section 11 claims where the remaining named plaintiffs had purchased their shares in the aftermarket, rather than in the challenged offerings. Finding that at the time of the plaintiffs’ purchases, the issuer’s outstanding shares were not exclusively shares that had been issued in those offerings (because the market included, *inter alia*, insider shares), the court rejected plaintiffs’ attempt to “trace” to the challenged registration statements through a statistical analysis and held that the plaintiffs bore the burden of establishing that *all* of their shares were traceable to the offering as to which the registration statement was alleged to contain false or misleading statements. *Id.* at 497-98; *see also In re Dynegy, Inc. Sec. Litig.*, 2005 WL 807076 at *2 (S.D. Tex. May 10, 2005) (following *Krim*); *In re Initial Public Offering Sec. Litig.* 227 F.R.D. 65, 117-18 (S.D.N.Y. 2004) (limiting class period for section 11 claims to period from offering until other shares entered the aftermarket), *rev’d on other grounds, Miles v. Merrill Lynch & Co., Inc.*, 471 F.3d 24 (2d Cir. 2006).
- (4) Since *Krim*, a number of district courts have dismissed section 11 claims based on the failure of the named plaintiffs to allege that their aftermarket shares were traceable to a challenged registration statement. *See In re Authentidate Holding Corp.*, 2006 WL 2034644, at *7 (S.D.N.Y. July 14, 2006); *Davidco Investors, LLC v. Anchor Glass Container Corp.*, 2006 WL 547989, at *22-23 (M.D. Fla. Mar. 6, 2006) (following *Krim* and granting motion to dismiss under Rule 12(b)(1) for lack of subject matter jurisdiction); *In re Friedman’s Inc. Sec. Litig.*, 385 F. Supp. 2d 1345, 1371-72 (N.D. Ga. 2005) (dismissing section 11 claims against underwriter defendant where plaintiffs did not allege purchases traceable to first of two registration statements as to which it had acted as

underwriter); *In re Alamosa Holdings Inc. Sec. Litig.*, 382 F. Supp. 2d 832, 864 (N.D. Tex. 2005) (granting motion to dismiss despite conclusory allegation that named plaintiff purchased shares “traceable” to registration statement); *see also In re Exodus Comms. Inc. Sec. Litig.*, 2006 WL 1530081 (N.D. Cal. June 2, 2006) (granting summary judgment based on expert opinion that named plaintiff’s shares could not be traceable); *but see Freeland v. Iridium World Comms. Ltd.*, 233 F.R.D. 40 (D.D.C. 2006) (certifying subclass of aftermarket purchasers despite difficulty in establishing standing through tracing).

c. ***Limited Class of Defendants.*** Section 11(a) does not provide for a private cause of action for aiding and abetting a violation of the statute and limits the persons who may be sued under section 11 to the following:

- (1) Every person who signed the registration statement;
- (2) Every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his or her liability is asserted;
- (3) Every person who, with his or her consent, is named in the registration statement as being or about to become a director, person performing similar functions or partner;
- (4) Every accountant, engineer or appraiser, or any person whose profession gives authority to a statement made by him or her, who has with his or her 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 or her;
- (5) Every underwriter with respect to such security.

d. ***Reliance.***

- (1) The general rule is that a plaintiff need not allege reliance on an alleged misrepresentation or omission to state a claim under section 11. *See, e.g., Sherman v. Network Commerce, Inc.*, 94 Fed. Appx. 574, 575 (9th Cir. 2004).

- (2) Exception: Reliance Required After Twelve Month Earnings Statement. Section 11(a) provides that if the plaintiff “acquired the security after the issuer has made generally available to its security holders an earnings statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.” 15 U.S.C. § 77k(a).

Materiality. Plaintiff must allege and prove that the alleged misstatement was of a material fact. A fact is material if there is a substantial likelihood that a reasonable investor would attach importance to it in determining whether to purchase the security. *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *see also Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). Materiality is a mixed question of fact and law. Because materiality involves a fact-intensive inquiry, a registration statement or prospectus must be read as a whole. *DeMaria v. Andersen*, 318 F.3d 170, 180 (2d Cir. 2003); *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 658 (S.D.N.Y. 2004). The touchstone of the inquiry is whether the defendants’ representations or omissions, considered together in context, would affect the total mix of information available to the public and thereby mislead a reasonable investor. *Halperin v. ebanner Usa.com, Inc.*, 295 F.3d 352, 357 (2d Cir. 2002); *WorldCom*, 346 F. Supp. 2d at 658.

Some courts have held that information required to be disclosed by Regulation S-K is presumptively material. *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1296 (9th Cir. 1998); *In re Initial Public Offering Sec. Litig.*, 358 F. Supp. 2d 189, 211 (S.D.N.Y. 2004).

If alleged omissions are so obviously unimportant to investors that reasonable minds could not differ on the question of materiality, then the court may rule such omissions to be immaterial as a matter of law. *Klein v. Gen. Nutrition Co.*, 186 F.3d 338, 342-343 (3d Cir. 1999); *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 546 (8th Cir. 1997); *In re Stac Electronics Sec. Litig.*, 89 F.3d 1399, 1405 (9th Cir. 1996); *In re Alliance Pharm. Corp. Sec. Litig.*, 279 F. Supp. 2d 171, 188 (S.D.N.Y. 2003); *In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371, 408 (S.D.N.Y. 2001).

On the other hand, when a material fact is disclosed but “where the method of presentation obscures or distorts the significance of material facts, a violation of Section 11 will be found.”

Greenapple v. Detroit Edison Co., 618 F.2d 198, 205 (2d Cir. 1980); *I. Meyer Pincus & Assoc., P.C. v. Oppenheimer & Co., Inc.*, 936 F.2d 759, 761 (2d Cir. 1991).

- e. **Negative Causation.** Unlike claims for securities fraud under section 10(b) of the '34 Act and Rule 10b-5, a section 11 plaintiff is not required to establish loss causation to establish liability under section 11. *See generally In re Worlds of Wonder Securities Litigation*, 35 F.3d 1407, 1421-22 (9th Cir. 1994); *Lincoln Adair v. Kaye Kotts Assoc., Inc.*, 1998 WL 142353, *7 (S.D.N.Y. Mar. 27, 1998). However, a section 11 defendant can refute liability in whole or in part by demonstrating the absence of loss causation, as discussed further below. *See* 15 U.S.C. § 77k(e).
- f. **Statute of Limitations.** A section 11 claim must be brought within one year of discovery or constructive knowledge of the misstatement or omission and in no event later than three years after the security was offered to the public. 15 U.S.C. § 77m.

A section 11 plaintiff must establish that the claim is not time-barred by alleging: (1) the time and circumstance of the discovery of the misstatement or omission; (2) the reasons why it was not discovered earlier; and (3) the efforts taken by plaintiff in making or seeking such discovery. *See Dorchester Investors v. Peak Int'l Ltd.*, 134 F. Supp. 2d 569, 578 (S.D.N.Y. 2001). The three-year limitation is not subject to equitable tolling for alleged fraudulent concealment by defendant. *See In re Enron Corp. Securities, Derivative & “ERISA” Litig.*, 310 F. Supp. 2d 819, 856-859 (S.D.Tex. 2004) (collecting cases). The extended statute of limitations set forth in section 804 of the Sarbanes-Oxley Act does not apply to claims brought under section 11. *See In re WorldCom, Inc. Sec. Litig.*, 308 F. Supp. 2d 214, 225 (S.D.N.Y. 2004); *Stephenson v. Deutsche Bank AG*, 282 F. Supp. 2d 1032, 1067 (D. Minn. 2003).

