SURVEY OF SECURITIES REGULATION  
(L03.3040-001)  
NEW YORK UNIVERSITY SCHOOL OF LAW  
PROFESSOR CARLSON  
(WINTER-SPRING 2005)  


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SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 211
Release No. SIA 99
Staff Accounting Bulletin No. 99

AGENCY: Securities and Exchange Commission

ACTION: Publication of Staff Accounting Bulletin

SUMMARY: This staff accounting bulletin expresses the views of the staff but exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall below a numerical threshold.

DATE: August 12, 1999

FOR FURTHER INFORMATION CONTACT: W. Scott Hayless, Associate Chief Accountant, or Robert E. Burns, Chief Counsel, Office of the Chief Accountant, Washington, D.C. 20549-0990, (202) 941-4396. 

SUPLPLEMENTARY INFORMATION: The statements in this staff accounting bulletin are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Date: August 12, 1999

Jonathan G. Katz
Secretary

Part 211 (AmEND) Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 99 to the table found in Subpart B.

STAFF ACCOUNTING BULLETIN NO. 99

The staff hereby adds Section M to Topic I of the Staff Accounting Bulletin Series. Section M, entitled "Materiality," provides guidance in applying materiality thresholds in the preparation of financial statements filed with the Commission and the performance of audits of those financial statements.

STAFF ACCOUNTING BULLETINS

TOPIC I: FINANCIAL STATEMENTS
I. Assessing Materiality

Materiality

The concept of materiality in the context of preparing and presenting financial statements is a critical aspect of accounting. Materiality is the idea that financial statements should be prepared and presented in a manner that reflects the economic reality of the transactions and events that have occurred, and that the financial statements should be free from material misstatement.

The concept of materiality is based on the principle that financial statements should be prepared and presented in a manner that reflects the economic reality of the transactions and events that have occurred, and that the financial statements should be free from material misstatement. Materiality is the idea that financial statements should be prepared and presented in a manner that reflects the economic reality of the transactions and events that have occurred, and that the financial statements should be free from material misstatement.

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been identified as playing a significant role in the registrant's operating profitability
whether the misstatement affects the registrant's compliance with regulatory requirements
whether the misstatement affects the registrant's compliance with covenants or other contractual requirements
whether the misstatement has the effect of increasing management's compensation (for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation)
whether the misstatement involves concealment of unlawful activity.

This is not an exhaustive list of the circumstances that may affect the materiality of a quantitatively small misstatement. Among other factors, the demonstrated reliability of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material. Consideration of potential market reactions to disclosure of a misstatement by itself should not be used to determine whether a fact is material. When, however, management or the independent auditor expects, based, for example, on a pattern of market performance that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.

For the reasons noted above, the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example, in the amount of receivables or earnings, are immaterial. While the intent of management does not render a misstatement immaterial, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in financial statements or "management" repeated earnings. In that instance, it is important to consider not only the magnitude and materiality of the misstatement, but also the significance of the segment information in the financial statements taken as a whole. Registrants and their auditors should consider not only the effect of the misstatement but also the significance of the segment information in the financial statements taken as a whole. "A misstatement of the revenue and operating profit of a relatively small segment that is presented as management's intention to the future profitability of the entity" is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. In assessing the materiality of misstatements in a segment, consideration should also be given to such factors as:

- the industry
- the nature of the segment
- the expected effect of materiality on earnings per share
- the effect on earnings per share
- the level of volatility of the price of a registrant's securities
- the nature of the registrant's business
- the effect of the misstatement on the registrant's earnings per share.

A registrant and its auditors should evaluate misstatements in light of quantitative and qualitative factors and "consider whether, in light of the information available to management and the registrant, an incorrect measurement of an item is material within the limits of judgment and inference." The general practice of aggregating misstatements should be revised to ensure that misstatements are considered individually and not as a group. In addition, registrants and their auditors should consider the effect of misstatements on the registrant's financial statements taken as a whole.

The staff believes that, in considering the aggregate effect of multiple misstatements, registrants and the auditors of their financial statements should exercise particular care when considering whether to report in the aggregate. The aggregate error may be material to the financial statements taken as a whole and may need to be disclosed in the financial statements. The aggregate error may also be material to the financial statements taken as a whole and may need to be disclosed in the financial statements.

Aggregating and Noting Misstatements

In determining whether multiple misstatements cause the financial statements to be materially misstated, registrants and their auditors should consider the effect of each misstatement individually and the aggregate effect of all misstatements. Registrants and their auditors should also evaluate the effect of misstatements in light of quantitative and qualitative factors and "consider whether, in light of the information available to management and the registrant, an incorrect measurement of an item is material within the limits of judgment and inference." The general practice of aggregating misstatements should be revised to ensure that misstatements are considered individually and not as a group. In addition, registrants and their auditors should consider the effect of misstatements on the registrant's financial statements taken as a whole.

This requires consideration of:

- the significance of an item in a particular financial statement (for example, inventories or a manufacturing company)
- the pertinence of all misstatements (such as whether it affects the presentation of income or other statements)

the effect of the misstatement on the financial statements taken as a whole...

Registants and their auditors should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The literature notes that an analysis should consider whether the misstatement of "individual amounts" causes a material misstatement of the financial statements taken as a whole. As with materiality generally, this analysis requires consideration of both quantitative and qualitative factors.

If the misstatement of individual amounts causes the financial statements to be materially misstated, that effect should be analyzed to determine whether the misstatement is material to the financial statements. To take an obvious example, if a registrant's financial statements are materially misstated and the financial statements taken as a whole are materially misstated, the financial statements taken as a whole may be materially misleading even if the effect on earnings is completely offset by an equivalent adjustment to other components.

Even though a misstatement of an individual amount may not cause the financial statements to be materially misstated, that effect may still be material to the registrant's financial statements. For example, a misstatement of a single item that is not material to the financial statements as a whole may be material to the financial statements of a subsidiary or division of the registrant. Registrants and their auditors should consider the effect of the misstatement on the financial statements of the subsidiary or division and whether the materiality of the misstatement is material to the financial statements of the subsidiary or division taken as a whole.

The staff believes that, in considering the aggregate effect of multiple misstatements, registrants and their auditors should exercise particular care when considering whether to report in the aggregate. The aggregate error may be material to the financial statements taken as a whole and may need to be disclosed in the financial statements. The aggregate error may also be material to the financial statements taken as a whole and may need to be disclosed in the financial statements.

Registrants and auditors also should consider the effect of misstatements from prior periods on the current financial statements. For example, the auditors should consider the effect of misstatements on the current financial statements. The auditors should consider the effect of misstatements on the current financial statements. The auditors should consider the effect of misstatements on the current financial statements. The auditors should consider the effect of misstatements on the current financial statements.

This may be particularly the case where misstatements recur in several years and the cumulative effect becomes material in the current year.

2. Material Misstatements That are Intentional

Facts: A registrant's management intentionally has made adjustments to various financial statement items in each accounting period in which such actions were taken. The effect of these adjustments on the financial statements for each period was material. The registrant's management has been misstating the financial statements as a whole.
Documents, reports, or other materials submitted in connection with an audit shall be treated as confidential except as otherwise provided by law.

The auditor's response to intentional misstatements:

Section 1A(6) of the Exchange Act requires auditors to take certain actions upon discovery of an "illegal act." The statute specifies that these obligations are triggered "whether or not the illegal act is identified by the independent auditor as such." Among other things, Section 10A(6)(A) requires the auditor to inform the proper level of management if an illegal act is identified or to inform the board of directors or its audit committee if the illegal act involves a material misstatement or omission. If the illegal act is a material misstatement or omission, the auditor will be required to report the illegal act to the board of directors or its audit committee.

The requirements of Section 10A also prohibit the auditor from releasing confidential information to unauthorized persons. The auditor must also keep the information confidential until it is no longer necessary to do so.

Advisory statements on the existence of material weaknesses in an audit report may also be required to be re-evaluated for the degree of audit risk involved in the audit engagement. The advisory statement should also consider whether internal controls are subject to limitations, and if so, consider whether to resign.

Intentional misstatements due to material weaknesses may also require the auditor to report the issue to management and the audit committee. If the issue is identified as a material misstatement or omission, the auditor will be required to report the issue to the board of directors or its audit committee.

The auditor's response to intentional misstatements is correspondingly weaker.
of the examination of the registrant's financial statements.

GAP Procedure Over Industry Practice

Some have argued that staff should report to an industry accounting practice even though practice is consistent with authoritative accounting literature. This situation may occur when issues develop over long periods. The accounting results are clearly unconsensual, and the practice never changes despite substantial growth in the number of transactions. The staff disagrees with this argument. Authoritative literature specifies procedures over industry practice that are not covered under AAAP.

General Comments

This SAB is not intended to change current law or guidance in the accounting or auditing literature. This SAB is not intended to change existing rules or regulations that the SEC has issued to address the regulation of financial statements. However, this SAB is intended to provide guidance for preparing financial statements, and it is intended to provide guidance for ensuring that materiality judgments in other contexts, such as in the context of merger and acquisition transactions, are made in a manner consistent with materiality judgments in the context of financial statement preparation. See, e.g., Rule 2a-4, 17 CFR 2a-4, under the Investment Company Act of 1940.

Footnotes

1. American Institute of Certified Public Accountants ("AICPA"). Auditing Standards ("AASB") 121, "Audit Risk and Materiality in Conducting an Audit.", states that the auditor should consider materiality in all material respect conformance with generally accepted auditing standards. The purpose of this SAB is to provide guidance for financial statement preparation and to provide guidance for ensuring that materiality judgments in other contexts, such as in the context of merger and acquisition transactions, are made in a manner consistent with materiality judgments in the context of financial statement preparation. See, e.g., Rule 2a-4, 17 CFR 2a-4, under the Investment Company Act of 1940.

2. As stated in this SAB, "materiality" or "reasonable" refers to a financial statement assertion that would not be a matter of controversy under AACAP.


5. See, e.g., Concepts Statement No. 2, 123-124, AICPA Statement 310 ("Materiality and Qualitative Considerations"). AICPA Statement 310 ("Materiality and Qualitative Considerations") also includes the definition of materiality in the context of financial statement preparation. See, e.g., Concepts Statement No. 2, 123-124, AICPA Statement 310 ("Materiality and Qualitative Considerations").
The subcommittee notes that the 'concept of materiality recognizes that some matters, either individually or in the aggregate, are important for full presentation of financial statements in conformity with generally accepted accounting principles.'

The conference committee adopted the provision in question in order to clarify that the materiality standard does not constrain management's discretion in evaluating the significance of the factors, including the costs of compliance.
unnecessarily subjective judgments on uncertainties. See All §316.12 and 13.

All §§ 316.34 and 316.35, incorporating the auditor to consider whether fundamental investments are material and in requiring differing responses depending on whether the misstatement in material, make clear that frauds, as involve material misstatements lacked, the misstatement can be "materiality" and still involve fraud.

Under SAS 82, assessing whether misstatement due to fraud are material to the financial statements via "cumulative process" that should occur both during and at the completion of the audit. SAS 85 before stated that the auditor should primarily a "decisional" based on the auditor's judgment. All §316.32. The staff believes that in deciding whether the auditor's judgment, management and auditors should refer to the discussion in paras thatPART 2 of this SAS.

All §§ 316.34 and 316.4. Auditors should document their determinations in accordance with All §§ 316.37, 319.57, 339, and other appropriate sections.

See i.e., All § 316.39.

Report of the National Commission on Fraudulent Financial Reporting at 32 (October 1983) See also Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees at 3 (January 1999).

All § 316.2. See also All § 316.09, which, in discussing matters to be communicated by the auditor to the audit committee, states.

The auditor should inform the audit committee about any adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment shall be deemed significant if, in the auditor's judgment, it is not recorded by the entity, as proposed correction of the financial statements.

See All § 316.18

The AICPA's Audit Committee Statement: Criteria for Determining Materiality, states that the financial accounting and reporting process considers that any error at all might be serious during the accounting process considering insignificant errors. If presentations of financial information are to be prepared economically and timely basis, and interpreted in a consistent, recognizable basis, the concept of materiality is crucial. This SAS is not intended to require that financial statements arising from insignificant errors and, consequently, individually and in the aggregate arising from the normal return an acceptable basis, such as a clerical error or an adjustment for accrued or unaccrued revenue, always be corrected. If the error is identified in the audit process and known to management, the auditor would need to consider the various factors described elsewhere in this SAS in assisting whether such misstatements are material, need to be corrected, and comply with the (IPA) or other industry requirements under Section 11A of the Exchange Act. However, this SAS does not change current law or guidance in the accounting and auditing literature. Agreement to the principles described in this SAS should not raise the costs associated with reauditing or with audits of financial statements.

http://www.aicpa.org/auditscrap/sh99.htm
2. Disclosures of Material Nonpublic Information

The final regulation, like the proposal, applies to disclosures of "material nonpublic" information about the issuer or its securities. The regulation does not define the terms "material" and "nonpublic," but relies on existing definitions of these terms established in the case law. Information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision. To fulfill the materiality requirement, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.

The use of the materiality standard in Regulation FD was the subject of many comments. Some commenters supported the use of the existing definition of materiality, noting that attempts to define materiality for purposes of Regulation FD could have implications beyond this regulation. Other commenters, however, including securities industry representatives, securities lawyers, and some issuers or issuer groups, stated that using a general materiality standard in the regulation would cause difficulties for issuer compliance. These commenters claimed that materiality was too unclear and complex a standard for issuer personnel to use in making "real time" judgments about disclosures, and that this vagueness would lead to litigation and a chilling effect on corporate disclosure practices. These commenters offered a variety of recommendations to address this issue.

Some commenters suggested that the regulation include a bright-line standard or other limitation on what was material for purposes of Regulation FD, or identify in the regulation an exclusive list of types of information covered. While we acknowledged in the Proposing Release that materiality judgments can be difficult, we do not believe an appropriate answer to this difficulty is to set forth a bright-line test, or an exclusive list of "material" items for purposes of Regulation FD. The problem addressed by this regulation is the selective disclosure of corporate information of various types; the general materiality standard has always been understood to encompass the necessary flexibility to fit the circumstances of each case. As the Supreme Court stated in responding to a very similar argument: "A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over- or underinclusive."

Other suggestions from commenters included providing more interpretive guidance about types of information or events that are more likely to be considered material. While it is not possible to create an exhaustive list, the following items are some types of information or events that should be reviewed carefully to determine whether they are material: (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a

http://www.sec.gov/rules/final/33-7881.htm

04/04/2001
contract); (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor’s audit report; (6) events regarding the issuer’s securities -- e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships.47

By including this list, we do not mean to imply that each of these items is per se material. The information and events on this list still require determinations as to their materiality (although some determinations will be reached more easily than others). For example, some new products or contracts may clearly be material to an issuer; yet that does not mean that all product developments or contracts will be material. This demonstrates, in our view, why no “bright-line” standard or list of items can adequately address the range of situations that may arise. Furthermore, we do not and cannot create an exclusive list of events and information that have a higher probability of being considered material.

One common situation that raises special concerns about selective disclosure has been the practice of securities analysts seeking “guidance” from issuers regarding earnings forecasts. When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company’s anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer likely will have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect “guidance,” the meaning of which is apparent though implied. Similarly, an issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces.

At the same time, an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a ‘mosaic’ of information that, taken together, is material. Similarly, since materiality is an objective test keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst. Analysts can provide a valuable service in sifting through and extracting information that would not be significant to the ordinary investor to reach material conclusions. We do not intend, by Regulation FD, to discourage this sort of activity. The focus of Regulation FD is on whether the issuer discloses material nonpublic information, not on whether an analyst, through some combination of persistence, knowledge, and insight, regards as material information whose significance is not apparent to the reasonable investor.

Finally, some commenters stated that greater protection would be afforded to issuers if we made clear that the regulation’s requirement for “intentional” (knowing or reckless) conduct also extended to the judgment of whether the information disclosed was material.48 We agree that this clarification is appropriate. As adopted, Rule 101(a) states that a person acts “intentionally” only if the person knows, or is reckless in not knowing, that the information he or she is communicating is both material and
nonpublic. As commenters suggested, this aspect of the regulation provides additional protection that issuers need not fear being second-guessed by the Commission in enforcement actions for mistaken judgments about materiality in close cases.

3. Intentional and Non-intentional Selective Disclosures: Timing of Required Public Disclosures

A key provision of Regulation FD is that the timing of required public disclosure differs depending on whether the issuer has made an "intentional" selective disclosure or a selective disclosure that was not intentional. For an "intentional" selective disclosure, the issuer is required to publicly disclose the same information simultaneously.50

a. Standard of "Intentional" Selective Disclosure

Under the regulation, a selective disclosure is "intentional" when the issuer or person acting on behalf of the issuer making the disclosure either knows, or is reckless in not knowing, prior to making the disclosure, that the information he or she is communicating is both material and nonpublic.51 A number of commenters thought that the distinction between intentional and non-intentional disclosures was appropriate.52 Others, however, stated that the "intentional" standard should not include reckless conduct, because of the risk that this standard, in hindsight, could be interpreted as close to a negligence standard.53 Some commenters suggested that there be a safe harbor for good-faith efforts to comply with Regulation FD or for good-faith determinations that information was not material.54

After considering these comments, we have determined to adopt the "intentional"/non-intentional distinction essentially as proposed. By creating this distinction, Regulation FD already provides greater flexibility as to the timing of required disclosure in the event of erroneous judgments than do other issuer disclosure provisions under the federal securities laws; it essentially incorporates the knowing or reckless mental state required for fraud into this disclosure provision. Since recklessness suffices to meet the mental state requirement even for purposes of the antifraud provisions,55 we believe it is appropriate to retain recklessness in Regulation FD's definition of "intentional" as well. Further, in view of the definition of recklessness that is prevalent in the federal courts,56 it is unlikely that issuers engaged in good-faith efforts to comply with the regulation will be considered to have acted recklessly.

As requested by several commenters, moreover, we emphasize that the definition of "intentional" in Rule 101(a) requires that the individual making the disclosure must know (or be reckless in not knowing) that he or she would be communicating information that was both material and nonpublic. Thus, in the case of a selective disclosure attributable to a mistaken determination of materiality, liability will arise only if no reasonable person under the circumstances would have made the same determination.57 As a result, the circumstances in which a selective disclosure is made may be important. We recognize, for example, that a materiality judgment that might be reckless in the context of a prepared written statement would not necessarily be reckless in the context of an impromptu answer to an unanticipated question.
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*DUE DILIGENCE IN THE SECURITIES LITIGATION REFORM ERA: SOME PRACTICAL TIPS FROM LITIGATORS ON THE EFFECTIVE CONDUCT, DOCUMENTATION AND DEFENSE OF UNDERWRITER INVESTIGATION

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John Kanberg

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*363 I. INTRODUCTION [FN1]

How can a managing underwriter committed to conducting a reasonable due diligence investigation perform and document its work in a way that maximizes its ability to obtain a pretrial summary judgment in the event post-offering developments lead to litigation challenging the integrity of the offering?

The explosion of securities class action litigation in recent years has been accompanied by a phenomenon all too familiar to investment banking firms: when the litigation involves an underwritten public offering or a managed private placement, the "round up the usual suspects" mentality that typically accompanies the drafting of a complaint often results in the underwriters or private placement agents being swept into the plaintiffs' broadly-cast net of accusations. The usual scenario has found investment bankers responding with substantial efforts to extricate themselves at the pleading stage which, if unsuccessful, lead to years of laborious and expensive discovery. Even when the investment banker has a strong case, it still faces a choice between settling the case for blackmail money or risking the uncertain fact-finding of a jury. Win or lose, the investment banker will have spent many thousands, perhaps millions, of dollars in defending both its reputation and its checkbook.

In recent years, however, courts have shown an increased willingness to dismiss meritless claims against investment bankers at the summary judgment stage, before the Hobson's choice between expensive settlement and expensive trial defense becomes inescapable. Cases in which the courts have awarded summary judgment to the *364 underwriters of public offerings after extensive records were developed regarding the underwriters' due diligence investigations include:

in part, 38 F.3d 1078 (9th Cir. 1994), amended, 50 F.3d 615 (9th Cir. 1995), cert. denied, 116 S. Ct. 274 (1995);

In re Worlds of Wonder Sec. Litig., 814 F. Supp. 850 (N.D. Cal. 1993), aff'd in part, rev'd in part, 35 F.3d 1407 (9th Cir. 1994), cert. denied, 116 S. Ct. 185 (1995);


*365 At the same time, Congress' enactment of the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act in 1998 demonstrated legislative recognition of the fact that securities class actions had gotten out of hand. The first half of 1996 saw a significantly reduced number of new filings in federal court (partially offset by an increased number of filings in state courts, particularly in California). Since then, however, the pace of federal filings has returned to, and even exceeded, historical levels. [FN3] In 1998, the filing of 239 new securities class actions in federal court not only outnumbered the prior year by 55% and surpassed the average number of filings in the five years prior to the Reform Act by over 30%; it also eclipsed the record for any single year, even before the Reform Act. [FN4]

Although there is evidence that courts have generally been more favorably disposed to early dismissal of securities class actions since passage of the Reform Act, [FN5] it remains to be seen whether a long-term trend in this direction will develop. Nevertheless, it is safe to say that the Reform Act's principal modifications to the 1933 and 1934 Acts -- including the safe harbor for forward-looking statements accompanied by meaningful risk disclosure, the provisions relating to appointment of responsible class representatives, the heightened standards for pleading fraud, and revisions regarding loss causation, damage calculation, joint and several liability, settlement, and indemnity and contribution -- can provide procedural and substantive advantages to underwriters and others named as defendants in the cases that continue to be filed. [FN6] These advantages will be most readily available to those underwriters able to demonstrate their commitment to careful due diligence and appropriate documentation.

The purpose of this outline is to provide practical guidance to underwriters and their counsel, based on the authors' experience in defending underwriters in class action litigation, regarding the effective conduct and documentation of due diligence investigations. We believe that structuring and documenting the investigation with adequate foresight will enhance the underwriter's ability to obtain pretrial dismissal in the event an offering is claimed with hindsight to violate the securities laws. In Part I we *367 provide an overview of factors the courts have seen as significant in addressing an underwriter's due diligence defense under Sections 11 and 12(a)(2) (formerly Section 12(2)) of the 1933 Act. [FN7] In Part II we consider how an underwriter's documentation of its investigation can improve its ability to establish a due diligence defense. [FN8]

II. GUIDANCE FROM THE CASE LAW

Both Section 11 and Section 12(a)(2) of the 1933 Act contain express due diligence defenses that, although worded somewhat differently, have been held to create identical standards when applied to a given offering. E.g., Software Toolworks, 38 F.3d at 1083. [FN9]

*368 Notwithstanding that judicial interpretation of the defense is surprisingly sparse, the cases do provide ample clues to what kinds of investigation will satisfy an underwriter's burden of proof. While the totality of an underwriter's investigation will determine whether or not it is reasonable under the circumstances, the underwriter's ability to point out parallels between specific steps it
undertook and those cited as relevant in reported cases will obviously enhance its position in the event it is forced to defend against a claim that it sold securities by means of a materially untrue statement or omission. [FN10] Some of these steps are described below.

