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Building the Section 11 “Due Diligence” Defense for Outside Directors

By [D. Anthony Rodriguez](#)

Section 11 of the Securities Act of 1933 (15 U.S.C. § 77k(a)) imposes civil liability when a securities registration statement filed with the Securities and Exchange Commission contains a false or misleading material statement or material omission. Among those who may be a defendant in a section 11 claim are anyone who was a director or performing similar functions when the registration statement was filed, or who was named in the registration statement as about to become a director.

A section 11 claim can be particularly difficult to defend because, other than for certain forward-looking statements, it does not include a scienter element, unlike section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Nor does section 11 require an investor who lost money on his or her securities purchase to prove that the false statement caused his or her loss, again in contrast to section 10(b).

Section 11, however, gives defendants other than the issuer a powerful defense—the “due diligence” defense. Outside directors should be exceptionally well-positioned to establish this defense, but their counsel must be mindful of potential complications.

The Due Diligence Defense

A non-issuer defendant who establishes that he or she believed the challenged statements were true and did not contain

any material omissions, had reasonable grounds for that belief, and undertook a reasonable “investigation” into the truth of the challenged statements, is not liable for the challenged statements. Section 11 defines the standard for “what constitutes reasonable investigation and reasonable ground for belief” as “that required of a prudent man in the management of his own property.” When applying the defense, “[t]he defense is calibrated to the objective reasonable person in each defendant’s position.” *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1174 (C.D. Cal. 2008). The diligence standard is higher for inside directors and underwriters than for outside directors.

The word “investigation” in section 11 requires a showing that the outside director received or sought out information of reasonable scope and from reliable sources, not a showing of forensic or detective work. *See Weinberger v. Jackson*, No. 89-2301-CAL, 1990 U.S. Dist. LEXIS 18394, at *10 (N.D. Cal. Oct. 12, 1990). An outside director may rely “upon the reasonable representations of management, if his own conduct and level of inquiry were reasonable under the circumstances.” In *Weinberger*, the director showed that he “was reasonably familiar with the company’s business and operations,” and that he “regularly attended board meetings at which the board discussed every aspect of the company’s

business.” The director had “reviewed the company’s financial statements” and drafts of the challenged statements, and discussed “certain aspects” of the challenged statements with management. The director also established that he was “given comfort by the fact that the prospectus and the information in it were reviewed by underwriters, counsel and accountants.” Finally, he had seen nothing in the challenged statements that was “inconsistent with the knowledge he had acquired as a director.” The court held that the outside director therefore “met the standards of due diligence.”

Similar steps established an outside director’s due diligence in *Avante-Guarde Computing Securities Litigation*, No. 85-4149, 1989 U.S. Dist. LEXIS 10483 (D.N.J. Sept. 5, 1989). In *Avante-Guarde*, the court granted summary judgment on due diligence grounds to an outside director who had joined the board approximately three months before the company’s initial public offering (and had resigned five months after the offering). The outside director established that, during his three months on the board before the offering, he had participated in four board meetings, read the draft prospectus, and met with company personnel to ask them about the business. The director also had learned that the outside auditors had reviewed the company’s financial statements, though he failed to learn that the previous audi-

tors had been replaced after they had made critical statements. Even outside directors whose work was “imperfect” have established their due diligence on summary judgment. In *Laven v. Flanagan*, 695 F. Supp. 800 (D.N.J. 1988), the court granted summary judgment to outside directors who established that they had worked to bring themselves “up to speed” about the company in the approximately eight months between joining the board and signing the offering documents. The court held that the outside directors’ reliance on management representations “cannot be characterized as unreasonable,” particularly when it was “confirmed” by the company’s independent auditors. The court described the outside directors’ work as “imperfect,” but granted them summary judgment on due diligence grounds, distinguishing their “activities [as] a far cry from the passive and total reliance on company management that defeated the due diligence defense in *Escott v. Bar-Chris Construction Corp.*, 283 F. Supp. 643, 688-89 (S.D.N.Y. 1968).”