2. **Affirmative Defenses Under Section 11**

- a. **Plaintiff’s Knowledge.** A plaintiff may not recover under section 11 if at the time of the challenged security transaction he knew the true facts concerning the alleged misrepresentation or omission. 15 U.S.C. § 77k(a). This was a significant factor in the Second Circuit’s decision reversing class certification in *IPO Securities*, in which plaintiffs alleged that allegedly misleading IPO allocation practices were widespread and well-known. *See*

Miles v. Merrill Lynch & Co., Inc. (In re Initial Public Offering Sec. Litig.), 471 F.3d 24, 43 (2d Cir. 2006).

- b. **No Causation.** A defendant may limit or eliminate section 11 damages by proving that plaintiffs losses were caused by factors other than the alleged misstatement or omission. 15 U.S.C. §77k(e).

Although “but for” causation is an affirmative defense for section 11 claims, as to which the defendant bears the burden of proof, some courts have dismissed section 11 claims when the complaint on its face establishes “negative causation.” *See, e.g., In re Alamosa Holdings, Inc. Sec. Litig.*, 382 F. Supp. 2d 832, 865-66 (N.D. Tex. 2005); *Davidco Investors LLC v. Anchor Glass Container Corp.*, 2006 WL 547989, at *25 (M.D. Fla. Mar. 6, 2006) (collecting cases). Other courts have refused to dismiss section 11 claims on this ground, however. *See In re WRT Energy Sec. Litig.*, 2005 WL 2088406, at *2 (Aug. 30, 2005) (on reconsideration, denying motion to dismiss section 11 claims for negative causation, holding that “[t]o conclude otherwise places a burden of pleading loss causation on plaintiffs and removes the burden of establishing negative causation from the defendants, where it properly lies”).

There is some support for the proposition that the standard required to establish causation under section 11 is more lenient than the loss causation standard under section 10(b). *See Garbini v. Protection One, Inc.*, 49 Fed. Appx. 169, 170 (9th Cir. 2002) (reversing dismissal of section 11 claim on loss causation grounds).

- c. **Due Diligence.** Defendants other than the issuer can avoid liability under section 11 if they establish that they acted reasonably in disseminating the portions of the registration statement for which they were responsible. 15 U.S.C. § 77k(b). This “due diligence defense” is discussed at length in the following subsection.

3. **The Due Diligence Defense**

- a. **Basic Definition:** With the exception of the issuer, defendants may avoid section 11 liability by demonstrating that they conducted a reasonable investigation with regard to the portions of the registration statement for which they were responsible. *See* 15 U.S.C. § 77k(b).
- b. **Issuers:** The defense is not available to issuers.

c. ***Non-expert defendants:*** Underwriters and other non-expert defendants (such as directors or officers) can defeat liability if they can demonstrate that they met the appropriate standard of due diligence, which varies depending on whether the challenged portion of the registration statement has been made in part or in whole on the authority of an expert. *See* 15 U.S.C. §§ 77k(b)(3)(A), (C).

(1) *Non-expertised portions of registration statement (“due diligence” defense.* For portions of a registration statement that are not made “on the authority of an expert,” an underwriter or other non-issuer defendant must show that it “had, after reasonable investigation, reasonable ground to believe and did believe,” at the time that the relevant part of the registration statement became effective, that there was no material misstatement or omission. 15 U.S.C. § 77k(b)(3)(A). The standard of care applied under this subsection “is understood as ‘a negligence standard.’” *WorldCom*, 346 F. Supp. 2d at 662 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 (1976)). Much of the information contained in a registration statement – such as the description of the registrant, its history, its structure and its business – is not “expertised.”

(2) *Expertised portions of registration statement (“reliance” defense).* Underwriters and other non-expert defendants do not generally have an independent duty to investigate portions of the registration statement that are made “on the authority of an expert,” and will not be held liable for such statements if such defendants sustain the burden of proof that, at the time the registration statement became effective, they “had no reasonable ground to believe and did not believe” that a material misstatement or omission existed. 15 U.S.C. § 77k(b)(3)(C). This subpart of section 11 is sometimes referred to as the “reliance” defense to distinguish it from the affirmative “due diligence” defense, which in contrast requires a defendant to conduct a reasonable investigation. *See, e.g., WorldCom*, 346 F. Supp. 2d at 663.

a. *Audit Opinions.* An outside auditor’s audit opinion on financial statements that is incorporated into a registration statement permits a non-issuer defendant (other than the auditors) to assert the “reliance” defense under section 11(b)(3)(C). *WorldCom*, 346 F.Supp.2d at 666. However, underwriters and other non-expert defendants

“remain responsible” for unaudited interim financial information as in the case of other non-expertised information. *Id.*

- b. *Comfort Letters.* A comfort letter, which contains representations about the auditor’s review of an issuer’s interim financial statements but is not equivalent to an audit opinion, can have significant weight in establishing an underwriter’s due diligence. *See Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303, 323 (S.D.N.Y. 1996), *aff’d*, 108 F.3d 1370 (2d Cir. 1997). However, according to the district court in *WorldCom*, a comfort letter does not “expertise” the financial statements and is not sufficient to permit the assertion of the “reliance” defense. *WorldCom*, 346 F. Supp. 2d at 683.

- d. ***WorldCom and Underwriters:*** In a decision denying summary judgment that sparked considerable discussion, the district court in *WorldCom* explored at length the standard of reasonableness applicable to underwriters asserting the due diligence and reliance defenses.

The court held that underwriters could not rely on an auditing firm’s “comfort letter” with respect to WorldCom’s interim (unaudited) financial statements to receive the benefit of the more lenient “reliance” standard applicable to “expertised” portions of a registration statement, concluding that the underwriters still were required to “demonstrate that they have conducted a meaningful investigation . . . includ[ing] a reasonable investigation of unaudited financial information.” *Id.* at 677. In addition, and perhaps more significantly, the court held that underwriters “must look deeper and question more where confronted with red flags.” *Id.*

Even with respect to “expertised” portions of a registration statement, however, including audited financial statements, the district court reminded readers that an underwriter’s reliance on audited financial statements “may not be blind.” *WorldCom*, 346 F. Supp. 2d at 672. An underwriter must show “that it had no reasonable ground to believe and did not believe that the statements within the registration statement that were made on an expert’s authority were untrue.” *In re WorldCom, Inc. Sec. Litig.*, 2005 WL 408137, at *3 (S.D.N.Y. Feb. 22, 2005) (citing *WorldCom*, 346 F. Supp. 2d at 667-78); *see* 15 U.S.C. § 77k(b)(3)(C); *see also In re Enron Corp. Sec., Deriv. and “ERISA” Litig.*, 2005 WL 3704688, at *19 (S.D. Tex. Dec. 5,

2005) (following *WorldCom* in denying underwriter motion to dismiss, and holding that due diligence arguments “raise fact issues that may even preclude summary judgment”).