*369 A. Independent Verification. Courts often look at the underwriter's efforts to independently verify management representations. E.g., Software Toolworks, 789 F. Supp. at 1496 ("It would be unreasonable ... to rely on management representations when said representations could have been reasonably verified"), Glassman, 90 F.3d at 628 (same), Escott v. Bar-Chris, 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968) (identifying independent verification as essential element of due diligence).

1. Exceptions: "It is not unreasonable, however, to rely on management's representations with regard to information that is solely in the possession of the issuer and cannot be reasonably verified by third parties." Software Toolworks, 789 F. Supp. at 1496 (granting summary judgment to underwriters and rejecting plaintiff's argument that proper due diligence "require[s] an audit"). Courts have also permitted underwriters to rely upon the issuer's statements to the SEC outside the registration statement. Id. at 1497-98; see also, Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 644, 683 (E.D.N.Y. 1971); but see Software Toolworks, 38 F.3d at 1086-88 (underwriter could be liable for non-prospectus statements to the SEC that it knows are materially misleading).

2. Reasonable, independent verification usually means referencing information sources outside the issuer -- for example, speaking with the issuer's customers, lenders, manufacturers, distributors, licensees, etc., and reviewing news articles and industry publications regarding the issuer, its market and competition. The courts are favorably impressed by such palpable efforts to "cross.*370 check" the issuer's representations. See, e.g., Int'l Rectifier at 97,140 (finding that underwriters satisfied the "reasonableness" standard based, in part, on interviews with the issuer's major customers, outside quality consultants and counsel), 97,141-42 (oral interview of outside consultants, rather than reading their report, was sufficient as it "may have simply represented a better use of the Underwriters' limited time and resources"), 97,142 (while interviewing only "major" customers was "not entirely satisfactory," court concluded that one judgmental error would not negate the overall reasonableness of the investigation); Software Toolworks, 789 F. Supp. at 1497 (noting that underwriters "verified management's representations by contacting three major Nintendo customers, that distributors of Toolworks' PC software, three major software developers or licensees, and customers of the Priority subsidiary [and] ... contacted Nintendo of America regarding the health of the Nintendo market"); 38 F.3d at 1084, 1087 (same); Weinberger v. Jackson, [1990-91] Fed. Sec. L. Rep. (CCH) ¶ 95,693 at 98,255 (granting summary judgment and noting that the underwriters "contacted many of Altus' suppliers, customers and distributors, who were asked extensive questions about the company's operations ... (and the underwriters) examined trade journals and other industry related publications to ascertain industry trends, market trends and competitive information"); Phillips, 933 F. Supp. at 318-19, 325 (granting summary judgment where underwriter spoke with issuer's suppliers, customers, banks, accountants and lawyers, analyzed the relevant business sector, researched the background of management, reviewed IPO prospectuses of competitors, and relied on independent market analyses); Perrigo at *53 (underwriters spoke with customers and reviewed various sources about the company and its industry).

*371 3. Independent verification can also be achieved, at least in part, by accessing information sources within the issuer itself. For example:

a. Speaking with lower-level employees to search for inconsistencies with statements of higher-level management. See generally, Software Toolworks, 789 F. Supp. at 1497 (noting interviews with "over a dozen Toolworks and Mindscape officials"); Weinberger v. Jackson, [1990-91] Fed. Sec. L. Rep. (CCH) ¶ 95,693 at 98,255 (noting meetings with "various management personnel"); Phillips, 933 F. Supp. at 318 (noting "discussions and/or meetings" with management). But see Int'l Rectifier at 97,142 (concluding that "given the time constraints under which the underwriters operated, their decision to interview only senior and middle management, (the employees who would presumably possess the broadest knowledge about [the issuer's] operations, finances, etc.), as opposed to lower level employees, was reasonable").
b. Reviewing the issuer's internal documents is an effective means of cross-checking officer representations. E.g., Weinberger at 98,255 (noting that "[t]he underwriters reviewed company documents including operating plans, product literature, corporate records, financial statements, contracts and lists of distributors and customers"); Software Toolworks, 789 F. Supp. at 1497 n.7 (same); Int'l Rectifier at 97,137 (review of issuer's internal business plans, key contracts); Perrigo at *52-53 (review of internal growth plan, projections and other documents). Cf. Feit, 332 F. Supp. at 561-62 (holding due diligence standard "barely" satisfied where underwriter "rel[ied] upon the issuer or its counsel to produce relevant material from its files"); BarChris, 283 F. Supp. at 694 (due diligence inadequate where underwriters *372 looked at no contracts other than insurance policy and did not press for missing board minutes). It is useful to get a representation from the issuer that access has been granted to all material documents.

c. Physical inspections of the issuer's facilities are also effective. See Weinberger at 98,255; Int'l Rectifier at 97,140; Perrigo at *53.

d. Several courts have noted the significance of the underwriters' receipt of signed representations and warranties from the issuer, insiders, company counsel and underwriters' counsel as to the accuracy of the prospectus. See Software Toolworks, 789 F. Supp. at 1497, 38 F.3d at 1084; Weinberger at 98,255; Int'l Rectifier at 97,140; Perrigo at *42, 53. These can be included in the underwriting agreement, officer certificates, and/or officer and director questionnaires.

4. Independent verification is not required for "expertised" portions of the registration statement, such as the audited financial statements. Section 11(b)(3)(C) requires only that the underwriter had "no reasonable grounds to believe," and no actual belief, that information was misrepresented or omitted. Worlds of Wonder, 814 F. Supp. at 864, 867-68 (granting summary judgment and holding that underwriter "had no duty to independently repeat" the auditors' investigation); 38 F.3d at 1421 (once company discloses facts to auditors, underwriters can rely on auditor's accounting decisions); Software Toolworks, 789 F. Supp. at 1498 ("Given the complexity of the accounting issues, the Underwriters were entitled to rely on [the auditor's] expertise"); 38 F.3d at 1085 (underwriter need not conduct due diligence into the "expertised" parts of a prospectus); Phillips, 933 F. Supp. at 319 n.11, 323 (underwriter could rely on accountant's cold comfort letter *373 itemizing its review); Int'l Rectifier at 97,137; Perrigo at *42, 53; cf., Crazy Eddie, 817 F. Supp. at 316 (showing that underwriters placed too much reliance on comfort letters from auditor and general counsel and failed to conduct independent inquiry would not establish scienter under Rule 10b-5).

Nevertheless, the courts have cited with approval the practice of underwriters to discuss with the experts/auditors their conclusions, and the bases for them. See, e.g., Worlds of Wonder, 814 F. Supp. at 868 (noting that underwriter "specifically sought and received assurances from" the auditor on the "facts that supported" the auditors' revenue recognition conclusions), 35 F.3d at 1423 (same); Software Toolworks, 38 F.3d at 1084 to 1086 (to assure accuracy of revenue recognition, underwriters confronted auditors, asked for reconfirmation of contracts and contacted other accounting firms to verify auditor's accounting methods); Perrigo at *52 (noting that underwriters questioned outside accountants about a variety of financial matters, including effect of changes in accounting treatment on financial statements); In re Gap Stores Sec. Litig., 78 F.R.D. 283, 299 n.19 (N.D. Cal. 1978) (quoting E.L. Folk III, "Civil Liabilities Under The Federal Securities Acts, Part I: The BarChris Case," 55 Va. L. Rev. 1, 54 (1969) for the proposition that "a complete review and analysis of the financial statements is the "commonly accepted norm" of the underwriting community).
"sufficient to ask questions, to obtain answers which, if true, would be thought satisfactory, and to let it go at that, without seeking to ascertain from the records whether the answers in fact are true and complete").

2. Following up on any anomalous or negative information learned is necessary. Compare Software Toolworks, 789 F. Supp. at 1497 (granting summary judgment where underwriters "properly followed up any 'negative or questionable' information that developed as a result of their investigation," including recontacting outside parties to inquire as to anomalous information), Weinberger at 98,255 (same), and Perigo at "41-42, 55-56 (same) with Escott v. BarChris, 283 F. Supp. at 693 (underwriter's and underwriter's counsel's reliance on issuer's explanations as to missing board minutes and of immaterial nature of risks of customer defaults held insufficient).

a. Other Investment Bankers. Plaintiffs will likely imply that any withdrawal from a transaction by other investment banking firms demonstrates their discovery of "deal-busting" negative information. Thus, underwriters should satisfy themselves as to why any prior dealings with other prospective underwriters were abandoned.

b. Insider Sales. If insiders have sold, are selling and/or want to sell in the offering a large *375 amount (relative to their total holdings) of stock, appropriate investigation should be made to provide comfort that such sales do not reflect a pessimistic view of the issuer's future financial results.

3. Courts applauded creation by the underwriters of their own economic models of expected earnings to test the issuer's projections. Int'l Rectifier at 97,137 (underwriters' model showed issuer's internal projections to be conservative).

4. It is helpful at the outset of the engagement, and at the outset of each management interview, to explain the rationale for what may appear to the issuer's personnel to be an unreasonably adversarial spirit. The issuer is more likely to cooperate when it is made to understand that full exploration of facts and risks and full prospectus disclosure benefits everyone, and can help protect against the risk of even more adversarial (hostile) cross-examination down the road. The issuer's counsel can obviously help to insure that the issuer's personnel understand, accept and cooperate with the underwriter's need to ask probing questions and to obtain candid answers. Outside directors can be allies in this regard as well, inasmuch as they too will want to support a due diligence defense in the event of litigation. Every effort should be made to achieve an atmosphere of openness and critical examination both between underwriter and issuer and within the underwriting team itself.

C. "Bringdown" Due Diligence. Proof that the underwriter continued to investigate up until the effective date of the registration statement will help to protect against a claim that the underwriter should have uncovered some late-breaking development not disclosed in the *376 prospectus. Additional interviews of key personnel or customers, for example, may identify changes in sales trends. It is remarkable how often the cases focus on the disclosure or non-disclosure of events just prior to the effective date. E.g., Software Toolworks, 769 F. Supp. at 497-98. In Software Toolworks, the only issues on which the court of appeal reversed summary judgment were based on events subsequent to the preliminary prospectus (allegedly false statements in a letter to the SEC and allegedly false recording of stub-period transactions). 38 F.3d at 1086-88. Bringing down the due diligence through additional meetings, conference calls, re-examination of disclosure items, and updating of issuer representations and warranties can be useful. See, e.g., Perigo at "42 (noting that underwriters conducted a "bringdown" due diligence conference call to confirm that no changes had occurred in the issuer's financial or operating condition); Int'l Rectifier at 97,137 (due diligence continued throughout pre-offering period). In addition to the customary bringdown comfort letter from the auditors, it may also be helpful to include a representation and warranty in the underwriting agreement that the issuer's performance in the current quarter is consistent with its operating plans and that nothing therein necessitates modification or supplementation of the prospectus.

Note, however, that courts have declined to impose on issuers any duty to disclose variations between internal projections and expected results for the incomplete quarter in which an offering
occurs. See, e.g., Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1297-98 (9th Cir. 1998) (affirming dismissal with prejudice on initial motions to dismiss, including motion by the authors on behalf of underwriters, where plaintiff claimed intra-quarter results revealed known adverse trend); Worlds of Wonder, 35 F.3d at 1419; Glassman, 90 F.3d at 631. Nevertheless, the court *377 in Glassman pointed out that, while the Section 11 requirement that statements in a prospectus be true "as of the effective date of the offering" prevents a hindsight attack based on later developments, id. at 627, it also means that "a failure to continue to investigate the company up to the effective date of the offering is likely to be a failure to do due diligence." Id. at 628 (emphasis in original).

D. Adequacy Of Due Diligence Investigation Will Be Evaluated Both Cumulatively And On An Issue-Specific Basis.

1. Spending significant time, meeting numerous times with management and reviewing numerous documents are all helpful in proving a due diligence defense, but are not necessarily sufficient. See Eiscott v. BarChris (time-consuming but essentially pro forma investigation held insufficient). Cf., Weinberger v. Jackson (granting summary judgment to underwriters and noting that underwriters had held "over 20" meetings with various management personnel of the issuer); Software Toolworks, 789 F. Supp. at 1489 (noting that underwriters had interviewed "over a dozen" members of management); Int'l Rectifier at 97,137 (underwriters interviewed eleven senior and middle managers).

2. The inquiry in litigation is typically focused on what investigation was performed with respect to a particular issue or a particular representation in the disclosure document (i.e., whatever issue or statement has assumed importance by reason of post-offering events).

a. For example, plaintiffs' counsel will often point to a specific representation in a prospectus, and ask the underwriter personnel: "What did you do to verify this statement?" "How did you satisfy yourself that *378 this statement was true?" "Did you consider altering the language in this section in the light of your discussion re fact X with person Y?"

b. It is therefore helpful to avoid a rigid "checklist" mentality, to focus the investigation on the particular issues that arise, and to view the effort as a series of independent mini-investigations with respect to the key issues. This also underscores the usefulness of a "line-by-line" review of the registration statement. See Felt, 332 F. Supp. at 582; Int'l Rectifier at 97,137 (working group reviewed preliminary prospectus line by line).

E. Adequacy Of Due Diligence Investigation Should Be Evaluated Not With Benefit Of Hindsight, But Rather As Of The Time Of The Investigation. According to Software Toolworks, "plaintiffs' contention that had the Underwriters done more, they would have revealed problems, is unpersuasive. The Court cannot evaluate an underwriter's due diligence defense with the benefit of hindsight. The overall investigation performed here was reasonable under the circumstances at the time of the investigation." 789 F. Supp. at 1498 n.14, see also, Int'l Rectifier at 97,142 ("the standard under which this court must measure the Underwriters' due diligence is one of reasonableness, not perfection"). Cf., Competitive Associates, Inc. v. International Health Sciences, Inc., [1974-75] Fed. Sec. L. Rep. (CCH) ¶ 94,966 at 97,337 (S.D.N.Y. 1975) (focusing on whether the type of investigation that would have been required to unveil the untruth would have been unreasonably onerous).

F. Neither Perfect Investigation Nor Perfect Recall Is Required. Reasonableness "is a question of degree, a matter of judgment in each case." Int'l Rectifier at 97,137, quoting BarChris, 283 F. Supp. at 697. The *379 "diligence conducted must be reasonable, not perfect." Int'l Rectifier at 97,139. Indeed, expert testimony criticizing the underwriters' due diligence cannot prevent summary judgment where the underlying facts are undisputed. Int'l Rectifier at 97,142 (noting that "it would be truly surprising, given the advantage of hindsight," if expert could not identify possible shortcomings, and that the expert's "ability to poke holes in the diligence conducted is not dispositive ..."); see also, Worlds of Wonder, 35 F.3d at 1427 (rejecting "self-righteous" statements of accounting expert); Software Toolworks, 50 F.3d at 628 (same); In re Apple Computer Sec. Litig., 886 F.2d 1109,
1116 (9th Cir. 1988) ("where the evidence is as clear as that in this record, the court is not required to defer to the contrary opinion of plaintiffs' 'experts').

Nor will summary judgment be defeated if the underwriters have less than perfect recall of details when their depositions are taken. In Perrigo, plaintiff argued that "the inability of certain witnesses to recall specific details of the due diligence investigation undercuts the Underwriter Defendants' evidence supporting their due diligence defense and creates an issue for the jury." Perrigo at 54. The court invoked common sense to reject the argument: "common everyday experience teaches us that very few persons, if any, can, after three or four years, recall the details of lengthy meetings. This judge has difficulty remembering the details of trials that occurred some months ago and must refer to transcripts. Attorneys order transcripts because they cannot, and are not expected to, recall the details of every argument and every bit of testimony. Based upon their individual differences in life, jurors often recall and forget different aspects of a trial that has just concluded. People with J.D.'s and M.D.'s, and maybe even Ph.D.'s, forget where they have parked their cars when returning from even fairly short trips by *380 airplane." Id at 55. Despite these "common shortcomings," the court in Perrigo concluded that the underwriters' testimony that they had in fact covered all due diligence meetings all of the questions in their written outlines constituted substantial evidence that, standing uncontradicted, warranted summary judgment. Id.

In International Rectifier, the court drew on prior cases in summarizing the factors to be considered in assessing the overall reasonableness of an underwriter's investigation as follows: whether the underwriters (1) were familiar with the issuer's finances, management and operations, (2) possessed knowledge of the issuer's industry, (3) conducted interviews of the issuer's employees, (4) conducted interviews of and/or confirmed data with the issuer's customers or other third parties, and (5) obtained written verification from the issuer and/or outside accountants that the information contained in the prospectus was accurate. Id. at 97,140.

G. Due Diligence Standards Vary With The Issuer And Offering. The SEC has stated that "[a] thorough and intensive underwriters' investigation is especially important in an initial public offering by companies in the developmental stage or those dealing with 'high technology' products or processes ... [where] the issuer is still engaged in research or development and has not yet subjected the product to the critical evaluation of the marketplace." SEC Release No. 33-5275 (July 26, 1972); see also, SEC Rule 176(a) and (b), 17 C.F.R. §230.176(a) and (b) (May 24, 1982) (listing "the type of issuer" and "the type of security" as two of the "relevant circumstances" to consider in determining the adequacy of a due diligence investigation). Conversely, substantially less should be required in an investigation of a long-established issuer for whom the underwriter has done day-to-day work throughout the years, and which has been followed by industry analysts over the years. Id.

While plaintiffs often suggest that an underwriter's experience in an issuer's prior offerings led it to take shortcuts or do a less thorough job in subsequent offerings, the courts have regularly portrayed such experience as a positive rather than negative factor. See, e.g., Int'l Rectifier at 97,137; Perrigo at *38-39 and n.13, 42 n.15, 62.

The integrated disclosure system, see Release No. 33-5923 (April 11, 1978) and Release No. 33-6235 (September 2, 1980), permits issuers in certain offerings to incorporate Exchange Act reports into Securities Act registration statements, and the shelf registration procedure set forth in SEC Rule 415. 17 C.F.R. §230.415, permits issuers to register securities and then sell them up to two years later, at which time the prospectus need only be updated if material changes are not disclosed in Exchange Act filings made subsequent to the registration. Most commentators believe these procedures have undercut the ability of underwriters to conduct due diligence in those offerings in which they are used. See, e.g., M.H. Cohn, "The Integrated Disclosure System - Unfinished Business," 40 Bus. Law. 987, 992 (1985); M.F. Fox, "Shelf Registration, Integrated Disclosure and
Underwriter Due Diligence: An Economic Analysis," 70 Va. L. Rev. 1005, 1025-28 (1984). Accordingly, it seems likely that the standards of due diligence would be reduced concomitantly in shelf registrations or other offerings in which 1934 Act disclosures are incorporated by reference. E.g., Cohn, supra, at 994-95; Fox, supra, 1030-32; accord, SEC Rule 176, 17 C.F.R. § 230.176 (1984) (including, among the relevant circumstances in evaluating the reasonableness of an investigation, "[w]hether, with respect *382 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"). Those procedures are not applicable to IPO's or sales of junk bonds.

H. Comprehensive Risk Disclosure. An underwriter is not required to have perfect clairvoyance and can be found to have conducted a reasonable investigation even if what ultimately went wrong was so unanticipated that the risk of such an occurrence was not disclosed. Nevertheless, the temptation to exercise hindsight in litigation is so powerful that it can be challenging to demonstrate that what ultimately "materialized" was not a "material" risk at the time of the offering. Accordingly, the more comprehensive the risk disclosure, the more likely a court will be able to grant summary judgment on the basis that appropriate disclosure was made. See, e.g., Worlds of Wonder, 814 F. Supp. at 856-60, 35 F.3d at 1413-15 (prospectus warnings which "bespoke caution" adequately disclosed risks to investors); Software Toolworks, 785 F. Supp. at 1497 n.10 (noting in dictum that the risk factor disclosures in the prospectus "may, by themselves, entitle the underwriters to summary judgment"); see also, In re Donald J. Trump Casino Sec. Litig., 7 F.3d 357 (3d Cir. 1993) (citing extensive authority on the "bespeaks caution" doctrine). It is obviously useful for the underwriter to continuously ask itself (as well as those interviewed during due diligence), "what could possibly go wrong" and to disclose all material risks which have any likelihood at all of occurring. Risk disclosure is cheap. Defending litigation is not.

1. Risk and Realities. Plaintiffs routinely claim, in hindsight, that risk disclosures were insufficient because what was described only as a future risk was "*383 already an existing fact. Thus, consider in appropriate circumstances phrasing the preamble in the "risk factors" section so that it is not exclusively forward-looking and investors are alerted to the uncertain current status of the disclosed risks. E.g., "In evaluating an investment in the shares of Common Stock offered by this Prospectus, prospective investors are urged to carefully consider, in addition to the other information in this Prospectus, each of the following risks which can affect the Company's current position and future prospects."

2. Business Plans. Although a prospectus rarely refers to the company's past or current budgets or other planning tools, plaintiffs will commonly argue that any pre-offering shortfall in performance from plan should have been disclosed, and/or that the company's future plans at the time of the offering were overly optimistic. Bear in mind that litigation almost always involves a scenario where the company's subsequent performance is short of its expectations at the time of the offering. As a result, it is helpful if financial analysis done by the underwriter as part of its due diligence shows that sensitivity to a variety of possible scenarios was examined. E.g., Worlds of Wonder, 35 F.3d at 1416 (underwriters specifically analyzed company's capital requirements based on assumed lower offering proceeds and concluded sufficient). In appropriate cases, it may be useful to specifically disavow any assurance that a particular plan can be achieved, whether or not the plan itself is a basis for anything stated in the prospectus.

