WHITE PAPER

UNDERSTANDING THE FOUR DIMENSIONS OF CONTEXT

BY G.M. LAWRENCE©

INTRODUCTION

What constitutes reasonable due diligence and reliance can only be determined with reference to the context in which the investigation or decision to rely was taken.[1] The ABA Task Force on Seller's Due Diligence and Similar Defenses under the Federal Securities Laws expressed this concept as follows:

> "as a standard of conduct, 'reasonableness' is meaningless except in a specific factual context."[2]

Moreover, the formal report of the SEC's Advisory Committee on Corporate Disclosure[3] stressed that due diligence related decisions, including with respect to reliance, are "judgmental in nature" and impossible to "translate into a numerical formula."[4]

Thus, there is no "one-size-fits-all" approach to a reasonable investigation or reliance, nor is there a safe harbor list of specific steps or practices that investigators must follow in every setting or circumstance to achieve "reasonableness." Regarding reasonableness, context is the essential element.

This white paper examines the four dimensions of context that are relevant considerations in the determination of reasonableness of due diligence and reliance, and gives examples of each.

FOUR DIMENSIONS OF CONTEXT

Context has four dimensions—transactional, situational, positional and temporal.

Transactional Context

Does the diligence investigation in question relate to a public offering of securities, a private placement of securities, a negotiated transaction, a lending transaction, investment advisor or investment steward activities, or some other commercial setting? Different transactions can involve different due diligence and different degrees of reliance.

Situational Context

© Copyrighted material. No reproduction without the author's consent.

[1] *See, e.g.*, SEC Rule 176 which sets forth several contextual elements that it considers relevant to the determination of reasonableness of a party's due diligence. The Commission's adopting release clarified that these factors are not exclusive and that there might be other circumstances which bear upon the issues of the reasonableness of the investigation. *See* Circumstances Affecting Reasonableness Release 6335.

[2] American Bar Association Comm. on Federal Regulation of Securities, Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws, 48 BUS. LAW. 1185, 1232 (1993) at 1232.

[3] REPORT OF ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION, House Committee on Interstate and Foreign Commerce, Report of the, 95th Cong., 1st Sess. (U.S. Gov. Printing Office, Nov. 3, 1977).

[4] *Id.*

What is the nature of the transaction, the securities involved, the prior course of dealing among the parties, the level of risk involved, the budget for conducting the investigation, the complexity or expert nature of the issues to be investigated, the sophistication of the parties and similar factors? Different situations can involve different due diligence and different degrees of reliance.

Positional Context

Is the party conducting the due diligence a buyer, seller, borrower, lender, issuer, professional services firm, investment banker or other participant? Different positional contexts can involve different due diligence and different degrees of reliance.

Temporal Context

What were the customary practices and standards at the time in question as opposed to some later or different time? Diligence practices evolve over time to take account of experience, good and bad. Therefore, what constitutes a reasonable investigation or reasonable reliance may vary over time, and the law, standards, and practice must be judged without the benefit of hindsight or subsequent events knowledge.

OVERVIEW OF COMMON TRANSACTIONAL CONTEXTS

A. Registered Public Offerings

A registered offering of securities is the offer for sale of an issue of securities (such as common stock, preferred stock, bonds, notes, derivatives such as residential mortgage backed securities or similar financial instruments) to the investing public after the filing of a registration statement and other offering documents with the SEC. Such offerings may be further categorized as traditional offerings (for example, an initial public offering),[5] which commonly involve a more extended period for the conduct of current due diligence, or expedited offerings (such as a shelf takedown)[6] where the time available for current due diligence can be severely limited, sometimes involving only a matter of days. Public offerings are a particularly important transactional context in due diligence because many of the modern origins of customary standards and practice were developed in that context.[7] Therefore, public offerings are among the most useful and informative transactional contexts for the study of due diligence and reliance.

B. Private Placements

A private placement is an issuance of securities is exempt from the registration requirements of Section 5 of the Securities Act[8] and therefore is not required to be

---

[5] *See generally*, Joseph K. Leahy, *The Irrepressible Myths of BarChris*, 37 DEL. J. CORP. L. 411 (2012).

[6] *See generally*, Andrew Seth Bogen, *The Impact of the SEC's Shelf Registration Rule on Underwriters' Due-Diligence Investigations*, 51 GEO. WASH. L. REV. 767 (1983).

[7] FINRA is the primary standards setting body for underwriters, however other standards setting bodies address customary practice and standards in this and other contexts. *See, e.g.*, MSRB, ASF, and the "Prudent Practices" series published by the CFS which are directed at investment advisor and investment steward due diligence (and other practices).

