White Paper
Selected Characteristics of Recent Section 11 Cases Involving Initial Public Offerings

By G.M. Lawrence©

INTRODUCTION

In the United States, a public offering of securities, such as an initial public offering (IPO), must be registered with the Securities and Exchange Commission (SEC). Such securities are then issued pursuant to a registration statement and prospectus (collectively, offering documents) filed in accordance with the Securities Act. Under Section 11 of the Securities Act of 1933 (the Securities Act)[1], any person who purchases such a security on the basis of offering documents that contain a material misstatement or omission has a private cause of action.[2] Although the determination of materiality depends on both the context in which a statement or omission was made and the connection between the issuer's actual statement and other factors, courts generally consider something material if a reasonable investor, considering the "total mix" of information, would deem it important to his investment decision.[3]

In an IPO context, plaintiffs often are a class of individuals and/or institutions who purchased securities in the IPO. Defendants typically include one or more of the issuer and its directors and officers; signatories of the registration statement; underwriters; accountants and other experts. Unlike claims brought under the anti-fraud provisions of the Securities Exchange Act of 1934, Securities Act claims do not require plaintiffs to prove scienter (*i.e.*, culpable state of mind), but merely the presence of a material misstatement or omission.

Issuers are strictly liable for material misstatements and omissions, but other potential defendants, including underwriters and directors, have two affirmative due diligence defenses under Section 11. The first is the "reasonable investigation" defense which applies to non-expertized material. The second is the "reasonable reliance" defense which applies to expertized material. In both instances, "reasonableness" is defined as what a reasonable person in a similar context would have done in the management of his or her own property.[4] The standard is applied using a "sliding scale" wherein the bar for establishing reasonableness is higher for insiders, such as officers and inside directors, than for outsiders such as underwriters and outside directors.[5] Thus, what constitutes a reasonable investigation or reasonable reliance in one context may or may not be sufficient in another context. This means that there is no "one-size-fits-all" approach to a reasonable investigations or reasonable reliance, nor is there safe harbor list of specific steps or practices that investigators can follow in every setting or circumstance to achieve "reasonableness."

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[1] 15 U.S.C. § 77k and 15 U.S.C. § 77l.

[2] 15 U.S.C. § 77k.

[3] *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224, 231–32, 108 S. Ct. 978, 983, 99 L.Ed.2d 194 (1988).

[4] 15 U.S.C. § 77k.

[5] *See, e.g.*, Federal Housing Finance Agency v. Nomura Holding America, Inc., No. 11cv6201 (S.D. N.Y., Dec. 18, 2014) ("As these factors suggest, there is a 'sliding scale' in the diligence required of parties, with heavier demands of those with more central roles and greater access to the information and expertise needed to confirm the accuracy of the registration statement."); WorldCom, 346 F. Supp. 2d at 675 ("Feit [referring to Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971)] insists that '[w]hat constitutes reasonable investigation and a reasonable ground to believe will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data.").

This white paper focuses on recent industry, defendant and allegation trends in class action lawsuits involving IPOs brought under Section 11, and is based on aggregate information from a range of published databases over the three-year period between 2014 and 2016. These suits typically allege material misstatements or omissions in the offering documents relating to historical or projected financial information, inadequate risk disclosure and/or fraud. Defendants usually include the issuers, directors, underwriters and accountants, among others.

THE HISTORY BEHIND THE TREND

Before examining the recent trendline data regarding Section 11 class action lawsuits, it is helpful to have some perspective regarding the history of the Section 11 due diligence defenses.

For nearly 35 years after passage of the Securities Act, no court substantively addressed the due diligence defenses or the kinds of conduct required to assert them successfully. However, in 1968, Judge McLean of the Federal District Court for the Southern District of New York issued what *The Wall Street Journal* called a "Legal Blockbuster,"[6] *Escott v. BarChris Construction*, the first fulsome judicial examination of these matters.[7]

In a lengthy and sometimes nuanced opinion, the Court ruled that the offering documents contained material misstatements and omissions, and that the due diligence conducted by the underwriters, directors, officers and accountants did not meet the statutory standard of "reasonableness." Thus, *BarChris* marked the beginning of an era of increasing judicial scrutiny of the affirmative due diligence defenses under the Securities Act.