3. Forward-looking statements. While it formerly discouraged the inclusion of projections in registration statements, the SEC has recently encouraged disclosure of "soft" information by creating a "safe harbor" in Rule 175 (and Rule 3b-6 under the 1934 Act). Rule 175 *384 exempts projections and other statements of plans and objectives for future operations or their underlying assumptions from Sections 11, 12(a)(2) and 17(a) unless a plaintiff can show that the statement "was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." Courts have also made clear that disclosure of internal financial projections is not required in a variety of situations. E.g., In re Lyondell Petrochemical Co. Sec. Litig., 884 F.2d 1050 (9th Cir. 1993); Walter v. Holiday Inns, Inc., 985 F.2d 1232 (3d Cir. 1993). On the other hand, underwriter analysis and review of

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projected performance and budgets can support a due diligence defense even where results fail to meet disclosed expectations. Phillips, 933 F. Supp. at 318-19. [FN11]

I. Limiting The Underwriter’s Exposure To Statements In The Prospectus. Under Section 11, an underwriter’s exposure is limited to statements or omissions in a registration statement. Under Section 12(a)(2) and Section 10(b), however, plaintiffs may attempt to hold the underwriter responsible for statements made by it or others in other contexts. These commonly include statements in research analyst reports, projections or other statements at road show meetings, statements to rating agencies, or statements by the issuer in press releases, presentations to analysts or SEC filings. [FN12] Indeed, recent *385 class action complaints are regularly alleging that underwriters conspired with issuers and management to pump a stock’s market price with “booster shots” in analyst reports so that insiders could dump stock at inflated prices once the lock-up period has ended following an offering. Even though the underwriter’s legal responsibility for these kinds of statements may be very different from those in a prospectus, it is nevertheless wise to sensitize members of the underwriting team to be as careful and professional in these contexts as they are in conducting and documenting due diligence. In addition, the underwriting team can help to avoid further litigation issues by counseling issuer representatives to be equally cautious (at the most *386 conservative extreme, not to go beyond the four corners of the prospectus) in settings in which the underwriter has a role (e.g., road show presentations). [FN13]

J. Delegation To Qualified Professionals Of Investigation Of Non-Expertised Portions Of Registration Statement.

1. Delegation of non-expertised investigation to others is permissible where delegates are those "whose duties should have given them knowledge of particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing).” SEC Rule 176(f), 17 C.F.R. § 230.176(f); see also, SEC Rel. No. 33-6335 [Second Extra Edition] Fed. Sec. L. Rep. (CCH) Report No. 926 (Aug. 6, 1981) (proposing Rule 176 for comment); S.B. Fortenbaugh, III, "Underwriters' Due Diligence,” 14 Rev. Sec. Reg. 799, 800 (Dec. 1981) (reasonable to delegate portion of investigation that "involves professional skills or facilities the underwriter does not possess"); B.L. Resnik, "Understanding Comfort Letters For Underwriters," 34 Bus. Law. 1725, 1731-32 (July 1979) (same); Int’l Rectifier at 97,140 (noting work done by underwriters "and/or other members of the Working Group" as showing reasonable investigation).

a. It is reasonable for underwriters to delegate the investigation of non-expertised financial *387 information (i.e., financial information outside the audited financial statements regarding such matters as the issuer’s accounting and financial controls and unaudited financial data) in the registration statement to outside auditors, and to rely to some degree on the auditors’ conclusions as to its accuracy. See, e.g., B.L. Resnik, 34 Bus. Law. at 1731-32 (“It is generally impracticable for the underwriters to undertake such an investigation themselves. However, the issuer’s accountants are particularly able to conduct such an investigation because of their familiarity with the issuer’s accounting records based upon their review of the issuer’s internal accounting controls conducted in the course of each annual audit”).

b. While unquestioned reliance upon the investigation performed by the auditor on non-expertised information, as memorialized in the auditor’s comfort letter or management letter, may be inappropriate, careful review of such documents and questioning the auditor with respect to the bases for its conclusions should be sufficient. See, e.g., B.L. Resnik, 34 Bus. Law. at 1733.

c. Consider seeking further comfort from the auditors on other forward- looking financial issues such as the “going concern” analysis and revenue recognition on sales with deferred or conditional payment terms.

2. Delegation to outside professionals can be an effective means of documenting due diligence. Examples:

a. Hiring a professional investigative firm to investigate the employment and personal backgrounds of key management personnel.

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c. Hiring consumer marketing experts, industry specialists, or significant commentators in the trade.

K. Delegation To Inexperienced Members Of Underwriting Team Or Inexperienced Underwriter’s Counsel. Although it is common to delegate the task of reviewing the issuer’s documents to junior attorneys, and to delegate other investigative tasks to junior members of the underwriting team, the courts have highlighted the importance of having experienced people supervise the investigation. See, e.g., Weinberger v. Chaitkin at 98,255 (noting that the investigation “was conducted by experienced people”); and compare BarChris v. FTC at 655 (holding that underwriter had not established the due diligence defense and noting that much of the investigation had been conducted by an associate that had been admitted to the bar three months before the investigation began) with Feit, 332 F. Supp. at 562 (holding that the underwriters had established the defense and noting that a partner of a reputable law firm, and formerly an SEC commissioner, was “primarily in charge” of, and an active participant in, the investigation).

Providing organized in-house or other training to junior bankers or lawyers on appropriate due diligence techniques and documentation can help dispel any future claim that they were insufficiently experienced to perform assigned roles; in addition, thorough documentation by the junior team member will facilitate review and supervision by the more senior members, thereby not only helping to catch and correct any shortcomings in the work, but also enabling the underwriter *388 to point to the careful nature of the process that was used. Finally, encouraging the junior team members who have performed document review to participate in drafting sessions will enhance their ability both to spot issues and to bring them to the attention of more senior team members.

III. DUE DILIGENCE CONSIDERATIONS IN THE EMERGING TECHNOLOGY SECTOR

The explosion of e-commerce and the proliferation of Internet-related public offerings have highlighted new areas of due diligence concern. These concerns flow from the fact that many Internet companies: (a) have a large portion of their value tied to intangible assets; (b) rely upon emerging technologies, the viability of which cannot be easily assessed; (c) operate in an extremely dynamic market. In order for underwriters to avail themselves of their statutory defense under these highly volatile conditions, we recommend that they consider supplementing their traditional due diligence investigations.

For example, many high technology start-up companies will not have any significant physical assets such as manufacturing facilities or inventory. Instead, the principal asset of these Internet entities may well be their intangible intellectual property. Thus, rather than the “tire-kicking” investigations of years past, due diligence in the technology sector may need to focus on the identification and analysis of a range of intellectual property rights.

Increasingly, the companies that offer on-line products and services are affected by a variety of overlapping intellectual property rights including copyright, *390 utility patents, design patents, trade secrets and trademarks. Because each of these rights is territorial, while ecommerce is increasingly international, the assessment of a company’s intellectual property may further require an understanding of the domestic laws of various countries as well as several international conventions and treaties. Indeed, because the status of a company’s intellectual property rights can be of paramount importance to its business prospects and subject to a highly specialized and quickly changing body of law, we recommend that in appropriate matters the underwriting team include intellectual property specialists.

Although intellectual property rights in the Internet context typically include a variety of legal
doctrines (which are discussed below in greater detail), the following are the most prominent:

a. Patents. Patents provide protection for inventions and discoveries that are new and non-obvious. Computer hardware and other machines, processes and articles of manufacture are often the subject of patent protection, as well as browsers and some software tools.

b. Copyrights. Copyrights protect original works that reflect some degree of creativity and that are fixed in a tangible medium of expression. While firmware, software, documentation and marketing materials may be subject to copyright, there will not be any such protection for concepts, ideas and principles. Recent case law has generally narrowed the scope of copyright protection for computer software.

*391 c. Trademarks. Trademarks are symbols that identify the source of products or services, and may include words, logos, designs, slogans, packaging, sounds and smells. In the United States, trademarks are created by use but may also be registered. In many other countries, trademarks rights are derived solely from registration. Recently, the Federal Trademark Dilution Act has provided protection for the owners of “famous” names that might otherwise be misappropriated into an address on the World Wide Web.

d. Trade Secrets. Trade Secrets are non-public business information that has economic value because of its secrecy, and that the owner has taken reasonable steps to protect. Trade secrets can include technology, manufacturing procedures, formulas, programs, and almost any other kind of proprietary information. Owners of trade secrets have the right to prevent others from using them without permission, but there is no public registration system for such trade secrets.

A. Due Diligence in Connection with Patents. The underwriter's investigation of patent rights is likely to focus on an analysis of scope, validity and strength. The scope of a patent is defined by its numbered claims, each of which is considered by law to be a separate invention. Although the issuance of a patent creates a presumption of validity, a due diligence investigation can help assess the strength of potential (or actual) claims against acquired patents that could subsequently lead to their invalidation. Because courts typically construe patents based on the language used to draft patent claims, a broadly drafted *392 patent that appears to offer more value may thereby be subject to a greater risk of challenge.

The steps that should be considered with respect to an underwriter's patent-related due diligence investigation typically include the following:

- a review of all patents and pending applications including their issue date and country of issuance.
- an examination of the "file wrappers" for patent applications, including any assignments from inventors.
- verification that patent rights have not lapsed due to a failure to pay annual "maintenance fees" or other fees.
- verification of the remaining term of any patent that has been issued.
- The collection of files concerning any threatened or potential patent infringement litigation.

In addition to a standard "validity search" to analyze whether the claims of a patent are likely to survive a challenge based upon prior art, the underwriting team may consider seeking an opinion letter concerning non-infringement and patentability.

*393 B. Due Diligence With Respect To Copyrights. Because recent cases appear to have limited the scope of copyright protection for computer software, due diligence investigations will increasingly need to focus on the issuer's ability to preserve its competitive advantage in this field. For example, in Computer Associates v. Altai, 982 F. 2d 693 (2d Cir. 1993) the court set forth a three-step "abstraction-filtration-comparison" test for determining whether a computer program infringed the copyright of a "substantially similar" program. The Altai court acknowledged that its decision narrowed the scope of copyright protection when it ruled that elements of a program that were

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already in the public domain, or that were dictated by "efficiency" or by "external factors", were unprotectible. Similarly, Lotus Development Corp. v. Borland International, Inc., 49 F. 3d 807 (1st Cir. 1995), affirmed by an equally divided court, 116 S. Ct. 804 (1996) (per curiam) allowed the copying of user interface menu structures employed in a user interface.

In addition to investigating the scope of copyright protection, a key issue will often be the ownership of software intellectual property rights. Challenges to copyright ownership typically arise in connection with materials that have been developed by independent contractors, or that have been licensed or assigned in whole or part. The underwriting team may consider incorporating the following investigative steps concerning registration, licensing and non-infringement into their due diligence investigation:

1. Verification of title to the copyright, the dates of registration and the accuracy of facts recited in those certifications.

*394 A review of the protectibility of a copyright under the Altai analysis, including whether authorship has been claimed with respect to elements of a software program that courts have now held are not protectible.

2. Verification that the purported copyright owner has not assigned or licensed its intellectual property rights in whole or in part.

3. A review of company files containing copyright assignments, licenees, security interests and international registrations.

4. Confirmation that the company acquired valid ownership rights of software written for it by employees or independent contractors.

Particularly with respect to potential claims of infringement that have been identified in the due diligence process, it may be possible to obtain copyright clearance opinion letters to support the underwriters’ investigation.

C. Due Diligence Investigations of Trademark Rights. A particular concern with respect to trademark rights is that they can be lost through abandonment, cancellation or by becoming generic. Thus, in addition to the ownership analysis that applies to patents and copyrights, the due diligence investigation of trademark rights may well include a monitoring of the current use of a mark. Moreover, an emerging issue with respect to *395 trademark law and e-commerce is the range of protection (and lack thereof) afforded trademarks in some foreign jurisdictions.

Underwriters should consider adding the following steps to their due diligence investigation with respect to significant trademark rights:

1. A survey of all trademark and service mark registrations and applications including their filing date, status, countries of issuance and any assignments.

2. Searches and opinion letters concerning the clearance and registrability of all corporate marks.

3. Files related to any Internet domain names, including any controversy with respect to the use of such domain names.

4. An analysis of any cancellation proceedings in the Trademark Office, as well as any other federal or state claims for trademark infringement, dilution or unfair competition.

5. An analysis of the company’s policing efforts to ensure that a mark is in continual use, and that its non-use by others is policed.

D. Due Diligence With Respect To Trade Secrets. Trade secret law can protect a wide variety of "formulas, patterns, compilations, programs, devices, methods, techniques or processes," Uniform Trade Secrets Act 1(4XII), and can potentially last as long as they are kept secret and reasonable steps are taken to preserve their *396 secrecy. Thus, in the context of due diligence with respect to trade secret protection, it will be important to determine what practices and procedures have been employed by the issuer to ensure the broadest trade secret protection. The following steps are likely
to be viewed as supportive of an appropriate due diligence investigation:
   . An analysis of any inventions that are not yet the subject of issued patents but could be the subject of patent applications, as well as software developed by the company and that has been maintained in confidentiality.
   . An assessment of the confidentiality provisions in employment agreements, and the access of sensitive business information to employees.
   . An analysis use of a company’s use of independent contractors and the effect of such use on the protectibility of any presumed trade secret.
   . Documentation relating to the receipt of unsolicited submissions or inadvertent receipt by the company of competitive information.

IV. PRESERVING AND MAINTAINING AN ACCURATE RECORD OF THE INVESTIGATION

Underwriters sometimes give little thought to the kind of documentation that should be created and preserved to reflect their due diligence investigation. Some may have a packrat mentality that indiscriminately *397 preserves every piece of paper. Others may throw out virtually everything as a matter of policy. And perhaps most commonly, what gets created and what gets retained is a matter of chance, the habits of individual team members, or the vagaries of post-offering office moves or storage space requirements and costs.

We recommend a more disciplined approach to the creation and preservation of due diligence documentation. While the absence of documentation may in other settings advantage a plaintiff that is dependent on the defendant’s documents to prove its case, the question is more complex in the case of underwriter due diligence. Because due diligence is an affirmative defense, it is the underwriter rather than the plaintiff that must provide the evidence. While oral recollections alone are admissible and may be sufficient to prove the underwriter’s case, an absence of documentation can present practical problems. Beyond the persuasive power that contemporaneous documents often hold for judges and jurors, documentation is obviously helpful in refreshing the recollections of witnesses whose testimony may not be given until years after the investigation took place. With recent case law confirming that “the adequacy of due diligence may be decided on summary judgment when the underlying historical facts are undisputed,” Software Toolworks, 38 F.3d at 1084, it is increasingly important for underwriters to be able to prove the “underlying historical facts” in order to extricate themselves from class actions in a cost-effective manner.

The recent decision in Perrigo illustrates how crucial the availability of contemporaneous documentation can be in establishing a due diligence defense. In their depositions, the members of the underwriting team could not recall numerous details of *398 their due diligence interviews. They had, however, kept lists of the questions they had intended to ask. Perrigo at *40-41. In response to plaintiff’s argument that the underwriters’ inability to recall specific conversations undercut the due diligence defense and created a jury issue, the court held that the underwriters’ testimony that they in fact covered all questions in their outlines and had followed up on management’s answers constituted substantial evidence that warranted summary judgment. Id. at *54-56.

In addition, plaintiff’s counsel typically argues that an underwriter’s failure to maintain -- or its destruction of-- contemporaneous documentation is evidence of an improper investigation. See, e.g., Competitive Associates, [1974-75] Fed. Sec. L. Rep. (CCH) ¶ 94,966 at 97,337 (acknowledging plaintiff’s argument and noting that “maintenance of these records may have been advisable,” but ruling that underwriters had established their due diligence defense). Finally, if the only available documents at the time of litigation are in the issuer’s routinely-kept files, they can create ambiguities or a misleading impression that an issue was left unresolved in the course of due diligence. Subsequent oral explanations of apparent gaps in the documents may not be as persuasive as complete contemporaneous documentation.

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We explore below some of the basic principles of effective documentation, including some that run contrary to the conventional wisdom commonly accepted by underwriters and their counsel.

A. Filing Systems. Think ahead about what you will want to keep and what you will want to discard after the closing, as well as which attorney-client communications you will want to keep confidential and which ones you will want to rely on to prove due diligence in the event of litigation.

1. Some documents created during the course of an underwriter’s due diligence will clearly be kept in a permanent file and others will clearly be discarded once the offering has closed. This process will be facilitated, and the choices about what to keep and what not to keep will be qualitatively improved, if some ground rules, and separate filing systems for each category, are created at the outset. For example, there is no good reason to keep drafts of registration statements once the statement is on file. Any difference between draft language and that ultimately agreed on can be misused by plaintiffs’ counsel to suggest that the final language was less accurate or complete than that appearing in a draft (notwithstanding that such changes may be entirely defensible, e.g., Software Toolworks, 38 F.3d at 1085). As a consequence, it is useful to establish the habit of drafting sessions of keeping notes that you want to preserve (e.g., factual representations by management about the accuracy of a statement in the draft prospectus) somewhere other than in the margins of a draft that will not be kept.

2. Think ahead about what attorney-client communications, or documents in the attorney’s own files, will be important to reveal as evidence of a reasonable investigation, or evidence of a belief in the accuracy of the prospectus, in the event of future litigation. In all likelihood, the underwriter will want to disclose documents from its counsel’s files in order to rely on counsel’s work as part of a thorough due diligence investigation. Even if it does not, there is a risk that the attorney’s files are nonetheless discoverable by plaintiffs. Conversely, there may be attorney-client communications that both the underwriter and its counsel would know in advance should be kept confidential for all the policy reasons underlying the existence of the privilege (e.g., attorney-client discussion regarding legal advice about a specific disclosure issue, in contrast to factual investigation).

It will not only lessen the potential burden of future document disclosure in the event of litigation, but also minimize the risk of inadvertent waiver of privilege or inability to claim privilege, if both the underwriter and its counsel file privileged confidential communications separately from those routine communications and due diligence files on which the underwriter will likely want to rely if there is litigation. This same need to establish common ground rules also applies to communications between the underwriter and its counsel on the one hand, and the issuer: and its counsel on the other. One party’s view of what is confidential and what is not, or of what will be kept and what will not, may not accomplish its intended purpose if others have a different view.

3. We believe it is helpful to have a designated member of the underwriter’s team and of the underwriter’s counsel’s team act as the central repository or “librarian” of those documents that will be preserved by each. This person can ensure that desired documentation is created and filed, make information readily available to other team members, and spot any omissions from the documentation, all more easily than if record-keeping responsibility is randomly distributed among team members. He or she can then carry out the responsibility of preparing the due diligence record for permanent storage at the end of the offering with a minimum of additional work. Within either a corporate finance department or law firm, an experienced and well-trained paralegal may be the ideal person to hold this role, but additional comfort could be achieved by having the senior team member review the records and help fill any gaps with an eye to the big picture.

4. Some underwriters have their counsel review the files to decide what should be retained in permanent storage. Such a review might best be done prior to closing by an experienced litigator who can not only exercise sound judgment about documentation, but also play devil’s advocate in spotting issues that appear to need further investigation or documentation (e.g., filling the gap where the documents show an issue to have been spotted but not to have been resolved).
B. Checklists. From time immemorial underwriters and underwriter’s counsel have debated the pros and cons of using and/or keeping due diligence checklists. The debate took on a public dimension when the SEC requested that the NASD consider creating a set of due diligence standards and the NASD then circulated a proposed statement of policy regarding underwriter due diligence. SEC Release No. 5275 (1972); NASD Notice to Members 75-33 (April 25, 1975). The NASD’s proposal was ultimately withdrawn, however, because of concerns that guidelines would either limit an underwriter’s thinking to what was on the checklist or convert the due diligence defense into an affirmative duty to do everything appearing in the guidelines.

Contrary to the views of some, we encourage the use of checklists as long as underwriters are careful (a) not to regard the checklist as a limitation on what may be needed to be reasonable under the circumstances as an investigation unfolds, and (b) to document the accomplishment of each item on the checklist or the reasons why accomplishment was ultimately deemed unnecessary. See, e.g., Perrigo at *40-41, 54-56 (testimony *402 that items on checklist were completed was adequate substitute for failed recollections of details).

Our experience in defending underwriters leads us to conclude that it is usually easier to establish the due diligence defense against a claim that the underwriter should have done more to investigate a perceived risk than against a claim that it failed to anticipate at all the risk which ultimately caused alleged damage. Accordingly, we believe anything that stimulates expansive thinking by members of the underwriting team and stretches their horizons is an aid to effective due diligence and disclosure, and correspondingly an aid in the defense of any future litigation that may arise.

In addition to substantive utility, checklists can help the underwriter defend future litigation by demonstrating the care with which it did its job and the seriousness of its approach. Documents showing that a thoughtful, professional and organized process took place can have a persuasive power of their own, entirely independent of their substance.

Beyond comprehensive checklists of potentially useful steps, developed and augmented from transaction to transaction, it can be helpful to prepare a transaction specific checklist early in an engagement and document the accomplishment of each specific task with appropriate signoffs. The model of an audit program as used by auditors may be useful to think about and adapt in planning and documenting a due diligence investigation.

C. What To Keep. In contrast to some traditional views, we encourage underwriters and their counsel to maintain records of the work they perform in a due diligence investigation. We believe it is helpful (but, we *403 reemphasize, not something whose absence will prevent proof of due diligence through oral testimony) to keep handwritten notes or prepared memoranda documenting such matters as:

1. Due diligence meetings and interviews, including dates, attendees and topics discussed;
2. Documents reviewed, including summaries or copies as appropriate;
3. Visits to facilities, including dates, attendees and discussion;
4. Discussions and interviews with third-party personnel, including dates, attendees and topics discussed;
5. Outlines or checklists used in interviewing issuer and third-party personnel;
6. Director and officer questionnaires and certificates; and
7. Reports by investigators or other independent experts engaged to perform parts of the investigation. [FN14]

D. What To Say. All documents, including notes, should be written with sensitivity to their future disclosure in the event of litigation. Statements may be read out of context by a judge or jury, with “guidance” from plaintiff’s *404 counsel. Care should be taken in the use of language. Avoid

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profanity, jokes or sarcastic remarks. Avoid using colloquial references a plaintiff's lawyer might use to paint an unwanted picture. It is undeniable that an underwriter has, in addition to its due diligence and prospectus-related roles in an offering, the job of selling the securities. Nevertheless, it is better not to use sales terminology in the due diligence record because plaintiff's counsel will use it to suggest that all the underwriter cared about was selling securities and making money rather than conducting thorough, professional, probing and candid due diligence and disclosure.

E. Research Analysts And The "Wall". Any pre-offering or post-offering comment published by an underwriter's research department will predictably be cited as the basis for claims by open-market purchasers in the event of litigation. If a research analyst has been part of the due diligence team, plaintiffs may try to connect the research report to the offering by arguing that the analyst was "tainted" by inside information obtained during due diligence. This risk may be minimized by insuring that the flow of information is one-way only. [FN15] Consider solidifying the "wall" prior to an offering by obtaining a written "Statement of Understanding" that acknowledges:

- the analyst will be used as resource by the corporate finance team;
- *405 the analyst may be rewarded for his or her time and efforts in serving as a resource, but his or her compensation will not otherwise be affected by the success of an offering;
- although the corporate finance department may rely upon the analyst for independent investigation, they will not reciprocate by making the analyst privy to the information they discover in the course of their due diligence investigation.