Bar-Chris is an oft-cited case on due diligence. In that case, the court ruled on outside directors’ due diligence defense after a bench trial. The court found that one director had spent “about ten minutes” reading the filing that was at issue, and the other had only “glanced” at the document. The court found these directors “made no investigation” of the accuracy of the statements in the prospectus, but instead relied solely on assurances from the founders of the company, whom the court described as “men of limited education” who were not “equipped to handle financial matters.” The court held that the outside directors’ “minimal conduct” did not support a due diligence defense. The court in *In re Worldcom, Inc. Securities Litigation*, No. 02 Civ. 3288 (DLC), 2005 U.S. Dist. LEXIS 4193 (S.D.N.Y. Mar. 21, 2005), denied an outside director’s motion for summary judgment on due diligence grounds. *Worldcom*, however, is by no means a death-knell to the due diligence defense for outside directors. Indeed, the *Worldcom* court stated that a “careful examination” of management presentations

could be enough to win summary judgment on due diligence grounds. Moreover, the court noted that it was not clear that the moving director, who was a former CEO of MCI, which Worldcom acquired in a transaction that led to him becoming a Worldcom director, was an outside director. The court held the distinction was irrelevant in that case, because the director had, like the outside directors in *Bar-Chris*, shown only “passive and total reliance on company management.” The director had failed to demonstrate that he had “conducted any sort of investigation, much less a reasonable investigation.” Nor did the director show that he had engaged in “active dialogue” with the company’s management or with its outside auditors, even in the face of abnormal information that was related to the most critical aspect of the company’s business, and which ultimately was the key to a “massive” restatement (the largest corporate restatement in history to that date). *Worldcom* could pose a problem to an outside director who was passive, engaged in no dialogue, even in the face of abnormal information about a critically important topic, and does not show that he or she conducted “any sort of investigation,” but such a person also would be unlikely to be able to invoke *Weinberger*, *Avante-Guarde*, or *Laven*.

Showing Due Diligence

As the above discussion shows, to build a strong due diligence defense to present at summary judgment, an outside director will establish his or her attendance at board and committee meetings; dialogue with management about key policies and practices, the state of the business, and unusual developments; reasonable reliance on management, the company’s retained professionals, and other sources; and that he or she believed the challenged statements were consistent with his or her knowledge of the company at the time. The outside director may also choose to present his or her motion as unnecessary to reach, because the challenged statements were not false or material, or because section 11(e)’s “negative loss causation” defense applies.

In building his or her due diligence defense, the outside director should marshal facts from his or her recollection and files, and from materials that the company and others produce in discovery, such as from board and committee packets, memoranda and presentations to the board or its committees, and communications with directors, management, and retained professionals (such as auditors, consultants, and experts). The outside director should show his or her attendance at board and committee meetings, how he or she prepared for those meetings, and information (relevant to the case) to which he or she paid particular attention.

Each outside director also should describe what he or she did over the course of his or her tenure, before the statement at issue was made, to become familiar with the company. This could include showing his or her awareness of relevant policies (e.g., anti-bribery policies in overseas operations and related monitoring) and principles (e.g., an oft-stated commitment not to sacrifice product quality for growth in market share) that he or she understood the company followed, including when management or a third party communicated about those policies or principles to the board. The outside director also should describe processes within the company, particularly those that he or she was aware of, for drafting and verifying the statement at issue before it reached the outside director. On this point, before litigation, outside directors should consider requesting an annual briefing on how the company prepares its SEC filings.

Dealing with Complications

In building the due diligence defense for outside directors, counsel should be aware of potential complications, such as the following.