- e. ***Accountants and other experts:*** A “due diligence” defense is also available to accountants and other experts whose opinions are incorporated in a registration statement against liability arising from misstatements or omissions in such opinions. 15 U.S.C. § 77k(b)(3)(C). Most often, such claims are asserted against outside auditors after financial restatements or the revelation of other accounting problems in an issuer’s financial statements.

Under the statute, to defeat liability based on the affirmative defense, “the expert must prove that he had, after reasonable investigation, reasonable ground to believe and did believe,” at the time that . . . the registration statement became effective, that there was no material misstatement or omission.” 15 U.S.C. § 77k(b)(3)(B).

Accountants are experts with regard to portions of the registration statement they certify in their capacity as auditors. *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 623 (9th Cir. 1994); *WorldCom*, 346 F. Supp. 2d at 664; *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 434 (N.D. Ill. 1995). Not every accountant’s opinion, however, qualifies as an expert’s opinion for purposes of the section 11 reliance defense. As discussed above, unaudited and interim financial statements are not “expertised” for purposes of section 11. *WorldCom*, 346 F. Supp. 2d at 665; see also 17 C.F.R. §§ 230.436(c)-(d); SEC Rel. No. 33-6173, 1979 WL 170299 (Dec. 28, 1979) (SEC discussion upon adoption of Rules 436(c) & (d), which exclude an accountant from section 11 liability arising from a report of a review of unaudited interim financial information); SEC Rel. No. 33-6127, 1979 WL 169953 (SEC Rel. No. 33-6127) (Sept. 20, 1979). Further, comfort letters do not “expertise” any portion of the registration statement that is otherwise “non-expertised.” *WorldCom*, 346 F. Supp. 2d at 666.

- (1) ***Other experts:*** In addition to accountants, section 11(a)(4) defines an “expert” as every “engineer,” “appraiser” “or any person whose profession gives authority to a statement made by him,” who has consented to being named as having prepared or certified any portion of or any report used in connection with the registration statement.

Lawyers generally are not considered section 11 “experts” and their participation in, or drafting of, the registration statement does not serve to “expertise” the entire

registration statement. Under narrow circumstances, however, lawyers can be section 11 “experts,” for example when a legal opinion on tax, patent, FCC or FDA matters is incorporated into a registration statement.

- f. ***Standard of reasonableness:*** Section 11(c) provides that the standard for determining reasonable investigation and reasonable grounds for belief is “the standard of reasonableness . . . required of a prudent man in the management of his own property.” 15 U.S.C. § 77k(c).

SEC Rule 176 provides a list of “relevant circumstances” in determining whether a person’s conduct is reasonable under section 11(c). The list includes the type of issuer, the security, the type of person, the office held if the person is an officer, the presence or absence of another relationship to the issuer if the person is a director, reasonable reliance on officers, employees, or others, the role of the underwriter, the type of underwriting arrangement, and whether the person had any responsibility for a document incorporated by reference into the registration statement. 17 C.F.R. § 230.176; SEC Release Nos. 7606A, 40632A, 33-7606A, 34-40632A, IC - 23519A), 1998 WL 792508, at *92 (Nov. 17, 1998).

Plaintiffs frequently attempt to defeat the due diligence defense by arguing that, in hindsight, the inadequacy of the investigation was demonstrated by a failure to detect or disclose business problems that ultimately came to fruition. Courts have held that “the due diligence conducted must be reasonable, not perfect.” *In re International Rectifier Sec. Litig.*, 1997 WL 529600, *7 (C.D. Cal. Mar. 31, 1997) (citing *In re Software Toolworks Sec. Litig.*, 789 F. Supp. 1489, 1496 (N.D. Cal. 1992), *aff’d in part and rev’d in part*, 38 F.3d 1078 (9th Cir. 1994)); *see also Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.*, 1998 WL 513091, *15 (W.D. Mich. June 15, 1998); *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303, 322 (S.D.N.Y. 1996); *Weinberger v. Jackson*, 1990 WL 260676, **3-4 (N.D. Cal. 1990).

4. **Damages**

Section 11(e) limits the damages available to a plaintiff to “the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment” if less than the difference between the purchase price and the value of the

security at the time of suit. 15 U.S.C. § 77k(e). This list of damage theories is exclusive and precludes recovery on any other theories. *McMahan & Co. v. Warehouse Entertainment, Inc.*, 65 F.3d 1044, 1048 (2d Cir. 1995); *Goldkrantz v. Griffin*, 1999 WL 191540, at *3 (S.D.N.Y. Apr. 6, 1999).

5. Contribution and Indemnity

- a. **Indemnification.** Although slightly modified by the PSLRA (as discussed below), the general rule is that indemnity is not permitted to shift liability arising under the Securities Act. See *Riverhead Sav. Bank v. National Mort. Equity Corp.*, 893 F.2d 672, 116 (9th Cir. 1990); *Laventhol, Krekstein, Horwath & Horwath v. Horwitch*, 637 F.2d 672, 676 (9th Cir. 1980). In *Laventhol*, the court observed that “in extending liability to underwriters and those who prepared misleading statements, the purpose of the Act is regulatory rather than compensatory, and permitting indemnity would undermine the statutory purpose of assuring diligent performance of duty and deterring negligence.” *Id.*; see also *Eichenholtz v. Brennan*, 52 F.3d 478, 483 (3rd Cir. 1995); *Globus v. Law Research Serv. Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969) (“the SEC has announced its view that indemnification of directors, officers and controlling persons for liabilities arising under the 1933 Act is against the public policy of the Act. 17 C.F.R. § 230.460. If we follow the syllogism through to its conclusion, underwriters should be treated equally with controlling persons and hence prohibited from obtaining indemnity from the issuer.”).

With respect to contractual rights to indemnity, the PSLRA added section 21D(f)(2)(B)(ii) to the Exchange Act to expressly validate enforcement of contractual indemnity in favor of a prevailing defendant for defense costs. 15 U.S.C. § 78u-4(f)(2)(B)(ii). Courts might apply this provision to permit such limited indemnification for prevailing Securities Act defendants as well.

- b. Section 11(f) provides an express right of contribution:

“All or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.” 15 U.S.C. § 77k(f)(1).

B. **Section 12(a)(2) of the Securities Act**

Section 12(a)(2) of the Securities Act provides, in relevant part, as follows:

Any person who . . . offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission shall be liable . . .

15 U.S.C. § 77l.

1. **Elements of a Cause of Action Under Section 12 (a)(2)**

- An offer or sale of a security;
- By the use of any means of interstate commerce;
- Through a prospectus or oral communication;
- Which includes an untrue statement of a material fact or omits to state a material fact; and
- The plaintiff did not know of the statements were false or misleading at the time of the purchase.