In the nearly 60 years since the *BarChris* ruling, courts have issued a modest but steady stream of decisions addressing the due diligence defenses. Notable among these is Judge Cotes' denial of the underwriters' motion for summary judgment *In re WorldCom Securities Litigation.*"[8] In that case, the court held that audited financial statements (a form of expertised material that, for many decades, courts had confirmed did not require a "reasonable investigation" but rather only "reasonable reliance") may contain "red flags" that require investigation. Understandably, the ruling sent shockwaves through the industry, in part because it rejected Justice Powell's dissenting opinion in *John Nuveen & Co. v. Sanders* that "almost by definition, it is reasonable to rely on financial statements certified by public accountants."[9] And, more recently, Judge Cote ruled in

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[6] The Wall Street Journal, May 14, 1968, at 1, col. 6.

[7] Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

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

[9] Sanders v. John Nuveen & Co., 619 F.2d 1222, 1228 (7th Cir.1980), cert. denied, 450 U.S. 1005, 101 S. Ct. 1719, 68 L.Ed.2d 210 (1981). Justice Powell further observed that reliance on certified financial statements "is essential to the proper functioning of securities marketing, to the trading in securities, to the lending of money by banks and financial institutions, and to the reliance by stockholders on the reports of their corporations." Id., 450 U.S. 1005 at 1010, note 4. He also stated that "where breaches by accountants occur, it is the accountants themselves—not those who rely in good faith on their professional expertise—who are at fault and who should be held responsible." Id. Note that he used the term "certified" not "audited" thus leaving open the issue of whether his comments should apply both to audited information and unaudited information which is the subject of an auditor's comfort letter.

FHFA v. Nomura[10] that the underwriter's due diligence was not reasonable as a matter of law, the first ever ruling of its kind.

The collective impact of these kinds of rulings has been a marked increase in due diligence based securities litigation. For example, according to a recent study conducted by Stanford Law School Securities Class Action Clearinghouse and Cornerstone Research, 226 new federal class action securities cases were filed in the first six months of 2017, a number that was "135 percent above the 1997–2016 historical semiannual average of 96 filings and the highest filing rate since the Securities Clearinghouse began tracking these data."[11] By understanding the characteristics of recent Section 11 class action lawsuits, defendants may be better positioned to make decisions about the nature and character of their due diligence and reliance in pending and future securities offerings.

