Section 11 in Review

A Reminder to Directors and Officers

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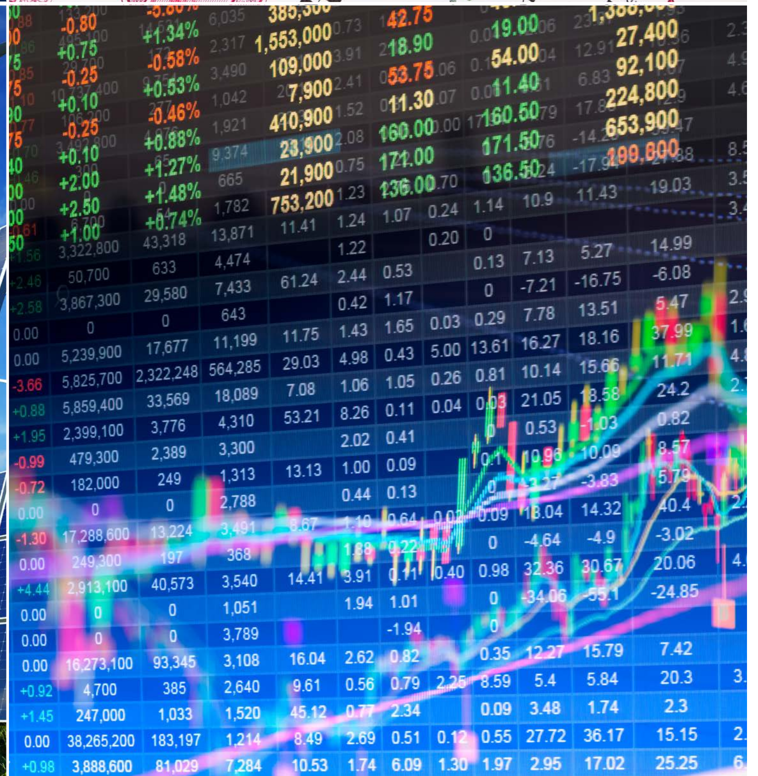

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I. Introduction – Section 11 Generally

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

(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.

II. Affirmative Defenses

A. *General*

There are, of course, defenses to an action under Section 11, the burden of proof being on the defendant in each case. An absolute defense is that there was no misstatement or omission of the fact in question or that such fact was not material. In addition, there are several affirmative defenses available to any defendant including:

- that the plaintiff knew of such misstatement or omission[5];
- circumstances involving the resignation by the defendant director or officer from every relationship with the issuer and, in certain cases, notification of the SEC; and
- that the depreciation in the value of the security in question was the result of factors other than the alleged misstatement or omission.

Any defendant (other than the issuer) has additional affirmative defenses to an action under Section 11 if such defendant sustains the burden of proof that:

(1) Non-Expertised Part of Registration Statement

> [A]s regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert and not purporting to be made on the authority of a public official document or statement, ***he had, after reasonable investigation, reasonable ground to believe and did believe***, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; (emphasis added) (Section 11(b)(3)(A))

(2) Expertised Part of Registration Statement

> [A]s regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), ***he had no reasonable ground to believe and did not believe***, at the time such part of the registration

statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert. (emphasis added) (Section 11(b)(3)(C))

The two affirmative defenses quoted above, and the subject of this note, are together sometimes called the "due diligence defenses", while the defense provided by Section 11(b)(3)(C) is also sometimes called the "reliance defense". As noted, in either case, the burden of proof lies with the defendant to establish the defense.

For completeness, it is noted that Section 11(b)(3)(D) provides an affirmative defense, similar to that provided by Section 11(b)(3)(C), with respect to statements purported to be made by public officials or extracts from public official documents, and Section 11(b)(3)(B) provides an affirmative defense to a defendant expert, similar to that provided by Section 11(b)(3)(A), with respect to information provided by that expert. Discussion of those affirmative defenses is beyond the scope of this note.

B. *Non-Expertised Part of Registration Statement*

(1) General

In order to establish a defense under Section 11(b)(3)(A), a defendant (other than the issuer) must establish

- first, that s/he made a reasonable investigation; and
- second, that, as a result of such investigation, s/he had reasonable ground to believe, and did believe…

It is not sufficient that no misstatement or omission came to the attention of the defendant. The defendant must show that s/he actually made an investigation and that such investigation was reasonable. Section 11 itself gives no guidance as to what a reasonable investigation should entail, except that, under Section 11(c), the standard for determining the reasonableness of an investigation and/or a ground for belief is "that required of a prudent man in the management of his own property."

There is a line of judicial decisions on the liability of directors and officers under Section 11 starting with *Escott v. BarChris Construction Corporation*[6] ("*BarChris")*, which analyzes the responsibilities of various specific directors and officers. Other cases following *BarChris* include *Feit v. Leasco Data Processing Equipment Corp*[7] *("Feit"*) and *In re WorldCom, Inc. Securities Litigation*[8] ("*WorldCom*"). These cases do not set forth any specific, iron-clad rule as to what constitutes a reasonable investigation. Rather, they all contemplate that the investigation conducted by each individual director or officer must be evaluated under the particular

circumstances. However, the court in *WorldCom* observed that "the word 'investigation' connotes a 'thorough' or 'searching inquiry', "and that "the word 'investigate' is defined as 'to inquire and examine into with systematic attention to detail and relationship'." *WorldCom* at 678, citing various editions of Webster's International Dictionary.

