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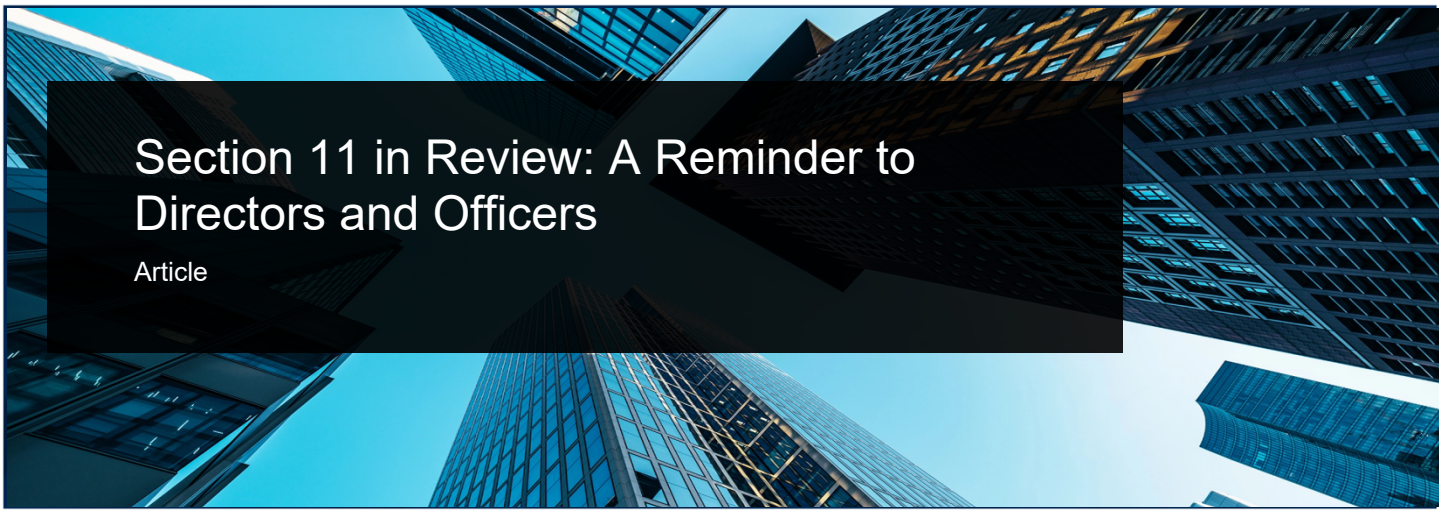

Section 11 in Review: A Reminder to Directors and Officers

Article

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Section 11 of the Securities Act of 1933, as amended (the "1933 Act"), affords investors the primary remedy for misstatements and omissions in registration statements filed with the Securities and Exchange Commission (the "SEC"). Investors may also look to other provisions of the federal securities laws, including without limitation Section 12(a)(2) of the 1933 Act (relating to misstatements and omissions in a prospectus or oral communication) and Rule 10b-5 under the Securities Exchange Act of 1934, as amended (the "1934 Act") (relating to misstatements and omissions generally). However, in the case of a defect in the registration statement itself, the remedy under Section 11 of the 1933 Act is perhaps the easiest for a plaintiff to prosecute, and the most difficult for a defendant to defend, as compared to all other available remedies.

Section 11(a) provides generally that if a registration statement, at the time it became effective[1], "contained an untrue statement of a material fact [2] or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security[3] (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity…sue:"

1. every person who signed the registration statement;
2. every person who was a director of … the issuer at the time of the filing of the registration statement;
3. every person who, with his [or her] consent, is named in the registration statement as being or about to become a director;
4. every accountant, engineer or appraiser … who, with his [or her] consent, is named as having prepared or certified any part of the registration statement; and

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5. every underwriter with respect to [the registered] security. (Section 11(a))

Section 11 of the 1933 Act effectively imposes strict liability upon the defendants, subject to the defenses outlined below, and, unlike Rule 10b-5 under the 1934 Act, requires no proof by the plaintiff of "scienter", reliance[4] or loss causation. "Section 11 of the Securities Act 'was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering.'" *WorldCom, infra*, citing the United States Supreme Court in *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381 (1983). Liability under Section 11 is joint and several, with statutory rights of contribution, as provided in Section 11(f)(1), except as liability of outside directors may be limited under Section 11(f)(2).

