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**SECURITIES ACT SECTION 11:
A PRIMER AND UPDATE
OF RECENT TRENDS**

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Public and judicial scrutiny of officers and directors of public companies has never been greater. Indeed, recent headlines regarding the sentencing of Dennis Koslowski (8 ¹/₃–25 years), of Tyco International, and John Rigas (15 years), of Adelphia Communications, as well as the unprecedented settlements paid out-of-pocket by the outside directors of WorldCom (\$18 million) and Enron (\$13 million), suggest that concern over the potential liability of officers and directors has not been misdirected.

Following the passage of the Sarbanes-Oxley Act, the Securities and Exchange Commission (SEC), as well as private litigants, have increasingly endeavored to use litigation as a means to reform the behavior of boards of directors. Likewise, in a series of recent decisions, the Delaware courts have given close scrutiny to director conduct and independence – re-examining, among other issues, Section 145 of the Delaware General Corporation law, which permits a corporation to indemnify directors and officers if their actions were “in good faith,” and Section 102(b)(7), which allows corporations to limit or eliminate a director’s personal liability for breach of a fiduciary duty, excluding breaches of the duty of loyalty and “acts or omissions not in good faith or which involve intentional misconduct not in good faith or which involve intentional misconduct or a knowing violation of law.”¹ Section 11 of the Securities Act of

¹For examples of the Delaware courts’ fresh look at director conduct following the Sarbanes-Oxley Act, see *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004) (dismissing claim for

1933, by contrast, has received significantly less attention than these developments. Directors and officers should make no mistake, however, Section 11 remains alive and well and could materially effect whether a claim is brought, the size of the claim, and who will pay it.

Section 11 expressly provides for near strict liability for all issuers, directors, officers, underwriters, and experts who intentionally make a material misstatement or omission in a registration statement for publicly offered securities. This “virtually absolute”² liability exists regardless of Sarbanes-Oxley or Delaware rules. That is, a director may be fully independent under Delaware law, and still face Section 11 liability. Moreover, the absence of any requirement, that a plaintiff plead scienter or, in most circumstances, reliance, makes Section 11 claims far easier to sustain than Section 10 claims.³ Damages under Section 11 can also be severe, with liability joint and several. In short, the possibility of Section 11 liability must remain an important consideration for

breaches of fiduciary duty and loyalty, but conducting searching inquiry of the independence of board of directors including all aspects of its relationship with company’s primary shareholder); *In re The Walt Disney Company Deriv. Litig.*, No. 15452, 2004 Del. Ch. LEXIS 132 (Del. Ch. Sept. 10, 2004) (denying summary judgment and rejecting defendant’s Section 102(b)(7) argument, where factual question remained as to whether the board of directors had acted in good faith with regard to executive’s compensation); *In re Emerging Communs., Inc. Shareholders Litig.*, No. 16415, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004) (finding special litigation committee (“SLC”) was not independent where only potential independent board member was deprived of the information necessary to evaluate the fair value of proposed merger); *In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917 (Del. Ch. 2003) (finding two-member SLC was not independent in its conclusion that trading by corporate directors was not on basis of inside information). It should be noted that in the *Disney* matter, the Delaware Chancery Court ultimately concluded that the company’s board of directors did not violate its duties with respect to the termination of the corporation’s president, the president did not breach his duty of loyalty to the corporation, and the company’s chief executive officer acted in good faith in the hiring and termination of the president. See *In re The Walt Disney Company Deriv. Litig.*, No. Civ. A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005).

²*Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).

³One exception is where a plaintiff asserts a Section 11 claim more than one year after the effective date of a registration statement. In this instance, the plaintiff must plead actual reliance on any purported material misstatement or omission. See 15 U.S.C. §77k(a); *DeMaria v. Andersen*, 318 F.3d 170, 176 (2d Cir. 2003).

current and prospective directors and officers of public companies.

