

## Incorporating Caution into Incorporating by Reference

By Tony Rodriguez & Tyson E. Marshall

The Securities and Exchange Commission (SEC) allows eligible issuers to incorporate by reference, rather than reprint, information from earlier filings made pursuant to the Securities Exchange Act of 1934, such as Forms 10-K, 10-Q, and 8-K, into forms the issuers file under the Securities Act of 1933 for registering securities for public offerings. This allows issuers to prepare an offering, particularly a “takedown” offering for which there is a “shelf” registration statement on file, more quickly and less expensively than if they could not incorporate by reference. Issuers, directors, underwriters, and other potential Securities Act defendants should be careful, however, about what is incorporated by reference, lest an issuer or others inadvertently provide fodder for later Securities Act claims.

### The SEC Rules

The SEC permits eligible issuers to incorporate by reference reports such as Forms 10-K, 8-K, and 10-Q into Forms S-1, S-3, and, as of 2008, Form S-11.<sup>1</sup> Form S-1 is a long-form registration statement intended for new and “unseasoned” issuers. Form S-3 is a short-form registration statement for already public companies. Form S-11 is similar to Form S-1, and is used by real estate investment trusts or by companies involved in purchasing and holding real estate for investment purposes. An issuer is eligible to incorporate by reference if it: (1) filed an annual report for the most recent fiscal year; (2) is current in its reporting obligations under the Exchange Act; and (3) makes the incorporated documents available on its website.<sup>2</sup> Blank check, shell, and penny stock companies may not incorporate by reference.<sup>3</sup>

### Benefits

Incorporation by reference can help a public offering process move more quickly and be less cumbersome. Rather than repeating the contents of earlier-filed documents, the issuer may simply incorporate them by reference. Doing so prevents the registration statement from ballooning to an unwieldy size. Incorporating earlier-filed documents also lets a “takedown” offering—when an issuer offers securities pursuant to a previously filed shelf registration statement—proceed more quickly than it otherwise might. The requirements that the issuer be current in its reporting obligations and place the incorporated documents on its website ensure the documents are recent and readily available.

Incorporation by reference can also save an issuer money. The SEC estimated that the use of incorporation by reference by issuers using Form S-11 potentially decreases the amount of hours devoted by in-house and outside professionals to

completing the Form S-11 by nearly 38,000 hours each year, for an estimated annual cost savings to issuers of over \$45 million. We safely can assume the savings associated with incorporation by reference in the more common Forms S-1 and S-3 are even greater.

### Liability

Section 11 of the Securities Act imposes liability upon those persons who play a statutorily specified role in a public offering (i.e., certain officers, directors, and/or underwriters), where the registration statement for the offering “contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.”<sup>4</sup> Section 12(a)(2) of the Securities Act imposes liability on any person who offers to sell or sells the issuer’s securities by means of false or misleading offering materials.<sup>5</sup> Documents incorporated by reference into registration statements constitute part of the registration statement.<sup>6</sup> Thus, liability under the Securities Act may arise from statements actually made in the registration statement, statements incorporated by reference into the registration statement, or both.

### Securities Act Plaintiffs

The attractiveness to the plaintiffs’ bar of bringing a Securities Act claim makes it particularly important to be careful when incorporating by reference. It generally is easier for plaintiffs to plead and prove claims under sections 11 and 12(a)(2) (which typically do not require a demonstration of reliance or scienter (state of mind)) than a fraud claim pursuant to section 10(b) of the Exchange Act (which includes reliance and scienter elements). Unless the claim sounds in fraud or concerns a forward-looking statement, a section 11 or 12(a)(2) plaintiff typically must satisfy only Federal Rule of Civil Procedure 8(a), rather than Rule 9(b) or the strict pleading standards imposed by the Private Securities Litigation Reform Act of 1996.<sup>7</sup> In many cases, allegations of even innocent or negligent material misstatements or omissions will state a claim.<sup>8</sup> Moreover, a class-action section 11 or 12(a)(2) claim, unlike an Exchange Act section 10(b) claim, may be brought in state court. State court rules often allow a plaintiff to begin the expensive discovery process sooner than it could in a federal action.

Thus, when a Form S-1 or S-3 “links” to an earlier-filed document through incorporation by reference, the earlier-filed document becomes a potential basis for a Securities Act claim, with its comparative advantages to a plaintiff over an Exchange Act claim, even if the earlier document previously

could not have been the basis of a Securities Act claim.

### Decreasing the Chances of Being Sued

Issuers and other potential Securities Act defendants should consider these steps before incorporating by reference.