15 U.S.C. § 77l(a)(2); *see also Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 567-68 (1995).

- a. ***Reliance***. A plaintiff need not allege reliance on the misrepresentation or omission. *WorldCom*, 326 F. Supp. 2d at 659; *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1225-26 (7th Cir. 1980).
- b. ***Scienter***. A plaintiff need not allege scienter on the part of the seller. *Hill York Corp. v. America Int'l. Franchises, Inc.*, 448 F.2d 680, 695 (5th Cir. 1971); *WorldCom*, 326 F. Supp. 2d at 659.
- c. ***Plaintiff's knowledge based on information available "as of" time of offer or sale***. In adopting the securities offering reform rules, the SEC stated its interpretation of sections 12(a)(2) and 17(a)(2) that, for purposes of determining whether a statement was false or misleading under those sections, only information that was available to an investor at the time of sale (including a commitment to purchase in an upcoming offering) should be considered. The SEC incorporated this interpretation into new

Rule 159, 17 C.F.R. § 230.159. Under this rule, information conveyed to the investor only after the time of sale should be not be taken into account in assessing liability under these provisions.

The adoption of Rule 159 will affect the prior assumption of some offering participants that revisions in a final prospectus would cure any incomplete or incorrect information that was provided to investors during the pre-offering sales process (most typically, pricing). In the SEC's view, such corrective disclosure will not eliminate potential liability if a contract for sale of securities has been entered into prior to the issuance of the final prospectus. The SEC has suggested that new sales contracts be entered into with early investors at the time of the final prospectus when such circumstances arise. Because the securities laws invalidate agreements to waive violations of those statutes, care should be taken in such circumstances that the investor is provided sufficient information to determine to enter into the new contract on a voluntary and informed basis.

The adopting release for the securities offering reform rules also notes the possibility that an issuer could trigger section 12(a)(2) liability for historical information contained on its website during the course of an offering unless the issuer follows guidelines for identifying the information as such. Similarly, an issuer can be deemed to have adopted the contents of research reports if it hyperlinks to such reports on its website or in communications about an offering.

- d. **Causation.** Courts have held that a plaintiff need not prove transaction causation, *i.e.*, that the sale would not have occurred absent the material misrepresentation or omission. *See, e.g., Hill York v. American Int'l. Franchises, Inc.*, 448 F.2d at 696 (5th Cir. 1971). To establish liability, a plaintiff need only show "some causal connection between the alleged communication and the sale, even if not decisive." *Metromedia Co. v. Fugazy*, 983 F.2d 350 (2d Cir. 1992). Loss causation is a statutory defense to a section 12 claim, comparable to that available under section 11. *See* discussion below.
- e. **Purchaser.** To state a claim under section 12, plaintiff must be a purchaser of the subject security in the initial offering. *See Gustafson*, 513 U.S. at 577-78 (stating that only investors who purchased shares *in* an offering have standing to sue under section 12(a)(2)). Under *Gustafson*, aftermarket purchasers do not have standing to assert claims under section 12(a)(2).

- (1) Some cases have borrowed the prospectus delivery requirements for dealers (as opposed to the underwriters or issuer) from section 4(3)(B) of the Securities Act to extend the period of an IPO for the purposes of bringing section 12 claims. *Levitin v. A Pea In The Pod, Inc.*, 1997 WL 160184, *3 (N.D. Tex. Mar. 31, 1997); *Wade v. Industrial Funding Corp.*, 1993 WL 650837, *5 (N.D. Cal. Aug. 30, 1993).
- (2) However, based on the analysis set forth in *Gustafson* -- which focused on limiting statutory claims to failures in connection with the duties imposed by the Securities Act -- there should be no basis for expanding disclosure liability for issuers and underwriters based upon the delivery requirements imposed upon dealers. See *In re AHI Healthcare Systems Sec. Litig.*, C.D. Cal. No. 95-8658 MRP (January 17, 1997 Order); *Murphy v. Hollywood Entertainment Corp.*, 1996 WL 393662, **3-4 (D. Or. May 9, 1996).

2. “Seller” Status

Section 12(a)(2) limits liability to a person who “offers or sells” a security.

- a. Prior to *Pinter v. Dahl*, 486 U.S. 622 (1988), the lower courts disagreed as to the definition of “seller” for purposes of section 12. In *Pinter*, the Supreme Court held that in order for a nonowner of securities to be a “seller” for purposes of section 12(a)(1), the person must solicit the purchasers, motivated at least in part by a desire to serve his own financial interests or those of the securities owner. *Pinter*, 486 U.S. at 646-48.

Most courts have applied the Supreme Court’s analysis in *Pinter* in determining whether a given defendant is a “seller” for purposes of liability under section 12(a)(2). See, e.g., *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1215 (1st Cir. 1996), *Moore v. Kayport Package Exp., Inc.*, 885 F.2d 531, 537 (9th Cir. 1989); *Maher v. Durango Metals, Inc.*, 144 F.3d 1302 (10th Cir. 1998); *Capri v. Murphy*, 856 F.2d 473, 478 (2d Cir. 1988); but see *Adalman v. Baker, Watts & Co.*, 807 F.2d 359 (4th Cir. 1986) (applying section 12(a)(2) “substantial factor” test to dealer-manager of a private offering of limited partnership interests in tax shelter).

- b. ***Issuer as “Seller” in Firm-Commitment Underwriting.*** In adopting the securities offering reform rules, the SEC stated its view that issuers should be considered “sellers” for purposes of

section 12(a)(2) in firm commitment underwritings. The SEC believes that there has been “unwarranted uncertainty as to issuer liability under Section 12(a)(2) for issuer information” in such offerings. SEC Release Nos. 33-8591, 34-52056, 70 Fed. Reg. at 44769 (citing *Rosenzweig v. Azurix Corp.*, 332 F.3d 854 (5th Cir. 2003); *Lone Star Ladies Investment Club v. Schlotzsky’s, Inc.*, 238 F.3d 363, 370 (5th Cir. 2001); *Capri v. Murphy*, 856 F.2d 473, 478 (2d Cir. 1988)). In a firm-commitment underwriting, the underwriters purchase the securities to be offered and then resell those securities in the offering, giving rise to an argument that the issuer is not a “seller” for purposes of section 12(a)(2).

Rule 159A now provides, however, that an issuer will be considered a “seller” under section 12(a)(2) as to any of the following communications:

- (1) any preliminary prospectus;
- (2) any “free-writing prospectus” prepared by or on behalf of or used or referred to by the issuer;
- (3) the portion of any other “free-writing prospectus” about the issuer or its securities provided by or on behalf of the issuer; and
- (4) any other communication that is an “offer” made by the issuer.

c. **Section 12 Claims Against Professionals.** The judicial expansion of section 12 “seller” status to persons other than the direct seller (or offeror) of a security has allowed for section 12 claims against professionals involved in the public offering process. While courts have cautioned that “the draconian provisions of section 12 must not be extended” to professionals who simply prepare documents in connection with an offering,” *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126 (2d Cir. 1989), plaintiffs have not always been deterred from bringing such claims. *See, e.g., Silva Run Worldwide Ltd. v. Gaming Lottery Corp.*, [Current Tr. Binder] Fed.Sec.L.Rep. (CCH) ¶ 90,196 at 90,726 (S.D.N.Y. Apr. 8, 1998) (attorney not a “statutory seller within the meaning of section 12).