(2) Rule 176

In 1982, the SEC adopted Rule 176 under the 1933 Act (as amended in 2011, "Rule 176") to give guidance to directors, officers and underwriters in determining what constitutes a reasonable investigation and/or a reasonable ground for belief under Section 11, particularly in light of the different registration procedures dictated by incorporation by reference and shelf registration. In relevant part, Rule 176 provides that circumstances to be considered in this determination include, in addition to the type of issuer and the type of security:

- the office held when the person is an officer;

- the presence or absence of another relationship to the issuer when the person is a director or proposed director;

- reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in light of the functions and responsibilities of the particular person with respect to the issuer and the filing); and

- whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

See Rule 176(d), (e), (f) and (g). Despite the aforesaid changes in procedures for the registration and offering of securities, the SEC observed in Release Nos. 33-6335; 34-11889 (1981), which proposed Rule 176, that

> For directors, their continuing involvement in their company's activities must be considered. They receive reports, request information from management, meet periodically, and analyze, plan and participate in the company's business. These activities provide a strong basis for their evaluation of disclosure in a registration statement, and for considering what further due diligence is necessary on their part. In particular, their roles in reviewing the company's Form 10-K annual report and other Exchange Act filings are relevant to their due diligence for a registration statement incorporating those filings.

Rule 176 embodies the concept of differential liability expressed in *Feit* that "[w]hat constitutes 'reasonable investigation' and a 'reasonable ground to believe' will vary with the degree of involvement of the individual, his expertise and his access to the pertinent information and data." As more recently confirmed by the same court in *Federal Housing Finance Agency v.*

Nomura Holding America Inc. et al ("*Federal Housing*"), 68 F. Supp. 3d 439, 468-69 (S.D.N.Y. 2014),

> …there is a "sliding scale" in the diligence required of parties, with heavier demands of those with more central roles and greater access to the information and expertise needed to confirm the accuracy of the registration statement.

While "expertise" is not specifically listed in Rule 176, it is a factor to be considered under *BarChris, Feit* and *Federal Housing*, although it is not determinative in and of itself.[9]

The "sliding scale" concept appears to be embodied in Section 11(f)(2) of the 1933 Act and Section 21D(f) of the 1934 Act, discussed below, which, together, may limit the amount of damages for which an "outside director" is liable.

(3) Internal Controls

Pursuant to Section 302 of the Sarbanes−Oxley Act of 2002, the SEC adopted:

- Rule 13a-15 which, in relevant part, requires public companies to maintain "disclosure controls and procedures" and "internal control over financial reporting" (each as defined in that Rule and presumably consistent with, and not in duplication of, the system of accounting controls required by Section 13(b)(2) of the 1934 Act); and

- Rule 13a-14 which, in relevant part, requires the chief executive officer and the chief financial officer of a public company to make certifications as to the accuracy (based on the knowledge of the signer) of annual and quarterly reports filed with the SEC and as to the maintenance and effectiveness of such internal controls.

In recognition of the fact that directors and senior officers cannot themselves assure the absolute accuracy or completeness of all the issuer's disclosures, these internal controls set up a structure for responsibility and reporting throughout the organization that, if established properly, maintained consistently and tested rigorously, should provide a reasonable level of confidence in the quality of such disclosures. It is a legal obligation of the issuer and its senior officers to implement and maintain such systems of internal controls, and presumably, directors and senior officers are entitled to some degree of reliance on information provided by subordinates through the processes and procedures embodied in such internal controls in the performance of their due diligence investigation. This would be consistent with the "reasonable reliance" contemplated in Rule 176, noted above. On the other hand, the absence or ineffectiveness of such internal controls would seem to impair entitlement to such reliance.

It is worthy of note that the notion of protection afforded by effective internal controls is consistent with the corporation law of most states, as well as the Model Business Corporation Act put forth by the Business Law Section of the American Bar Association[10], and particularly the *Caremark* doctrine first developed in Delaware.[11]

C. ***Expertised Part of Registration Statement***

(1) General

The expertised part of a registration statement would ordinarily include the audited financial statements (including the related notes and schedules), as well as any other part stated to have been prepared or certified by an expert. The expertised part of a registration statement does **not** include unaudited financial statements (or related notes) even if they are "reviewed" by an independent accountant. *WorldCom,* 346 F.Supp.2d at 664.

As shown above, there is no requirement expressed in the statute that a defendant (other than the issuer) prove that s/he made any investigation as to the part of a registration statement prepared or certified by an expert. Rather, such a defendant only has to show that s/he "had no reasonable ground to believe, and did not believe…" (Section 11(b)(3)(C)) However, at least in the Second Circuit, "reliance on audited financial statements may not be blind. Rather, where 'red flags' regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability." (*WorldCom,* 346 F.Supp.2d at 672).

(2) Red Flags

The next question, of course, is what constitutes a "red flag". As discussed in *WorldCom*, "[a]ny information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements is a red flag…". *(WorldCom,* 346 F.Supp.2d at 673). "If a 'prudent man in the management of his own property'…, upon reading the 1999 Form 10-K and being familiar with the other relevant information about the issuer's competitors would have questioned the accuracy of the figures, then those figures constituted a "red flag" and imposed a duty of investigation…" (*Id.* at 679). Stated another way, if a prudent person in the management of his/her own property would have been alerted by an item of information (whether within or without the registration statement) and made reasonable inquiry regarding the same, then such information constituted a "red flag", and, absent such inquiry by the defendant, the defendant would be unable to show that s/he "'had no reasonable grounds to believe and did not believe' that [the] registration statement contained material misstatements…", as required under Section 11(b)(3)(C). *Id* at 679. Thus, the presence of a "red flag", absent such inquiry, effectively deprives the defendant of any defense provided by Section 11(b)(3), at least with respect to subject matter relating to such "red flag".

D. ***Proportionate Liability; Indemnification; Insurance; Out-of-Pocket Payment; No Exculpation***

(1) Proportionate Liability of Outside Directors

As originally enacted, Section 11(f) imposed joint and several liability for the entire judgement on each defendant, with rights of contribution among all defendants. *See* Section 11(f)(1). Section 201 of the Private Securities Litigation Reform Act of 1995 (the "PSLRA") amended Section 11 and the 1934 Act to, among other things, provide that an "outside director"

(without definition) will be liable under Section 11 for damages jointly and severally only if s/he is found to have "knowingly" (meaning with actual knowledge) made a misstatement or omission of a material fact. Absent such actual knowledge, the outside director is liable "solely for the portion of the judgment that corresponds to the percentage of responsibility" of that person; and a person's "percentage of responsibility" is his/her percentage of "the total fault of all persons who caused or contributed to the loss incurred by the plaintiff." *See* Section 11(f)(2) of the 1933 Act and Section 21D(f) of the 1934 Act. Notably, the provisions introduced by the PSLRA apply only to the allocation of the responsibility to pay damages -- they do not "affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws." Section 21D(f)(1) of the 1934 Act. That said, these provisions do in fact appear to be consistent with the "sliding scale" concept of embodied in *Feit* and Rule 176. Of course, these provisions do not limit the liability of defendants other than outside directors, and they have no applicability at all in the context of a settlement.