[8] Sections 3(b) and 4(2) of the Securities Act set forth the general terms of these exemptions which apply to "exempt securities" and "exempt transactions." Most commonly, private placements are made as "exempt transactions" under Section 4(2) and Regulation D promulgated thereunder. Regulation D is a series of six rules, Rules 501-506, establishing certain transactional exemptions from the registration requirements of the Securities Act. 17 CFR §§ 230.501 *et seq*.

registered with the SEC.[9] Private placements typically are sold either directly by the issuer to the investor without an intermediary such as an underwriter in the public context) or through a participating or executing intermediary such as a broker-dealer in the private context. While exempt from registration, private placements are subject to the anti-fraud provisions of the Exchange Act, and various state laws. Just like public offerings, private placements typically involve due diligence and reliance.[10]

C. Negotiated Transactions

A second category of transactions in which due diligence issues typically arise is "negotiated transactions," a term of art generally referring to mergers, acquisitions, joint ventures and lending transactions. Negotiated transactions have a buy-side and a sell-side. Buy-side, as the name implies, refers to the parties acting on behalf of the purchaser (which can be a public or private company), lender, or similarly positioned joint venturer. Sell-side refers to the parties acting on behalf of the seller (which also can be a public or private company), borrower or similarly positioned joint venturer.

D. Financial Services

A fourth category in which transactional due diligence issues typically arise involves the provision of financial services by investment advisors and investment stewards. Such parties manage or invest funds and perform related activities conduct due diligence (or reasonably rely on others to do so) into the investments considered and/or made. While there is no self-regulating organization similar to FINRA that sets standards and mandates conduct for investment advisors and investment stewards, there is an abundance of informative sources that provide guidance regarding customary standards and practice.[11] Among these are the CFS[12] which has published the two leading standards-articulating works in the field, *Prudent Practices for Investment Advisor*" and *Prudent Practices for Investment Stewards*, and the MFA,[13] which has published *Sound Practices for Hedge Fund Managers*.

EXAMPLES OF POSITIONAL CONTEXT

The range and complexity of matters involved in a business transaction can be extensive. No one investigator, however capable or dedicated, can conduct the entirety of a diligence investigation on his or her own. Instead, due diligence requires a multi-disciplinary team of principals, attorneys, accountants and others tailored to the context, with team members relying not only on their own work but of that of others. As the SEC has observed, reasonable reliance is a fundamental tenet of due diligence and a part of a reasonable

---

[9] *See generally*, Robert N. Rapp, *Due Diligence: A Newly Demanding Legal and Regulatory Environment*, published in American Law Institute-American Bar Association Continuing Legal Education ALI-ABA Course of Study Regulation D Offerings and Private Placements (March 17-19, 2011).

[10] *See, e.g.*, FINRA Regulatory Notice 10-22: Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings (April 2010).

[11] *See, e.g.*, CORPORATE DIRECTOR'S GUIDEBOOK; Center for Corporate Governance at http://www2.deloitte.com/us/en/pages/center-for-corporate-governance/topics/board-governance.html; Stanford University Rock Center for Corporate Governance at http://rockcenter.law.stanford.edu/; National Association of Corporate Directors at https://www.nacdonline.org/; and other informative works by scholars and practitioners.

[12] http://www.fi360.com/center-for-fiduciary-studies.

[13] https://www.managedfunds.org/industry-resources/.

investigation and the exercise of reasonable care.[14] Following is brief overview of some of the parties who often are part of the multi-disciplinary due diligence team.

A. Issuers

Under Section 11 of the Securities Act, issuers in a public offering are strictly liable for material misstatements and omissions in their securities offering documents. They do not have a due diligence defense under Section 11 (though they may have a due diligence defense under state laws[15]). Issuers also may be liable as sellers under Section 12(a)(2) of the Securities Act but are generally considered to have no practical access to that Section's "reasonable care" defense. In addition, issuers may be liable under Section 10(b) and Rule 10b-5 of the Exchange Act in the case of fraud.

The strict liability standard applicable to issuers, however, does not mean that they are not interested in conducting reasonable due diligence. To the contrary, issuers arguably have the greatest interest in conducting reasonable due diligence. While all the parties involved in a securities offering may be thought of as tight ropewalkers, from a due diligence perspective, issuers may be thought of as tightrope walkers without a net.