Information Contrary to the Challenged Statement

The due diligence defense, by definition, requires a showing that the outside director believed the challenged statement was true and not misleading, and had a reasonable basis for that belief. If a defendant

argues that information that corrected the statement, or that supplied allegedly omitted information, was publicly available, this embedded concession that the statement was incorrect or incomplete could complicate the outside director's due diligence defense.

Outside directors will want to be careful about joining in another defendant's brief that argues corrective or complete information was available to the market when the statement was made. The outside director will have to assess whether that argument is consistent with his or her due diligence showing. If the additional information supplements the challenged statement by containing detail that does not contradict the statement, or provides statements of opinion or forecasts, it should not pose a problem to the outside director's due diligence defense.

If, however, the other defendant is expressly or tacitly conceding that the challenged statement was false or materially incomplete, but that the correct or missing information was supplied elsewhere, this could be in tension with the outside director's assertions that his or her reasonable "investigation" led him or her to believe the statement was true. How can it be, plaintiffs will argue, that one defendant says he or she investigated and reasonably believed a statement that another defendant expressly or implicitly concedes was incorrect or misleading? If the outside director was not aware of, or did not consider, the information that the other defendant is citing, plaintiffs might argue that this shows the cited information was immaterial, or was inadequate to correct the allegedly false or misleading statement.

Of course, it is entirely possible that the other defendant is citing a valid point from a source that the outside director did not happen to consider, such as one line in a transcript of a lengthy earnings call that did not receive unusual press or analyst attention. If so, the outside director should be able to show, based on the information that he or she considered after a reasonable "investigation," that he or she reasonably believed the challenged statement was true and not misleading. If the

other defendant is citing various sources to show that they disclosed information that supposedly was omitted, while clearly arguing that the omission was not material, those citations likewise should not hinder the outside director's due diligence defense. Counsel for the outside director will need to stay apprised of other defendants' plans on this front.

Management-Only Communications

Executives meet with and e-mail each other throughout the day without copying the outside directors. In their discussions, executives might debate issues, air differing analyses, express concerns, demand action, and the like. E-mails, especially those composed late at night or while the author is in an airport security line, might be rushed, pithy, or even rude. When discovery brings those e-mails before the various defendants, it could be the outside director's first look at management-only communications. Putting aside obviously "bad" e-mails such as any that direct or describe the publication of false statements, say the outside director knew the challenged statement was false or misleading, or criticize the outside director's oversight, management-only e-mails still can complicate matters for the outside director.

The outside director should expect the plaintiff to use management-only e-mails (the likely predominant form of written communication) to make the outside director question or criticize management, or even himself or herself. The plaintiff might attempt to paint the outside director as a victim of management deception, or, less dramatically, to obtain director testimony expressing concern and questions about perceived disparities between the management-only communications and the challenged statement (e.g., "I do wonder why we made this statement, if Joe really believed what he writes in this e-mail . . ."). Should the plaintiff succeed in obtaining testimony that expresses skepticism or doubt about management's candor, it could look peculiar to the judge or jury for the outside director to cite reliance on management as a basis of his or her due diligence defense.

An outside director who is asked to testify to his or her reaction to negative or dramatic statements in a management e-mail should be careful not to react hastily and imprecisely, whether in criticizing management, admitting the statement in the e-mail contradicts the challenged statement or should have been disclosed, or agreeing that he or she should have asked harder questions to uncover the information that is in the e-mail. The outside director must tell the truth, but has no obligation to shoot from the hip or to speculate based on an e-mail snippet, without knowing the full context. If something in an e-mail strikes the outside director as interesting, or differs from his or her recollection, he or she should say so (if asked), but should consider whether he or she has enough information to testify that someone was doing anything wrong, or was failing to act reasonably.