F. Written Policies. We encourage underwriters to establish written internal policies regarding the adherence to high professional standards and the retention of permanent due diligence files. The courts have shown concern for the damage to a professional's reputation that can result from meritless claims of securities fraud. E.g., Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439, 1454 (1994); Semegen v. Weidner, 780 F.2d 727 (9th Cir. 1985). If underwriters show equal sensitivity in their own internal communications to their team members, their ability to motivate a court to invoke these same concerns will be enhanced. As more and more firms adopt such policies, it may be that something like an "industry standard" will develop that in and of itself could constitute evidence of what should be viewed as "reasonable investigation."

In addition, we suggest a step we have not yet seen addressed in a reported decision. Beyond the customary representations and warranties obtained from the issuer and its officers regarding their belief in the accuracy *406 and completeness of the registration statement, why not obtain from each team member at both the underwriter and its counsel a certificate that parallels the language of the due diligence defense? We believe such a step serves several purposes. First, it provides a milestone at which every member of the team must ask himself or herself about any reservations in signing such a statement for permanent filing; if there is any hesitation to sign, it may be that more work is appropriate. Second, it is evidence of the seriousness with which each professional viewed his or her job; while a conclusory claim in a pleading may not carry much weight, the unanimous commitment of multiple team members, each speaking for himself or herself at the time of the offering, is of a different order. Third, it is entirely possible that some team members may be unavailable if depositions are taken years after an offering closes. A contemporaneous statement at the time of the offering may be the only evidence available to the underwriter to prove the missing witness's state of mind, and will prevent any suggestion by plaintiff's counsel that the missing witness would have told a different story. Finally, such a statement can help refresh a witness's recollection as to the confident state of mind he or she had at the time of the offering, prior to the occurrence of the intervening events giving rise to litigation.

V. CONCLUSION

Recent developments in the Supreme Court (e.g., narrow statutory interpretations in Central Bank
and Gustafson), in the courts of appeal (e.g., affirmance of summary judgments for underwriters on
due diligence defense in Software Toolworks and Worlds of Wonder), and in Congress (the Reform
Act and SLUSA) elevate the incentive for underwriters and their counsel to reexamine their due
diligence practices and documentation. The increasingly hospitable environment in the courts
and Congress enhances the likelihood that demonstrably careful due diligence and documentation
will be rewarded by a reduced risk of litigation and an improved prospect of summary judgment in
the event litigation occurs.

While even the most optimistic observers doubt that the recent judicial and legislative trends will
dramatically reduce the incidence of public offering litigation, it seems clear to us that a disciplined
approach to due diligence and its documentation is essential to the cost-effective management of that
risk.

FN1. Earlier versions of this article have appeared in the course materials for the PLI course on Initial Public
Offerings in 1993-98.

FN2. The authors represented the underwriters in Worlds of Wonder and represented the Securities Industry
Association as amicus curiae in the appeal from summary judgment in favor of the underwriters in Software
Toolworks. In Worlds of Wonder, the Ninth Circuit Court of Appeals affirmed summary judgment for the
underwriters but reversed in part as to the accountants. In Software Toolworks, the same court largely affirmed
summary judgment for the underwriters and accountants, but reversed as to several discrete issues. In both cases,
the court denied petitions for rehearing and rejected suggestions for en banc.

FN3. For a comprehensive analysis of the earliest post-Reform Act cases, see Grundfest and Perino, Securities

FN4. For analyses of post-Reform Act filing rates, see PricewaterhouseCoopers LLP 1998 Securities Litigation
Study (available at http://10b.5.com); Grundfest, et al., Securities Class Action Litigation in Q1 1998: A Report to
securities.stanford.edu/report/nasdaq/).

FN5. As one non-scientific example, courts subsequent to the Reform Act have granted twelve initial motions to
dismiss filed by the authors, most without leave to amend. Post-Reform Act decisions are regularly reported in the
Securities Reform Act Litigation Reporter, co-edited by the authors and several of their partners (see http://
users.aol.com/lawreport/ch.html). For tips on summary judgment motions generally, see Alderman & Bader,
Motion Practice, Business and Commercial Litigation in Federal Courts ch. 24 (West Group & ABA 1998); Oliver,
Summary Judgment, id. ch. 25.

FN6. For a thorough discussion of the Reform Act's provisions, see Moses, "Securities Litigation Reformed?,”

FN7. An underwriter entitled to a due diligence defense under the 1933 Act should also be able to obtain dismissal
of claims under Section 10(b) of the 1934 Act, inasmuch as its reasonable investigation and lack of knowledge of
material misstatement or omission will ordinarily establish the absence of scienter. Software Toolworks, 38 F.3d at
1088; Int'l Rectifier at 97,143 ("the Underwriters' establishment of a due diligence defense under Sections 11 and
12(2) of the 1933 Act negates the existence of scienter under Section 10(b) of the 1934 Act"); cf., in re Crazy
Eddie Sec. Litig., 817 F. Supp. 306, 316 (E.D.N.Y. 1993) (underwriters entitled to summary judgment on Section
10(b) claim even assuming negligent due diligence).

FN8. While the focus of this article is underwriter due diligence, much of it is equally applicable to other
participants in public offerings to whom a due diligence defense is available under Sections 11 and 12(a)(2), i.e.,
directors and prospective directors, other signers of the registration statement, accountants, appraisers and other

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experts, and other section 12(a)(2) "sellers."

FN9. Section 11(b)(3)(A) provides that an underwriter (or other person subject to Section 11) is not liable for material misstatements or omissions in a registration statement if it sustains the burden of proving that it had, after reasonable investigation, reasonable ground to believe, and did believe, at the time the registration statement became effective, that it was free of material misstatements or omissions. The standard of reasonableness is that required of a prudent man in the management of his own property, in effect making due diligence a negligence standard. Section 11(c); Software Toolworks, 38 F.3d at 1083; Glassman v. Comerision Corp., 90 F.3d 617, 627 n. 12 (1st Cir. 1996) ("Due diligence is equivalent to non-negligence"); Int'l Recifier at 97, 139; Perrigo at *49-50. Section 11(b)(3)(C) provides a more relaxed standard as to "expertised" portions of the registration statement (e.g., made on the authority of an auditor, appraiser or other expert); the defense is available if the Section 11 defendant proves that it had no reasonable ground to believe, and did not believe, at the time the registration statement became effective, that it contained a material misrepresentation or omission. Section 12(a)(2) provides a defense to a seller who sustains the burden of proving that it did not know, and in the exercise of reasonable care could not have known, of a material misrepresentation or omission in a prospectus or oral communication.

FN10. The need to examine reasonableness in the light of all the circumstances of a specific case should make it clear that we are not suggesting that any single investigative step taken alone is either necessary or sufficient in a particular case. Rather, our purpose is to draw attention to steps the courts have seen as noteworthy within their particular settings.

FN11. Although the "safe harbor" afforded by the 1995 Reform Act to forward-looking statements accompanied by meaningful risk disclosure is inapplicable to initial public offerings, we anticipate that case law under the "bespeaks caution" doctrine and under the statutory safe harbor will likely develop in parallel, such that "safe harbor" cases will be of help even in the IPO context.


FN14. Even those underwriters preferring not to keep notes or memoranda documenting the substance of discussion with personnel of the issuer and third parties would be wise to keep logs confirming at least the dates and participants.

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FN15. Including the analyst in the working group as a source (but not recipient) of information can not only enhance the quality of due diligence, but also contribute to establishment of the defense. E.g., Int'l Rectifier at 97,140 (employing knowledgeable industry analysts viewed as a factor helping to show reasonable investigation).
Institutional Buyer Beware: Recent Decisions Reinforce Narrow Range of Remedies Available to QIBs in Rule 144A Offerings

BY RANDALL W. BODNER AND PETER L. WELSH

Rule 144A private placements have become a favored mechanism for cost-effectively and timely placing securities, particularly high-yield and asset-backed securities, in the capital markets. Rule 144A provides generally that securities sold to "Qualified Institutional Buyers" ("QIBs")—typically institutional investors with more than $100 million to invest—will not be deemed to have been sold in a public offering under the Securities Act of 1933. Rule 144A offers involve the private placement to a QIB or QIBs of securities through a quasi-underwriter, known as an "initial purchaser." Rule 144A offerings are often followed shortly thereafter by a registered exchange offering, known as an "A/B exchange," involving the issuance of registered securities which are exchanged for the privately placed 144A securities. Rule 144A offerings have grown enormously in popularity since Rule 144A was issued in 1990. Roughly two-thirds to three-quarters of high-yield offerings are now accomplished by a Rule 144A private placement, often followed by an A/B exchange.

In releasing Rule 144A, the Securities and Exchange Commission recognized that "certain institutions can fend for themselves and, therefore, offers and sales to such institutions do not involve a public offering." In re Hayes Lemmerz Int'l, Inc. Equity Sec. Litig. v. Cuccuz, 271 F. Supp. 2d 1007 (E.D. Mich. 2003) (quoting SEC Rel. No. 33-6806, 1988 SEC LX 2104, ¶ 51 (Oct. 25, 1988)). The question arises, however: What tools are available to QIBs in the event that they wish to fend for themselves through litigation?

Recent judicial decisions have largely reinforced the limited rights and remedies available to QIBs who may have been misled in a Rule 144A offering. In particular, several recent decisions strongly suggest that buyers in a private placement under Rule 144A are left with little more than Rule 10b-5 (along with its onerous pleading requirements) and state law causes of action, in the event that they are misled by a private placement offering memorandum. Yet, in three recent decisions, courts have permitted QIBs to survive a motion to dismiss on the theory that an ostensible private placement under 144A was, in reality, a public offering and that, as a consequence, a private right of action potentially exists under the '33 Act for misstatements made in a purported 144A offering memorandum. The law in this area nonetheless still remains largely a cautionary tale for QIBs.

144A Offerings and Liability Under the Federal Securities Laws.

For purposes of liability in connection with a Rule 144A resale and A/B exchange, both the Securities Act of 1933, 15 U.S.C. §§ 77a et seq. (the "'33 Act"), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. (the "'34 Act"), are relevant. All things being equal, and given a choice, a QIB/plaintiff would prefer to make a claim for defective disclosure in a 144A or A/B exchange transaction under the '33 Act because of the lower standard of proof required to establish a violation for defective disclosure. While the '33 Act imposes liability for defective disclosures on the basis of strict liability in certain circumstances and mere negligence in others, transactions to which the '33 Act applies are relatively limited. The '34 Act, on the other hand, has wider applicability and generally encompasses a broader array of defendants. Because claims under this statute are based on fraud and require proof of scienter, however, the '34 Act erects a higher hurdle of both pleading a claim and proving a violation.

Liability Under the Securities Act of 1933

Section 11. A Rule 144A resale does not involve the preparation or filing of a registration statement, and there should, therefore, be no liability under Section 11 of the Securities Act for misstatements contained in a 144A offering memorandum. Section 11 covers only de-
fective disclosures made in a "registration statement." See 15 U.S.C. § 77k. While a Rule 144A offering memorandum often looks like the prospectus, portions of a registration statement, the offering memorandum is nevertheless not a "registration statement" within the meaning of the Securities Act. See In re Livent, Inc., Noteholders Sec. Litig., 151 F. Supp. 2d 371, 430 (S.D.N.Y. 2000); see also In re Worldcom Sec. Litig., 294 F. Supp. 2d 431, 456 (S.D.N.Y 2003) ("plaintiffs admit they can bring no Section 11 claim based on the December 2000 Offering because it was exempt from registration requirements other than as a private placement"); in re Safety-Kleen Corp., Bondholders Litig., C.A. 3:00-1145-17 Order (March 27, 2002).

This lack of any Section 11 liability in connection with a 144A resale contrasts sharply with the disclosure law as it applies to an underwritten public offering of high-yield debt. The market and the participants, the pricing and the discounts, the format and the substance of the disclosure may be the same in a 144A resale and underwritten public offering. Section 11 liability in all likelihood attaches only to the underwritten public offering and not to the Rule 144A resale.3

The A/B exchange, on the other hand, does involve a registration statement and, as a consequence, an issuer would, if it repeated an offering memorandum's defective disclosures in the registration statement or made new defective disclosures, likely have Section 11 "strict liability" for the misstatements contained in the A/B exchange offering materials. 15 U.S.C. § 77k. So, too, an issuer's directors and officers would have liability, subject to the statute's due diligence defense. Id. But, ordinarily, the investor put in the initial due diligence and helped prepare the Rule 144A offering memorandum does not participate in any way in the A/B exchange, and it is consequently unlikely that the initial purchaser would have Section 11 liability for defects in the A/B exchange registration statement. See In re Livent, 151 F. Supp. 2d at 432 ("Therefore, this court concludes that § 11 liability for securities purchased pursuant to a registration statement does not apply to initial purchasers of unregistered securities who were not directly involved in the preparation of the registration statement or the subsequent exchange for registered securities of unregistered securities that the initial purchasers no longer held."); see also Letter from David M. Becker, General Counsel, Securities and Exchange Commission, to Honorable Joseph M. Anderson dated Aug. 9, 2001, as amicus curiae, In re Safety-Kleen Bondholders Litig., C.A. 3:00-1145-17(D.S.C.)(herein the "Safety-Kleen Letter").

If liability can be established, Section 11 provides for the recovery of the "amount paid" for the B securities, less the value or price of the A security on the day of suit or when sold.4 15 U.S.C. § 77k. The inquiry then shifts to the "amount paid" by a QIB for the B securities at the time of the A/B exchange. A court could take the position that what was "paid" for the B security was an A security, the value of which necessarily tracks that of the B security. This view of the A/B exchange effectively would eliminate any recovery of damages, since virtually by definition the "amount paid" (i.e., the A security) equals what was received (i.e., the B security). The United States District Court for the District of South Carolina in the Safety-Kleen bondholder litigation came to this very conclusion regarding the possible damages arising out of an A/B exchange transaction. in re Safety-Kleen Bondholders Litig., C.A. No. 3:00-1145-17 at 2 ("no [Section 11] damages can be demonstrated because the transaction involves two sets of identical bonds").

Alternatively, it is possible—but not likely—that a court would integrate the A/B exchange with the 144A resale to find that a 144A resale is essentially the start of a public offering of securities and that damages from the A/B exchange may, therefore, be calculated by reference to the "amount paid" for the A securities in the original Rule 144A resale. Cf. In re Livent, 151 F. Supp. 2d at 431-32; but see Safety-Kleen Letter at ¶11 ff. ("We do not agree that because the Rule 144A offering contemplated a subsequent registered exchange offer, those who participated in the Rule 144A offering were underwriters in that exchange offer.").5 Viewed from

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2 Specifically, Section 11 provides as follows: "(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact 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 (unless it is proved that at the time of such acquisition he knew of such truth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—
(1) every person who signed the registration statement;
(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement;... and
(5) every underwriter with respect to such security."

3 It is conceivable, though, as discussed below, unlikely—
that a court might integrate the 144A resale with the follow-on A/B exchange and impose Section 11 liability on participants involved in any phase of the entire integrated transaction. Cf. In re Livent, 151 F. Supp. 2d. at 431-32; but see Safety-Kleen Letter at ¶11 and 12.

4 With respect to damages, Section 11 provides generally as follows: "The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought, provided, that if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or necessary to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable."

5 The SEC's position in its Safety-Kleen Letter comports with the SEC's established position on A/B exchanges gener-
Section 12(a)(2) and the 14AA Offering Memorandum. Section 12(a)(2) imposes liability for material misstatements in a "prospectus" or related "oral communication." Until mid-1995, securities counsel for institutional high-yield purchasers, as well as the SEC and other practitioners, had thought that a Rule 14AA offering memorandum might be considered a "prospectus" within the meaning of Section 12(a)(2). See, e.g., Safety-Kleen Letter at ¶ 9. But, in 1995, the Supreme Court, in Gustafson v. Alliedy Co., Inc., 513 U.S. 561 (1995), made clear that Section 12(a)(2) applies only to a prospectus issued in a transaction registered or required to be registered under the '33 Act and to oral communications directly associated with that prospectus, as expressed in the Exxon Capital and Morgan Stanley No-Action Letters and their progeny. See Exxon Capital Holding Corp., SEC No-Action Letter (May 13, 1988); Morgan Stanley & Co. No-Action Letter (June 5, 1991). As General Counsel Becker indicated in the Safety-Kleen Letter, the consequences of integrating the Rule 14AA resale with the 14A B exchange would be to greatly diminish the usefulness of Rule 14AA. The consequences of accepting plaintiffs' integration argument would be significant, as two-step transactions similar to the one at issue in this case account for the majority of registered high-yield bond offerings and a significant portion of all initial public offerings. Id.; see also In re Livent, 151 F. Supp. 2d at 431-32 ("To import underwriter liability for entities that serve as initial purchasers prior to an Exxon Capital Exchange would render Rule 14AA ineffective for a very substantial number of securities transactions and defeat the capital market financing objectives the Rule 14AA exemption was designed to achieve, a fact which undoubtedly would have been known and addressed by the promulgation of Rule 14AA if such a major exception was intended.").

The POI! (for Private Offerings, Resales and Trading through Automated Linkage) market is an electronic trading platform created and regulated by the NASD to facilitate transactions between QBIs in securities privately placed under Rule 14AA.

Specifically, Section 12(a)(2) provides as follows: "Any person who: (1) offers or sells a security in violation of section 5, or (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraphs (2) and (4) of subsection (a) thereof), by use of any means of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable subject to subsection (b), to the person purchasing such security who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."
prospectus, understood as "a document that, absent an
overriding exemption [under Section 3], must include the
information contained in the registration statement," Section 12(a)(2) is likely not applicable under
Gustafson. Because Rule 144A does not involve
a transaction registered under the '33 Act; Section
12(a)(2) does not apply to any defective disclosures
that may be made in the offering memorandum or any oral
communications associated therewith. Cf. id.

Section 12(a)(2) and the A/B Exchange. The
application of Section 12(a)(2) in the context of an A/B
exchange is more complicated. Although we are not
aware of any case so holding; there is a significant
possibility that Section 12(a)(2) would apply to the
prospectus issued in an A/B Exchange notwithstanding
that an A/B exchange is not itself a public offering. Cf.
Gustafson, 513 U.S. at 568-69. The prospectus in the
typical A/B exchange is intended to be a security,
document to facilitate the resale of the securities and
contain[s] the information contained in the
Consequently, an issuer that repeats defective disclosures
from the offering memorandum or introduces new
defective disclosures in the A/B exchange prospectus is at
significant risk of Section 12(a)(2) liability.\[6\] Cf. In re
Livent, 151 F. Supp. 2d at 432.

Section 12(a)(2) provides for liability only on the part
of one who "offers or sells a security." 15 U.S.C.
§ 77l(a)(2). This restriction has been applied to limit
liability only to those who actually sold or offered to sell

Gustafson, at 568-69 ("Whatever else 'prospectus' may
mean, the term is confined to a document that, absent an over-
riding exemption, must include "the information contained in
the registration statement."). See also id. at 581 ("It will be
recalled that as to private transactions, such as the Alloyd
purchase, there will never have been a registration statement. If
§ 12(2) liability were imposed here, it would cover transactions
not within the contemplated reach of the statute."). Id. at 583
("Nothing in the legislative history, moreover, suggests
Congress intended to create two types of prospectuses, a formal
prospectus required to comply with both §§ 10 and 12, and a
second, less formal prospectus, to which only § 12 would be
applicable.").

Section 12(a)(2) also imposes liability for misstatements
contained in an "oral communication." See 15 U.S.C.
§ 77l(2). The law is well settled, however, that the term "oral
communication" in Section 12(a)(2) applies only to oral
communications that relate to a statutory prospectus. See Gustafson,
513 U.S. at 567.

There is an argument under Gustafson that Section
12(a)(2) would not apply to the A/B exchange, since the
exchange was not a sale "to the public" even though a '33 Act
prospectus was used in the exchange. Gustafson dealt with
whether representations made in connection with a stock pur-
chase agreement between two private parties exposed the selling
party to liability under Section 12(a)(2), 513 U.S. at 564-65,
a factual setting quite different from that present in an A/B
exchange. The Supreme Court's decision is not entirely consis-
tent in its reasoning, at times describing the "determinative
determination," as whether the contract at issue was a "prospectus" id. at 583, while at other times phrasing the key inquiry in terms of
whether the transaction was a "public offering" using a prospectus. Id. at 583.

In an A/B exchange, the prospectus under the '33 Act is used, but
not in connection with a "public offering" per se. Instead, the
prospectus is used to facilitate an exchange of securities in which
unregistered "A" securities are exchanged for the regis-
tered and tradable "B" securities. Thus, the impact of
Gustafson on this specific transaction is not clear.

10 Along similar lines, the SEC has argued that the circum-
stances of the transaction at issue in Gustafson were quite dist-
inct from the circumstances of the typical 144A resale, and
have raised the possibility that the Supreme Court might,
therefore, find a Rule 144A offering memorandum to be
recently akin to a statutory prospectus which give rise to liability under
Section 12(a)(2). As General Counsel Becker noted in the
Safety-Kleen Letter:

There are significant differences between the Rule 144A trans-
action . . . and the private transaction that was held not to be
subject to Section 12(a)(2) in Gustafson. The sale in Gustafson
was indisputably a private one in which three shareholders
sold their stock to a single corporate buyer, pursuant to a nego-
tiated contract . . . . [T]he offering memorandum in the [the
Safety-Kleen] Rule 144A offering was an important part of the
entire transaction, and it was understood by all parties that the
memorandum would likely form the basis for the registration
statement and prospectus in the subsequent [A/B] exchange
offer. Perhaps in light of the factual distinctions between the [the
Safety-Kleen 144A resale and Gustafson], the Supreme Court
might have accepted plaintiffs' theory in this case that the
offering memorandum was a prospectus.

Safety-Kleen Letter at ¶ 7. Cf. Ruttenberg, C.A. No. 00-C-
1404-S at 15-16.

11 The court in Ruttenberg quotes Gustafson for the follow-
ing "unreasonable" principles: "[L]iability imposed by § 12(a)(2) has noth-
ting to do with the fact of registration," but rather with "whether a
prospectus is a document soliciting the public to purchase secu-
rities from the issuer." Ruttenberg at 12; compare

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the security or to one who was "directly involved in the actual solicitation of a securities purchase."

