

# The Section 11 Due Diligence Defense for Director Defendants

By Tony Rodriguez and Karen Petroski

This article is about the directors' due diligence affirmative defense to a claim under Section 11 of the Securities Act of 1933.<sup>1</sup> Section 11 creates a due diligence defense for directors and several categories of defendants, including accountants and underwriters.<sup>2</sup>

Anyone who signs a registration statement, was a director or was performing similar functions when the registration statement was filed, or is named in the registration statement as about to become a director, can be sued under Section 11 if the registration statement is alleged to have contained a false or misleading material statement.<sup>3</sup>

In general, scienter, or state of mind, is not an element of a plaintiff's Section 11 claim, aside from claims based on forward-looking statements, which plaintiffs must prove were made with actual knowledge of their falsity.<sup>4</sup> State of mind, however, is an element of the due diligence defense. The director defendant must present evidence of his or her state of mind and knowledge to establish the defense.<sup>5</sup> To establish due diligence, a director must prove that he or she made a reasonable investigation of the subject of the challenged statement and had reasonable grounds to believe that the statement was true when it was made.<sup>6</sup> By establishing the due diligence defense to a Section 11 claim, a director also can negate the element of scienter in a Section 10(b) claim based on the same statement.

To prove the defense, directors only need to show that they acted reasonably, not that they acted perfectly.<sup>7</sup>

## What is the Due Diligence Defense?

Section 11(b)(3)(A) provides that a director is not liable if he or she proves that,

as 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[']s] 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.<sup>8</sup>

Section 11(c) states the standard for reasonable

investigation and reasonable ground for belief: "In determining, for the purposes of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."<sup>9</sup>

Courts have held inside directors to a higher standard of reasonableness than outside directors, on grounds that inside directors are likely more familiar with the subject matter and better positioned to identify and investigate issues.<sup>10</sup> The SEC's Rule 176 also implies a higher standard of care for inside directors by identifying as a factor relevant to the determination of the reasonableness of conduct under Section 11(c), the "presence or absence of another relationship to the issuer when the person is a director or proposed director."<sup>11</sup>

## When to Raise the Due Diligence Defense?

Defendants have the burden of proving the due diligence defense,<sup>12</sup> and therefore the issue often may not be resolvable on a pleading challenge.<sup>13</sup> When directors answer a Section 11 complaint, they should assert the due diligence defense and, if appropriate, the reasonable reliance defense, which is available for "expertised" portions of the registration statement.

The due diligence defense can be decided on summary judgment if the court concludes that it is deciding the legal issue of whether a defendant, on the basis of undisputed facts, is entitled to the defense.<sup>14</sup> If the court finds that material facts necessary to prove the defense are in dispute, the motion will fail.<sup>15</sup>

If the directors dispute that the statement in question was materially false or misleading, they will move for summary judgment on those independent grounds or join in the issuer's motion. Regardless of the stage of the case at which they raise the defense, directors should emphasize that their due diligence defense can succeed even if the statement was materially false or misleading.

## Proving the Due Diligence Defense

The directors should strive to present a coherent, documented narrative that shows their due diligence.

### *Documenting Review Can Pay Dividends Later*

A director does not necessarily need to have read the challenged statement to be liable for the challenged statement or to prove the due diligence defense.<sup>16</sup> A director who does not remember reading the statement

at issue, but who can prove that he or she had a reasonable basis for believing what was stated in the challenged statement, should succeed on a due diligence defense. A director who cannot prove that he or she read the challenged statement, however, may be in a less favorable position. There will be a hole in his or her narrative of due diligence and reasonable belief. This director's due diligence protection will be by fortune—

because the director's knowledge and experiences are consistent with the challenged statement—rather than by design.

Good documentation will support later efforts to prove the due diligence defense. Ideally, directors would make a practice of reviewing the registration statement in as close to final form as practical. A cover memorandum to the draft registration statement could advise directors to notify a management liaison if they have any questions or concerns.

Any such notification, and any responses to a director, could be documented and distributed to the full board. The company (and the directors) would retain this documentation. In-house counsel should consider carefully whether this documentation will be maintained as attorney-client privileged information. Treating the documentation as privileged could make it difficult to use in connection with a due diligence defense, unless the privilege is waived.