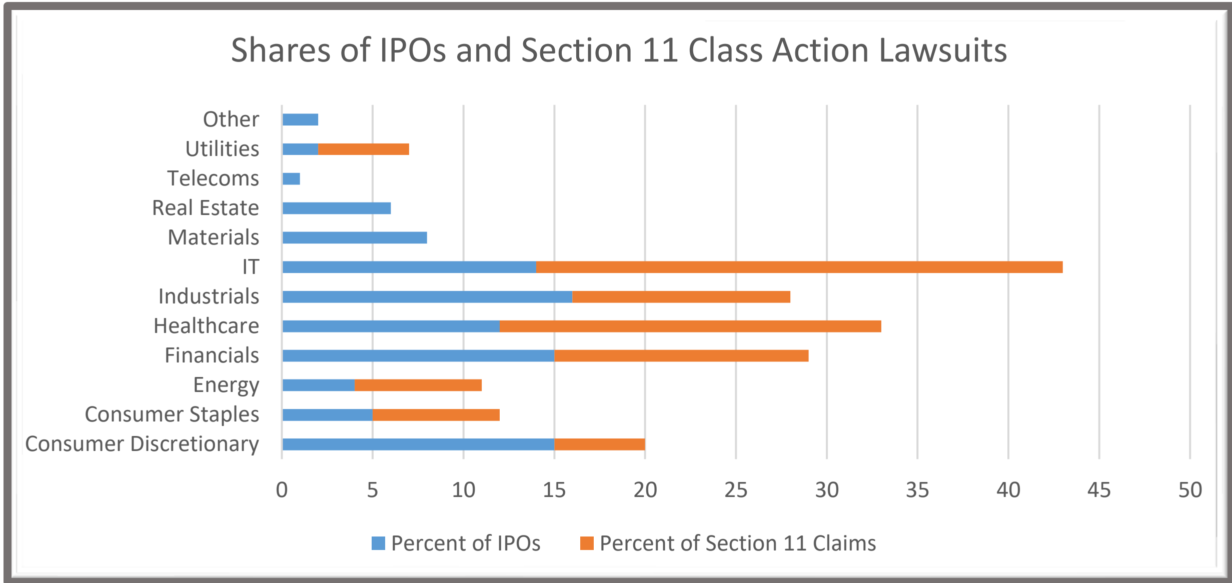
RECENT TRENDS

To better understand the current class action securities litigation landscape for IPOs and the role of the due diligence defenses in those cases, it is instructive to examine various characteristics of the industries, defendants and allegations involved. Following are several charts reflecting aggregate information from a range of public and private databases.

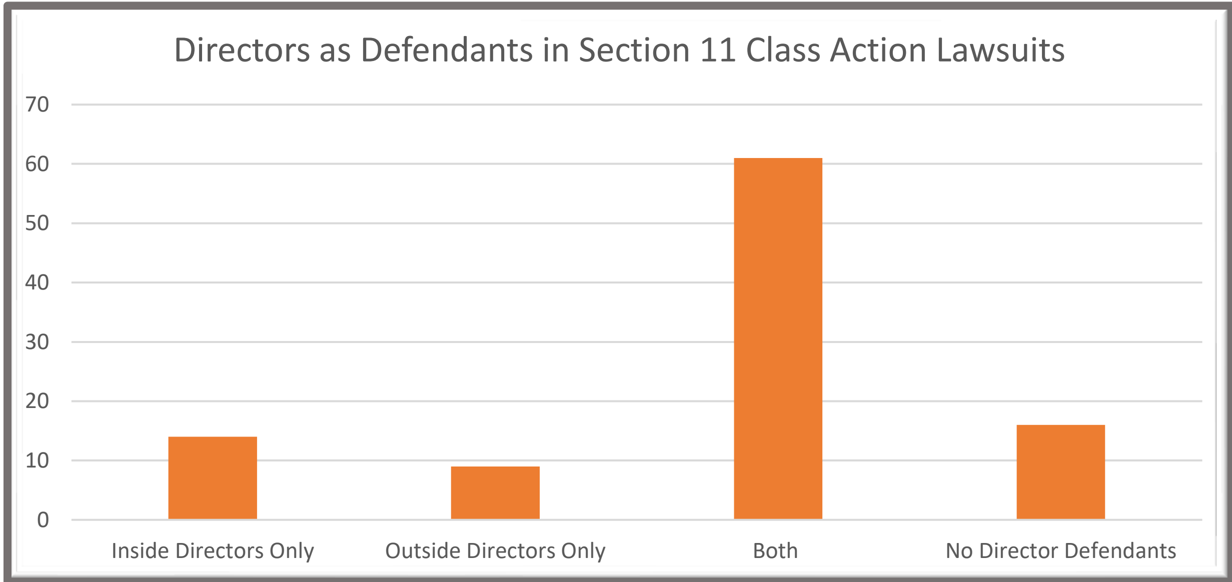
The first chart compares the number of IPOs across different industries with the number of suits involving Section 11 allegations related to IPOs over the three-year period between 2014 and 2016. As is evident from this chart, the share of IPOs and suits with Section 11 allegations are approximately equal for most industries. However, information technology, for example, has a share of Section 11 lawsuits approximately twice that of its IPOs. And, consumer discretionary has a share of Section 11 lawsuits that is approximately one-third of its share of IPOs. Thus, different industry sectors have different levels of risk regarding such claims.

[10] Federal Housing Finance Agency vs. Nomura Holding America, Inc., 68 F.Supp.3d 439 (S.D.N.Y. 2014). At the time of publication of this white paper, the ruling is before the Second Circuit on appeal.

[11] https://corpgov.law.harvard.edu/2017/08/07/federal-class-action-securities-fraud-filings-hit-record-pace-in-h1-2017/.