I. THE 1933 SECURITIES ACT

A. Overview

In the hope of restoring investor confidence following a rash of corporate scandals and the stock market crash of 1929, Congress enacted the Securities Act of 1933 to ensure accurate reporting by companies in their registration statements.⁴ Section 11 provided teeth to the statute by giving plaintiffs a private remedy for any false or misleading statement contained in a registration statement. In order to sustain a Section 11 claim, four elements must be proven: (1) claimant purchased securities pursuant to the allegedly deficient registration statement; (2) the registration statement includes a material misrepresentation or omits a material statement; (3) claimant commenced suit within the 1 year/3 year statute of limitations period; and (4) the claim is asserted against defendants who are covered by the statute.

Liability under Section 11 attaches to a defined class of defendants. Those who may be held liable are restricted to: the issuer; each individual who signed the registration statement; every director at the time the registration was filed; every person, who with his or her consent, is named in the registration statement as about to become a director; experts (*e.g.*, accountants) who prepared or certified portions of the registration; and underwriters.

Because almost any substantial public offering of securities, including initial public offerings and bond offerings, must be conducted by means of a registration statement, Section 11 can have a far-reaching impact.⁵ For example,

⁴15 U.S.C. § 77k; S. Rep. No. 47, at 1 (1933) (“The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.”).

⁵See Allan Horwich, *Section 11 of the Securities Act: The Cornerstone Needs Some Tuckpointing*, 58 BUS. LAW. 1, 4 (2002).

established corporations often employ so-called “shelf registrations.” A shelf registration is the registration of securities that are not presently offered for sale. Companies register these securities in advance so they can be placed “on the shelf” until capital needs require their issuance. When a shelf registration becomes effective, the company must periodically update the registration by filing post-effective amendments or supplements. These amendments may create a new “effective” date for the registration (the date the amendment was filed) for Section 11 purposes.⁶ Therefore, a director, who signs a post-effective amendment (*e.g.*, a Form 10-K that through incorporation by reference becomes part of the original registration statement), may face a Section 11 claim with respect to that amendment.⁷

Moreover, unlike its counterpart, Section 10(b) of the 1934 Securities and Exchange Act, Section 11 does not require a plaintiff to prove causation or scienter. Thus, so long as the plaintiff can show that (i) he purchased securities pursuant to a registration statement, (ii) the registration statement contained a material misstatement or omission, the (iii) defendants are covered by the statute, and (iv) the complaint was timely brought, a Section 11 claim will be viable.

Section 11 also has a specific statutory formula for calculating damages. A plaintiff may recover the amount paid for the security measured by (i) the difference between the purchase price of the security and its value at the time the lawsuit was commenced, or (ii) the price at which plaintiff sold the security, if the sale occurred prior to commencing suit, or (iii) the price at which the security was

⁶15 U.S.C. § 77j(a)(3); *see also Finkel v. Stratton Corp.*, 962 F.2d 169, 174 (2d Cir. 1992) (discussing SEC requirement that issuer of shelf registration amend the initial prospectus and that, by SEC rule, this shifts the effective date of the registration statement, for Section 11 statute of limitation purposes, to the date of the amendment).

⁷*See In re Friedman's Inc. Secs. Litig.*, No. 1:03 CV 3475 (WSD), 2005 WL 2175936, at *17-*18 (N.D. Ga. Sept. 7, 2005) (holding that plaintiffs had sufficiently stated Section 11 claim against outside directors who had signed the company's shelf registration).

sold after suit but before judgment. Total damages are capped; in no case may the amount recoverable exceed the price at which the security was offered to the public.⁸ Moreover, damages may be reduced to the extent that defendants can demonstrate that the reduction in value of the security was the result of some factor other than the material misstatement or omission.⁹

Liability for defendants is joint and several with a right of contribution from co-defendants, except where the defendant seeking contribution is found to have made a fraudulent misrepresentation and the defendant from whom contribution is sought is not.¹⁰ However, the 1995 Private Securities Litigation Reform Act (“PSLRA”) did amend Section 11(f)(2) so that outside directors will no longer be subject to joint and several liability (except for a knowing violation). Instead, outside directors will only be liable for proportionate liability (measured as a percentage of total liability as fixed by a jury verdict) in accordance with Section 21D(f) of the 1934 Exchange Act.¹¹

In addition, Section 15 of the 1933 Securities Act provides that controlling persons are liable if they cause a Section 11 violation through their direction of corporate action, or if they fail to prevent a violation of Sections 11 or 12 unless “the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.”¹² Officers or directors who have substantial influence over the direction of a corporation (*e.g.*, members of senior management who may not have signed the registration statement) may therefore be exposed to potential

⁸15 U.S.C. § 77k(g).