These steps may be difficult to schedule during the short time frames in which registration statements often are prepared or otherwise not practical in all settings. Use of even some of these measures, however, could strengthen a later due diligence defense by decreasing or eliminating the likelihood that directors are unable to reconstruct why it was reasonable for them to believe the challenged statement was true when made.

The directors may need to refresh their recollection from minutes, emails, or other documentation of attendance at meetings and review of documents. By documenting when and how they reviewed the registration statements, the directors will find it easier to prove what they actually did, instead of having to describe what they “usually” do in connection with a registration statement or what they “probably” did.

Directors must prove that they believed the statement was true and that they had reasonable grounds for that belief when the statement was made.

### *Proving Grounds for Believing a Statement to Be True*

Directors must prove that they believed the statement was true and that they had reasonable grounds for that belief when the statement was made. There are a number of possible grounds for a director's reasonable belief that something was true.

First, a director may rely on the director's experience and familiarity with the issuer. This expertise needs to have a demonstrable link to the statement. It may not be enough, on its own, for the director to refer generally to a lengthy tenure with the company. Instead, the director should cite and document particular experiences and activities that were a part of the director's knowledge base when the director read the registration statement or when the statement was made.<sup>17</sup> So, for example, asserting that the director had been involved in discussions about the general topics at issue in the case—for example, that the director generally had been aware of product quality control measures—will not be as effective as proving that the director received specific reports and attended specific or regularly scheduled meetings in which the director learned of, for example, low defect rates with the product at issue.

Second, a director should be able to rely on relevant knowledge of the industry. Familiarity with the industry was, for instance, a factor in the SEC's 1998 proposed amendment to Rule 176 pertaining to the due diligence defense for underwriters. Under the proposed rule, an underwriter's consultation of a research analyst familiar with the industry would have been evidence in favor of a conclusion that the underwriter acted reasonably.<sup>18</sup> A similar rationale should apply to directors' familiarity with the industry in question.

Third, a director may rely on nonexperts, such as officers and executives.<sup>19</sup> An outside director may have an easier time making this showing than an inside director, because of the outside director's possible lower level of familiarity with the particular sources and items of information available within the company.<sup>20</sup>

Fourth, a director may rely on an expert, such as an accountant or investment banker if the director did not believe, and did not have grounds to believe, that the statements attributable to the expert were untrue or misleading.<sup>21</sup> Section 11(b)(3)(C) creates this “reasonable reliance” defense. There are limits to who qualifies as an expert and how much of the registration statement can be “expertised.” For example, a director generally will not be able to invoke this defense by claiming that the director relied on inside and outside counsel's expertise in drafting registration statements.<sup>22</sup> A director may rely on the portion of the registration statement prepared by an accountant as “expertised,”

but not on other sections of the registration statement that happen to refer to financial matters.<sup>23</sup> Reliance on audited financial statements included in the registration statement will usually be reasonable as a matter of law, unless these statements contain serious “red flags” or discrepancies.<sup>24</sup> Reports on unaudited financial statements are not considered “expertised” and are therefore subject to the reasonable investigation requirement.<sup>25</sup>

Finally, other witnesses may be helpful to a director’s due diligence defense. In their depositions, others may establish that they reviewed the statements at issue with the director or presented information supporting the director’s belief that the statement was true not long before the registration statement was filed.

## Conclusion

The due diligence defense illustrates the saying that an ounce of prevention is worth a pound of cure. Directors and their counsel should be mindful of the benefits that some time and careful documentation in the run-up to the filing of a registration statement can yield in a later Section 11 lawsuit.<sup>z</sup>