3. Defenses Available Under Section 12(a)(2)

a. **Knowledge.** The plaintiff knew the truth of the misrepresented or omitted material fact. 15 U.S.C. § 77l(a)(2); *see Mayer v. Oil Field Systems Corp.*, 803 F.2d 749, 755 (2d Cir. 1986); *Ames v. Uranus, Inc.*, 1994 WL 482626, n.16 (D. Kan. Aug. 24, 1994); *In*

re MetLife Demutualization Litig., 156 F. Supp. 2d 254, 269 (E.D.N.Y. 2001); *In re Intel Securities Litigation*, 89 F.R.D. 104, 115 (N.D. Cal. 1981). In bringing a motion to dismiss, defendants are entitled to raise all information or documents as to which plaintiff had “actual notice” and upon which plaintiff must have relied in drafting their complaint. *Cortes Indus., Inc. v. Sum Holding, L.P.*, 949 F.2d 42 (2d Cir. 1991).

- b. **Reasonable Care/Due Diligence.** Defendant did not know and through the exercise of reasonable care could not have known of the misrepresentation or omission of material fact. 15 U.S.C. § 77l(a)(2). For a discussion of the “due diligence” defense under section 12(a)(2), *see* below.
- c. **Materiality.** The misrepresented or omitted fact was not material. *P. Stolz Family P’ship L.P. v. Daum*, 355 F.3d 92, 96 (2d Cir. 2004); *Suna v. Bailey Corp.*, 107 F.3d 64, 71 (1st Cir. 1997); *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 546 (8th Cir. 1997); *In re BankAmerica Corp. Sec. Litig.*, 78 F. Supp. 2d 976, 991-92 (E.D. Mo. 1999); *In re WebSecure, Inc. Sec. Litig.*, 182 F.R.D. 364 (D. Mass. 1998).
- d. **Statute of Limitations.** Any action under section 12(a)(2) must be “brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . [and], in no event, shall any such action be brought . . . more than three years after the sale.” 15 U.S.C. § 77m.

4. **Due Diligence Defense**

- a. In common with section 11, section 12(a)(2) provides an express “due diligence” defense which permits a defendant to avoid liability for an allegedly misleading statement if he can establish “he did not know, and in the exercise of reasonable care, could not have known of the untruth or omission.” 15 U.S.C. § 77l(a)(2).
- b. There is some question whether the “reasonable care” standard of section 12(a)(2) is less demanding or more demanding than the “reasonable investigation” standard under the section 11 “due diligence” defense. The district court in *WorldCom* concluded that a defendant’s burden to show “reasonable care” under section 12(a)(2) is lower than a defendant’s burden to show “reasonable investigation” under section 11. *WorldCom*, 346 F. Supp. 2d at 663. While “Section 11 imposes a duty to conduct a reasonable investigation as to any portion of a registration statement not made on the authority of an expert,

Section 12(a)(2) does not make any distinction based upon expertised statements and only requires the defendant to show that it used reasonable care.” *Id.*

In its adopting release for the securities offering reform rules, the SEC expressed its view that “the standard of care under Section 12(a)(2) is less demanding than that prescribed by Section 11, or put another way, that Section 11 requires a more diligent investigation than Section 12(a)(2).” SEC Release Nos. 33-8591, 34-52056, 70 Fed. Reg. 44,722 at 44,770 (August 3, 2005). It also stated that this has been the SEC position for many years, including in its brief submitted in the *John Nuveen* case. In that much earlier case, the Seventh Circuit concluded that the difference in the language of the two standards, with respect to underwriters, was not significant. *See Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1228 (7th Cir. 1980).

5. Damages

- a. Section 12(a)(2) provides for rescissory damages (“the consideration paid for the security with interest thereon, less the amount of any income received thereon, upon tender of the security”), or for damages if the plaintiff no longer owns the security. 15 U.S.C. § 77l; *see Randall v. Loftsgaarden*, 478 U.S. 647 (1986).
- b. The PSLRA added section 12(b), providing the defendant in a 12(a)(2) action with a “loss causation” defense similar to the defense that already had been available under section 11. *See* 15 U.S.C. § 77l(b); *Fisk v. Superannuities, Inc.*, 927 F. Supp. 718, 729 n.7 (S.D.N.Y. 1996). The seller or offeror of a security must establish that some portion of the claimant’s recovery represents depreciation not resulting from the alleged defects in the prospectus or oral communication. This amendment to the statute allows courts to prevent windfall recoveries by plaintiffs whose losses were attributable to market events rather than non-issuer

6. Comparison with Section 11

- a. Section 12(a)(2) is distinguishable from Section 11 in the following major respects:
 - (1) Section 12(a)(2) does not limit misrepresentations to the final registration statement but includes other documents and oral misrepresentations in connection with public offerings such as road shows;

- (2) Section 12(a)(2) claims only can be brought against a “seller,” as defined in *Pinter v. Dahl*.
- b. Section 12(a)(2) is similar to section 11 in the following major ways:
- (1) Neither section requires scienter;
 - (2) Neither section requires reliance (subject to the special exemption in section 11 after publication of a twelve months earnings statement);
 - (3) Both sections cover misrepresentations in the registration statement;
 - (4) The burden of proving the due diligence defense is on the defendant;
 - (5) The burden of proving a loss causation defense is on the defendant.

C. **Section 10(b) and Rule 10b-5**

The requirements and standards applicable to claims arising under section 10(b) of the Exchange Act and Rule 10b-5 thereunder are the subject of extensive commentary elsewhere. Rather than repeat in detail that commentary here, we will limit this discussion to the basic requirements.

Rule 10b-5 provides a private right of action against any person who makes an untrue statement of material fact or omits to state a material fact in connection with the purchase or sale of a security. Section 10(b) and Rule 10b-5 apply to any oral or written communication, or manipulative or deceptive practice, in connection with the purchase or sale of a security whether or not the offering is registered under the Securities Act.

1. **Elements.** In order to state a cause of action under section 10(b) and Rule 10b-5, a private plaintiff must allege each of the following elements:
 - a. ***Purchaser/Seller.*** Plaintiff must be either a purchaser or seller of securities. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).
 - b. ***Material Misstatement or Omission.*** Defendant must have made a misstatement of a material fact or must have failed to state a material fact necessary to make statements that were made, in light of the circumstances under which they were made, not misleading, 17 C.F.R. § 240.10b-5. “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider

it important” in making an investment decision. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

- (1) Duty of Disclosure. A defendant cannot be held liable for a failure to disclose information allegedly withheld from the market unless the defendant was under a duty to disclose the information at the time. *Chiarella v. United States*, 445 U. S. 222, 230 (1980) (Rule 10b-5 liability for silence “is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction”); *Dirks v. S.E.C.*, 463 U.S. 646, 654 (1983) (Rule 10b-5 liability requires a duty of disclosure arising from the relationship between the parties); *Gallagher v. Abbott Labs.*, 269 F.3d 806, 808 (7th Cir. 2001) (“[w]e do not have a system of continuous disclosure. Instead firms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty to disclose”).
- (2) Item 303. Several courts have concluded that matters required to be disclosed by Item 303 of the Securities Act rules are not presumptively material for purposes of claims of securities fraud under section 10(b) of the Exchange Act and Rule 10b-5. *See, e.g., Oran v. Stafford*, 226 F.3d 275, 288 (3d Cir. 2000) (violation of Item 303 “does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5” because materiality standards for Rule 10b-5 and SK-303 “differ significantly”); *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 402 (6th Cir. 1997); *In re Boston Technology, Inc. Sec. Litig.*, 8 F. Supp. 2d 43, 67 (observing that “[t]he very relevance of an Item 303 violation to a 10b-5 suit remains subject to some dispute”). There is also authority to the contrary, however. *See Wallace v. Systems & Computer Tech. Corp.*, 1996 U.S. Dist. LEXIS 5328, *28 (E.D. Pa. Apr. 22, 1996) (“Item 303(b) is important for if disclosure . . . is warranted . . . then [defendant] may have a duty to disclose that information.”).