See Pinter v. Dahl, 486 U.S. 644, n. 21 (1988). It is, accordingly, unlikely that the initial purchaser would face liability under Section 12(a)(2) because a 144A initial purchaser is rarely, if ever, a "seller" in the A/B exchange. The result might be different, however, if it could be shown that the initial purchaser was directly involved in the solicitation efforts leading up to the A/B exchange. See In re Livent, 181 F. Supp. 2d at 432 ("CIBC may stand in a very different position from PaineWebber and Furman Selz because the Noteholders indicate in their opposition memorandum that CIBC sold notes directly to them."); cf. Pinter, 486 U.S. at 643-46. In the typical A/B exchange, the "seller" of the B securities is the issuer. A QIB acquiring B securities issued based on a prospectus containing a material misstatement would most likely be able to proceed against the issuer under Section 12(a)(2) to the extent the issuer's prospectus for the "B" exchange contained a material misstatement or omission in connection with the offering of a security. As with the Section 11 claim, moreover, a QIB would not have to plead or prove that the issuer/seller acted intentionally or with recklessness. See 15 U.S.C. § 77i(a)(2).

Upon establishing liability, the remedy available under Section 12(a)(2) would depend upon whether the QIB/plaintiff still owned the B securities. If the QIB had already sold the B securities, the QIB essentially would be entitled to recover the price it paid for the securities, less the price received when the securities were sold. As with the Section 11 damages discussed above, it is not clear how a court would determine exactly what a QIB would be entitled to recover as damages in this situation. In other words, a court would need to determine what the "price" was for the B securities, facing all the uncertainties discussed above. See In re Safety-Kleen Bondholders Litig., C.A. No. 3:00 1145-17 at 2 (holding that under Section 11, "no damages can be demonstrated because the transaction involves two sets of identical bonds."). If, on the other hand, the QIB/plaintiff still held the B securities in question, it would only be entitled to rescission as the term under the statute. 15 U.S.C. § 77i(a)(2). Such a rescission remedy, however, could prove hollow if "rescission" were applied formally to the A/B exchange: The QIB would merely be entitled to the return of the restricted A securities. Accordingly, if the QIB brought a claim under Section 12(a)(2) while still holding the B securities, it would have to argue that the court should, in essence, look back to the 144A resale and rescind that part of the overall transaction as well. Only in that way, by recovering the amount originally paid for the A securities, would the QIB obtain effective relief. The case law in this specific area has not been developed, and it is difficult to predict whether any such "look back" argument for damages would hold sway with the courts. What discussion of this general approach is found in the relevant authorities is not encouraging for QIB/plaintiffs. See In re Safety-Kleen Bondholders Litig., C.A. No. 3:00 1145-17 at 2; In re Livent, 181 F. Supp. 2d at 430-32.

144A Offerings and Liability Under the Exchange Act Section 10(b), along with Rule 10b-5 promulgated by the SEC, imposes liability where (1) a defendant has made a materially false or misleading statement or omitted to state a material fact necessary to make a statement not misleading; (2) the defendant acted with an intent to defraud; (3) the plaintiff relied on the misstatement; and (4) the plaintiff was injured as a result. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. Any person who actually "uses or employs" a manipulative or fraudulent device in connection with the purchase or sale of a security may be liable for a violation of the '34 Act. In this way, the '34 Act does not restrict who may be held liable as do Sections 11 and 12(a)(2) of the '34 Act.

Of course, while Section 10(b) does not restrict the field of potential defendants to narrowly drawn categories as does the '34 Act, its reach does not extend to those who merely aided or abetted someone else in connection with a Section 10(b) violation. See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (rejecting "aiding and abetting" liability under Section 10(b)). To be liable, a defendant must have itself actually engaged in the prohibited conduct. See, e.g., In re Enron Corp. Sec. Litig., C.A. No. H-01-3624, 2002 WL 31854963, *1, *161-24 (S.D. Tex. Dec. 20, 2002). Moreover, the standard for liability under Section 10(b) is substantially higher than that required under the '34 Act. In addition to proving the added substantive elements of fraud and reliance, a plaintiff must meet the heightened pleading standards of Fed. R. Civ. P. 9(b) requiring the plaintiff to describe the alleged fraud in the complaint with "particularity." 15 U.S.C. § 78u-4(b)(1).

The difficulties inherent in bringing a claim under Section 10(b) were further increased when Congress passed the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67 (the "Reform Act"), which imposed stricter pleading requirements for claims under 10(b), stayed discovery during the pendency of motions to dismiss, and provided for certain "safe harbors" for forward-looking statements. See, e.g., 15 U.S.C. § 78u-4 and 78u-5. The practical effect of these amendments has been to erect an even higher hurdle for asserting a '34 Act claim and to slow or possibly preclude pursuing

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**Note to Readers**

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discovery to support such a claim. These additional factors simply underscore the attractiveness of asserting claims under the '33 Act when possible.\footnote{In view of the legal hurdles facing QIBs under the '33 Act, Section 10(b) may well be the only federal securities remedy available for alleged misstatements in an offering memorandum. Thus after dismissing a Section 11 and Section 12(a)(2) count for the reasons discussed herein, the Court in the Safety-Kleen litigation allowed the QIB plaintiffs to proceed on their claim under Section 10(b) and Rule 10b-5. In re Safety-Kleen Bondholders Litig., C.A. No. 3:00-1145-17 at 3.}  

If a plaintiff/purchaser establishes a violation of Section 10(b), it is entitled to recover its damages caused by the violation. Although the '33 Act itself is silent as to the appropriate measure of damages for a violation of Section 10(b), it is likely that a plaintiff will be able to recover “the excess of what he paid over the value of what he got.” Levine v. Seton, Inc., 439 F.2d 328, 334 (2d Cir. 1971); Robbins v. Koger Properties, Inc., 116 F.3d 1441, 1447 (11th Cir. 1997) (same). In other words, the plaintiff can recover the difference between the price paid for the security and the true value of the security on the day of purchase “but for” the fraud.\footnote{The Uniform Securities Act of 1956, which has been adopted by a number of states, holds civilly liable anyone who “offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, the buyer not knowing of the untruth or omission, and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.” See e.g. Mass. Gen. Laws, Ch. 110A, § 410(a)(2).}

\section*{144A Offerings and Liability Under Blue Sky Laws and Common Law} 

When facing an actual situation of defective disclosure in connection with a Rule 144A resale and an A/B exchange, it is not sufficient to analyze the matter only under the federal securities laws. There is an entire separate body of law—state law—that may provide an attractive avenue for recovery for such defective disclosures. See Northwestern Mutual Life Ins. Co. v. Banc of America Securities, L.L.C., 254 F. Supp. 2d 390, 392-93 (S.D.N.Y. 2003). Moreover, the threshold for establishing liability is often lower under state “blue sky” anti-fraud/civil liability provisions as compared with rights of action under federal law. For example, state blue sky statutes typically do not require proof of either scienter or reliance.\footnote{10} The common-law count of negligent misrepresentation might provide a similarly effective vehicle for pursuing claims in the 144A context. Additionally, a monetary recovery enhanced by multiple damages and attorney fees, may also be available under relevant state consumer protection laws. See Twotti Fruits Investment LLC v. Morgan Stanley Dean Witter & Co., C.A. No. 00-00751-F 2002 WL 31875204 (Mass. Super.) (applying Massachusetts’s Ch. 93A to a securities transaction).}  

State blue sky laws are not often used, or even seriously considered, in connection with defective disclosure claims brought by class action plaintiffs attorneys. Ordinarily, the lawyers representing the plaintiffs in such actions have an incentive to “recruit” the largest class of “victims” possible in order to drive up the amount that can be recovered in settlement. There is a significant limitation on the availability of a state law cause of action in the class action context. However, the Securities Litigation Uniform Standards Act, 15 U.S.C. § 78bb(f) (“SLUSA”), provides for the “removal of state court securities class actions to federal court and abolishes state law causes of action in securities fraud [class action] cases involving securities covered by the federal statutes.” See In re Livoti, 151 F. Supp. 2d 432. As a result, these plaintiffs’ lawyers are not inclined to look to state laws that require less in the way of individualized proof in order to prevail. However, an institutional investor, or even a handful of institutional investors who find that they were misled in the 144A resale might find it economical to avail themselves, without running afoul of SLUSA, of state blue sky anti-fraud provisions in a non-class action against the issuer and initial purchaser. See Northwestern Mutual Life Ins. Co., 254 F. Supp. 2d at 392. Remedies under state law should, in any event, always be considered by a wronged QIB.
SECTION 16 SHORT-SWING TRADING: SELECTED PRACTICAL ISSUES AND PITFALLS TO AVOID

I. MOVING "IN-AND-OUT" OF INSIDER STATUS

A. OFFICERS AND DIRECTORS

1. Officers and directors who are not otherwise insiders are generally not liable for transactions occurring prior to becoming an officer or director. Accordingly, transactions effected during the six-month period prior to becoming an officer or director generally will not be matched with transactions that occur after becoming an officer or director to determine Section 16(b) short-swing profit liability.

2. Transactions effected after termination of officer or director status are subject to Section 16(b) if executed within six months of an opposite way transaction (e.g., sale/purchase or purchase/sale) that occurred while the individual was an officer or director. The date the officer or director loses his or her insider status may therefore be critical.

For Section 16 purposes, "officer" status is based upon a person's functional responsibilities, not his or her title. Therefore, if an officer resigns or is terminated from his or her position but continues to have the same functional responsibilities and access to insider information, he or she may continue to be an "officer" for Section 16(b) purposes. Consequently, transactions following
the resignation but preceding actual departure in some cases may be subject to Section 16(b). A complete severance of access to insider information after resignation or termination and prior to departure can help avoid Section 16(b) liability. Documentation of such severance would be prudent.

B. 10% SHAREHOLDERS

A person who is subject to Section 16(b) only because he or she is a greater than 10% shareholder is only liable for transactions occurring while he or she is such a shareholder. Thus, the purchase that creates the 10% shareholder status is not subject to Section 16(b), while the sale that causes the loss of such status is subject to Section 16(b).

II. INITIAL PUBLIC OFFERING

A. OFFICERS AND DIRECTORS

1. Transactions by an officer or director during the six months preceding the company becoming a Section 12 registrant can result in Section 16(b) liability. A transaction preceding an initial public offering ("IPO") can therefore be matched with a post-IPO transaction or sale by the officer or director in the IPO if the transactions occur within a six-month period. To avoid unexpected liability, officers and directors should be timely notified of the timing of the IPO and the associated potential short-swing profit liability.

B. 10% SHAREHOLDER

Unlike officers and directors, transactions effected by 10% shareholders prior to an IPO are not subject to Section 16(b) and cannot be matched with transactions occurring after the IPO, even though such transactions occur within a six-month period.

III. EXEMPTIONS FROM SECTION 16(b)

A. GRANTS, AWARDS, AND OTHER ACQUISITIONS

1. Under Rule 16b-3, grants, awards or other acquisitions by an officer or director of securities from the issuer will be exempt if any of the following three conditions is met:

   a). The issuer's board of directors or committee of two or more "Non-Employee Directors"
approves the grant, award or other acquisition in advance. A "Non-Employee Director" is defined as a person who (i) is not currently an officer or employee of the issuer or a parent or subsidiary, (ii) does not receive compensation of more than $60,000 per year for services except as a director and (iii) does not otherwise have transactions or business relationships with the issuer that are required to be disclosed under the proxy rules. A disclosed transaction or relationship which terminates before a director's service as a Non-Employee Director begins will not bar the director from acting as a Non-Employee Director. However, if a current or currently contemplated transaction or relationship with a director will require disclosure in a future filing, such director will no longer be eligible to serve as a Non-Employee Director. Loss of Non-Employee Director eligibility will not cause retroactive loss of a Rule 16b-3 exemption for a transaction previously approved by the director while serving as a Non-Employee Director. (ABA No Action Letter, December 20, 1996).

A committee of two or more "Non-Employee Directors" may consist of (i) a subcommittee, composed solely of two or more Non-Employee Directors of a committee of the board of directors or (ii) a committee of the board of directors which, following abstention or recusal of all members who are not Non-Employee Directors, is composed solely of two or more Non-Employee Directors. (American Society of Corporate Secretaries No Action Letter, December 11 3, 1996).

b). The issuer's shareholders approve the acquisition in advance or ratify it not later than the date of the next annual meeting of shareholders following the transaction.

c). The director or officer holds the securities acquired for six months or, in the case of a derivative security (such as a stock option), at least six months elapse between the date of acquisition of the derivative security and the date of disposition of the underlying security.

B. TAX-CONDITIONED PLANS

1. In addition to the three alternative exceptions described above for acquisitions of securities by officers and directors, Rule 16b-3 exempts most routine transactions under plans that satisfy specified provisions of the Internal Revenue Code of 1986 ("IRC"), such as thrift plans, stock purchase plans and excess benefit plans, without needing to satisfy additional conditions. In that regard, Rule 16b-3 will broadly exempt from Section 16(b) liability any transactions in a "Tax-Conditioned Plan" (i.e., a "Qualified Plan," "Excess Benefit Plan" or "Stock Purchase Plan") other than "Discretionary Transactions." "Qualified Plan" is defined broadly to include: (i) an employee benefit plan that satisfies the broad-based coverage and participation requirements of IRC §§ 410 and 401(a)(26). "Excess Benefit Plan" is defined as any employee benefit plan operated in conjunction with a Qualified Plan that provides only the benefits that
would have been provided under the Qualified Plan but for the benefit and contribution limitations of IRC §§ 401(a)(17), 415 and similar IRC benefit and contribution limitations. However, there are certain types of supplemental plans operated in conjunction with a Qualified Plan that do not constitute Excess Benefit Plans (ABA No Action Letter, February 10, 1999, superseding American Express Company, February 26, 1997). A "Stock Purchase Plan" is defined as any employee benefit plan that satisfies the coverage and participation standards of IRC §§ 423(b)(3) and 423(b)(5) or § 410.

2. Employee thrift and stock purchase plans often permit a participant to choose one of several funds in which to invest (e.g., an issuer stock fund, a money market fund, a bond fund or an indexed fund). Plan participants typically are permitted to transfer assets from one fund to another and often have the right to withdraw their investments in cash from a fund containing equity securities of the issuer. These discretionary plan transactions involving an issuer's securities are defined under Rule 16b-3 as "Discretionary Transactions." However, the SEC staff has indicated that the term "Discretionary Transactions" does not cover elections to participate in a Tax-Conditioned Plan or election to change the level of (or termination of voluntary contributions to) a Tax-Conditioned Plan. Under Rule 16b-3, Discretionary Transactions are not automatically exempt as is the case for other transactions in Tax-Conditioned Plans. However, a Discretionary Transaction, including the switching of assets into or out of an issuer stock fund or withdrawing cash from an issuer stock fund regardless of whether or not the

Discretionary Transaction is effected pursuant to a Tax-Conditioned Plan, will be exempt if the election by the officer or director to effect the Discretionary Transaction is made at least six months following any "opposite way" (a disposition in the case of an acquisition or an acquisition in the case of a disposition) election made under the plan in question or any other plan of the issuer. The definition of "Discretionary Transaction" excludes transactions that are incident to death, disability, termination of employment or diversification elections required under ERISA.

C. DISPOSITIONS TO THE ISSUER

1. Rule 16b-3 provides that any transaction other than a Discretionary Transaction involving a disposition of an equity security to the issuer would be exempt from Section 16(b) liability if the disposition is approved in advance by the board of directors, by a committee of two or more Non-Employee Directors or by the shareholders (ratification by shareholders will not be sufficient). If the terms of a subsequent transaction involving the disposition of securities to the issuer are provided for in the transaction as initially approved (such as the delivery to the issuer of shares in payment of the exercise price of a previously approved option providing for that form of payment of the exercise price or the withholding of shares to pay the exercise price or tax withholding obligations in connection with a previously approved option that contained those provisions), the subsequent transaction does not require further specific approval.
2. If the disposition is a Discretionary Transaction, to be exempt the transaction must satisfy the Rule 16b-3 conditions, specifically applicable to Discretionary Transactions as described above. The specific terms of the disposition, including price, will require prior approval of either the full board, the committee of Non-Employee Directors or shareholders. If shareholder approval is to be relied upon, both the proxy card and the proxy statement should provide that a vote in favor of the transaction also constitutes approval of the disposition of the equity securities to the issuer in connection with the transaction.

3. This exemption will cover delivery (or withholding) of shares to the issuer to exercise an option or pay withholding taxes in connection with the exercise of an option or the vesting of restricted stock. In the context of a merger, Rule 16b-3 would exempt the disposition of issuer equity securities (including derivative securities) solely to the issuer, provided the conditions of the rule are satisfied. See Section IV below.

4. Transactions with a majority-owned subsidiary (more than 50% of whose outstanding securities representing the right to elect directors is owned by the subsidiary's issuer-parent), or a benefit plan sponsored by such a majority-owned subsidiary, are considered to be transactions with the issuer-parent and are eligible for exemption under Rule 16b-3. (ABA No Action Letter, February 10, 1999).

5. Transactions between the issuer and certain parties related to an officer or director with an indirect pecuniary interest (i.e. beneficial ownership interest in a partnership or corporation, interest held by a family member or by a trust), are exempt under Rule 16b-3. In order to satisfy the approval conditions of Rules 16b-3 (d) and (e) and apply those rules to the transactions, the approval must specify the extent of the officer's or director's indirect interest in the transaction, and that the approval is granted for purposes of making the transaction exempt under Rule 16b-3. (ABA No Action Letter, February 10, 1999).

IV. MERGERS

A. OFFICERS AND DIRECTORS; DISPOSITIONS TO, AND ACQUISITIONS FROM, THE ISSUER

1. The conversion or cancellation of securities in connection with a merger (both the disposition of target securities and the acquisition of acquirer securities) by an officer or director is eligible for exemption from Section 16(b). (Skadden, Arps, Slate, Meagher & Flom LLP, No Action Letter, January 12, 1999).

2. The conversion in a merger of target equity securities (including derivative securities) by officers and directors of the target are eligible for the Rule 16b-3(e) exemption whether the disposition is a conversion, exchange, or cancellation of the target securities for equity, debt or cash. Each such transaction constitutes a disposition to the issuer of target-issuer securities and is exempt so long as the conversion or cancellation occurs simultaneously or immediately before the merger and certain approval procedures are followed by the target. Such dispositions are exempt regardless of how
such securities were acquired (employee benefit plan, open market or otherwise). Payment of consideration directly to the target equity holders by the acquirer will not change the result. In addition, time of payment does not affect the result.

3. The acquisition of acquirer-issuer securities (including derivative securities) by officers and directors of the acquirer (including those employees and directors of the target who become officers and or directors of the acquirer before, or at the time of, the merger) through the conversion of target-issuer equity securities, constitutes an acquisition from the acquirer-issuer and is also eligible for exemption under Rule 16b-3(d) if certain approval procedures are followed by the acquirer.

4. Approval conditions of Rule 16b-3(e) dispossession and Rule 16b-3(d) acquisitions may be satisfied only by the target and acquirer, respectively. Approval conditions must be satisfied at the same time or following approval of the merger by the respective boards of directors but before consummation of the merger. Approval given by the board of directors or by a committee of Non-Employee Directors, must specify (i) the name of each officer or director, (ii) the number of securities to be acquired or disposed of for each named person, (iii) where derivative securities are acquired, the material terms of such securities, and (iv) that approval is granted for purposes of exempting the transaction under Rule 16b-3.

5. Persons who will become officers or directors of the acquirer as a result of the merger need not have attained insider status with respect to the acquirer at or prior to the time of board or committee approval in order for the acquisition of acquirer securities to be exempt under Rule 16b-3(d) where either (i) target securities are converted into acquirer securities in the merger, or (ii) the acquirer board or committee, prior to the merger, grants acquirer securities to such insiders, effective upon consummation of the merger. In neither case does the grant of approval adversely affect the acquiree's ability to subsequently determine that a new insider has not in fact become an officer or director of the acquirer.

B. 10% SHAREHOLDERS

1. Unlike officers and directors, there are no specific rules exempting 10% shareholders in transactions relating to mergers (except if a shareholder, as a result of the merger, becomes a 10% shareholder of the acquiring company's stock, then such acquisition is not subject to Section 16(b)). Therefore, the exchange of securities in connection with such transactions can be matched with another transaction within a six-month period to determine Section 16(b) liability. Any transaction relating to a merger that causes a shareholder to become a 10% shareholder is exempt.

2. Transactions relating to friendly mergers with non-affiliates may be exempt if the exchange was involuntary and not vulnerable to abuse. The test for this exemption is based upon potential and not actual abuse. The insider must therefore go beyond a showing of no actual abuse and show that given his or her individual situation there was no possibility of abuse. Although the courts have
not provided clear criteria for making this determination, generally the insider must show that he or she had no ability to control the circumstances and timing of the transaction relating to the merger and had no access to inside information. Insiders who are involved in activities relating to the merger may find it difficult to make such a showing.

3. Transactions by 10% shareholders in connection with a defensive merger may also be exempt from Section 16(b) liability if the insider can show that he or she had no active participation in the transaction and, thus, had no influence or control over the merger.
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U.S. Securities and Exchange Commission

03-9350

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

IN RE WORLDCOM, INC. SECURITIES LITIGATION

ALAN G. HEVESI, COMPTROLLER OF THE STATE OF NEW YORK, AS ADMINISTRATIVE HEAD OF THE NEW YORK STATE AND LOCAL RETIREMENT SYSTEMS AND AS TRUSTEE OF THE NEW YORK STATE

(caption continued on inside cover)

On Appeal from the United States District Court for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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V.

CITIGROUP INC., CITIGROUP GLOBAL MARKETS INC. F/K/A SALOMON SMITH BARNEY INC., and JACK GRUBMAN,

Defendants-Petitioners.


Defendants.

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 03-9350

IN RE WORLDCOM, INC. SECURITIES LITIGATION

ALAN G. HEVESI, Comptroller of the State of New York, as Administrative
Head of the New York State and Local Retirement Systems and as Trustee
of the New York State Common Retirement Fund et al.,

Plaintiffs-Respondents,

V.

CITIGROUP, INC. et al.,

Defendants-Petitioners.

On Appeal from the United States District Court for the Southern District of
New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission, the agency responsible for the
administration and enforcement of the federal securities laws, submits this
brief as amicus curiae to address an important legal issue regarding the
proper interpretation of the fraud-on-the-market presumption of reliance in
private securities fraud actions under Section 10(b) of the Securities
Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated
thereunder, 17 C.F.R. 240.10b-5. Under the fraud-on-the-market
presumption adopted by the Supreme Court in Basic Inc. v. Levinson, 485
U.S. 224 (1988), a plaintiff in a private action under Rule 10b-5 is not
required to show direct reliance on a defendant's misrepresentation, but is
presumed to have relied on the market price of the security, which reflects
all publicly available material information.