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1. 15 U.S.C. § 77k.
2. 15 U.S.C. § 77k(a)(4) (accountants’, engineers’, and appraisers’ due diligence defense); § 11(a)(5), 15 U.S.C. § 77k(a)(5) (underwriters’ due diligence defense).
3. 15 U.S.C. § 77k(a)(1)–(3).
4. 15 U.S.C. § 77z-2(c)(1)(B); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 201 (1st Cir. 1999).
5. *See In re Int’l Rectifier Sec. Litig.*, No. CV91-3357-RMT (BQRx), 1997 WL 529600, at \*12 (C.D. Cal. Mar. 31, 1997); *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 626–27 (9th Cir. 1994).
6. § 11(b)(3)(A), 15 U.S.C. § 77k(b)(3)(A).
7. 15 U.S.C. § 77k(b)(3)(A); § 11(c), 15 U.S.C. § 77k(c); *see also In re Int’l Rectifier Sec. Litig.*, 1997 WL 529600, at \*7, 11.
8. 15 U.S.C. § 77k(b)(3)(A).
9. 15 U.S.C. § 77k(c).
10. *See, e.g.*, 17 C.F.R. § 230.176(f); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 690 (S.D.N.Y. 1968); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 578 (E.D.N.Y. 1971); SEC Release No. 33-6335, *Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act*, 1981 WL 31062, at \*13–15 (Aug. 6, 1981). *See also In re*
- WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288, 2005 WL 638268, at \*10 (S.D.N.Y. Mar. 21, 2005) (discussing difficulty of defining “inside director”).
11. 17 C.F.R. § 230.176 (last amended 1982). *See also* SEC Release No. 33-6335, *Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act*, 1981 WL 31062, at \*13–15.
12. *In re Friedman’s, Inc. Sec. Litig.*, 385 F. Supp. 2d 1345, 1369 (N.D. Ga. 2005) (citing 15 U.S.C. § 77k(b)); *In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 258 F. Supp. 2d 576, 639 (S.D. Tex. 2003).
13. *See, e.g., In re Dynegy, Inc., Sec. Litig.*, 339 F. Supp. 2d 804, 874–75 (S.D. Tex. 2004); *In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 258 F. Supp. 2d at 596–97 (citing *Griffin v. PaineWebber Inc.*, 84 F. Supp. 2d 508, 513 (S.D.N.Y. 2000)).
14. *See, e.g., In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d at 621–22; *In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489, 1494–96 (N.D. Cal. 1992), *rev’d on other grounds*, 38 F.3d 1078 (9th Cir. 1994).
15. *See, e.g., In re Livent, Inc. Noteholders Sec. Litig.*, 355 F. Supp. 2d 722, 734–38 (S.D.N.Y. 2005).
16. *See Escott*, 283 F. Supp. at 684.
17. *See, e.g., Laven v. Flanagan*, 695 F. Supp. 800, 811–12 (D.N.J. 1988); *Weinberger v. Jackson*, No. C-89-2301, 1990 WL 260676, at \*4–5 (N.D. Cal. Oct. 11, 1990).
18. SEC Release No. 33-7606A, *Notice of Proposed Rulemaking, The Regulation of Securities Offerings*, 63 Fed. Reg. 67174, 67231–67232 (Dec. 4, 1998). To date, this proposed amendment has not been adopted. *See* 17 C.F.R. § 230.176 (last amended 1982); *see also SEC Official Defends Agency’s Delay in Reforming ‘33 Act Offering Process*, 22 BNA SEC. REG. & LAW REP. 827 (2001).
19. SEC Release No. 33-6335, *Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act*, 1981 WL 31062, at \*14.
20. *See, e.g., Weinberger*, 1990 WL 260676, at \*4–5; *Laven*, 695 F. Supp. at 811–12; *Feit*, 332 F. Supp. at 578, *but see In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d at 872 (denying summary judgment to outside director defendants who “argue[d] that they did not need to conduct an investigation because they reasonably relied on representations made by Dynegy’s managers”).
21. *See* § 11(b)(3)(C), 15 U.S.C. § 77k(b)(3)(C). *See also In re WorldCom, Inc. Sec. Litig.*, 2005 WL 638268, at \*7 (citing *John Nuveen & Co. v. Sanders*, 450 U.S. 1005, 1010 (1981) (Powell, J., dissenting from denial of cert.)).
22. *See Escott*, 283 F. Supp. at 683.
23. *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 664 (S.D.N.Y. 2004).
24. *See William K. Sjoström Jr., The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 601–9 (2006).
25. 17 C.F.R. § 230.436(c).