- c. **Reliance**. Plaintiff must have relied on the allegedly false or misleading statement in making the investment decision. In *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), the Supreme Court approved the “fraud on the market” doctrine in Rule 10b-5 cases. Under that doctrine, securities fraud plaintiffs can satisfy the reliance requirement by claiming that they relied on the integrity of the market price which allegedly reflected the false or misleading information rather than relying directly on the allegedly false or misleading statements at issue. The presumption of reliance can be

rebutted by showing, *inter alia*, that a plaintiff's decision to purchase or sell shares was not influenced by the alleged misstatements or that the misrepresentations did not, in fact, distort the price of the stock.

Reliance has become the new battleground in class certification, with several appellate courts reversing class certification decisions where the facts at issue did not support plaintiffs' assertion that the securities at issue traded in an efficient market and therefore permitted the presumption of reliance afforded under the "fraud on the market" framework of *Basic Inc. v. Levinson*. See *Oscar Private Equity Investments v. Allegiance Telecom Inc.*, 487 F.3d 261 (5th Cir. 2007); *Regents of University of Calif. v. Credit Suisse First Boston (USA) Inc.*, 482 F.3d 372 (5th Cir. 2007); *Miles v. Merrill Lynch & Co. (In re IPO Sec. Litig.)*, 471 F.3d 24, 41-45 (2d Cir. 2006), *rehearing denied*, 483 F.3d 70 (2d Cir. 2007).

- d. **Transaction Causation.** Transaction causation requires that a plaintiff show that the violations in question caused plaintiff to engage in the transaction. See, e.g., *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 172 (3d Cir. 2001); *Suez Equity Investors, L.P. v. Toronto Dominion Bank*, 250 F.3d 87, 95-96 (2d Cir. 2001); *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 315 (3d Cir. 1997); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997). Transaction causation conceptually overlaps with the element of reliance, since a showing of transaction causation hinges on a determination that plaintiff relied on the violation. *Newton*, 259 F.3d at 172; *AUSA Life Ins. Co. v. Ernst and Young*, 206 F.3d 202, 209 (2d Cir. 2000); *Binder v. Gillespie*, 172 F.3d 649, (9th Cir. 1999). Both "transaction causation" (also referred to as, "cause in fact" and "but for" causation) and "loss causation" (also referred to as, "proximate causation" and "legal causation") are necessary to prevail on a 10b-5 claim. See, e.g., *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95-96 (2d Cir. 2001).
- e. **Loss Causation.** Loss causation is often referred to as "proximate causation" or "legal causation." It involves a "determination that the harm suffered by the investor 'flowed' from the misstatement." See, e.g., *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974).

In *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), the Supreme Court reemphasized the importance of "loss causation" for claims under section 10(b) and Rule 10b-5. The *Dura* Court concluded that stockholder plaintiffs cannot rely solely on evidence that the price of an issuer's stock was inflated at the

time it was purchased to satisfy the “loss causation” element. At the time a share is purchased, the Court reasoned, an inflated price “is offset by ownership of a share that *at that instant* possesses equivalent value” because the share could be resold at the market price. If the market price later declines, however, factors other than the alleged fraud - such as general market conditions, different developments in the issuer's business or recent news about other companies in the industry - might be the reason for that price decline. The Court held that under the federal securities laws, it is the stockholder plaintiff's burden to prove that the subsequent price decline is attributable to fraud rather than such extraneous factors. Since the decision in *Dura*, failure to allege “loss causation” has become a regular basis for seeking dismissal of securities class action complaints, with mixed results.

- f. **Scienter.** Plaintiff must allege that defendant acted with scienter when engaged in conduct proscribed by Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Although the PSLRA requires actual knowledge of falsity for liability that is based on “forward-looking statements,” 15 U.S.C. § 77z-2, this “safe harbor” is inapplicable to IPO claims. The PSLRA does, however, limit joint and several liability under section 10(b) to persons who “knowingly committed” a violation of the securities laws, *id.* § 78u-4(g)(2), and generally requires plaintiffs to “state particular facts giving rise to a strong inference that the defendant acted with the required state of mind.” *Id.* § 78u-4(b)(2).

This year, in *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (June 21, 2007), the Supreme Court resolved a long-running dispute among the Circuits concerning the PSLRA requirement that a plaintiff alleging securities fraud must set forth facts supporting a “strong inference of scienter.” The *Tellabs* Court held that courts evaluating motions to dismiss securities fraud complaints must evaluate all of the available allegations, as well as other permissible sources (such as SEC filings), and must take into account plausible inferences *other than* the inference that a defendant acted with the intention to defraud. The complaint should be dismissed unless it includes sufficient factual allegations to make the inference of scienter cogent and at least as compelling as any plausible opposing inference one could draw from the facts alleged.

The *Tellabs* holding is intended to suggest that the required “strong inference of scienter” creates a high hurdle for securities fraud complaints to clear before discovery is permitted. As with the Court's 2005 decision on loss causation in *Dura*, however, it

remains to be seen how the newly articulated standard will be applied by the lower courts.

2. **No Due Diligence Defense**

Neither section 10(b) nor Rule 10b-5 contains an express due diligence defense. However, a defendant's ability to satisfy the due diligence defense under sections 11 or 12(a)(2) of the Securities Act might preclude a finding of scienter under Rule 10b-5. *See In re Software Toolworks Inc. Securities Litigation*, 38 F.3d 1078, 1088 (9th Cir. 1994); *In re International Rectifier Sec. Litig.*, 1997 WL 529600, *12 (C.D. Cal. Mar. 31, 1997).

3. **Statute of Limitations**

Section 804 of the Sarbanes-Oxley Act of 2002 amended the federal statute of limitations applicable to claims of securities fraud. As a result of that enactment, the statute of limitations applicable to such claims is the earlier of two years after discovery of the facts constituting a violation of the securities laws or five years after such a violation occurs. *See* 28 U.S.C. § 1658(b).

4. **Indemnity and Contribution**

While most courts have been hostile to claims for indemnification in Rule 10b-5 cases, the PSLRA added section 21D(g)(2)(B)(ii) to the Exchange Act to expressly permit a limited right to enforce contractual indemnity for defense costs in favor of a prevailing defendant.