This appeal was taken from a district court decision certifying a class of
investors, who alleged that they were defrauded in purchasing WorldCom,
Inc.'s securities based in large part upon misrepresentations contained in
defendants’ analyst reports. In re WorldCom, Inc. Sec. Litig., 219 F.R.D. 267 (S.D.N.Y. 2003). In seeking to have the district court’s decision reversed, the defendants argue that the fraud-on-the-market presumption, used by the district court in certifying the class, is inapplicable to misrepresentations contained in an analyst’s report. The Commission disagrees with this view and believes that the presumption applies to public material misrepresentations by securities analysts. The Commission takes no position on whether the class was properly certified or on any of the other legal issues raised by the parties or on any factual disputes.1

While the Commission is not required to show reliance in its own enforcement actions, the Commission believes that the proper interpretation and application of the fraud-on-the-market presumption is important to the effective enforcement of the federal securities laws. It is well recognized that private securities actions “provide `a most effective weapon in the enforcement’ of the securities laws and are `a necessary supplement to Commission action.’” Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) (quoting J.I. Case Co. v. Barak, 377 U.S. 426, 432 (1964)); see Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975).


ISSUE ADDRESSED BY THE COMMISSION

Whether the fraud-on-the-market presumption of reliance applies to public material misrepresentations by analysts.

SUMMARY OF THE ARGUMENT

As adopted by the Supreme Court in Basic Inc. v. Levinson, 485 U.S. 224 (1988), the fraud-on-the-market presumption posits that all publicly disseminated material information about a publicly-traded security is reflected in its market price, and that investors rely on the integrity of this price when making a decision to buy or sell the security. When publicly disseminated information about a company or its securities is materially false or misleading, the market price reflects this mis-information, and investors relying on the market price have thus indirectly relied on the material misrepresentation.

Nothing in the Court’s decision in Basic or in the underpinnings of the theory itself justifies excluding analysts from the presumption’s reach. Although the Commission takes no position on whether the presumption is
applicable to non-issuers other than analysts (an issue that is not before the Court), applying the presumption to analysts is consistent both with economic studies showing the market effect of analyst reports and with the very nature of such reports, which are intended to provide information upon which investment decisions are based.

ARGUMENT

I. BASIC AND THE FRAUD-ON-THE-MARKET PRESUMPTION OF RELIANCE

The Supreme Court adopted the fraud-on-the-market presumption of reliance in private damages actions under Rule 10b-5 in Basic, agreeing with numerous courts of appeals and the Commission's amicus curiae brief that there should be a rebuttable presumption that material public information is reflected in the market price of a security and that investors rely on the integrity of this market price in making investment decisions. 485 U.S. at 247.

A private plaintiff in a securities fraud action ordinarily must show reliance on a defendant's misrepresentation to provide "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." Id. at 243. The fraud-on-the-market presumption of reliance addresses the fact that "modern securities markets ** differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences." Id. at 243-244 (citation omitted). "[T]he market is interposed between the seller and buyer and, ideally, transmits information to the investor in the processed form of a market price." Id. at 244 (quotation omitted).

As the Court recognized, "[t]he fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business," and "[m]isleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements." Id. at 241-42 (quotation omitted). Proceeding from this hypothesis, the Court held: "Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." Id. at 247. The defendant, in turn, "may rebut proof of the elements giving rise to the presumption, or show that the misrepresentation in fact did not lead to a distortion of price or that an individual plaintiff traded or would have traded despite his knowing the statement was false." Id. at 248.

The fraud-on-the-market presumption of reliance, the Court explained, "is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act," because "[i]n drafting that Act, Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets ** ." Id. at 245-46. In addition, the Court held that the presumption is "supported by common sense and probability," pointing to "empirical studies [that] have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence,
any material misrepresentations." *Id.* at 246.

The Court's opinion reflects the arguments presented by the Commission in its *amicus curiae* brief. The Commission explained that in addition to "empirical and commonsense evidence" supporting the presumption, it "facilitates important policy objectives underlying the federal securities laws" and "relieves the plaintiff of an evidentiary burden it is not practical to place on him." Brief for the Securities and Exchange Commission as Amicus Curiae at 23, *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (No. 86-279).

The Commission noted in its brief that "[a] fundamental premise of the Securities Exchange Act is * * * that the markets are affected by information, so that '[t]here cannot be honest markets without honest publicity.' *Id.* at 25 (quoting H.R. Rep. 1383, 73rd Cong., 2d Sess. 11 (1934)). The Commission also noted that courts "have viewed the fraud on the market theory, and the accompanying presumption of reliance, as a means of furthering the statutory goal of ensuring honest securities markets." *Id.*. Placing the burden of proof on the plaintiff to show that the market price of a security was affected by a misrepresentation "would impose an unrealistic evidentiary burden" by requiring the plaintiff to present "extensive and hard to obtain evidence" concerning how the information affected the market. *Id.* at 26. The presumption accommodates this concern "by recognizing the obvious, that market prices generally reflect corporate information and that investors generally rely on the integrity of the market price." *Id.* at 27.

II. APPLICATION OF THE FRAUD-ON-THE-MARKET PRESUMPTION TO SECURITIES ANALYSTS

Although *Basic* arose in the context of false statements by an issuer, the Supreme Court's opinion does not limit the theory to that context. The Commission believes that applying the presumption to securities analysts is consistent with the "common sense and probability" considerations that led the Court to adopt the presumption in *Basic*.

The Court stated in *Basic* that the theory applies to "any public material misrepresentations * * *." 485 U.S. at 247. The Court further referred to "available material information regarding the company and its business," without any limitation based on the source of the information. *Id.* at 241 (quotation omitted). The Court noted that the economic studies that led courts to adopt the theory "tended to confirm * * * that the market price of shares traded on well-developed markets reflects all publicly available information * * *." *Id.* at 246.

Thus the Court imposed no limitation that the source of the information be the company itself. The Commission believes that applying the presumption to analysts is consistent both with economic studies showing the market effect of analyst reports and with their very purpose - providing information on which to base investment decisions. The Commission takes no position on whether the presumption is applicable to non-issuers other than analysts, an issue that is not before the Court in this case.

Recent economic studies document the market effect of research reports and recommendations by sell-side analysts. These statistical analyses, which examine historical data from a broad set of sell-side research
analysts' recommendations and earnings forecasts and historical price data of equity securities in the publicly traded markets, are published by academic researchers in finance and accounting research journals after an extensive peer-review process. See Kent L. Womack, Do Brokerage Analysts' Recommendations Have Investment Value?, 51 J. Fin. 137 (1996), demonstrates that stock prices react within the 3-day period around the time a recommendation is issued and continue to drift in the direction recommended for one or more months. The author concludes that "there is strong evidence that stock prices are significantly influenced by analysts' recommendation changes, not only at the immediate time of the announcement but also in subsequent months." Id. at 164. See also Jeffrey A. Busse & T. Clifton Green, Market Efficiency in Real Time, 65 J. Fin. Econ. 415 (2002); Brad Barber et al., Can Investors Profit from the Prophets? Security Analyst Recommendations and Stock Returns, 56 J. Fin. 531 (2001); Zoran Ivkovic & Narikimhan Jegadeesh, The Timing and Value of Forecast and Recommendation Revisions: Do Analysts Receive Early Peek at Good News?, 3 J. Fin. (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=359320. Prices of securities also react to analysts' issuance or revision of target trading prices (Alon Brav & Reuven Lehavy, An Empirical Analysis of Analysts' Target Prices: Short-term Informativeness and Long-term Dynamics, 58 J. Fin. 193 (2003), and to analysts' issuance or revision of earnings forecasts (Rick A. Cooper et al., Following the Leader: A Study of Individual Analysts' Earnings Forecasts, 61 J. Fin. Econ. 383 (2001); Cristi A. Gleason and Charles M.C. Lee, Analyst Forecast Revisions and Market Price Discovery, 78 Acct. Rev. 193 (2003)).

Contrary to the defendants' contention that institutional investors ignore the reports of sell side analysts, studies show that institutional investors rely on such information. See T. Clifton Green, The Value of Client Access to Analyst Recommendations 1 (2004) (working paper, Emory Univ.), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=438725 ("Institutional Investors pay significant amounts to obtain real-time access to brokerage firm research through providers such as First Call * * *."); Paul J. Irvine, Analysts' Forecasts and Brokerage-Firm Trading, 79 Acct. Rev. 125, 126, 147-48 (2004)(clients of brokerage firms, including institutional investors, increase trading in response to recommendations and forecast revisions of brokerage firm analysts).

In addition to the demonstrated market effect of their statements, securities analysts hold themselves out as providing information that investors can use to make decisions on buying and selling securities. As one district court recently observed, an investment bank "that has a research department engaged in the business of analyzing companies in order to disseminate in the public information and opinions about specific securities clearly intends that the market take into account its recommendations to buy or sell securities." De Marco v. Robertson Stephens, Inc., No. 03 Civ. 590 (GEL), 2004 U.S. Dist. LEXIS 265, at *21-22 (S.D.N.Y. Jan. 9, 2004). The court rejected the defendants' argument that the fraud-on-the-market presumption should not apply to opinions in analyst reports, stating: "[I]t is disingenuous, to say the least, for defendants to now argue that their
published purchase recommendations are somehow excluded from the information available to market actors when valuing securities." Id. at 22. See also DeMarco v. Lehman Bros. Inc., __ F. Supp. 2d __, Nos. 03 Civ. 3770 (JSR), 03 Civ. 3705 (JSR), 03 Civ. 4511 (JSR), 2004 WL 602668, at *3 (S.D.N.Y. Mar. 29, 2004) (declining to exempt analysts' reports from fraud-on-the-market presumption because the "very purpose was to advise Lehman's readers to buy stock in a company").


The important role of analysts in the securities markets and the potential that conflicts of interest can influence the integrity of their research reports has been the subject of statutory and regulatory action in recent years. Congress, as part of the Sarbanes-Oxley Act, directed the Commission (or, upon the authorization and direction of the Commission, a registered securities association or national securities exchange) to adopt "rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information **."


In response, the Commission has approved rule changes by the New York Stock Exchange and the National Association of Securities Dealers prohibiting analysts for member firms from issuing research reports recommending securities for which their firm acted as the manager or co-manager of a public offering during a specified period before and after the offering. NYSE Rule 472(f); NASD Rule 2711(f). In approving these rules, the Commission noted that the purpose was to "permit market forces to determine the price of the security in the aftermarket unaffected by research reports issued by firms with the most substantial interest in the offering." Exchange Act Release No. 45,908, 67 Fed. Reg. 34968, 34975 (May 10, 2002). The Commission also adopted Regulation AC — Analyst Certification, which includes measures to assure research analyst integrity and specifically requires analysts' reports to include a statement attesting that the views expressed therein "accurately reflect the research analysts' personal views about any and all of the subject securities or issuers." 17 C.F.R. 242.501(a)(1).

In issuing the proposed rule, the Commission stated that "by requiring research analysts to certify as to the accuracy of the views expressed in research reports, investor confidence in the securities markets should be enhanced, thereby leading to the benefit of more liquid and efficient markets." Securities Act Release No. 8119, Exchange Act Release No. 46,301, 67 Fed. Reg. 51510, 51514 (Aug. 8, 2002).

The Commission believes the concerns raised by the defendants and amicus curiae Securities Industry Association that applying the presumption to statements by analysts will result in securities fraud damages actions agains
anyone who publicly disseminates a favorable opinion about a security are mitigated by the rebuttable presumption that is part of the fraud-on-the-market presumption of reliance and the barriers against unwarranted suits imposed by the Private Securities Litigation Reform Act, 15 U.S.C. 78u-4 et seq.

Many of the arguments that the defendants raise about applying the theory to analysts' opinions — that such opinions are part of an undifferentiated mass of secondary information and do not have any distinct price effects, that major institutional investors whose decisions have an impact on prices do not rely on retail research reports, and that the effects of an analyst's recommendations can be short lived — seek to rebut the presumption that an analyst's opinion really affected the market price. See Basic, 485 U.S. at 248 ("[a]ny showing that severs the link between the alleged misrepresentation and the price received (or paid) by the plaintiff will be sufficient to rebut the presumption of reliance"). Thus, the defendant could seek to rebut the presumption by showing that any effect was ephemeral or that the particular analyst did not have sufficient influence to actually have an effect on the market price.

The potential for unwarranted actions against anyone who asserts an optimistic view of a company and its securities that proves later proves wrong is addressed by the Private Securities Litigation Reform Act, especially the provisions requiring plaintiffs to plead fraud with particularity (15 U.S.C. 78u-4(b)(1)(B)), to state with particularity facts giving a strong inference that the defendant acted with scienter (15 U.S.C. 78u-4(b)(2)), and to establish that the defendant's fraud caused the plaintiff's loss (15 U.S.C. 78u-4(b)(4)). See Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 598, 597 (2001) (noting that concerns about unwarranted securities actions are unlikely "to prove serious in the future" because of the PSLRA, which "impos[ed], beginning in 1995, stricter pleading requirements in private securities fraud actions").

In sum, the Commission believes that the "common sense and probability" considerations that led the Supreme Court to adopt the fraud-on-the-market presumption in Basic, a case involving misrepresentations by an issuer of securities, should also apply to misrepresentations by securities analysts.

CONCLUSION

For the foregoing reasons, the Commission urges the Court to hold that the fraud-on-the-market presumption of reliance applies to public material misrepresentation by analysts.

Respectfully submitted,

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1 Although the fraud-on-the-market issue in this case arises in the context of a class action, the fraud-on-the-market presumption applies to all private damages actions under Rule 10b-5 and is grounded on characteristics of the securities markets and investors' behavior and also on policy objectives that are equally applicable to individual and class actions. See, e.g., Panzirer v. Wolf, 663 F.2d 365, 367-68 (2d Cir. 1981) (applying the presumption to an individual plaintiff's Rule 10b-5 claim), vacated on other grounds sub nom. Price Waterhouse v. Panzirer, 459 U.S. 1027 (1982).

2 The Commission's brief in Basic framed the issue as whether "the court of appeals in this case correctly held, as has every other court to consider the issue, that a plaintiff alleging fraud under Rule 10b-5 may, in circumstances where a materially false or misleading corporate statement has been disseminated into the trading market, invoke a rebuttable presumption of reliance upon the integrity of the market price." Id. at 21 (citations omitted). All of the cases in which appellate courts had adopted the presumption prior to the Basic decision involved misrepresentations by issuers. See id. at 21 n.24.


4 An article designated as a "working paper" has not yet completed this peer-review process and been accepted for publication.

5 An indication of how important companies themselves view analysts' reports is shown in a recent article finding that almost a third of companies switch underwriters from an initial public offering to a follow-on offering (within three years of the IPO), and that a key reason that companies switch underwriters is to "buy additional and influential analyst coverage from the new lead underwriter." Laurie Krigman et al., Why Do Firms Switch Underwriters?, 60 J. Fin. Econ. 245, 245 (2001).

6 Irvine notes that "[s]ell-side research analysts must * * * serve the institutional clients who provide commission revenue to their brokers" and that "often brokerage firms conduct a formal poll asking the institutional sales force to rate analysts on how much trade they generate * * *." 79
In re WorldCom Securities Litigation (Hevesi): Amicus curiae brief addressing whether the fraud-on-t...

Acct. Rev. at 125, 126.


8 The Senate Banking Committee report recommending enactment noted that the provision was intended to address the "critical" need to "restore investor confidence" in the integrity and credibility of securities analysts. Senate Comm. on Banking, Housing, and Urban Affairs, 107th Cong., Public Company Accounting Reform and Investor Protection Act of 2002, Report to Accompany S. 2673 Together With Additional Views, S. Rep. No. 107-205, at 33 (June 26, 2002).

9 Regulation AC applies to "research analysts," who are defined as natural persons responsible for preparing a "research report," which, in turn, is defined as "a written communication (including an electronic communication) that includes an analysis of a security or an issuer and provides information reasonably sufficient upon which to base an investment decision." 17 C.F.R. 242.500.

http://www.sec.gov/litigation/briefs/wchevesi_amicus.htm

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Modified: 04/20/2004
The Uncertain Future of Speculators’ Insurance

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Introduction

In its fall 2004 term, the Supreme Court will take on the issue of loss causation, having granted certiorari to review the Ninth Circuit's decision in Broudo v. Dura Pharmaceuticals, Inc. In that case, the Ninth Circuit held that when transaction causation is established through the fraud-on-the-market theory, allegations of a price disparity at time of purchase are sufficient to plead loss causation. This view of loss causation has created a kind of "speculator's insurance," by which allegations of fraud can be made to cover investment losses unrelated to the alleged fraud. It is widely expected that the Court will reverse the Ninth

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2 339 F.3d 933, 938 (9th Cir. 2003).
Circuit's decision. In doing so, the Court may choose to focus only on the question of whether a purchase price disparity is sufficient to establish loss causation. Recent developments within the Second Circuit, however, demonstrate that taking this narrow view of the issue would leave many questions about loss causation unanswered. The Court should look to those recent cases in the Second Circuit and use Broudo as an opportunity not only to eliminate the purchase price disparity theory but also to enunciate clear requirements for pleading and proving loss causation.

Discussion

The typical way to establish loss causation for misrepresentations or omissions is to show a connection between the revelation of the alleged misrepresentation/omission (i.e., the corrective disclosure) and a drop in the price of the stock. The "purchase price disparity" theory of loss causation has developed in cases in which the price drop upon which the plaintiffs base their damages claims was not preceded by a corrective disclosure. In Broudo, for example, the plaintiffs alleged that the defendant, a pharmaceutical corporation, had made misrepresentations regarding a delivery device for asthma medication. The price drop that the plaintiffs used as the closing date of the class period and as the basis for their damages claim, however, was the result of an earnings

3 See John C. Coffee, Causation and the Analyst, N.Y.L.J., July 15, 2004, at 5 (predicting that the Ninth Circuit's Broudo approach "will not survive the Supreme Court").

announcement unrelated to the device. The Ninth Circuit held that the lack of a connection between the price drop and the alleged misrepresentations was not fatal to the plaintiffs' claims because "loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise [; i]t merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause." Without providing much explanation, the Ninth Circuit found that the plaintiffs had met this pleading standard.

The Ninth Circuit's Broduo decision did not invent the purchase price disparity theory of loss causation.

5 339 F.3d at 935-36. In Broduo, there was a subsequent smaller price drop when the defendant made a corrective disclosure regarding the device, but the plaintiffs chose to base their damages claims on the earlier larger drop that was unrelated to the alleged misrepresentations about the device. See Reply Brief on Petition for a Writ of Certiorari at *7-*8, Dura Pharm., Inc. v. Broduo, 2004 WL 329364 (U.S. 2004) (No. 03-932).

6 339 F.3d at 938.

7 Id.

In fact, it did not even create the split among the appellate circuits on the subject. The Ninth Circuit accepted the purchase price disparity theory of loss causation in two cases in 19968 And the Eighth Circuit has twice endorsed the theory, including once just a few months before Broduo.9 On the other side of the circuit split are the Second, Third, Seventh, and Eleventh Circuits, which have all rejected the argument that a purchase price disparity allegation suffices to plead loss causation.10

8 Gray v. First Winthrop Corp., 82 F.3d 877, 886 (9th Cir. 1996); Knapp v. Ernst & Whitney, 90 F.3d 1431, 1438 (9th Cir. 1996) (holding that "[i]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation").

9 In re Control Data Corp. Sec. Litig., 933 F.2d 615, 619-20 (8th Cir. 1991) ("The fact that the misrepresented earnings figures did not affect the stock price does not negate the possibility that investors were misled in other ways by the improper accounting maneuvers."); Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824, 831-32 (8th Cir. 2003) (holding that loss causation was adequately alleged because plaintiffs could "invoke fraud-on-the-market theory and assert that the misrepresentations inflated the stock's price").

The circuit split that the Supreme Court is now confronting resembles the state of the law within the Second Circuit prior to September 2003. At that time, the Second Circuit's view on the purchase price disparity question was not clear. The circuit court's foremost opinion on the subject, *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, written by Judge Cardamone, had seemingly endorsed the purchase price disparity theory, stating that "plaintiffs may allege transaction and loss causation by averring both that they would not have entered the transaction but for the misrepresentations and that the defendants' misrepresentation induced a disparity between the transaction price and the true 'investment quality' of the securities at the time of the transaction." 11 Relying on language in *Suez*, Judge Scheindlin in the *In re: Initial Public Offering Securities Litigation* found that the plaintiffs adequately pled loss causation by alleging that the defendants' actions "had the effect of inflating the price of the [] stock above the price that would have otherwise prevailed in a fair and open market." 12

Other judges in the Second Circuit, however, resisted this reading of *Suez*. Most notable among them was Judge Pollack who limited the holding of *Suez* to cases in which the fraud allegations "involved a claim of actual reliance in a face-to-face transaction" rather than fraud on the market for a publicly-traded security. 13 He dismissed a case in which the plaintiffs relied on the purchase price disparity theory to allege fraud against stock analysts, and he wrote

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11 250 F.3d 87, 97-98 (2d Cir. 2001).


that the plaintiffs who advanced the theory were trying to "twist the federal securities laws into a scheme of cost-free speculators' insurance".\textsuperscript{14} The Second Circuit's attempt to close the split within its own jurisdiction came in \textit{Emergent Capital Inv. Mgmt. LLC v. Stonepath Group, Inc.}\textsuperscript{15} The court noted that allegations of loss causation that rely only on purchase price disparity "amount[] to nothing more than a paraphrased allegation of transaction causation [which] may explain why plaintiff purchased the [] stock [but] does not explain why it lost money on the purchase, the very question that the loss causation allegation must answer".\textsuperscript{17} In what he deemed a "clarification", Judge Cardamone all but withdrew that portion of its \textit{Suez} decision that had endorsed the theory,\textsuperscript{18} and explained that the finding of loss causation in \textit{Suez} was based on the fact that the plaintiffs had "specifically asserted\textsuperscript{16}

\textsuperscript{14} Id. at 358. In a passage that cannot possibly be paraphrased, Judge Pollack wrote:

Seeking to lay the blame for the enormous Internet Bubble solely at the feet of a single actor, Merrill Lynch, plaintiffs would have this Court conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining a freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches, but which delivered such riches to only a scant handful of lucky winners. Those few lucky winners, who are not before the Court, now hold the monies that the unlucky plaintiffs have lost-fair and square-and they will never return those monies to plaintiffs. Had plaintiffs themselves won the game instead of losing, they would have owed not a single penny of their winnings to those they left to hold the bag (or to defendants).

\textsuperscript{15} 343 F.3d 189 (2d Cir. 2003).

\textsuperscript{16} Id. at 198.

\textsuperscript{17} Id.