⁹15 U.S.C. § 77k(e).

¹⁰15 U.S.C. § 77k(f)(1).

¹¹15 U.S.C. § 77k(f)(2)(A).

¹²15 U.S.C. § 77o.

Section 15 liability for failing to prevent a misstatement or omission in a registration statement.¹³

Finally, claims brought pursuant to Section 12(a)(2) of the 1933 Securities Act often accompany Section 11 claims. Section 12(a)(2), however, differs in some significant respects from Section 11. Unlike Section 11's virtually strict liability, Section 12(a)(2) is a negligence-like claim for misstatements or omissions in a "prospectus or oral communication" in connection with the sale of a security.¹⁴ Another important distinction is that Section 12(a)(2) liability is limited to sellers of a security and also requires privity between the buyer and seller.¹⁵ Moreover, Section 12(a)(2) plaintiffs bear the burden of demonstrating that they were unaware of the misstatement or omission at the time of purchase and defendants may argue that they neither knew, nor reasonably could have been expected to know, of the alleged misstatement or omission. However, the sections do share the same statute of limitations period and, in jurisdictions that recognize it, the same tracing requirements and, similar to many Section 11 claims, reliance is not a factor in Section 12(a)(2) actions.

Focusing on Section 11 liability, we now turn to some specific aspects of defending a Section 11 claim.

B. Section 11 — Motion to Dismiss

Despite the strict statutory structure of Section 11, there are several

¹³See, e.g., *In re CNL Hotels & Resorts, Inc. Sec. Litig.*, No. 604 CV 1231ORL31 (KRS), 604 CV 1341ORL19 (JGG), 2005 WL 1126561, at *11-*12 (M.D. Fla. May 9, 2005) (allegation that officers and directors were control persons by reason of their management positions, access to information regarding company's financial condition, ability to correct previously disseminated information, to prevent issuance of registration statement and had the power to control general affairs and specific policies of corporation, was sufficient to plead claim under § 15).

¹⁴15 U.S.C. § 771(2).

¹⁵See *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1220 (1st Cir. 1996) (requiring privity between buyer and seller in Section 12(a)(2) claim).

possible grounds for dismissing claims that may be available to defendants. First, the majority of courts have held that securities plaintiffs must satisfy the heightened pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure where a Section 11 claim lies in fraud.¹⁶ In other words, without the benefit of full discovery, a complaint must allege facts constituting the substance of a Section 11 claim with particularity, rather than simply offering a short, plain statement of the facts.¹⁷

Second, claims may be dismissed at an early stage where a plaintiff fails to show that the misstatement or omission in the registration statement was of a ‘material fact.’ While materiality may be a bit difficult to define, misstatements or omissions having “an important bearing upon the nature or condition of the issuing corporation or its business,” (*e.g.*, significant overstatements of corporate earnings or understatements of liability) are generally sufficient.¹⁸ The Supreme Court concluded that materiality requires that there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having altered the “total mix” of information available.¹⁹ Securities law claims have been dismissed by courts for lack of materiality, where the allegedly omitted statements impacted, at most, only three to nine percent of a company’s actual revenues.²⁰ In addition, a tender offeror’s statement that an asking price of \$20 per share in the event of a merger was “unrealistic” was

¹⁶*See Rombach v. Chang*, 355 F.3d 164 (2d Cir. 2004); *Melder v. Morris*, 27 F.3d 1097 (5th Cir. 1994). There is a minority line of cases suggesting that because the plain language of Section 11 does not include fraud or mistake as an element of the claim, only a simplified pleading is required. *See, e.g., Carlon v. Thaman (In re NationsMart Sec. Litig.)*, 130 F.3d 309 (8th Cir. 1997).

¹⁷FED. R. CIV. P. 8(a)(2).