(2) Indemnification

It is common for companies to have indemnification agreements protecting directors and officers from various liabilities. While these agreements should be examined to ascertain whether they cover liabilities under the federal securities law, it should be kept in mind that, in the view of the SEC, they are unenforceable as against public policy in the context of an action under Section 11 and that in every registration statement the company is required to undertake to submit the question to a court of appropriate jurisdiction prior to honoring a claim for indemnification. *See* Item 512(h) of Regulation S-K. *See* also *Perry v. Duoyuan Printing, Inc.*, 232 F. Supp. 3d 589 (S.D.N.Y. 2017) and the cases cited therein which, generally, show that it is established law that indemnification in a Section 11 case is enforceable only if the indemnitee is without fault (or less at fault than the indemnitor).

(3) Insurance

It would seem logical that, if indemnification of directors and officers in a Section 11 case offended public policy, that public policy would also be offended by an insurance policy covering the same liabilities ("D&O Insurance"). However, the SEC has not objected to D&O Insurance coverage of Section 11 liabilities. In fact, Rule 461(c) under the 1933 Act states that D&O Insurance will not be a bar to acceleration of the effective date of a registration statement. The enforceability of a D&O Insurance policy in any particular situation will depend on the language of the policy, the policy limit and any applicable exclusions and may be further limited by case law precluding recovery of any "ill-gotten gains".[12]

(4) Out-of-Pocket Payment

It should be noted that even where indemnity agreements and/or D&O Insurance may be available, directors and officers may still be at risk in the context of a settlement in which large financial institutions and/or public officials are involved. In the settlements of the *WorldCom* and *Enron* litigations, the lead plaintiffs – the New York State Common Retirement Fund in *WorldCom* and the University of California in *In re Enron Corp. Securities Litigation*[13] ("*Enron*") – were not

satisfied by mere recovery of their monetary investment. In each case, the lead plaintiff, as a condition to its agreeing to the settlement, required that directors pay a substantial portion of the settlement out of their own pockets for the purpose of sending a message to corporate directors generally. The New York State Comptroller famously stated that the purpose was to send "a strong message to directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent … We will hold them personally liable if they allow management of the companies on whose boards they sit to commit fraud."[14] Without doubt, *Enron* and *WorldCom* were egregious examples of corporate fraud. However, the message conveyed is generally applicable and is certainly not inconsistent with the current ESG movement.

(5) No Exculpation

It should also be noted that the corporation laws of many states permit a company's articles of incorporation to contain a provision eliminating or limiting (with certain exceptions) the personal liability of a director or officer to the corporation or stockholders for monetary damages for breach of fiduciary duty. See, for example, Section 102(b)(7) of the Delaware General Corporation law and Section 2.02(b)(4) of the Model Business Corporation Act. These exculpatory provisions relate to liabilities under state corporation law and have no effect on liabilities under the federal securities laws.

III. Establishment of Due Diligence Defense

A. *General*

As discussed above, each defendant (other than the issuer) has the burden of proving his/her own affirmative defense. Whether any particular defendant has sustained this burden depends on the facts and circumstances of each case including without limitation (1) in the case of a director of the issuer, any relationship with the issuer other than the directorship, any special expertise of the director and the board committees on which the director sits and (2) in the case of an officer of the issuer, the primary duties of the officer, the responsibility of the officer for the defective parts of the registration statement, the role of such officer in the performance by the issuer of the activities described in the defective part of the registration statement and any special expertise of such officer. *See BarChris, Feit* and *WorldCom* and other cases too numerous to analyze specific factual situations. This note will attempt only to outline basic principles. However, in all cases the initial step, and bare minimum, for establishing the due diligence defense is reading the registration statement including the documents incorporated therein by reference.

It is worthy of emphasis that a director or officer who has special expertise and thus has special responsibilities for reviewing a discrete part of a registration statement nevertheless is obligated, as a director and/or as a signer, to make an investigation as to the rest of the registration statement:

> He also failed to prove, as to [other] parts of the prospectus … that he made a reasonable investigation which afforded him a reasonable ground to believe that it was true. As far as appears, he made no investigation. He did what was asked of him and assumed that others would properly take care of supplying accurate data as to the other aspects of the company's business. This would have been well enough but for the fact that he signed the registration statement. As a signer, he could not avoid responsibility by leaving it up to others to make it accurate.

BarChris, 283 F.Supp. at 686.

B. *Directors*

(1) Outside Directors.

Outside directors generally are considered to be directors who are not also employees of the issuer and have no other relationship with the issuer that would provide any particular influence over the business of the issuer or enhanced access to information. There is no definition of the term in the 1933 Act or the 1934 Act or the SEC rules under either of such statutes. The definitions of the term "independent director" in Section 303A.02 of the Listed Company Manual of New York Stock Exchange and Rule 5605(a)(2) in the Listing Rules of the Nasdaq Stock Market LLC may be instructive.

As to expertized parts of the registration statement such as the audited financial statements, it should not be too burdensome for such a director to prove that s/he had no reason to believe, and did not believe, that such part was defective. However, while Section 11(b)(3)(C) does not specifically require any investigation (as does Section 11(b)(3)(A)), it would seem difficult to establish the absence of such a reason to believe, or such a belief, without ever having at least read the expertized part of the registration statement. Moreover, as noted above, if there are "red flags" in the expertized part, the director does have an obligation to make further inquiry. The director would likely not be able to discover any "red flags" without at least reading the expertized part of the registration statement.