\textsuperscript{18} See id. ("We did not mean to suggest in \textit{Suez Equity} that a purchase-time loss allegation alone could satisfy the loss causation pleading requirement.")
a causal connection between the concealed information... and the ultimate failure of the venture.19

It is clear after Emergent Capital that a mere purchase price disparity allegation will not be sufficient to allege loss causation in the Second Circuit, but it is not clear what additional allegations will suffice to show "a causal connection between the content of the alleged misstatements or omissions and the harm actually suffered".20 As one district court noted,

The central teaching of Emergent Capital, then, is that in misrepresentation cases, a plaintiff must allege something more than merely artificial inflation. What remains murky, however, is what that 'something more' must be.21

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19 Id.

20 Id. at 199 (internal citation omitted).

21 Fogarazzo v. Lehman Bros., Inc., No. 03 CV 5194, 2004 WL 1151542, at *9 (S.D.N.Y. May 21, 2004). See also Demarco v. Lehman Bros., Inc., 309 F. Supp.2d 631, 636 (S.D.N.Y. 2004) ("[S]ome of the cases in the Second Circuit and elsewhere suggest uncertainty as to whether or not [loss causation] requires proof that the losses suffered by the plaintiffs can be directly attributed to the market's learning..."

This uncertainty has resulted in a range of differing decisions within the Second Circuit in the months following Emergent Capital.

On the one hand, some courts have allowed plaintiffs to survive a motion to dismiss without connecting an alleged misrepresentation to a subsequent price drop. In In re AOL Time Warner, Inc. Sec. & ERISA Litig., a case in which my firm represents the corporate defendant and others, Judge Kram found loss causation adequately alleged without the link of a corrective disclosure to a price drop. The court did not address whether "generalized market conditions" (such as the bursting of a bubble) might have acted as an intervening cause, holding that this was a factor to be considered at the proof stage but not at the pleading stage.22

On the other hand, Judge Pollack (in a decision made after the true facts that the previous misrepresentations were concealed.")

Emergent Capital dismissed fraud claims upon a finding that there was no connection between the alleged fraud by the defendant-analysts and the decline in the plaintiffs’ stock prices. Judge Pollack’s decision was based in part on his taking judicial notice of the bursting of the Internet bubble, which preceded the decline in those stocks.

Judges Lynch and Cote have also considered this issue in the context of analyst cases, and, like Judge Pollack, have required plaintiffs to demonstrate a connection between alleged misrepresentations/omissions and a subsequent price drop to survive motions to dismiss. Unlike Judge Pollack, however, Judges Lynch and Cote have each found that a sufficient connection existed between analyst reports and a price drop. Judge Lynch reasoned that the defendant-analysts’ alleged misrepresentations helped to inflate a telecommunications bubble, and that the plaintiffs were harmed when that bubble “predictably collapsed.” Judge Cote relied on the “prominent role” that defendant-analysts played in “the public evaluation of the merits of an investment in WorldCom,” and concluded that there was “a synergy between the misrepresentations and omissions in the analyst reports and the public perception of the value of WorldCom securities.”

Judge Scheindlin has attempted to articulate the “something more” (than a purchase price disparity) that a securities fraud plaintiff must allege after Emergent Capital to plead loss causation. In Fogarazzo, Judge Scheindlin

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23 289 F. Supp. 2d 416, 420-23 (S.D.N.Y. 2003). See also In re Merrill Lynch Tyco Research Sec. Litig., No. 03 CV 4080, 2004 WL 305809, *2 (S.D.N.Y. Feb. 18, 2004) (Pollack, S.J.) (holding that loss causation was not adequately pled because it could not be “inferred that the alleged false statements in the research reports were the foreseeable cause of the decline in Tyco’s stock price on June 6, 2002, the last day of the class period, as opposed to the myriad negative factual information about Tyco that entered the marketplace that same day”).

24 289 F. Supp. 2d at 421.


26 In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288, 2003 WL 2253398, at *9-*12 (S.D.N.Y. 2003) (internal citation omitted).
concluded that plaintiffs need not allege a causal link between the misrepresentation itself and the loss, so long as “the subject of the misrepresentation caused the decline in the value of the security.”\(^{27}\) Under this standard, the court found a causal connection between the defendant-analysts’ withholding of their “true opinions” of certain publicly known facts, and the decline in these stocks that followed the bursting of the Internet bubble.\(^{28}\)

In a separate case, Judge Scheindlin has tackled one of the other questions left open by Emergent Capital: whether the loss causation standard is different in market manipulation cases than in misrepresentation/omission cases. Called upon to re-examine her IPO Litigation decision in light of Emergent Capital, Judge Scheindlin held that Emergent Capital was limited to cases of misrepresentation/omission (in violation of Rule 10b-5(b)) and concluded that a purchase price disparity is sufficient to allege loss causation when the alleged fraud consisted of market manipulation (in violation of Rule 10b-5(a) or Rule 10b-5(c)).\(^{29}\) The court’s rationale was that the harm suffered by a fraud victim is different in misrepresentation/omission cases than it is in market manipulation cases. Whereas the value added to a stock by a misrepresentation/omission potentially dissipates only upon a corrective disclosure (thus harming the investor), market manipulation involves “a discrete act” and the inflationary effect of that act “must inevitably diminish over time.”\(^{30}\) Based on this difference, Judge Scheindlin held that the plaintiffs’ allegations of a purchase price disparity were sufficient to allege loss causation for their market manipulation claims.\(^{31}\) The court also held that a purchase

\(^{27}\) 2004 WL 1151542, at *10.

\(^{28}\) Id., at *10-11.


\(^{30}\) Id.

\(^{31}\) Id.
price. Plausibly an allegation was sufficient to plead loss causation for the plaintiffs' separate misrepresentation/omission claims because the alleged misrepresentations and omissions "did nothing more than conceal the [defendants'] alleged market manipulation."\(^{32}\)

**Conclusion**

As the Supreme Court prepares to take up *Broudo*, it should look to the aftermath of the Second Circuit's *Emergent Capital* decision and consider the consequences of not defining clear pleading and proof standards for loss causation. If the Court does not go further than the Second Circuit went in *Emergent Capital*, federal courts will likely be sorting out the intricacies of loss causation in years to come, creating the possibility of a renewed circuit split. In light of how rarely securities cases are heard by the Supreme Court, it would be unfortunate if

\(^{32}\) *Id.* at 675.

RICHARD A. ROSEN

Under the Private Securities Litigation Reform Act ("PSLRA" or "Reform Act"), an issuer's forward-looking statement or projection does not give rise to securities law liability if: (1) the statement is identified as forward-looking and accompanied by meaningful cautionary language; or (2) the statement is immaterial; or (3) plaintiffs fail to establish that defendants had actual knowledge of the falsity of the statement.¹

There have been sixteen court of appeals decisions about the safe harbor since the enactment of the PSLRA, the majority of which were issued over the past year and a half. Since the safe harbor's passage, there have also been well over 150 district court opinions, over thirty of which have come down since April 2003.² Of all the district court and court of appeals decisions in the last nineteen months, only one decision was not in the context of a motion to dismiss.³

The PSLRA was designed in part to facilitate dismissal at the pleading stage, and thereby to avoid the necessity of burdensome and lengthy inquiry into a defendant's state of mind, if the issuer could show that any potentially misleading forward-looking statements had been accompanied by meaningful cautionary language.⁴ This goal, however, is under threat by two emerging lines of cases. Of most recent concern to issuers is Asher v. Baxter International Inc.,⁵ a Seventh Circuit decision which, if read too broadly, raises the question whether a court may ever determine the adequacy of cautionary language at the pleading stage. There is also an emerging circuit split on whether the safe harbor protects an issuer that made predictions accompanied by adequate cautionary language, even if the defendant made the predictions knowing they were false or had no reasonable basis.

A review of the cases decided in the last year and a half reveals, in addition, that case law remains inconsistent on whether statements that contain both factual and forward-looking elements can be afforded protection under the safe harbor, on whether cautionary language must literally "accompany" the predictions or may be incorporated by reference to another document, and on what constitutes immaterial "puffery" and when it is appropriate to decide that question.

I. Meaningful Cautionary Language

A. Does Asher Close the Safe Harbor? A recent decision from the U.S. Court of Appeals for the Seventh Circuit has caused many to fear that public companies will no longer be able to seek refuge in the safe harbor.⁶ Since the enactment of the statute, issuers have been


² The court of appeals and district court opinions are listed in Appendix A to this article. The earlier court cases are all cited in my "Safe Harbor for Forward-Looking Statements in the Courts: A Scorecard in the Courts From January 2002 Through April 2003" and "Safe Harbor for Forward-Looking Statements in the Courts: A Year 2001 Scorecard" articles.


⁴ The House Conference Report explains: "The use of the words 'meaningful' and 'important factors' are intended to provide a standard for the types of cautionary statements upon which a court may, where appropriate, decide a motion to dismiss, without examining the state of mind of the defendant. The first prong of the safe harbor requires courts to examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement."

⁵ 377 F.3d 727 (7th Cir. 2004).

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willing to make more forward-looking disclosures with some confidence that, should they be sued, they have a reasonable likelihood of obtaining a dismissal at the pleading stage so long as the predictions were accompanied by meaningful cautionary language identifying
"important factors that could cause actual results to differ materially from those in the forward-looking statement." Indeed, although plaintiff buyers continue to assert claims for such statements, they are generally regarded by practitioners on the plaintiffs' side as relatively weak.

This may be about to change. In Asher, the Seventh Circuit raises the question whether a court may ever determine the adequacy of cautionary language at the pleading stage. The plaintiff in Asher alleged that Baxter International, a medical manufacturer, made posi-


*377 F.3d 727 (7th Cir. 2004).

See id.; See also Org. v. Sears, Roebuck & Co., No. 03 C 4142, 2004 U.S. Dist. LEXIS 19-425, at *106-06 (N.D. Ill. Sept. 24, 2004) (applying Asher v. Baxter, Int'l, Inc.) In re Intertheme, Inc. Sec. Litig., No. 03-C-2935-51, 2004 U.S. Dist. LEXIS 15382, at *15 (N.D. Cal. July 30, 2004) ("To the extent that a statement is forward-looking and is not based on the most accurate information available to defendants, it would not be protected by the general safe harbor provision. The Court cannot conclude at this early stage whether defendants relied on the most accurate information or whether they failed to disclose negative information, as alleged by plaintiffs."). In New Jersey v. Sprint Corp., No. 03-20710-NWL, 2004 U.S. Dist. LEXIS 17766 (N.D. Cal. Sept. 4, 2004), the United District Court of Kansas applied Asher to find that plaintiffs adequately pled actual knowledge, the second prong of the safe harbor. Id. at *36-37. This application of Asher (though a more sensible application of the law) is not relevant to the current inquiry, which concerns the first prong of the safe harbor, adequate cautionary language.

tive projections about revenue growth without disclosing various internal and external risk factors. Although the lower court found Baxter's long and relatively company-specific list of warnings to be adequate,10 the Seventh Circuit reversed and remanded, writing, "[t]here is no reason to think—at least, no reason that a court can accept at the pleading stage, before plaintiffs have access to discovery—that the items mentioned in Baxter's cautionary language were those thought at the time to be the (or any of the) 'important' sources of variance."11

The court appears to be shifting the safe harbor inquir from whether the cautionary language identified "some important risks" to whether the language fully reflected what the issuers actually knew when they made the predictions. This interpretation is in acute tension with the language of the statute, which requires issuers only to identify "important factors that could cause actual results to differ materially from those in the forward-looking statement."12 Shifting the focus from whether the identified factors provided adequate notice of risk—an objective inquiry that can often be determined at the pleading stage—in an inquiry into what issuers knew when they made predictions seems to predictors-discovery. In extreme, the Asher court's formulation would require an inquiry into exactly what the issuers knew or should have known at the time of the forward-looking state-

Asher need not be the end of the world, however, for four reasons. First, the analysis should only come into play when the issuer failed to identify the risk that actually materialized. Second, the issuer in Asher failed to update its cautionary language in the face of changing risks—a circumstance that weighed heavily with the court. Third, much of the balance of the Asher decision is not consistent with the conclusion that the safe harbor is never available at the pleading stage, even in the Seventh Circuit. Finally, Asher is not the law in all the circuits; this is a critical issue of great practical importance that seems ripe for Supreme Court review.

First, Baxter failed to identify the risks that actually materialized. Though the court emphasizes that it is not necessary to do so,13 warning buyers of the very circumstance that eventually causes a negative outcome certainly should be sufficient to place forward-looking statements within the safe harbor.14 After all, it would be irrelevant to the outcome of the case if it turned out that management subjectively knew of material undisclosed risks that never in fact came to pass. Thus,


11 Asher, 377 F.3d at 734.


13 See Asher, 377 F.3d 734 ("The problem is not that what actually happened wasn't mentioned; issuers need not anticipate all sources of deviations from expectations.").

14 See, e.g., Miller v. Champion Enters., Inc., 364 F.3d 600, 678 (6th Cir. 2003) (finding adequate cautionary language and noting that "[p]laintiff] disclosed the exact risk that occurred in this situation ... and [is] not required to detail every facet or extent of this risk to have adequately disclosed the nature of the risk"). But see Org., No. 03 C 4142, 2004 U.S. Dist. LEXIS 19425, at *102-03 (rejecting defendant's argument that its warnings must have been adequate because they were "not only realistic; they actually came true").
where issuers have identified the risk that materialized. Ascher, properly read, should not adversely affect the viability of a motion to dismiss.

Second, whereas the district court found that Baxter’s failure to include certain known risks was mitigated by the “substantive and sufficiently tailored” cautionary disclosures, the appellate outcome seems to have been heavily influenced by the fact that Baxter’s cautionary language “remained fixed even as the risks changed.” For example, the complaint alleged that there was a “sterility failure” in the spring of 2002, but “Baxter left both its forecasts and cautions as is.” Also, Baxter allegedly “closed plants that were its least-cost sources of production,” yet “these forecasts and cautions continued without amendment.” For the court, the unchanging cautionary language was a red flag, raising “the possibility—no greater confidence is possible before discovery—that Baxter omitted important variables from the cautionary language and so made projections as more certain than internal estimates at the time warranted.” Of course, even before Ascher it was crucial for issuers to adapt their cautionary language to reflect any major changes in the risks their company faces.

The language of Ong v. Sears, Roebuck & Co., the only district court case to apply Ascher, similarly indicated that the defendant may have fared better had it been more current in its description of risk factors. Sears had made rosy predictions about the quality of its credit-card portfolio, cautioning that the accuracy of the predictions was subject to “changes in . . . delinquency and charge-off trends in the credit card receivables portfolio.” The court found this language to be insufficient, writing, “[a] warning that trends could change . . . is not the same as a warning that the current portfolio is experiencing rising delinquencies and charge-offs due to its high-risk customers.”

Third, the court’s discussion in Ascher includes several points on the safe harbor that are wholly inconsistent with the notion that it is never appropriate to apply the safe harbor at the pleading stage. For example, the court notes that, “unless it is possible to give a concrete and reliable answer [to the question of what constitutes meaningful cautionary language], the safe harbor is not safe.” The opinion goes on, “[a] safe harbor matters only when the firm’s disclosures (including the accompanying cautionary statements) are false or misleadingly incomplete; yet whenever that condition is satisfied, one can complain that the cautionary statement must have been inadequate. The safe harbor loses its function.”

Given these inherent difficulties, the court tries to discern a standard for applying the safe harbor. Clearly, “issuers need not anticipate all sources of deviations from expectations,” as that would render the safe harbor meaningless. Also, public companies need not reveal the calculations underlying predictions, as revealing this kind of confidential information might undermine the company’s competitiveness, ultimately hurting shareholders.

Finally, other circuit courts have recently affirmed dismissals based on the safe harbor, applying a far more lenient standard than the Ascher court. For example, in the same month as Ascher, the Third Circuit affirmed a district court’s dismissal based, in part, on the safe harbor. In In re Adams Family Golf Secs. Litig., the defendant, a manufacturer of custom-fit golf clubs, made forward-looking statements concerning “sanguine prospects for the golf industry and the rising popularity of the sport more generally.” Plaintiffs alleged that these statements were materially misleading given that there was an oversupply of clubs in the retail market. The court found that defendant’s registration statement contained adequate cautionary language that warned of “prospects of lagging demand for the Company’s products, competitive products from rivals, unseasonable weather patterns that could diminish the amount of golf played, and an overall decline in discretionary consumer spending.”

It did not concern the court that there was no warning about the oversupply specifically. Rather, the court focused on the fact that the risks identified “relate directly to the claim on which plaintiffs allegedly relied; the general representations of better business ahead were mitigated by the discussion of the several factors that could have caused poor financial results.” Thus, as the statute directs, the Third Circuit focused on whether the cautionary language appropriately modified the forward-looking statement, not whether the language matched exactly with what the defendant knew at the time it made the statement. While it remains to be seen how courts in other circuits will react to the Ascher decision, as of today, it stands virtually alone.

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26 Id. at 734.
27 Id. at 733.
28 See, e.g., In re Adams Family Golf Secs. Litig., 381 F.3d 267 (3d Cir. 2004); Rombach v. Chang, 355 F.3d 164 (2d Cir. 2004).
29 381 F.3d at 279.
30 Id.
31 See id.
32 Id.
33 Id.
34 It should be noted that the court placed this language within the safe harbor on two bases: because it was accompanied by adequate cautionary language and because it was too vague to be material. See id.

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16 377 F.3d at 734.
17 Id.
18 Id. at 734-35.
21 Ong, No. 03 C 4142, 2004 U.S. Dist. LEXIS 18425, at *102-03.
22 Id. at *102.
23 Id.
24 Ascher, 377 F.3d at 729.
25 Id.
B. Specificity. Decisions are unfortunately far from uniform as to the specificity required of cautionary language. In *In re Midway Games, Inc. Securities Litigation,* granting a motion to dismiss under the safe harbor provision, the court emphasized that cautionary language must be "sufficiently related in subject matter and strong in tone to counter the statement made." In this case, defendant Midway had made predictions about product release dates and growth in sales and revenue. The court found language such as "[w]e do not know when or whether we will become profitable again" to be "highly specific." The court emphasized that Midway's warnings "continued[ed] for pages" and identified "numerous factors" that might lead to adverse outcomes, including "variations in the level of market acceptance of our products," "delays and timing of product introductions," and "development and promotional expenses relating to the introduction of our products."

In *Rombach v. Chang,* the Second Circuit upheld a lower court's determination that the defendant's cautionary statements, though "formulistic," were sufficiently meaningful. The language included warnings "that the company's past performance was not necessarily indicative of future results" and "that no assurance could be given that the company's results would be reached, integrated into the company's operating structure." The Second Circuit ruled that the language offered "a sobering picture of a company's financial condition and future plans," and therefore was protected by the safe harbor. On the other hand, in *In re Ameriprise Express Securities Litigation,* the Southern District of New York found language that "potential deterioration in the high-yield sector...could result in further losses," accompanying the prediction that losses on high-yield investments would dwindle was inadequate because it was not based on specific facts, and therefore was insufficiently precise.

In light of *Asher* and other recent cases careful issuers would be wise to update their cautionary language every quarter to reflect all changes—both within the company and in the outside markets. The language must be as specific as possible. Issuers should also write cautionary language with an eye to the risk disclosures of competitors, suppliers and customers. Similarly, it is always helpful to review research reports of the analysts who follow the company. Their insights into industry-wide phenomena, and their nonpartisan view of the company and its prospects, will help to identify potential risk factors.

II. Is Actual Knowledge of Falsity a Barrier to Safe Harbor Protection?

Though the statute is clear and unambiguous on the issue, there is an emerging circuit split over the "actual knowledge" provision of the safe harbor. A literal reading of the statute provides three separate grounds for dismissing a count—the first, if its statements are forward-looking and accompanied by adequate cautionary language, the second, if the plaintiff has failed to allege that the defendant actually knew its statements were false, and the third, if the alleged misrepresentations were immaterial. Therefore, a defendant that loses on the cautionary language issue may nevertheless argue that plaintiff failed adequately to plead scienter. But the converse is not necessarily true. Circuits are split over whether a defendant that actually knew its statements were false or misleading at the time they were made may still avail itself of the safe harbor so long as the statements were forward-looking and accompanied by meaningful cautionary language. This split has a profound impact on how motions to dismiss get decided.

Over the past year and a half the Fifth, Sixth and Ninth Circuits have all found that the two prongs of the safe harbor provision operate totally independently of one another. For example, in *Miller v. Champion Enterprises,* the Sixth Circuit ruled that if a statement qualifies as forward-looking and is accompanied by cautionary language, it is "protected regardless of the actual state of mind." In *Southland Securities Corp. v. Inspire Insurance Solutions Inc.* the Fifth Circuit wrote, "[t]he safe harbor has two independent prongs: one focusing on the defendant's cautionary statements

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39 See *Rombach v. Chang,* 355 F. 3d 164, 175-77 (2d Cir. 2004); *In re Midway Games, Inc. Securities Litigation,* 332 F. Supp. 2d 1152, 1166 (N.D. Ill. 2004); *In re American Express Co. Sec. Litig.,* No. 02 Civ. 5533(WHP), 2004 WL 632750, at *12 (S.D.N.Y. Mar. 31, 2004); *In re VentiNet Universal, Inc.,* 203 U.S. Dist. LEXIS 19431, at *66-67 (S.D.N.Y. Nov. 3, 2003) ("The generic warning that actual results may differ...does not come close to the cautionary language needed to render reliance on the misrepresentation unreasonable.") (internal citations omitted).

40 332 F. Supp. 2d 1152. The court does not cite the Asher decision in its analysis.

41 Id. at 1160 (internal quotations omitted).

42 Id. at 1166.

43 Id. at 1166-67.

44 355 F.3d 164.

45 Id. at 1175-77.

46 Id. at 176.

47 Id. at 175.

48 Id. (internal citations omitted).

49 355 F.3d 164 (citing Credit Suisse First Boston v. ARM Fin. Group, Inc., No. 99 Civ. 12046, 2001 WL 300733, at *8 (S.D.N.Y. Mar. 28, 1991) ("Warnings of specific risks...do not shelter defendants from liability if they fail to disclose hard fact-intensive to appreciating the magnitude of the risks described.").)
and the other on the defendant’s state of mind. Similarly, in Employers Teamsters Local Nos. 175 and 505 Pension Trust Fund v. The Clorox Co., the Ninth Circuit affirmed the district court’s application of the safe harbor to allegedly “knowingly false statements” because it found that the statements were accompanied by “sufficient warnings.”

Some district courts in other circuits agree, most recently in the Northern District of Illinois, where the court noted that, “[f]or purposes of § 78u-5(c)(1)(A), proof of knowledge of the falsity of a forward-looking statement is ‘irrelevant’ when the statement is accompanied by meaningful cautionary language.”