The Supreme Court has held that contribution is available, at least as against parties other than defendants who have settled with plaintiffs. *Musick, Peeler & Garrett v. Employers Insurance of Wausau*, 508 U.S. 236 (1993). In *Musick*, the Court declined to determine which, if either, of the primary contribution formulas applied by lower courts should be used, *i.e.*, the "proportionate fault" rule (*e.g.*, *Franklin v. Kaypro Corp.*, 884 F.2d 1222 (9th Cir. 1989)), or the "pro tanto" rule (*e.g.*, *Singer v. Olympia Brewing Co.*, 878 F.2d 596 (2d Cir. 1989)). The PSLRA added an express right of contribution in private actions under the Exchange Act, with a six-month statute of limitations for contribution claims.

- (1) **Proportionate Liability.** The PSLRA instituted a system of proportionate, as opposed to joint and several, liability for "covered defendants" in private actions who are not found to have "knowingly committed a violation" of the securities laws. 15 U.S.C. § 78u-4. "Covered defendants" are defined as all defendants in actions brought under the

Exchange Act and outside directors in actions under the Securities Act. 15 U.S.C. § 78u-4(f)(10)(C).

- (2) ***Joint and Several Liability.*** Under the PSLRA, “covered defendants” are jointly and severally liable only if they “knowingly” commit a violation of the securities laws. For violations that are not made “knowingly,” defendants are proportionately liable based on the defendant’s degree of responsibility. 15 U.S.C. § 78u-4(f)(2).

5. **Secondary Liability Under Section 10(b)**

a. ***Secondary Liability in Private Securities Litigation***

In *Central Bank of Denver v. First Interstate Bank*, 511 U.S. 164 (1994), the Supreme Court held that section 10(b) does not permit private claims for aiding and abetting a violation of that statute. The Court made clear that the holding did not mean blanket immunity from liability for lawyers, accountants, banks, or similar third parties under section 10(b) and Rule 10b-5. In order to establish liability as to such actors, however, a plaintiff must satisfy “*all of the requirements for primary liability under Rule 10b-5.*” *Id.* at 191 (emphasis in original).

The *Central Bank* decision has been controversial, and it has led commentators and legislators to clamor for revision of the securities laws to permit claims for aiding and abetting liability. In addition, a number of courts confronted by claims against investment banks and other third parties that allegedly assisted issuers engaged in securities fraud have looked for ways around the *Central Bank* holding, most notably in the *Enron* and *Parmalat* consolidated litigations. *See In re Parmalat Sec. Litig.*, 414 F. Supp. 2d 428 (S.D.N.Y. 2006); *In re Enron Corp. Sec. Deriv. and ERISA Litig.*, 310 F. Supp. 2d 819 (S.D. Tex. 2004). Several appellate court decisions have suggested that this was an impermissible pleading strategy, however. *See Regents of University of Calif. v. Credit Suisse First Boston (USA) Inc.*, 482 F.3d 372 (5th Cir. 2007); *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006); *In re Charter Comms. Inc. Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006).

The issue will be resolved by the Supreme Court in the coming term. In March 2007, the Court granted certiorari in the *Charter Communications* case and argument will be heard in early October. Meanwhile, a petition for certiorari also has been filed from the decision of the Fifth Circuit in *Regents of California*, which reversed a class certification order on the basis of reasoning that implicated many of the same issues.

b. ***Application to SEC Enforcement Actions.***

Unlike a private litigant, the SEC is entitled to bring actions against any person who “knowingly provides substantial assistance to another person” in violation of the Exchange Act or rules or regulations issued under it. 15 U.S.C. § 78t. *See, e.g., SEC v. Scientific-Atlanta, Inc.*, SEC Litig. Rel. No. 19735 (disgorgement settlement based on “round-trip” transactions with Adelphia Communications); *see also SEC v. Fehn*, 97 F.3d 1276 (9th Cir. 1996).

c. ***Effect on Conspiracy Claims.***

In *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837 (2d Cir. 1998), the Second Circuit held that no conspiracy liability attached under section 10(b) after *Central Bank* – “where the requirements for primary liability are not independently met, they may not be satisfied based solely on one’s participation in a conspiracy in which other parties have committed a primary violation.” *Id.* at 843.

D. **Claims Under Section 18 of the Exchange Act**

Section 18(a) allows a right of action to any person who purchases or sells a security at an affected price in reliance on a false or misleading statement or omission that was made in a document required to be filed with the SEC under the Exchange Act or the rules thereunder. The statute does not provide a cause of action based on registration statements or prospectuses made in IPOs. Nevertheless, it is important to be aware of section 18(a), which for many years was not frequently invoked due to some demanding requirements but which is being used with increasing frequency by opt-out plaintiffs in large consolidated securities lawsuits.

Unlike claims under Rule 10b-5, claims under section 18(a) do not require a plaintiff to establish that a false or misleading statement was made with scienter. Similar to section 11 of the ’33 Act, the statute provides affirmative defenses of good faith or lack of knowledge, but the defendant bears the burden of proof on these defenses.

While a section 18 plaintiff need not allege or prove scienter, the statute contains a strict reliance requirement that has been interpreted to require a plaintiff to show that he actually read a copy of the document in which the false statement allegedly was made. *Heit v. Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968). This requirement makes it difficult to assert claims under section 18(a) on behalf of a class of investors, which generally depend on the “fraud on the market” presumption of reliance available for most claims under Rule 10b-5.

A section 18(a) plaintiff bears the burden of proof to show that the allegedly false or misleading statement affected the price at which he bought or sold the securities at issue. *See Jacobson v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 518, 525 (S.D.N.Y. 1979).

Similar to sections 11 and 12 of the ’33 Act, section 18(c) of the ’34 Act provides for a statute of limitations of three years from the date that the cause of action accrued or one year from the date of discovery.

E. **Other Potential Causes of Action**

In addition to claims under sections 11, 12 and 15 of the Securities Act and sections 10(b), 18(a) and 20(a) of the Exchange Act, plaintiffs in public offering litigation occasionally will assert claims under section 17(a) of the Securities Act and under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961 *et. seq.*

1. However, the PSLRA eliminated securities fraud violations as potential predicate offenses for civil RICO actions, except where the defendant has been criminally convicted in connection with the alleged fraud. 18 U.S.C. § 1964(c).
2. Moreover, the trend among the federal courts is to deny the existence of a private right of action under section 17(a) of the Securities Act. *See Maldonado v. Dominguez*, 137 F.3d 1, 7 (1st Cir. 1998); *Finkel v. Stratton Corp.*, 962 F.2d 169, 175 (2d Cir. 1992); *In re Washington Public Power Supply Systems Securities Litigation*, 823 F.2d 1349 (9th Cir. 1987) (*en banc*).