As to the non-expertized parts of the registration statement, the outside director has to make such investigation as would "a prudent man in the management of his own property." *BarChris,* 283 F.Supp. at 683. As noted above, to investigate means to conduct a systematic inquiry. The court in *BarChris*, and again in *WorldCom*, expounded on the requirement for an underwriter to make a reasonable effort to **verify** at least the most material data presented by the issuer.[15] It would seem that an outside director, in light of his/her continuing relationship with the issuer and consequent ability to exert more control over disclosure and the timing of an offering, should be expected to make an "investigation" at least as rigorous as that of an underwriter. *BarChris*, *Feit* and the ultimate treatment of directors in the resolution of the *Enron* and *WorldCom* litigations support this proposition. While not necessarily controlling for purposes of Section 11, as opposed to rule 10b-5 under which the SEC has enforcement power, it is perhaps instructive that the SEC views independent directors as "monitors" of the disclosures of public companies, with the responsibility "to ensure that companies comply with securities duties".[16]

A director should be able to rely, to some degree, on the review of a part of a registration statement by a committee of the board of which s/he is not a member to the extent that the matters covered by such part fall within the purview of such committee. For example, a director who is not on the audit committee may rely to some extent on the review of the financial statements by the audit committee. Likewise, a director who is not on the environmental committee should be able to rely to some degree on the review of the parts of the registration statement disclosing environmental issues by the environmental committee. Similarly, all outside directors may rely, to some degree on the preparation or review of the registration statement by competent officers of the issuer. This would seem consistent with the views of the SEC as expressed in Release Nos. 33-6335; 34-18011 (1981), which proposed Rule 176.

However, while the reasonableness of reliance may be considered in assessing the reasonableness of an investigation, reasonable reliance, of itself, does not constitute a reasonable investigation – the defendant director must be able to show that s/he actually made an investigation and that such investigation was reasonable under the circumstances. When the full board is assembled, each director, in order to establish his/her own due diligence defense, should ask questions of other directors and of officers of the issuer invited to the meeting, and review background material where necessary or appropriate, to achieve a reasonable level of confidence in the accuracy and completeness of the registration statement as a whole. This would suggest that the full board, not just the audit committee, should review and approve a substantially final draft of a registration statement, including any documents then or thereafter from time to time incorporated therein by reference – the directors should not just sign a blank signature page without reviewing the document to which it is to be attached.

On the other hand, when assessing the reasonableness of an investigation, courts generally do not require perfection. In *Laven v. Flanagan*, 695 F. Supp. 800 (D.N.J. 1988), for example, the court found that the defendant outside directors had "actively worked to bring their knowledge of Western Union activities up to speed in the months between their accession to the Western Union board and the Merrill Lynch offering". They had "acted carefully and diligently in choosing an investment" and had received representations of management. They had conducted a "careful review of the prospectus". Under these circumstances, their reliance on the accuracy of representations of management was not considered unreasonable, particularly since it was confirmed by investigations of the independent auditors and the underwriters.

> Their work was imperfect, to the regret of plaintiff … But their activities were a far cry from the passive and total reliance on company management that defeated the due diligence defense in [*BarChris*]. As such, we must deem it to have been a reasonable effort to seek verification of the truth of the registration statement. (*Id* at 812)

Specific investigatory activities that should be considered by outside directors are listed on Schedule A to this note.

(2) *New Outside Directors*.

It is common for directors to retire and for new directors to be elected during the year, after a shelf registration statement or an annual report on Form 10-K has been filed. It is quite possible that a new director may take office before s/he has had substantial opportunity to read the registration statement (including the incorporated documents) and independently perform the required investigation, perhaps relying on assurances of the incumbent directors. The court in *BarChris* had no sympathy for such a director, holding among other things that:

> Section 11 imposes liability in the first instance upon a director, no matter how new he is. He is presumed to know his responsibility when he becomes a director. In my opinion, a prudent man would not act on an important matter without any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case.

BarChris, 283 F.Supp. at 688.

(3) *Non-Outside Directors*.

For directors who are not outside directors, the extent of the investigation necessary to establish a due diligence defense would presumably exceed that of an outside director and would be determined primarily by the nature of such person's duties associated with his/her employment or other relationship with the issuer. A person whose duties include personal involvement in the activities described in the allegedly defective part of the registration statement, or make him/her responsible for the information contained in such part of the registration statement, may have no due diligence defense at all unless s/he can also show that s/he examined "the original written record". (*BarChris*, 283 F.Supp. at 684-692). For example, a person with responsibility for the preparation of, and intimate knowledge of, the financial statements may have difficulty establishing a due diligence defense against liability from misstatements or omissions in the financial statements, whether or not audited. (*See Id.* at 685-86)

(4) *ABA Corporate Director's Guidebook*

Commentary on the duties and responsibilities of corporate directors would not be complete without reference to the Corporate Director's Guidebook published by the Corporate Law Committee of the Business Law Section of the American Bar Association (7th ed., 2020). *See* 75 Bus. Law 2741-2838 (2020). This guidebook contains valuable discussion of corporate governance generally under state corporation law and federal securities law. Chapter 11, "Duties under the Federal Securities Laws", Part A, "SEC Reporting Requirements", deals with an issuer's general reporting requirements under the 1934 Act and the duty of all directors, separate and apart from specific audit committee requirements, to review reports filed under the 1934 Act.

> [A]ll directors should review and be satisfied with the corporate processes used to prepare the Form 10-K and understand the significant disclosures in the that report. Therefore, the full board should have an opportunity to read, comment on, and ask questions about the Form 10-K before it is filed.
>
> Directors are not expected to verify independently the accuracy of underlying facts contained in earnings releases or reports filed with the SEC, but they should be satisfied that the disclosures are not contrary to the facts as they know them...