B. Officers and Directors

The strict liability of issuers does not apply to an issuer's officers and directors. They are entitled to assert a "reasonable investigation" or "reasonable reliance" defense under Section 11 and a "reasonable care" defense under 12(a)(2) with respect to any alleged material misstatements and omissions in the offering documents. However, the burden of establishing those defenses for officers and inside directors (as distinct from outside directors) has generally been interpreted as increasing with the degree of informational access and influence such party possessed.[16] Thus officers and inside directors commonly must meet a higher bar (though the standard remains the same) in establishing the "reasonableness" of their investigations.[17]

---

[14] *See, e.g.*, SEC Rule 176 codified at 17 CFR 230.176, at 176(f).

[15] Under some state statutes, issuers may have a due diligence defense. *See, e.g.*, Ohio Rev Code § 1707.043 (2014) which appears to offer a "reasonable diligence" defense to issuers as well as others ("1707.29 Presumption of knowledge. In any prosecution brought under sections 1707.01 to 1707.45 of the Revised Code, except prosecutions brought for violation of division (A) of section 1707.042 of the Revised Code, the accused shall be deemed to have had knowledge of any matter of fact, where in the exercise of reasonable diligence, he should, prior to the alleged commission of the offense in question, have secured such knowledge.").

[16] *See, e.g.*, Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971) [hereinafter, "Feit"].

[17] With respect to the "reasonable investigation" defense for inside directors, courts have held that officers and inside directors are liable "in practically all cases of misrepresentation" and "[t]heir liability approaches that of the issuer as guarantor of the accuracy of the prospectus." Feit, 332 F. Supp. at 578. *See also*, *Comment, BarChris: Due Diligence Refined*, 68 COLUM. L. REV. 1411, 1420 (1968) ("This ruling suggests that an inside director who, either as an officer or in some other capacity, has intimate familiarity with the corporate affairs or handles major transactions, especially those as to which false statements or omissions appear in the prospectus, is least able to establish due diligence. BarChris indicates that for such an individual knowledge of the underlying facts precludes showing 'reasonable ground to believe' or belief in fact as to the truth of the non-expert statements. In substance, there is a strong though theoretically rebuttable presumption that he had no reasonable ground to believe or belief in fact that the registration statement was accurate. Since an individual so situated will also have difficulty showing an absence of reasonable grounds of belief or belief in fact that expertised portions contain no misleading statements or omissions, a similar although less weighty presumption is present there. It would be fair to say that this postulated presumption arises when the intimate connection of the individual with the affairs of the issuer is demonstrated. Such an individual comes close to the status of a guarantor of accuracy. Ernest L. Folk, III, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 1 SEC. L. REV. 3, 25 (1969) (reprinted from 55 VA. L. REV. 1 (1969).

The nature of an officer's and/or inside director's role often makes it difficult for him or her to avoid liability through a due diligence defense, because they are perceived as having an "intimate knowledge of corporate affairs and of … particular transactions."[18] Conversely, outside directors[19] are "under a lesser [due diligence] obligation,"[20] and rely on management, underwriters, attorneys and auditors regarding various aspects of due diligence.[21]

Like other transactional participants, officers and directors conduct due diligence and rely on others for many reasons including to avail themselves of the due diligence defense, to limit post-closing disputes and litigation and to safeguard their reputations.

C. Underwriters

Like officers and directors, underwriters are entitled to assert a "reasonable investigation" or "reasonable reliance" defense under Section 11 and a "reasonable care" defense under 12(a)(2) with respect to any alleged material misstatements and omissions in the offering documents. Many judicial decisions related to reasonable investigation, reasonable care and reasonable reliance focus on the activities of underwriters in public offerings of securities.[22]

Securities underwriting refers to the process in a public offering by which investment banks raise capital for issuers by buying securities from the issue (a "firm commitment" underwriting)[23] then sell them to investors, or by using their best efforts (a "best efforts" underwriting) to facilitate the issuer's direct sale of the securities to such investors. Underwriters also may advise the issuer regarding the structure of the offering, the pricing of the securities, the marketing of the securities and the after-market for the securities. Along with its multidisciplinary team, the lead underwriter(s) conducts due diligence into the material accuracy and completeness of the statements made in the offering documents and relies on experts and others regarding areas it has not independently investigated.

---

[18] Feit, 332 F. Supp. at 577-78.

[19] *See, e.g., Id*. and Worldcom, 2005 WL 638268 (S.D.N.Y. 2005) at *5-6. *See also*, Laven v. Flanagan, 695 F. Supp. 800 (D.N.J. 1988).

[20] Laven, 695 F. Supp. at 812 outside directors are "under a lesser obligation to conduct a painstaking investigation than an inside director" may rely heavily on representations of management, attorneys, auditors and underwriters).