F. **Claims Against Attorneys**

Section 10(b) claims against attorney defendants, although relatively rare, have produced several significant decisions. While the state of the law remains in flux, attorneys and other professionals should be mindful of the following cases:

1. ***Duty of Disclosure***. Several appellate decisions have held that when an attorney elects to speak, she assumes a duty under section 10(b) to ensure that her statements do not contain misstatements or omissions of material fact. *See, e.g., Kline v. First Western Government Sec., Inc.*, 24 F.3d 480, 490-91 (3d Cir. 1994) (a law firm that has chosen to speak cannot omit facts material to its non-confidential opinions).
 - a. In *Rubin v. Schottenstein, Zox & Dunn*, 110 F.3d 1247 (6th Cir. 1997), a divided Sixth Circuit panel affirmed the dismissal of section 10(b) claims against an attorney for a corporation who was alleged to have made material misstatements and omissions when he discussed his client's financial status with two prospective investors. Less than a year later, a majority of active Sixth Circuit judges voted to rehear the case *en banc*, and vacated the panel's 1997 judgment. *Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263 (6th Cir. 1998) (*en banc*). Writing for the court, Judge Boggs explained that, "while an attorney representing the seller in a securities transaction may not always be under an independent duty to volunteer information about the financial condition of his client, he assumes a duty to provide complete and nonmisleading information with respect to subjects on which he undertakes to speak." 143 F.3d at 268. Writing in dissent, Judge Kennedy

suggested that, in the absence of any fiduciary relationship, there should not be a duty of disclosure imposed on attorneys. *Id.* at 271.

- b. Likewise in *Klein v. Boyd*, 1998 WL 55245 (3d Cir. Feb. 12, 1998), *rehearing en banc granted, vacated* (3d Cir. Mar. 9, 1998), the Third Circuit concluded that “a duty to disclose may arise either from a fiduciary relationship or from affirmative representations that omit a material fact such that the representations made are misleading.” Moreover, according to the *Klein* court, “[t]he fact that the lawyer is speaking ‘behind the scenes’ does not absolve the lawyer of this duty.” In *Klein*, a law firm prepared several disclosure documents for distribution to investors in a limited partnership. One such document, which was given to officers of the partnership to deliver to investors, revealed that one officer had a history of securities violations. This disclosure document was never delivered to investors.
- c. In *Enron*, the Southern District of Texas held “that professionals, including lawyers and accountants, when they take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client's financial condition, do have a duty to third parties not in privity not to knowingly or with severe recklessness issue materially misleading statements on which they intend or have reason to expect that those third parties will rely.” 235 F. Supp. 2d at 610-11. The Court expressed concern about opening the “floodgates” for liability against professionals and thus held, applying a Texas rule, that the class of plaintiffs entitled to sue would be those individuals that the professionals “intended” or could have reasonably expected to rely on the false statements and suffer a pecuniary loss. *Id.*

2. ***Central Bank***. As discussed above, *Central Bank* has spawned divergent views of the scope of primary liability under section 10(b), in some instance permitting claims against attorneys and accountants to proceed. Two appellate decisions have attempted to clarify the impact of *Central Bank* in cases specifically involving attorney defendants. The continuing vitality of these decisions might be affected by the Supreme Court’s review of these issues this Fall in the *Charter Communications* appeal discussed above.

- a. In *Klein v. Boyd*, the initial appellate decision reversed summary judgment in favor of a law firm that allegedly prepared false and misleading offering memorandum for investors in a limited partnership. The lower court had held that the lawyers could not be primarily liable because the firm did not sign the allegedly false

documents, its name did not appear on any of them and investors were not aware of the firm's involvement. Reversing, the Third Circuit held that "lawyers and other secondary actors who significantly participate in the creation of their client's misrepresentations, to such a degree that they may fairly be deemed authors or co-authors of those misrepresentations, should be held accountable as primary violators under Section 10(b) and Rule 10b-5 even when the lawyers or other secondary actors are not identified to the investor, assuming the other requirements of primary liability are met." The *Klein* court distinguished *Central Bank* by explaining that, "[w]e do not suggest that a lawyer who merely provides 'substantial assistance' to a client may be liable under Section 10(b) and Rule 10b-5 Rather, we believe that a person may be liable for a primary violation of Section 10(b) and Rule 10b-5 when the person's participation in the creation of a statement containing a misrepresentation or omission of material fact is sufficiently significant that the statement can properly be attributed to the person as its author or co-author. At that point, the person has done more than provide mere substantial assistance; the person has become a primary violator of Section 10(b) and Rule 10b-5."

- b. In *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837 (2d Cir. 1998), the Second Circuit held that *Central Bank* precluded claims against a law firm for conspiracy under section 10(b). The law firm was alleged to have prolonged its client's fraudulent "Ponzi scheme" by making material misstatements and omissions to the SEC, and by drafting an offer of rescission to investors. The lower court denied the firm's motion to dismiss, concluding that *Central Bank* did not preclude conspiracy liability under section 10(b). The Second Circuit reversed, noting that "the reasoning leading to the Supreme Court's rejection of aiding and abetting liability under § 10(b) and Rule 10b-5 also applies to conspiracy." 135 F.3d at 841. However, the court emphasized that "while we decline to imply a cause of action for conspiracy to violate § 10(b) and Rule 10b-5, secondary actors who conspire to commit such violations will still be subject to liability so long as they independently satisfy the requirements for primary liability." *Id.* at 842.

G. State Causes of Action

After the PSLRA was enacted, there was a dramatic increase in the filing of state statutory and common law securities actions. In response, Congress enacted the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). See Pub. L. No. 105-353, 112 Stat. 3227 (1998). SLUSA largely federalized securities class actions, permitting the removal and dismissal of state claims brought by 50 or more plaintiffs.

In 2006, the Supreme Court construed SLUSA’s preemption provisions broadly to bar so-called “holder” claims, in which class actions were brought on behalf of investors who owned stock but had neither purchased nor sold their shares during the challenged period. *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, ___ U.S. ___, 126 S. Ct. 1503 (2006). In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Court had construed the “in connection with” provision of section 10(b) and Rule 10b-5 to require a “purchase” or “sale” of securities as a condition to obtaining standing to sue. Construing the same phrase as it appeared in SLUSA, however, the *Dabit* Court held that a purchase or sale was not required but that “it is enough that the fraud alleged ‘coincide’ with a securities transaction – whether by the plaintiff or by someone else” for preemption to apply. The Court distinguished the holding in *Blue Chip Stamps* as one that was based on policy considerations that did not apply in the preemption context.

APPENDIX

LIABILITIES IN PRIVATE SECURITIES LITIGATION

	SECURITIES ACT		EXCHANGE ACT
	§ 11	§ 12(a)(2)	§ 10(b) Rule 10b-5
COVERAGE	Material M/O in registration statement	Material M/O in "prospectus" or oral communication (<i>Gustafson</i> limits to public offering)	Material M/O "in connection with" purchase or sale (<i>Blue Chip</i>)
WHO CAN SUE (STANDING)	Purchaser in public offering and certain aftermarket purchasers who can "trace"	Purchaser in public offering	Purchaser or seller <ul style="list-style-type: none"> - public offering - aftermarket - private offering or transaction - most M&A
WHO CAN BE SUED	Issuer Signers Directors Underwriters Experts Control persons (§ 15)	"Sellers" (<i>Pinter</i>) Control persons (§ 15)	Participants (limited by <i>Central Bank</i>) Control persons (§ 20)
OTHER REQUIREMENTS			Scienter Reliance (fraud on market) Transaction Causation Loss Causation
DEFENSES	Statute of limitations (1/3) Due Diligence Negative loss causation (§ 11(e)) Pltf. knowledge	Statute of limitations (1/3) Due Diligence Negative loss causation (§ 12(b)) Pltf. knowledge	Statute of limitations (2/5) Pltf. knowledge