The last sentence quoted above may be a trap for the unwary - at least for the director who does not read the remainder of Chapter 11 of the guidebook. Part C of Chapter 11, "Registration Statements", indicates that registration statements (including the documents incorporated therein by reference) should be reviewed with considerably more rigor:

> The director's primary defense to registration statement liability is due diligence…During the registration process, directors should satisfy themselves that the corporation has developed and used appropriate corporate disclosure controls and procedures reasonably designed to ensure the registration statement's accuracy and completeness. Although all registration statements should be prepared with appropriate care, certain registered offerings may have a higher potential for liability, such as an initial public offering, a follow-on equity offering, a large acquisition using the corporation's equity, or a financing or reorganization of a public corporation that has experienced problems. Accordingly, a board meeting or meetings with counsel, accountants, and management present at which there is a discussion and analysis of the disclosures in the registration statement should precede the filing of registration statements for such offerings.
>
> For many companies, the disclosures in the corporation's Form 10-K and other reports filed previously with the SEC are incorporated into the registration statement. Therefore, the procedures used to review these reports are important when there is a registered securities offering. Each director should personally review the registration statement for accuracy, with particular attention to those statements and disclosures in the registration statement that are within the director's knowledge and competence. Directors may also want to consider consulting with the corporation's legal counsel to understand any material changes made to disclosure documents in response to SEC comments and to confirm that the process followed is intended to fulfill the due diligence requirements.

C. *Officers*

Officers of the issuer (who are not also directors) are not specifically contained in the list of potential defendants in Section 11(a). However, under subdivision (1) of Section 11(a) every signer of a registration statement may be sued under that Section. Section 6(a) of the 1933 Act

generally requires a registration statement to be signed by the principal executive officer (the "CEO"), the principal financial officer (the "CFO"), the principal accounting officer (the "CAO"), as well as a majority of the directors and the registrant itself.

Each of the signing officers is entitled to the due diligence defenses discussed above. However, whether or not any particular defendant has met the burden of establishing a defense depends on the particular facts, with each signer having a higher bar with respect to parts of the registration statement that contain information for which s/he is responsible but, as discussed above, having potential liability on the entire document***.*** For example, the CAO may be able to satisfy the standard with respect to non-accounting information, such as human capital resources, in the usual manner, while s/he might have more difficulty establishing any due diligence defense with respect to the financial statements. (*BarChris* at 685-86) Moreover, since the CAO, directly, and the CFO, indirectly, are responsible for the financial statements, the limitations on the due diligence defense available to either of such officers with respect to the financial statements would appear to apply equally to the audited and unaudited financial statements – that is, depending on the particular facts, each of the CFO and CAO may have difficulty taking advantage of the lower standard set forth in Section 11(b)(3)(C) because it may be hard to argue that s/he "had no reasonable grounds to believe" that there was a defect in the information given since that information is prepared under their supervision in the first place. (*BarChris* at 685-86)

Specific investigatory activities that should be considered by corporate officers are listed on Schedule B to this note.

IV. Section 12(a)(2)

Discussion of Section 11 would not be complete without at least a brief mention of its sister provision, Section 12(a)(2) of the 1933 Act. Section 12(a)(2) provides a remedy to the purchaser of a security offered or sold by means of a prospectus or oral communication that includes a misstatement or misleading omission of a material fact. As under Section 11, under Section 12(a)(2) the purchaser of the security may sue for rescission and does not have to prove "scienter", reliance or loss causation. Unlike under Section 11, under Section 12(a)(2) the plaintiff may sue only the person who directly sold the security or actively offered the security for sale to the plaintiff. *See Pinter v. Dahl.*[17]

In addition to the affirmative defenses of knowledge on the part of the plaintiff and lack of loss causation, the defendant has an affirmative defense if s/he sustains the burden of proof that s/he ***"did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission"*** (emphasis added) -- somewhat like the standard in Section 11(b)(3)(A) in that the defendant may have to prove the s/he used reasonable care (although s/he is not specifically required to prove that s/he made an investigation); and somewhat like the standard in Section 11(b)(3)(C) in that the defendant has to prove the negative proposition that s/he "did not know…and…could not have known…".

In a firm commitment underwriting, in which investors purchase securities from the underwriters and not from the issuer, it would seem that the issuer would have no liability under Section 12(a)(2). In 2005, the SEC adopted Rule 159A which provides that if the securities are offered or sold by means of a prospectus or other communication made by the issuer, the issuer will be considered to have offered or sold the security for purposes of Section 12(a)(2), regardless of the underwriting arrangements. There is some question as to the validity of Rule 159A – while some courts have applied it[18], other courts have held that the SEC exceeded its authority in adopting the rule and have declined to apply the rule regardless of the SEC's position.[19]

Rule 159A, however, applies only to the issuer and not to directors or officers of the issuer. Thus, in a firm commitment underwriting, it would seem that directors and officers have no liability under Section 12(a)(2), even if the rule were applicable. However, such individuals could have liability in cases where they play an active role in offering the security – such as, for example, by participating in a "road show" that may be considered to be part of the process of offering or soliciting the purchase of the security. In such a case, directors or officers or other employees of the issuer who participate in the "road show" could have liability under Section 12(a)(2) even if they are not on the list of possible defendants in an action under Section 11. Of course, if any such individual were considered to be a "controlling person" of the issuer, s/he could have liability under Section 12(a)(2) by way of Section 15 of the 1933 Act.