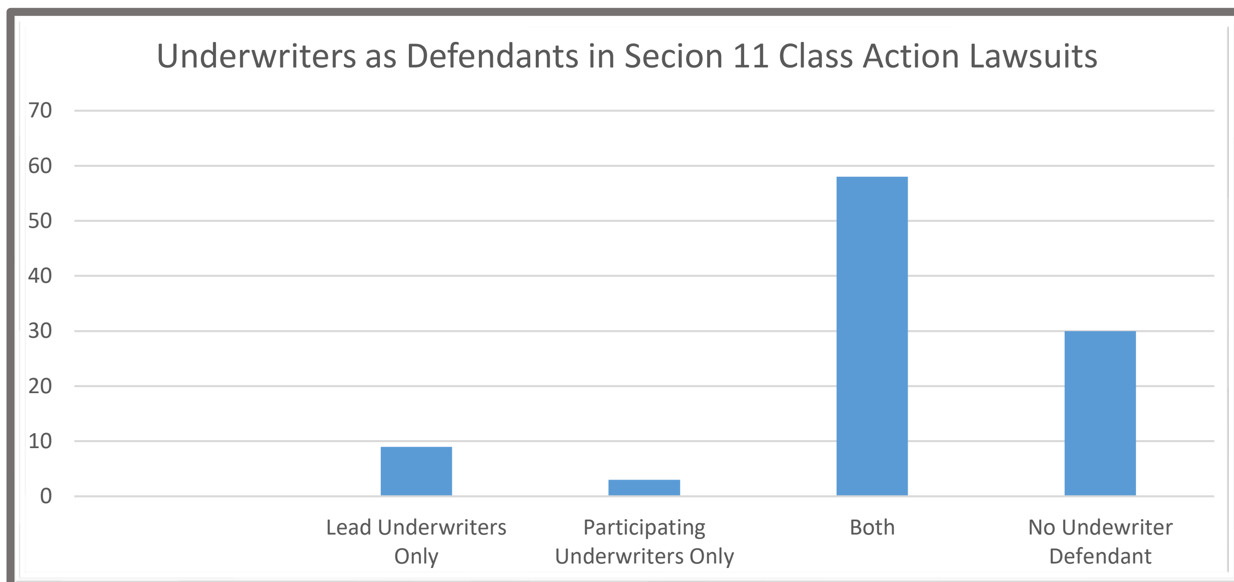
Moreover, different potential defendants have different risk exposure to class action securities lawsuits. Most important among these are directors and underwriters, each of which is named in a high percentage of such lawsuits. For example, directors were named in approximately 85% of the sample, as shown by the following chart.



The preponderance of these cases named both inside and outside directors as defendants.[12]

[12] There is no statutory definition of what constitutes an inside or outside director. Categorization of the directors as inside or outside here is based on descriptions in the reviewed complaints.

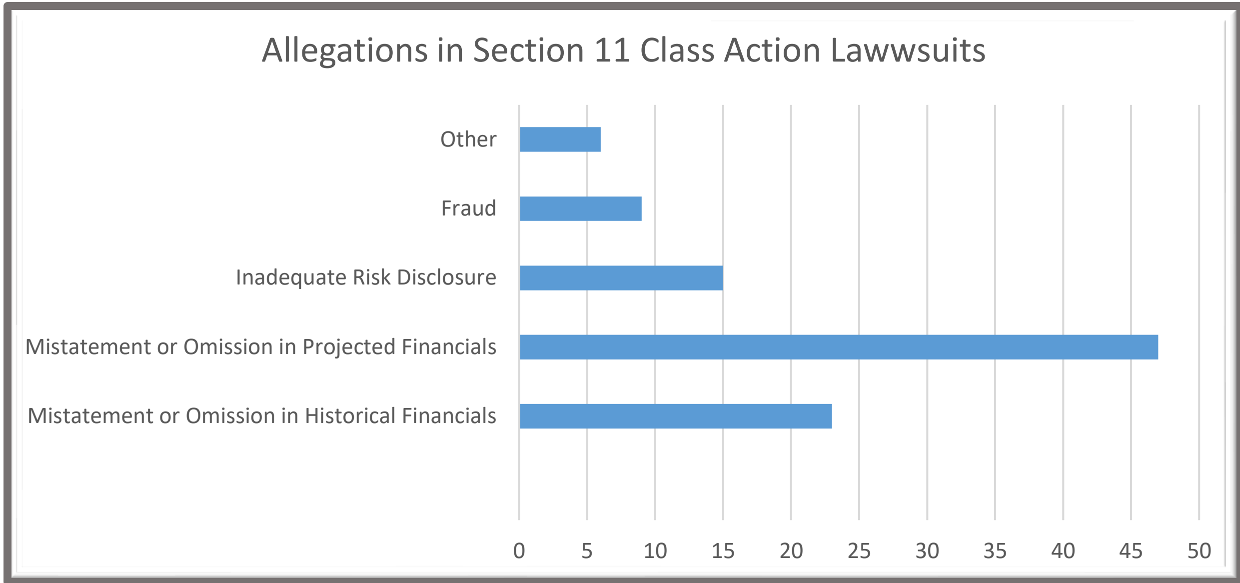
Over 70% of the sampled Section 11 class action lawsuits named lead and/or participating underwriters as defendants.[13] The following chart shows the share of suits that include allegations against underwriters by role.