A Section 11 suit is to recover the difference between the amount paid for the security (not exceeding the public offering price) and the value of the security at the time the suit is brought or, if the security has been sold, generally the price at which it was sold. (Section 11(e)). No action may be brought under Section 11 more than one year after discovery of the untrue statement or omission (or after discovery should have been made by the exercise of reasonable diligence) or, in any event, more than three years after the security was *bona fide* offered to the public. (Section 13 of 1933 Act)

While Section 11 imposes liability on all the potential defendants listed above, this note focuses on the liability of directors and officers. As such, the purpose of this note is merely to serve as a reminder and perhaps provide a check-off list to directors and officers, not to explore in exhaustive detail every nuance of the statute and the related case law.

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[1] In general, subject to various special exceptions not relevant here, assuming that a delaying amendment has been filed pursuant to Rule 473, a registration statement becomes effective when it is declared effective by the SEC pursuant to Rule 461, except that an "automatic shelf registration statement" (as defined in Rule 405), which is available only to a "well-known seasoned issuer" (as so defined), becomes effective immediately upon the filing thereof pursuant to Rule 462(e) (all such Rules being under the 1933 Act); provided, however, that for purposes of determining liability of the issuer and any underwriter under Section 11 in connection with certain offerings after such effective date, the effective date is moved forward to the earlier of the date the prospectus for the offering is first used and the date of the first contract of sale. *See* Rules 430B and 430D under the 1933 Act and SEC Release Nos. 33-8591 and 34-52056.

Interestingly, the effective date is not moved forward with respect to the liability of any defendant other than the issuer and underwriters. To the extent that the base prospectus in a registration statement does not include information that is

included in a prospectus supplement or in a subsequently filed 1934 Act report (except a report to update the registration statement pursuant to Section 10(a)(3) of the 1933 Act or to reflect a fundamental change in the information contained in the registration statement), it would appear that persons other than the issuer and the underwriters would have no Section 11 liability on such information because the effective date with respect to such persons is not moved forward (as in the case of the issuer and the underwriters) and such information was not, and was not required to be, included in the registration statement at the time it originally became effective. *See In re Countrywide Mortg. Backed Sec. Litig.*, 932 F.Supp.2d 1095 (C.D.Cal 2013). This suggests that a director's review of a subsequently filed 1934 Act report might not have to be as rigorous as the review of a report filed before the registration statement originally became effective. However, any relaxation of the standards of diligence to be performed in these circumstances would seem to be unwise because a director could still have Section 11 liability by way of Section 15 of the 1933 Act if s/he were a "controlling person," as well as possible liability under Section 12(a)(2) of the 1933 Act and Rule 10b-5 under the 1934 Act. In any case, any such relaxation would appear to be poor corporate governance.

[2] Rule 405 of Regulation C under the 1933 Act defines the term "material" as follows:

The term *material,* when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered.

This definition reflects the formulation adopted by the United States Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), which has been effectively adopted under substantially all provisions of the 1933 Act and the 1934 Act. Discussion of "materiality" is beyond the scope of this note. However, reference is made to *Materiality in Review – Probability, Magnitude and the Reasonable Investor*, by J. Anthony Terrell, available at https://bracewell.com/insights/materiality-review-%E2%80%94-probability-magnitude-and-reasonable-investor. Section 11 imposes liability for misstatements and omissions of material "facts". There is a line of cases commencing with *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 575 U.S. 175 (2015), that limit, subject to conditions, the imposition of liability on statements of opinion rather than fact. In addition, Section 27A of the 1933 Act and Section 21E of the 1934 Act, as well as the judicial "bespeaks caution" doctrine, limit, subject to conditions, the imposition of liability on forward-looking information. *See* Andrew W. Fine, *A Cautionary Look at a Cautionary Doctrine*, 10 Brook. J. Corp. Fin. & Com. L (2016) and the cases cited therein, as well as Rule 175 under the 1933 Act. Discussion of such limitations on liability is beyond the scope of this note.

[3] Section 11 is generally understood to give standing to sue to every person who purchased securities covered by the registration statement – that is, securities purchased in the public offering or purchased in the aftermarket that can be "traced" back to the public offering. *See Slack Technologies, LLC, fka Slack Technologies, Inc. et. al. v. Pirani,* 598 U.S. 759 (2023), and the cases cited therein, as well as *DeMaria v. Anderson,* 318 F.3rd 170 (2d Cir. 2003).

[4] The plaintiff must prove reliance if s/he acquired the security after the issuer published an earning statement covering a period of at least 12 months beginning after the effective date of the registration statement, but such reliance may be established without proof that the plaintiff actually read the registration statement. Section 11(a), last paragraph.