Due Diligence Investigation by Outside Directors

The foundation of any defense by directors to a Section 11 lawsuit would be the review of the registration statement itself, including, the documents initially, and thereafter from time to time, incorporated therein by reference. This is essential. Depending upon the particular circumstances, it would seem prudent for directors to consider the following, among other, additional due diligence:

1. review

- presentations by the company to, and reports on the company by, rating agencies and securities analysts, and, of course, the company's internal operating and financial projections;
- earnings press releases (and listen to related conference calls with analysts) and other material press releases;
- due diligence questions asked by underwriters in securities offerings; if feasible, listen to underwriters' due diligence calls;
- the 1934 Act reports of similar companies in the same industry and of critical suppliers and customers, as well as industry reports by trade associations;
- material regulatory orders or reports of regulatory agencies and basic pleadings in material litigation, or at least executive summaries thereof, and annual lawyers' letters to auditors regarding material contingencies;
- analyses of the various risks the company faces, both external and internal, and the various systems, procedures and contingency plans established to manage such risks; and
- without limiting the generality of the foregoing, executive summaries of the accounting, financial reporting and disclosure controls required by the 1934 Act, as well as the compliance and reporting systems required by the corporation law under the *Caremark* doctrine, and conduct whatever investigation is necessary to become reasonably comfortable that such internal controls and systems and procedures are effective to perform the functions for which they were designed, including consultations with internal and independent auditors, internal and, where appropriate, outside counsel and other independent advisors;

2. with respect to parts of the registration statement (including incorporated documents) relating to areas addressed by board committees of which a director is a member, the director should keep in mind that s/he may have a higher standard of

responsibility than directors not members of such committee; accordingly, directors on the committee should:

- attend committee meetings and discuss the relevant disclosures with other committee members, responsible officers of the company and counsel, if appropriate;

- examine background information, particularly with respect to matters that have caused, or are reasonably likely to cause, material changes in results of operations, financial position and/or business and financial prospects and material contingencies;

- if on the audit committee,

    - discuss with the independent auditors, alone and/or together with responsible company officers, as appropriate, critical audit matters, critical accounting policies, procedures and estimates and any material changes in therein, as well as material risks and contingencies and internal projections; and

    - review with the independent auditors and responsible company officers drafts of the financial statements (audited and unaudited) and notes thereto, as well as MD&A and other disclosures of material trends, risks and contingencies;

3. with respect to the entire registration statement (including the incorporated documents),

- all directors should attend full board meetings at which the disclosures in the registration statement are discussed, including particularly, but without limitation, financial statements (audited and unaudited) and notes thereto, MD&A and other disclosures of material trends, risks and contingencies;

- each committee should report to the full board material matters falling within the purview of that committee, bringing to the attention of the board any material trends, risks and contingencies, other matters materially affecting business or financial prospects and, in the case of the report of the audit committee, matters discussed with the independent auditors; and

- members of each committee should ask questions of members of other committees and of responsible company officers; and

4. with respect to the audited financial statements, except where “red flags” are reasonably observable after the investigations described above and assuming that the independent auditors, the directors on the audit committee and the CFO and the CAO all appear to be competent, responsible and reliable (as contemplated by Rule 176(f)), directors not on the audit committee ordinarily should not have to perform any investigation of the audited financial information in addition to that contemplated in items 1 and 3 above -- that is, based on their knowledge of the company’s business

> and affairs resulting from the activities described in items (1) and (3) above, they should have no reasonable ground to believe that there is any disclosure problem. However, if any "red flags" are observed, or should reasonably be observed, then further investigation is necessary.

Except with respect to matters within the purview of a director's own board committee, as outlined above, each director to some extent delegates his/her due diligence responsibility to the members of each other committee and to the company officers reporting to that committee. This should be permissible so long as the delegating person reasonably believes that such committee members and officers are competent and are performing their own due diligence investigation in proper fashion. Delegation must be reasonable, not blind, and must be followed up by the particular director asking questions of such committee members and officers and examining background information, particularly where information appears to be inconsistent with other information, within or without the registration statement (including the incorporated documents), known to such director.[20] As aforesaid, in some cases, any such inconsistency could be a "red flag" warranting further investigation. (*WorldCom*, 346 F.Supp.2d at 673-78)

The foregoing is not intended to be an exhaustive discussion of appropriate due diligence for purposes of Section 11. The scope of required due diligence necessarily varies with the particular industry and the particular company. Furthermore, it should go without saying that Section 11 due diligence is but a subset of the responsibilities of directors in their oversight of the management of a company, a topic which is beyond the specific purpose of this note.

Schedule B

Due Diligence Investigation
by Officers

General

As discussed above, every officer who signs a registration statement has the same liability as directors under Section 11(a) and, at least in theory, is entitled to the same defenses. The due diligence investigation required for any particular officer to establish a defense depends upon the responsibilities of that officer in the governance and operations of the particular company. That said, it would seem that, at a bare minimum, each signing officer's due diligence investigation should include, without limitation and in addition to reading the entire registration statement (including the documents initially, and thereafter from time to time, incorporated therein by reference),

- all the activities noted in item 1 in Schedule A hereto for directors;
- discussing each area covered in the registration statement (including the incorporated documents) with the officers primarily responsible for such area;
- making inquiry further down the employee chain and/or examining written material with respect to matters of critical importance and certainly anything that could be a "red flag";
- discussing material accounting issues with internal accountants and, where appropriate, the independent accountants;
- discussing material legal issues with internal and, where appropriate, external counsel; and
- discussing material risks, external and internal, with the personnel responsible for implementing the various systems, procedures and contingency plans established to manage such risks.

Chief Executive Officer

While in one sense the CEO is responsible for the conduct of the entirety of the business and affairs of the company, s/he, of course, does not do that alone. Rather, the role of the CEO is somewhat like that of an outside director in that s/he of necessity delegates the responsibility to various subordinate officers who are responsible for specific areas. Thus, there is not much that the CEO can do in addition to the investigations described in *General* above. However, as a signer of the registration statement, the CEO is required to make a reasonable investigation of the entire document, although s/he may not have special responsibility for any particular part.

Of course, the CEO has to perform whatever investigation is necessary to reasonably conclude, and certify in connection with each annual report on Form 10-K and each quarterly report on Form 10-Q, (a) that the company's financial reporting and disclosure controls (as well as, without duplication, the accounting controls required by Section 13(b)(2) of the 1934 Act) are in place and effective to perform the functions for which they were designed and (b) that such report fully complies with the requirements of the 1934 Act, does not contain any misstatement or omission of a material fact and fairly presents, in all material respects, the company's financial condition, results of operations and cash flows. *See* Rules 13a-14 and 13a-15 under the 1934 Act.