The outside director, no doubt, expects that there were blunt, real-time, exchanges between executives, and for different executives to show different personality traits, or to reflect their organization's biases (e.g., sales might advocate dropping prices, while finance might worry about keeping up margins). Whether any of those day-to-day exchanges contradict a statement that survived the company's drafting and vetting process is a very different question from whether something in the exchanges looks interesting, or is something the outside director would like to know more about. The outside director does not need to take it upon himself or herself to try to explain away what the parties to an e-mail exchange meant or thought, e.g., "Well, I'm sure what he's trying to say here is really . . ." On the other hand, if asked, and if he or she has a basis for doing so, the outside director can describe, based on his or her experience, that the sender or recipient had a tendency to make dramatic statements or to adopt a skeptical or negative tone.

In sum, it will be the extraordinary e-mail that on its face provides enough information and context for an outside director to state, after reviewing the e-mail at deposition, that he or she was wrong to

trust management or that he or she was not a diligent director.

Varying Levels of Outside Director Diligence

There is no one way for an outside director to show due diligence. The outside directors likely will vary in how they analyzed and questioned information. Some might have pored over every page of reports and presentations, while others focused on the executive summary and on particular pages. Some might have asked more questions than others. The cases described above highlight the common denominators of a successful due diligence defense, all of which rest on a reasonableness, not perfection, standard. Most outside directors should not expect to have a difficult time in making the necessary showing, particularly where falsity has not been conceded. However, the outside directors might find themselves, implicitly or expressly, at odds with each other as they each build their due diligence defense.

Plaintiffs may attempt to “divide and conquer,” by asking executives and directors to critique each other’s diligence, and then zeroing in on any outside director whom others describe as inattentive or uncurious. Outside directors faced with such questions must be truthful, and should remember that they do not need to make someone else look bad to make themselves look good. If they are presented with criticisms of their efforts, they should have measured, fact-based responses to those criticisms.

Due diligence is not a zero-sum matter. A “star” outside director’s diligence should not make others appear to lack diligence by comparison. The standard for all is reasonableness. The “star” outside director helps himself or herself by describing how he or she met the reasonableness standard, and then describing his or her extraordinary work. Others should demonstrate how their efforts meet the reasonableness standard, and can even show how they benefitted from the “star’s” extra efforts.

When an outside director has a weak diligence defense, can the same counsel

represent that director and others with a stronger diligence defense? The outside director with the weaker defense may want to minimize the importance of measures that the other directors may want to highlight, or may want to be more aggressive than the other directors in arguing what qualifies as due diligence. The outside directors with the stronger defense will want to contrast themselves with the diligence showing in cases such as *Bar-Chris* and *Worldcom*, which could reflect poorly on an outside director whose diligence (or lack thereof) is similar to the directors in those cases. If an outside director’s diligence is at the *Bar-Chris* level, he or she will want to consider carefully whether to move for summary judgment.

When counsel believes there is the potential for such conflicting arguments or showings, or when they have actually emerged, it should be determined if he or she needs to obtain the clients’ informed written consent before continuing with the representation. In California, an attorney is required to obtain informed written consent from each client regarding the potential or actual conflict of interests before accepting that representation, and to obtain informed written consent to continue the representation if a potential conflict becomes actual. Counsel should obtain written consent regarding which clients he or she will continue to represent if a client refuses to consent, or withdraws his or her consent, to a potential or actual conflict. Counsel may wish to explore having the director with the weak defense retain “shadow counsel,” who would be prepared to assume responsibility for the defense of that director if the client withdraws his or her consent to the joint representation. Counsel must be clear with the outside director who has the weak or inadequate defense that counsel will not water down the presentation of other clients’ defenses to avoid making that client look bad by comparison.

Conclusion

Section 11’s due diligence standard for outside directors requires reasonableness, not perfection. The diligence standard for

outside directors reflects that they have neither the responsibilities nor the knowledge of management or inside directors regarding the business. In building their defense, outside directors must be honest and precise in describing their reaction to management-only communications that they see during the case, and informed about whether and how their diligence arguments and showings may conflict. Obtaining the protection of the due diligence defense makes navigating these potential complications well worth the effort.

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