#### *Don't Overdo It*

The SEC requires issuers to disclose certain information, and those requirements, of course, must be satisfied.<sup>9</sup> In doing so, however, the issuer should think before it incorporates, particularly if it is considering the incorporation by reference of numerous items. Do all those items have to be incorporated? Could the incorporation of some or all of those items trigger a duty to update information in the documents, or to provide other disclosures? An issuer should not assume that the SEC or anyone else will give it some sort of “extra credit” for over-disclosure, and at a minimum it should weigh the potential downside of incorporating by reference more materials than necessary. If someone involved in preparing a Securities Act filing rattles off a list of documents to incorporate, a set of “fresh eyes” should make sure it really is necessary to incorporate those documents.

#### *Stay Current*

Once it is determined which information to incorporate, that information must be updated to reflect any material changes or corrections, even though the information was accurate when first made.<sup>10</sup> Otherwise, the information that is incorporated by reference may create a materially misleading registration statement in light of the present circumstances. Statements that were true when made and remain true at the time the registration statement becomes effective, however, need not be updated.

#### *Be Diligent*

If a Securities Act case is ever filed, each defendant besides the issuer will have the reasonable reliance and due diligence defenses available to it.<sup>11</sup> The reasonable reliance defense applies when a non-issuer defendant establishes that he or she had no reasonable ground to believe, and did not believe, that any part of the registration statement made on the authority of an expert (such as a company's auditors) was materially false or misleading. The due diligence defense applies to non-expertised parts of the registration statement that the non-issuer defendant shows he or she reasonably believed, after a reasonable investigation, to be true and not to have contained a material omission when those parts of the registration statement became effective.

Unfortunately, there is no formulaic test to determine what constitutes a reasonable investigation or reasonable reliance. The determination may be largely governed by what is subjectively reasonable given the set roles, responsibilities, and

duties of each defendant. Under the Securities Act, this standard for reasonableness is “that required of a prudent man in the management of his own property.”<sup>12</sup> To qualify for the due diligence defense, directors and officers only need to show that they acted reasonably, not that they acted perfectly.<sup>13</sup>

The more the issuer or underwriters can do to document their basis for believing the incorporated information was correct—particularly any discussions of risks, market conditions, reasons for achieving or missing performance targets, the nature and quality of the company's operations, forecasts, or financial statements—the stronger various defendants' reasonable reliance and due diligence defenses will be. By establishing reasonable reliance or due diligence for their section 11 or 12(a)(2) defense, individuals also can block a finding of scienter against them in any parallel Exchange Act claim. Because it can be difficult to win a motion to dismiss based on these defenses, a defendant may have to suffer the expense and distraction of discovery before it can attempt to exit the case by a motion for summary judgment on either or both of these defenses.

### Conclusion

Incorporation by reference is a useful tool for preparing offering documents, but comes with risks. Careful selection and review of what to incorporate can reduce those risks, whether by preventing litigation or by increasing the chances of prevailing on a reasonable reliance or due diligence defense. ✱

*Tony Rodriguez is a partner in the San Francisco, California, office of Morrison & Foerster, and Tyson E. Marshall is an associate in the firm's San Diego, California, office.*

1. See, e.g., 17 C.F.R. § 229.10.
2. See General Instruction VII of Form S-1; see also SEC Release No. 33-8909, Revisions to Form S-11 to Permit Historical Incorporation by Reference, 2008 WL 1004143, at \*6.
3. See General Instruction VII of Form S-1.
4. 15 U.S.C. § 77k(a); see also *In re Daou Systems, Inc. Sec. Litig.*, 411 F.3d 1006, 1027 (9th Cir. 2005).
5. 15 U.S.C. § 77l(a)(2).
6. 15 U.S.C. § 77b(a)(8).
7. *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1105 (9th Cir. 2003).
8. *Daou*, 411 F.3d at 1027.
9. For example, Item 303 of Regulation S-K requires a company to identify known trends or uncertainties concerning its business or financial condition. 17 C.F.R. § 229.303.
10. Information Required in Prospectus, Part I, Item 11A of Form S-1.
11. 15 U.S.C. § 77k(b)(3)(A),(C).
12. 15 U.S.C. § 77k(c).
13. 15 U.S.C. § 77k(b)(3)(A); 15 U.S.C. § 77k(c); see also *In re Int'l Rectifier Sec. Litig.*, No. CV91-3357-RMT (BQRx), 1997 WL 529600, at \*7, \*11 (C.D. Cal. Mar. 31, 1997).