Chief Financial Officer

The CFO ordinarily would be ultimately responsible for financial, accounting and tax matters and possibly also certain risk management and other functions. As such, s/he would have direct supervisory control over those areas. It may be difficult for the CFO to establish a due diligence defense in an action alleging material misstatements or omissions in those areas because s/he would not be investigating the work product of others but the work product for which s/he is primarily responsible. In order to establish such a defense, it would seem that the CFO would have to show, first, the s/he made the investigations noted above for the CEO in the areas for which s/he is responsible, including discussions with subordinate officers and employees directly responsible for the respective areas (including without limitation the CAO). In addition, s/he would likely have to show that, with respect to material issues, s/he made inquiry far down the employee chain, did indeed examine “the original written record” and, of course, consulted the independent auditors when appropriate.

In addition, as a signer of the registration statement, the CFO, like the CEO, has to make reasonable investigation as to the remainder of the registration statement − that is, those parts of the registration statement for which s/he does not have primary responsibility.

Like the CEO, the CFO has to perform whatever investigation is necessary to reach the conclusions and make the certifications required by Rules 13a-14 and 13a-15 under the 1934 Act, as described above.

Chief Accounting Officer

The CAO presumably has primary responsibility for only the company’s books of account, financial statements and related information. Thus, the investigation that must be conducted by the CAO is narrower in scope than that of the CFO. However, it may be difficult for the CAO, even more difficult than for the CFO, to establish an adequate investigation as to the financial statements since it is s/he who is directly responsible for their preparation. That said, there may not be much that the CAO can do in addition to what is described above with respect to the CFO, except that the investigation should likely cover all questionable areas whether or not clearly material and could require the CAO to make inquiry all the way to the bottom of the employee chain.

In addition, as a signer of the registration statement, the CAO, like the CFO, has to make reasonable investigation as to the remainder of the registration statement − that is, those parts of the registration statement for which s/he does not have primary responsibility.

Finally, the CAO should perform whatever investigation is necessary to reasonably conclude, and advise the CEO and the CFO of his/her conclusions, as to the matters then required to be certified by the CEO and the CFO pursuant to Rules 13a-14 and 13a-15 under the 1934 Act, as described above (to the extent related to the company’s books of account, financial statements and/or related matters).

ENDNOTES

[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.

[5] The affirmative defense of knowledge on the part of the plaintiff is generally construed to mean actual rather than constructive knowledge. *See New Jersey Carpenters Health Fund v. Rali Series 2006 – QOI Trust*, 477 F.Appx 809, 813 (2d Cir. 2012); *Kronfeld v.Trans World Airlines*, *Inc.* 832 F.2d 726, 736 (2d Cir. 1987). In other contexts, see *Dale v. Rosenfeld*, 229 F. 2d 855, 858 (2d Cir. 1956) (Section 12(a)(2)); *United Paperworkers International Union v. International Paper Co.*, 985 F. 2d 1190, 1199 (2d Cir. 1993) (Section 14(a) and Rule 14a-9).

[6] *Escott v. BarChris Construction Corporation*, 283 F. Supp. 643 (S.D.N.Y. 1968).

Various of the analyses set forth in *BarChris* have been cited as authority by most federal Circuit Courts of Appeal and by the Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208(1976).

[7] *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971).

[8] *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

The cited *WorldCom* decision involves cross-motions for summary judgement by the plaintiffs and the underwriter defendants. Accordingly, the decision is focused on the liability and defenses of underwriters under Section 11. As discussed in this note, the liability and defenses of directors and officers are substantially the same as those of underwriters. See the subsequent decisions of the court in the same litigation denying a motion for summary judgment by the chairman of the board of directors, Master File 02 Civ. 3288 (DLC) (S.D.N.Y. 2005), wherein the court, among other things, applied the same "red flag" concept to limit the defense of directors under Section 11(b)(3)(C). It is noted that it may be more difficult for directors and officers than for underwriters to establish a due diligence defense under Section 11(b)(3)(A) or Section 11(b)(3)(C) since directors and officers have a continuing relationship with the issuer while the underwriters' relationships are primarily transactional, so that, at least in theory, directors and certainly officers have more control over disclosure by the issuer.

Examples of "red flags" in *WorldCom* included the fact that WorldCom's E/R Ratio (the ratio of line costs to revenues) was significantly lower than that of its competitors and the fact that WorldCom's competitors had taken the asset impairment charges, due to the decline in the telecommunications sector, but WorldCom had not despite deterioration in its long-distance business.

[9] Inasmuch as the expertise of Section 11 defendants may be a factor in determining liability, it is suggested that this be kept in mind when preparing the biographies of directors and nominees (including particular qualifications and skills) to be included in proxy statements. *See also In re U.S. Bioscience Securities Litigation*, 806 F. Supp 1197 (E.D.Pa. 1992) and *Tischler v. Baltimore Bancorp*, 801 F. Supp. 1493 (D.Md. 1992) for the effect of expertise in establishing "scienter" in Rule 10b-5 litigation.

It should also be kept in mind, in this regard, that two misstatements or omissions can arise out of the same circumstance. For example, the failure to disclose a material risk could be an omission actionable under Section 11. In light of that failure, a statement in a 1934 Act report or proxy statement pursuant to Item 407(h) of Regulation S-K to the effect that the board plays an active role in risk oversight could constitute a separate (albeit related) misstatement actionable under Section 11.

[10] *See* Delaware General Corporation Law, Section 141(a); New York Business Corporation Law, Section 701; Texas Business Organizations Code, Section 21.401(a); California General Corporation Law, Section 300(a); and Model Business Corporation Act, Section 8.01(b). The corporation law (including the model) contemplates, generally, that the business and affairs of a corporation shall be managed by or under the direction of the board of directors and

that the role of the board of directors is to set corporate strategy and policy, direct generally the management of the business and approve specific major transactions, but is not to be involved in the day-to-day operations.