[21] *See generally*, BarChris, 283 F. Supp. at 697 ("It is impossible to lay down a rigid rule suitable for every case defining the extent … [of a defendant's due diligence]. It is a question of degree, a matter of judgment in each case."); Weinberger v. Jackson, No. C-89-2301-CAL, 1990 WL 260676, at *4 (N.D. Cal. Oct. 11, 1990) (outside directors are "not obliged to conduct an independent investigation into the accuracy of all the statements contained in the registration statement"); Laven, 695 F. Supp. at 812 (outside directors are "under a lesser obligation to conduct a painstaking investigation than an inside director" and may rely solely on representations of the company's management, external auditors, or underwriters); Feit, 332 F. Supp. at 577-78 (E.D.N.Y. 1971) (stating that inside directors "with intimate knowledge of corporate affairs and of the particular transaction" will be held to a different standard than outside directors who do not). *See also*, CORPORATE DIRECTORS' GUIDEBOOK (1994 ed.) ("As a general rule, directors are not expected to verify independently the accuracy of underlying facts contained in the periodic reports filed with the SEC. However, they should be alert for any material inaccuracies or omissions of information in such reports and should satisfy themselves that there are procedures in place reasonably designed to ensure the timeliness, accuracy, and completeness of corporate reports.") at 49.

[22] *See, e.g.*, Feit, 332 F. Supp. 544; BarChris, 283 F. Supp.643; Int'l Rectifier, No. CV91-3357-RMT (BQRX), 1997 WL 529600; and Worlds of Wonder Sec. Litig., 814 F. Supp. 850, among others.

[23] However, in some instances, underwriters agree to use best efforts to sell the securities for the issuer and do not buy them directly (a "best efforts" underwriting). *See, e.g.,* http://www.investopedia.com/terms/b/bestefforts.asp.

Lead underwriters conduct due diligence and rely on others for many reasons including to avail themselves of the due diligence defense, to limit post-closing disputes and litigation, to safeguard their reputations and business franchises[24] and to protect their customers (the investors) who are the ultimate purchasers of the securities.

D. Broker-Dealers

While they are exempt from registration, private placements can involve due diligence issues, especially with respect to the conduct of broker-dealers. In a private placement, a broker-dealer can be either: (i) a participating broker-dealer who participates in the preparation of the offering documents or (ii) an executing broker-dealer who merely executes the trade and is not involved in the preparation of the offering documents. A simple way to conceptualize a participating broker-dealer (as opposed to an executing broker-dealer that merely executes a trade and is not involved the preparation of the offering documents[25]) is as an underwriter for a private placement of securities. An executing broker-dealer, on the other hand, is merely the conduit through which the trade is consummated, like a real estate broker in a residential context. Given their limited role, courts have held that executing broker-dealers do not have an obligation to conduct due diligence.[26]

Despite the inapplicability of the Section 11 and 12(a)(2) due diligence defenses in a private placement, FINRA has made clear that participating broker-dealers have an affirmative obligation to conduct reasonable due diligence and to rely reasonably. Thus, like lead underwriters, participating broker-dealers conduct due diligence and rely on others for many reasons including complying with their regulatory obligations, challenging an allegation of scienter in an anti-fraud suit brought under the Exchange Act, limiting post-closing disputes and litigation, safeguarding their reputations and business franchises and protecting investors.

E. Buyers, Sellers and Joint Venturers

In negotiated transactions, there are no affirmative due diligence defenses under Section 11 or 12(a)(2), however all parties typically conduct some level of due diligence. The extent and character of that diligence varies with context. In most contexts, the primary burden of due diligence in a negotiated transaction tends to fall on the buy-side. Buy-side refers to the parties acting on behalf of the purchaser, lender or similarly situated joint venturer. However, sellers (including borrowers and similarly situated joint venturers) may also conduct due diligence.

While such parties may have any number of reasons for conducting due diligence and relying on others, they typically do so to protect their investments (in the case of the buy-

---

[24] *See* Corwin & Schultz at 449 ("Of course, an underwriter's reputation and ability to certify an IPO is harmed if the underwriter participates in the syndicates of mispriced IPOs.").

[25] *See, e.g.*, BNP Paribas Mortg. Corp. v. Bank of America, N.A., 866 F. Supp.2d 257 (S.D.N.Y. 2012) regarding the limited diligence obligations of a broker-dealer who merely executes a trade and was not involved in drafting the offering documents (in this treatise, the terms "participating broker-dealer" and "executing broker-dealer" are used to denote these different roles).