The First and Third Circuits, however, have rejected this reading, finding that forward-looking statements with adequate cautionary language fall within the safe harbor “unless the person making the forward-looking statements . . . had actual knowledge that they were false or misleading.” In these circuits, then, there is no possibility for dismissal at the pleading stage where plaintiff has adequately pleaded scienter. Moreover, if the plaintiff is able to prove scienter, the safe harbor will not apply at all, even if defendant’s predictions were couched in adequate cautionary language.

III. Is the Statement Forward-Looking?

Courts seem to have relatively little trouble determining whether a simple statement is forward-looking. Of late, this question has received less detailed attention than in the past. Courts are still sharply divided, however, on how to analyze statements with both factual and forward-looking elements.

Most courts determine whether an issuer’s statement is forward-looking simply by asking if the “the truth or falsity of the statement cannot be discerned until some point in time after the statement is made.” At times, however, courts will not apply even this level of analysis. Some statements are classically forward-looking and require little analysis because they relate to management’s expectations for the company’s future operations. For example, statements that speak of a “strategic operating plan” or indicate that management is “expecting a very good year” address future events and are prototypical forward-looking statements.

Complications arise when the court must review a statement that contains both forward-looking and historical or present fact elements. Five years ago, in Harris v. Ivox, the Eleventh Circuit adopted a “holistic” approach to mixed statements; treating a list of factors in the company’s disclosure document—some containing present assessments of business conditions, others including assumptions about future events—as a single forward-looking statement.

Some courts seem to have taken the Ivox approach to an extreme. For example, in Baron v. Smith, the First Circuit dispensed with almost all analysis and simply found that the press release, which plaintiff claimed was misleading due to the use of the word “unprecedented,” “contained forward-looking statements . . . and therefore comes under the protection of the statutory safe harbor.”

Not all courts, however, will afford safe harbor protection to factual statements intermingled with predictions. Some require that statements of present fact form the basis for forward-looking statements in order to fall within the safe harbor. In Miller v. Champion Enterprises, Inc., the Sixth Circuit reviewed two mixed statements that plaintiffs asserted were not forward-looking. The court determined that the phrase, “given the continuation of outstanding earnings growth and the successful implementation of our retail strategy,” included in a letter to shareholders discussing earnings estimates, might fall within the safe harbor because, though not inherently forward-looking, it was “the basis for later forward looking statements.” However, a)


Kindred Healthcare, 299 F. Supp. 2d at 737-38; see also GSC Partners CDO Fund v. Washington, 368 F.3d 228, 242 (3d Cir. (N.J.) 2004) (“[B]ecause the statement about collectability is a prediction of the likelihood of collection on charge off aris and claims, it is a classic forward-looking statement.”).

182 F.3d 700 (11th Cir. 1999).

Id. at 805-07.

See id.

380 F.3d 49 (1st Cir. 2004).

364 F.3d 660, 676-80 (6th Cir. 2003).

Id. at 677.
statement announcing that second quarter earnings per share grew thirteen percent was not protected by the safe harbor because the earnings statement was "easily separable" from the protected forward-looking statements and was not an assumption underlying them. Therefore, according to Miller, statements of present or historical fact will not be afforded safe harbor protection if they form the basis of predictions.

At the other extreme from lvax, for some courts, any intermingling of statements of present fact with predictions removes the entire statement from safe harbor eligibility. In AOL Time Warner, the court found that a forecast about revenue growth fell outside the scope of the PSLRA safe harbor because it was "combined with statements of existing fact." Similarly, in Wagner v. Barrick Gold Corp., the court declared, "[i]t is well recognized that even when an alleged false statement has both a forward-looking aspect and an aspect that encompasses a representation of present fact, the safe harbor provision of the PSLRA does not apply.

IV. The 'Accompaniment' Requirement

The safe harbor protects predictions "accompanied" by meaningful cautionary language, but courts differ in their interpretations of what this means. For example, while some courts will only apply the safe harbor to predictions in a press release if the release itself contains cautionary language, others have interpreted "accompanied" broadly, examining cautionary language in SEC filings (even if they are not specifically referenced) to determine whether forward-looking statements fall within the safe harbor. Cautious issuers should not rely on such a broad interpretation of the statute announcing that second quarter earnings per share grew thirteen percent was not protected by the safe harbor because the earnings statement was "easily separable" from the protected forward-looking statements and was not an assumption underlying them. Therefore, according to Miller, statements of present or historical fact will not be afforded safe harbor protection if they form the basis of predictions.

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V. The 'Accompaniment' Requirement and Oral Forward-Looking Statements

References to SEC filings may also protect oral forward-looking statements, such as those made in analyses."
lusty meetings or conference calls.\textsuperscript{82} For example, in Teamsters Local v. Clorox,\textsuperscript{83} the Ninth Circuit found that the caveat "actual results will depend on a number of competitive and economic factors." [N]ote refer you to our form 10K filing." sufficed to meet the safe harbor's accompaniment requirement.\textsuperscript{44}

If sued for fraudulent oral predictions, defendant issuers should bring all cautionary statements to the court's attention. In Friedman v. Rayovac Corp.,\textsuperscript{85} the court refused to consider cautionary language in an SEC filing alongside an oral forward-looking statement, because the defendant issuer failed either to provide a citation to the document or to identify what the cautionary language was.\textsuperscript{86} The court concluded, that "district courts are not required to scour the record for relevant information."\textsuperscript{87} Similarly, in In re QLT, Inc. Securities Litigation,\textsuperscript{88} the court ruled that the safe harbor does not apply to oral sales projections when the defendants fail to state that cautionary language accompanied the projections.\textsuperscript{89} The court "could not infer, on the basis of other instances of cautionary language QLT included, that such language had been provided in conjunction with [defendant's] statement or that it was in fact meaningful and adequate."\textsuperscript{90}

\section*{VI. The 'Identification' Requirement}

A number of recent cases focus specifically on the 'identification' requirement,\textsuperscript{91} but there remains no bright-line rule on what is sufficient language. While some courts have found that certain buzz words, such as "anticipate" or "predict" are sufficient to satisfy the identification requirement,\textsuperscript{92} others continue to require that issuers explicitly label even clearly forward-looking statements in order to take advantage of the safe harbor. Requiring explicit identification guards against the possibility that "investors might see or hear such statements and . . . not undertake the effort to read the accompanying press releases or SEC filings" that indicate such statements are forward-looking and carry risk.\textsuperscript{93} For example, in Southland Securities Corp. v. Insure Insurance Solutions Inc.,\textsuperscript{94} the Fifth Circuit determined that statements not explicitly identified as forward-looking were not protected by the safe harbor, even though the statements in substance were forward-looking.\textsuperscript{95} Similarly in In re Blockbuster Inc. Securities Litigation,\textsuperscript{96} a statement that "we think retail business will continue to grow and we think rental business will continue to grow" was not protected by the safe harbor because it was not specifically identified as forward-looking.\textsuperscript{97}

Identification may be accomplished through a relatively general statement and need not accompany each individual forward looking statement within the same document. In In re Copper Mountain Securities Litigation, the court ruled that a "statement at the end of each release or filing stating that forward-looking statements in this release or report are made pursuant to the safe harbor provisions of the PSLRA are considered sufficient."\textsuperscript{98} The court reasoned that companies are not required to label each forward-looking statement individually because, "to saddle companies with such a duty would be impractical at best and impossible at worst."\textsuperscript{99} Nevertheless, the court in Copper Mountain cautioned that a total failure to identify forward-looking-looking statements—even if such statements occurred within the same release or filing—would have been redundant forward-looking statements that were properly identified—would disqualify statements from the protection of the safe harbor.\textsuperscript{100}

\section*{VII. 'Immaterial' Forward-Looking Statements}

A projection is also immunized from liability under the safe harbor if it is immaterial. Four court of appeals and seven district court cases have recently dismissed claims on this ground.\textsuperscript{102} Others, however, have indicated

\begin{verbatim}
\footnotesize
82 See Skechers U.S.A., Inc. v. Rogers, 339 F.3d 1181 (9th Cir. 2004).
83 See also In re Copper Mountain Sec. Litig., 311 F. Supp. 2d 857, 882 (N.D. Cal. 2004).
84 Id. at 1132-33; see also In re Copper Mountain Sec. Litig., 311 F. Supp. 2d 857, 882 (N.D. Cal. 2004).
86 Id. at 989-90.
87 Id.
89 Id. at 533-34.
90 Id. at 533-34; see also Southland Secs. Corp. v. Inspire Ins. Solutions Inc., 366 F.3d 385, 379 (9th Cir. 2004).
92 Copper Mountain, 311 F. Supp. 2d at 882.
93 365 F.3d 353.
94 Id. at 372.
96 Id. at 17.
97 311 F. Supp. 2d at 882.
98 Id.
99 Id.
100 Id.
101 Id. at 881-882.
102 In re Adams Family Golf Sec. Litig., 381 F.3d 267, 279 (3d Cir. 2004) (also finding adequate cautionary language); Rombach v. Chang, 355 F.3d 164, 174 (2d Cir. 2004); Southland Secs. Corp. v. Inspire Ins. Solutions Inc., 365 F.3d 353, 374 (9th Cir. 2004); Rosenberg v. Azurix Corp., 332 F.3d 854, 869 (9th Cir. 2003); In re QLT, Inc. Sec. Litig., 312 F. Supp. 2d 526, 532-53 (S.D.N.Y. 2004); Gavish v. Revlon, Inc., No. 00 Civ.
\end{verbatim}
cated that this is a question best left to the trier of fact.103

In Rosenzweig v. Azurix Corp.,104 the Fifth Circuit ruled that representations made in defendant’s prospectus were not actionable because “generalized, positive statements about the company’s competitive strengths, experienced management, and future prospects ... are immaterial.”105 The court reasoned that analysts, who rely on facts in determining the price of a security, would not be misled by the prospectus because the statements were not specific enough to perpetrate fraud.106

Courts continue to dismiss claims for immateriality when the statement in question is mere puffery or when it is a vague statement of optimism. In Rombach v. Chang,107 the Second Circuit observed that, “companies must be permitted to operate with a hopeful outlook ... [and] ‘they can be expected to be confident about their stewardship and the prospects of the business they manage.’”108 In Taubenfeld v. Hotels.com,109 the court found claims that “we’re not seeing any slowing,” “we’re seeing very large increases and we expect that to continue,” and “we’re still ... doing incredibly well” to be “vague assertions of the condition of the company on which no reasonable investor would rely.”110 In Gavish v. Revlon,111 the court found Revlon’s statements, “our program to broaden distribution of our Ultima II line is showing significant strength” and “despite the challenges we now face, we are confident that our long-term outlook remains positive and we intend to pursue the fundamental business strategy that fueled our success to date” were “so vague, general, and hedged that they qualify for the PSI.RA’s safe harbor for ‘immaterial’ forward-looking statements.”112

More problematic, according to the court, was the statement, “the business fundamentals of our Company are strong.”113 The court ultimately found this statement to be “patently immaterial,” however, because it found that “fundamentals” referred to the strength of Revlon, a fact not alleged to be false.114

Nevertheless, puffery arguments are not always successful for defendants. In Friedman v. Rayovac Corp.,115 the court cautioned that there are no buzzwords for puffery, writing, “a statement is not immaterial as a matter of law simply because the speaker prefaces it with ‘I believe’ or ‘I think.’”116 To determine whether a statement is puffery, courts will look at who is speaking, who the audience is, and what aspect of the company the speaker is addressing.117

Of perhaps more concern to issuers is the reluctance by some courts to rule on puffery at the pleading stage. In In re Vivendi Universal, S.A. Securities Litigation,118 the court held that whether a statement is actionable, “depends on all relevant circumstances of the particular case, and is generally not an appropriate basis on which to dismiss a complaint at this stage of the action.”119 The Vivendi court also took into account the speaker’s state of mind, rejecting defendant’s argument that statements that Vivendi was “financially solid” were not mere puffery, because plaintiffs pleaded sufficient facts to show that defendants could not reasonably have believed the statements when they made them.120

VIII. The Continuing Relevance of the Pre-Reform Act Case Law

Cases decided under the pre-Reform Act “speaks caution” doctrine remain relevant in safe harbor cases.121 Such cases are commonly cited on the issues of whether cautionary language is sufficiently meaningful,122 or whether a statement is forward-looking or one of present fact.123 One issue where courts relied heavily on the “speaks caution” doctrine is the accompanying requirement. In Rombach, the Second Circuit incorporated the doctrine’s “total mix” analysis in its ma-

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106 332 F.3d 854.
107 Id. at 869.
108 Id. (citing Raab v. Gen. Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993)).
109 375 F.3d 104.
110 Id. at 174 (citing Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1129-30 (2d Cir. 1994)).
112 Id. at *8 (citing Rosenzweig v. Azurix Corp., 332 F.3d 854, 869-70 (5th Cir. 2003); see also In re QLT, Inc. Sec. Litig., 314 F. Supp. 2d 526, 532-35 (S.D.N.Y. 2004).
114 Id. at *21.
115 Id. at *22.
117 Id. at 990.
118 In re Vivendi Universal, S.A. Securities Litigation, the court held that statements such as “the year-over-year improvement in gross margins illustrates the growing momentum in our software and technology license business” were not mere puffery because they were made by the CEO and CFO to the general public about the financial condition of the company, No. 00-CV-1014, 2004 U.S. Dist. LEXIS 12255, at *31 (E.D. Pa. July 12, 2004).
120 Id. at *63. Similarly, the Ong court declined to rule on the question of materiality because it “presents a mixed question of law and fact and requires ... determinations that are particularly appropriate for resolution by the trier of fact.” Ong v. Sears, Roebuck & Co., No. 03 C 4142, 2004 U.S. Dist. LEXIS 19425, at *105-06 (N.D. Ill. Sept. 24, 2004).
121 In re Vivendi, No. 02 Civ. 5571 (HB), 2003 U.S. Dist. LEXIS 19431, at *62-68.
122 See In re Donald Trump Casino Sec. Litig., 7 F.3d 357 (3d Cir. 1993).
teriality inquiry. 124 Similarly, the court in Stavros v. Exelon Corp. 125 imported the total mix analysis from “bespeaks caution” doctrine case law and determined that courts may consider cautionary language from other available sources. 126

The continued relevance of the pre-Reform Act cases should not come as a surprise because the Reform Act, in many respects, codified prior, judicially developed law. In addition, because the safe harbor provision does not apply by its terms to various types of transactions, 127 or to a number of entities, 128 we will continue to see cases rely on earlier doctrines.

IX. Conclusion
While courts differ in their applications of the safe harbor, there is enough case law to assist counsel in advising an issuer on how to make forward-looking statements with relative safety from liability. The cautious counsel will advise clients, among other things, to update cautionary language frequently, with an eye to internal and external indicators of risk; to segregate factual statements from forward-looking ones unless the facts form the basis for the predictions; to identify forward-looking statement with appropriate vocabulary, such as “anticipate” or “predict,” and a general identifying statement; and, at the very least, to refer to specific cautionary statements in SEC filings when making or oral predictions.

Appendix A
PRESS RELEASE CHECKLIST

Nine questions for U.S. securities law counsel to ask before an SEC-reporting company client issues a press release.

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1. **Rule 10b-5 Liability.** Is the release materially false or misleading within the meaning of Rule 10b-5?
   - Has it been reviewed by appropriate Company personnel – legal, investor relations, finance/accounting, relevant business units, etc.?
   - Has the Company complied with its disclosure controls and procedures maintained pursuant to Rule 13a-15?
   - Is the release consistent with previously disclosed information and, if not, how will the Company explain the inconsistency?

2. **Forward-Looking Statements.** Does the release contain a forward-looking statement?
   - Is the safe harbor under Section 21E of the 1934 Act available? Is the statement “identified as a forward-looking statement” and is it “accompanied by meaningful cautionary statements”?
   - Does the release create a duty to update the forward-looking statement – e.g., does it discuss future plans or intentions, how specific is it and what are investor expectations likely to be? See In re Time Warner Inc. Secs. Litig., 7 F.3d 259 (2d Cir. 1994); Weiner v. Quaker Oats, 129 F. 3d 310 (3d Cir. 1997). Should the release disclaim a duty to update?
   - Does the release provide earnings guidance? If so, does the Company have an existing practice of providing earnings guidance and is the guidance in the release consistent with that practice (e.g., in frequency and scope)? Will the release create new expectations about future guidance? Does the release omit guidance of the kind previously given (e.g., because the outlook is disappointing)? Does the guidance involve a non-GAAP
3. **Regulation FD.** Does the release contain material, non-public information within the meaning of Regulation FD?

- If so, does the release satisfy the "public disclosure" requirement of Rule 10(e) of Regulation FD or should it also be furnished/filed under Item 7.01/8.01 of Form 8-K (if not under Item 2.02, as discussed in 4 below)?

- Does the release contain information that has previously been or is to be disclosed in another manner (e.g., analysts meeting, press conference or industry conference)? If so, how do the timing requirements of Regulation FD ("promptly" vs. "simultaneously") apply? See also 4 below for earnings releases.

- Does the Company maintain a shelf-registration statement and, if so, should the release be "filed" rather than "furnished" on Form 8-K so that it can be incorporated by reference into the registration statement? Should the release be incorporated in its entirety or is it desirable for certain parts of the release (e.g., "puffery" or highly sensitive forward-looking statements) not to be incorporated? If the latter, consider "furnishing" the release under Item 7.01 (or Item 2.02 for earnings releases as described in 4 below) and as an exhibit under Item 9.01, but "filing" only the appropriate parts of the release, for example by restating the substance of those parts under Item 8.01.

- Is the Company a non-U.S. issuer and, if so, does it endeavor to comply with Regulation FD voluntarily? Should the release be "furnished" or "filed" on Form 6-K?

- Should the release be submitted to the stock market(s) where the Company is listed (see, e.g., NYSE Listing Manual Section 202.05)?

4. **Earnings Releases.** Does the release disclose material information about the Company's financial results or condition for a completed quarterly or annual fiscal period, such as a quarterly earnings release does?

- If so, the release must be included as an exhibit to a current report "furnished" or "filed" under Item 2.02 of Form 8-K.

- If the contents of the release are to be discussed in a webcast, conference call or other similar forum, does the release provide adequate notice of that discussion and will the Form 8-K be furnished/filed in advance? Will the discussion be "complementary", and will it occur within 48 hours after the issuance of the release? See Item 2.02(b) of Form 8-K.

- Has the release been reviewed by the audit committee and does the committee's charter require such review?

- Has the release been reviewed by the Company's outside auditors? Have they completed their SAS 100 review (in the case of a fiscal quarter) or their audit (in the case of a fiscal year) of the Company's financial statements for the corresponding period?

- Will the release be incorporated by reference into a Company registration statement? If so, should it be incorporated in its entirety or only in appropriate part (see 3 above)? Will the outside auditors be asked by underwriters to provide "comfort" on the release and are the auditors prepared to do so?

- Does the release discuss the Company's business segments consistently with prior SEC reports? Does the release contain new categories of information that investors may expect in the future?

- Does the release contain a non-GAAP financial measure (see 5 below)?

5. **Non-GAAP Measures.** Does the release contain a "non-GAAP financial measure" as defined in Regulation G?

- If so, is this measure accompanied by (1) the most directly comparable financial measure under GAAP and (2) a quantitative reconciliation of the differences between the non-GAAP and GAAP measures (note limited exception for forward-looking measures)?

- Can the Company rely on the exception for non-U.S. issuers or proposed business combinations (see Rule 100 (c) and (d))?

- If the release is to be "filed" on Form 8-K, does it comply with Item 10(e) of Regulation S-K?

  - Is the comparable GAAP measure presented with equal or greater prominence?

  - Does the release disclose (1) the reasons why management believes the non-GAAP measure is useful to investors and (2) any other material purposes for which management uses the non-GAAP measure (see Item 10(e)(1)(i)(C) and (D))?
6. **Securities Offerings.** Is the Company offering or planning to offer (or has it recently offered) securities for sale?

- If so, does the release constitute an “offer to sell” the securities for the purpose of Section 5 of the 1933 Act? If so, unless an exemption for the release is available, the release could result in gun-jumping (if a registration statement has not been filed) or be an illegal prospectus (after-filing), or constitute “general solicitation” or “directed selling efforts” that could preclude reliance on an exemption from registration (in a private placement or Regulation S offering).

- If an exemption for the release is necessary, does the release comply with Rule 135 (registered offering, pre-filing), Rule 134 (registered offering, post-filing), Rule 115c (unregistered offering) or Rule 135e (offshore press release of non-U.S. issuer)?

- Does the release contain material information that should be included or incorporated in the offering document?

7. **Proxy Solicitations.** Is the Company soliciting or planning to solicit proxies?

- If so, does the release constitute a “solicitation” subject to Regulation 14A?

8. **Form 8-K Requirements.** Does the release describe events or developments that trigger the reporting requirements of Form 8-K?

- See Items 1.01 through 9.01 of Form 8-K, which require reports about various events including events involving material definitive agreements, significant asset purchases or sales, earnings releases (see 4 above), on- or off-balance sheet obligations or related triggers, exiting a business, material impairments, problems with prior financial statements, unregistered sales of equity securities and changes in officers or directors.

- If so, will the Form 8-K include the disclosures required by the applicable Item and should those disclosures be included in the release?

- See also Instruction B.3 to Form 8-K—that the Company “previously reported” substantially the same information as required by Form 8-K, in which case no Form 8-K may be required?

- Does the event described in the release trigger other federal securities law reporting requirements (e.g., Section 13(d) or 16(a) of 1934 Act)?

9. **Collateral Consequences.** Does the release describe “crisis” or other negative events that may have collateral consequences under the federal securities laws?

- Will the release create concerns about confidentiality — e.g., on the part of regulators conducting an investigation announced in the release?

- An “accounting restatement” resulting from “misconduct” could require the CEO and CFO to disgorge certain compensation and trading profits under Section 304 of the Sarbanes-Oxley Act.

- Entry of a judicial or administrative order arising from a governmental action prohibiting or finding violations of antifraud provisions of
securities laws (or prohibiting other conduct relating to securities transactions) could disqualify the Company, absent an SEC waiver:

- From relying on the safe harbors for forward-looking statements (see Section 27A of 1933 Act and Section 21E of 1934 Act).

- From relying on certain exemptions from registration under the 1933 Act for small securities offerings (see, e.g., Rule 505 of Regulation D and Rule 262 of Regulation A).

- If the company is a financial institution, from engaging in certain investment advisory, broker-dealer or commodities business and could require SRO reporting (see, e.g., Section 9(a)(2) and (b)(2) of 1940 Act; Section 203(e) of Investment Advisers Act and Rule 206(4)-3; Section 15(b)(4)(C) of 1934 Act; Section 8(a)(2)(E) of CEA; NASD By-laws Article 3, Section 3 and Rule 3070; and NYSE Rules 351 and 476).