[11] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del.Ch.1996). Under the *Caremark* doctrine, the directors must assure themselves that "information and reporting systems exist in the organization that are reasonably designed to provide to senior management and the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance." *Id.* at 970 *Caremark* has been followed in several subsequent decisions of Delaware courts including *Stone v. Ritter*, 911 A. 2d 362 (Del. 2006), and *Marchand v. Barnhill*, 212 A. 3d 805 (Del. 2019), in which the Supreme Court of Delaware not only approved the *Caremark* doctrine, in general, but also clarified *Caremark* by suggesting that a *Caremark* claim for breach of fiduciary duty will be sustained if the plaintiff can demonstrate either (1) that the board has not implemented board-level information and reporting systems reasonably designed to bring to its attention, at a minimum, "mission critical" matters or (2) that the board, even though having implemented such systems, has failed to monitor the information generated thereby. Conversely, the decision of the Delaware Chancery Court in *City of Detroit Police and Fire Retirement System v. Hamrock et al*., C.A. No.2021 – 0370 – KSJM, 2022 WL 2387653, at * 20-21 (Del.Ch. 2022), which involved the explosion of a gas pipeline, suggests that directors should have a defense to a *Caremark* claim if they can show documentation of such information and reporting systems, as well as documentary evidence of actually monitoring and acting upon the information (especially "red flags") so made available to them.

Like the internal controls required under the 1934 Act, the information and reporting systems required by *Caremark* might help in establishing the reasonableness of reliance contemplated by Rule 176(f), but the absence or ineffectiveness thereof, or the failure to utilize them, might well impair entitlement to such reliance.

[12] *See Level 3 Communications Inc. v. Federal Insurance Co.*, 272 F. 3d 908 (7th Cir. 2001); *CNL Hotels & Resorts v. Houston Casualty Company*, 505 F. Supp. 2d 1317 (M.D.Fla. 2007); Black, Cheffins and Klausner *Outside Director Liability*, 58 Stan. L. Rev 1055 (1085-1086).

[13] *In re Enron Corp. Securities Litigation*, 586 F. Supp. 2d 732 (S.D. Tex 2008).

[14] *See* Black, Cheffins and Klausner, *Outside Director Liability*, 58 Stan.L.Rev. 1055 (1057-1059); Spehr, Simone and Calica, *Securities Act Section 11: A Primer and Update of Recent Trends*, Washington Legal Foundation, Contemporary Legal Notes Series, Number 49, January 2006 (17-18); and the press releases and news articles cited in the foregoing.

[15] "The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection. To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to **verify** the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them." (*WorldCom,* 346 F.Supp.2d at 675 (citing *BarChris* 283 at 697) (emphasis added))

[16] "The Commission has 'long viewed the issue of corporate governance and the fiduciary obligations of members of management and the boards of directors of public companies to their investors as an issue of paramount importance to the integrity and soundness of capital markets.' SEC statements and prior enforcement actions set out a role for independent directors as securities monitors, tasking them with reviewing and managing company disclosures to ensure accuracy, updates, and corrections…[I]ndependent directors are on the board for a reason. They are to play a 'significant role in the direction of a company's affairs,' particularly when they have relevant expertise, experience,

and sophistication. They are to act as securities monitors and ensure that companies comply with securities duties. The securities monitor role is particularly serious when it involves statements the directors draft or sign, but it also requires directors to accept the 'responsibility affirmatively to keep themselves informed of developments within the company and to seek out the nature of corporate disclosures to determine if adequate disclosures are being made.' Managers prefer not to disclose bad news to the public. Yet, under the securities laws, the disclosure obligation for such information is often absolute. Independent directors are in the position to provide a check on management's desire to avoid or prolong sharing bad information with investors. Thus, they are securities monitors." Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 Bus. Law 1375, 1382-83 (2006) (internal citations omitted)

[17] *Pinter v. Dahl*, 486 U.S. 622, 642-43 (1988); *In re Morgan Stanley Information Fund Sec. Litig.*, 592 F.3d 347,359 (2d Cir. 2010); *See also* Catherine Masters Epstein, *Reasonable Care in Section 12(2) of the Securities Act of 1933*, 48 U. Chi. Law Rev. 372 (1981); Hirsh, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. Chi. Law Rev. 955 (1990); and Maynard, *Affirmative Defense of Reasonable Care under Section 12(2) of the Securities Act of 1933*, 69 Notre Dame Law Rev. 57 (1993).

[18] *See Federal Housing Finance Agency v. UBS Americas, Inc.*, 858 F.Supp.2d 306, 333 (S.D.N.Y. 2012); *Dimensional Emerging Markets Value Fund v. Petroleo Brasileiro S.A. (In re Petrobras Sec. Litig.)*, 152 F.Supp.3d 186, 195 (S.D.N.Y. 2016); *Mallen v. Alphatec Holdings, Inc.* 861 F.Supp.2d 1111, 1131 (S.D. Cal. 2012).

[19] *See Mass. Mutual Life Ins. Co. v. Residential Funding Co., LLC*, 843 F. Supp. 2d 191, 207 (D. Mass. 2012); and *In re Countrywide Fin. Corp*., Mortg. Backed Sec. Litig., 932 F.Supp.2d 1095, 1118 (C.D. Cal. 2013).

[20] This is consistent with the principles set forth in Section 8.30 of the Model Business Corporation Act, particularly the Official Comment to Section 8.30(d) which states in relevant part:

> Care in delegation and supervision includes appraisal of the capabilities and diligence of the delegatee in light of the subject and its relative importance and may be satisfied, in the usual case, by receipt of reports concerning the delegatee's activities … [D]irectors may not abdicate their responsibilities and avoid responsibility simply by delegating authority to others.

This note was prepared by J. Anthony Terrell as of September 1, 2023. Mr. Terrell is Of Counsel to Bracewell LLP, resident in the New York office. However, the views expressed herein are those of Mr. Terrell and do not necessarily reflect the views of the firm. Mr. Terrell is a member of the American Bar Association and the International Bar Association and various sections and committees of each. This note does not necessarily reflect the positions of any such bar associations, sections or committees.

This note was prepared to keep clients and other interested parties informed of legal principles and developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.

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