[26] *Id.*

side), to confirm the accuracy of the representations and warranties they are making (in the case of the sell-side) and to limit the risk of post-closing disputes and litigation.

F. Lenders, Borrowers, Guarantors and Administrative Parties

Lenders are the functional equivalent of the buyer in a purchase and sale or merger/acquisition context. The borrower and any guarantors are the functional equivalents of a seller. The term "administrative parties" refers to third parties (who sometimes have fiduciary or other obligations in addition to those set forth in their services agreements) that sometimes are involved in certain types of negotiated transactions. Common examples include collateral agents and trustees in asset backed commercial paper or other collateralized securitizations. Because administrative parties typically fulfill any of several investor protection roles (*e.g.*, monitoring collateral value, confirming covenant compliance, assessing defaults, etc.), they commonly have an interest in conducting both initial and ongoing (monitoring) due diligence.

Lending transaction participants also can have varying reasons for conducting due diligence and relying on others. These may include protecting the lender's investment in the borrower (in the case of the buy-side), assuring the accuracy of a borrower's representations and warranties (in the case of the sell-side), fulfilling contractual or other obligations (in the case of administrative parties), compliance with applicable law and minimization of post-closing disputes.

G. Accountants and Other Subject Matter Experts

Section 11 lists accountants, engineers and appraisers as examples of experts. In general, experts are parties who hold themselves out as having subject matter expertise, though not all such persons are considered experts in due diligence. For example, attorneys are not typically Section 11 experts.[27] Other investigators are permitted to reasonably rely on the due diligence conducted by experts with respect to expertised statements contained in the offering documents and have a "reliance defense" for those statements.

Under Section 11, experts may assert a due diligence defense with respect to their expertised statements. To establish the defense, the expert must prove that:

> "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[28]

Accountants and other experts conduct due diligence and rely on others for several reasons including their own due diligence defense, complying with applicable laws and regulations, protecting their reputations and minimizing post-closing disputes.

---

[27] For example, attorneys are legal experts, but they are not generally considered experts in this context unless they have expressly expertized material contained in the offering documents.

[28] Securities Act, Section 11(b)(3)(B)(i).

H. Attorneys

In most contexts, attorneys are not experts for purposes of Section 11 and therefore do not have an affirmative due diligence defense, unless the attorney has consented to be named as an expert in the offering documents and has expertised a portion of a registration statement.[29] Regardless of whether they are deemed "experts," attorneys typically are important actors in due diligence investigations, and sometimes are named as defendants in litigation.[30] Due diligence based claims against them tend to be based either on: (i) primary liability, in which the defendants assert that the professionals knew or should have known of the material misstatements or omissions in the registration statement, or (ii) secondary liability, where the defendants allege that the attorney assisted, aided or abetted the issuer in connection with an alleged violation of law.

Virtually every business transaction involves some level of due diligence by attorneys. For example, in a public offering, counsel to underwriters is typically active in the overall due diligence investigation. The attorney or law firm often leads the legal due diligence investigation into such areas as regulatory matters and, sometimes, disclosure. Attorneys may also work closely with parties conducting the business, financial and accounting due diligence. In negotiated transactions, buyer's counsel often plays a role in buy-side due diligence, and seller's counsel may act in a similar capacity on the sell-side. In lending transactions, both lender's counsel and borrower's counsel tend to be active participants due diligence.

Attorneys conduct due diligence and rely on others for various reasons including complying with applicable law and regulations, satisfying applicable standards of practice and minimizing post-closing disputes.

I. Investment Advisors and Investment Stewards

Given the context in which they work, investment advisors and stewards typically do not have an affirmative due diligence defense. However, they conduct investment strategy due diligence, operational due diligence or both. Investment advisors and investment stewards conduct due diligence and rely on others for various reasons including managing risk, complying with law, fulfilling fiduciary and regulatory obligations, protecting institutional and personal reputations and minimizing the risk of post-closing disputes.

CONCLUSION

The concept of reasonableness as applied to due diligence and reliance is meaningless outside a specific context. Thus, before assessing the reasonableness of investigatory or reliance conduct, one must first understand the context in which the conduct incurred. As explained above, there are four dimensions of context—transactional, situational, positional and temporal. Each must be considered separately and fully to make an informed and objective decision regarding reasonableness.

---

[29] An example would be offering a legal opinion, which is referenced in the offering document, stating that an issuer's defined benefit plan is a qualified plan under ERISA.

[30] *See, e.g.*, Thomas H. Lee Equity Fund V, L.P. v. Mayer Brown Rowe & Maw LLP, 612 F.Supp.2d 267 (S.D.N.Y., 2009).

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.