Thus, over half of the cases sampled named both lead and participating underwriters, while lead underwriters alone were only named in 9% of cases. Participating underwriters only were named in just 3% of cases.

Finally, it is also instructive to consider the specific types of allegations made in Section 11 cases, as different allegations can have different implications for the nature and scope of due diligence that courts may require of directors, underwriters, and others. As the chart below shows, nearly half of the sampled Section 11 cases involved allegations of a misstatement or omission regarding *projected* financial information, with the remainder including alleged misstatements of *historical* financial information, failure to disclose risks, and failure to disclose existence of fraud. This distribution, however, varied among industries. For example, the largest proportion of Financial Industry claims in these cases involved alleged fraud (43%) whereas for Information Technology and Healthcare the largest proportion (69% and 56%, respectively) involved alleged projected financial performance misstatements and/or omissions.

[13] Categorization of the underwriters as lead or participating is based on descriptions in the reviewed complaints and prospectuses.



CONCLUSION

As shown in the recent Stanford/Cornerstone analysis cited above, the number of class action securities litigation claims under Section 11 continues to grow. Moreover, directors and underwriters are frequently named among the defendants in those cases. By understanding the characteristics of recent Section 11 class action lawsuits, defendants may be better positioned to make decisions about the nature and character of their due diligence and reliance in pending and future securities offerings.

ABOUT THE AUTHOR

G. M. Lawrence is a prominent transactional and due diligence scholar whose academic work has been cited authoritatively in numerous publications, by the Federal District Court for the Southern District of New York and in pleadings before the Supreme Court of the United States. He also has advised the U.S. Securities and Exchange Commission regarding such matters and has served as a consulting expert in a number of high profile cases.

Professor Lawrence is a member of the adjunct faculty of the Dedman School of Law of Southern Methodist University where he teaches due diligence studies to MBA, JD and LLM candidates, the founder and executive director of the independent Center for Advanced Due Diligence Studies, and managing principal of Applied Research & Analytics, a consulting firm. He also is executive chairman of the investment firm, Pacific Financial Group.

He is the author of the two-volume treatise Due Diligence in Business Transactions, a leading work in the field for more than 20 years, and the graduate textbooks Due Diligence, Reliance and Verification: Law, Standards and Practice; Due Diligence: Law, Standards and Practice and Due Diligence, a Scholarly Study. He is co-author of the treatise Representing High Tech Companies. Recently, he served as Visiting Due Diligence Scholar in Residence at the University of London.

Professor Lawrence holds a FINRA Series 65 license, a professional certification in Strategic Decision and Risk Management from Stanford University's Center for Professional Development and a J.D. degree from Vanderbilt University Law School.

He is a current or former member of or active in, among others, the Securities Industry and Financial Markets Association Compliance and Legal Society, Investment Management Consultants Association, the National Association of Retirement Plan Advisors, the National Association of Corporate Directors, the Society of Decision Professionals, the Global Association of Risk Professionals, the Society for Judgment and Decision Making, the Academy of Financial Services and the American Securitization Forum, and has been admitted to the state bars of New York, the District of Columbia and Texas.

Previously, Professor Lawrence was a global managing partner with a global law firm where he founded and taught the firm's due diligence training program, managed the firm's investment fund and chaired the technology, media and telecommunications practice. He was a member of the firm's management, strategic planning, compensation and other committees. Professor Lawrence also has served on the board of directors and various committees of public and privately held companies.