¹⁸*Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 681 (S.D.N.Y. 1968).

¹⁹*TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (1976).

²⁰*Glassman v. Computervision Corp.*, 90 F.3d 617, 633 n.26 (1st Cir. 1996).

deemed immaterial where the target stock traded at \$4 prior to the tender offer.²¹ Moreover, a misstatement, which resulted from an innocent bookkeeping error, while “theoretically material,” was not deemed likely to have caused a stock price decline, when considered in the context of the prospectus’ pessimistic forecast of the performance of the company’s subsidiary.²²

Third, a defendant can also prevail at the motion to dismiss stage if the misstatement alleged is not in the registration statement itself. Misstatements outside the registration statement, such as press releases, while possibly actionable under Rule 10b-5, are not covered by Section 11.

Fourth, the PSLRA provides defendants with a safe-harbor for forward looking statements concerning future economic performance, management plans for future operations, or revenue predictions that are accompanied by the requisite cautionary language.²³ For example, representations regarding the state of a business’ position in a changing market or the soundness of its growth strategies are necessarily forward-looking.²⁴ In addition, the common law doctrine known as “bespeaks-caution,” provides that statements regarding positive economic forecasts or predictions when couched in meaningful cautionary language do not form the basis for Section 11 claims.²⁵ Moreover, courts have consistently held that certain statements are so devoid of any substantive information that they should be considered mere “puffery,” and not

²¹*Seaboard World Airlines, Inc. v. Tiger Int’l, Inc.*, 600 F.2d 355, 361–62 (2d Cir. 1979).

²²*See Akerman v. Oryx Commun’s, Inc.*, 810 F.2d 336, 341 (2d Cir. 1987).

²³15 U.S.C. § 77z-2.

²⁴*See Harris v. IVAX Corp.*, 998 F. Supp. 1449, 1454 (S.D. Fla. 1998) (dismissing claim based, in part, on the impossible burden of requiring defendants to warn of every factor that ultimately prevents a forward looking statement from materializing).

²⁵*See, e.g., In re Donald J. Trump Sec. Litig.*, 7 F.3d 357, 372–73 (3d Cir. 1993) (upholding dismissal by district court on 12(b)(6) grounds). The bespeaks-caution doctrine is also applicable to Section 12(a)(2) claims.

actionable under Section 11. Indeed, a prediction by a company's prospectus of "significant growth" was deemed mere puffery because such predictions almost always prove wrong in hindsight. The court noted that to impose such liability would place companies "in a whipsaw," with a lawsuit almost a certainty which would deter companies from discussing their prospects at all – an outcome that runs counter to the goals of Section 11.²⁶ Thus, forward-looking statements that are accompanied by cautionary language or statements that are so vague or hyperbolic that no reasonable investor would rely on them may not be the source of Section 11 liability.

Fifth, pursuant to Section 13, claims under Section 11, must also be brought within one year from the discovery of the false statement or omission, or from the time such discovery should have been made through the use of reasonable diligence, but in no case more than three years after the security was first offered to the public.²⁷ Determining the reasonable date of discovery for a securities fraud violation is a two-step inquiry. First, a court must determine inquiry notice or the point at which an investor could learn facts sufficient to indicate the probability of a fraud.²⁸ Once inquiry notice is triggered, the court then determines when, given the exercise of reasonable effort, the plaintiff should have discovered the facts underlying the alleged fraud.²⁹ If inquiry notice is found, the statute begins to run.

Recently, the District Court for the Southern District of New York ruled

²⁶*Parnes v. Gateway, Inc.*, 122 F.3d 539, 547 (8th Cir. 1997).

²⁷See, e.g., *Benak v. Alliance Capital Management L.P.*, 349 F. Supp. 2d 882, 886-92 (D.N.J. 2004); 15 U.S.C. § 77m. Additionally, a plaintiff must properly plead compliance with the statute of limitations to avoid dismissal. See *Charas v. Sand Tech. Sys. Int'l, Inc.*, No. 90 Civ. 5638 (JFK), 1992 WL 296406, at *8 (S.D.N.Y. Oct. 7, 1992) (Section 11 makes compliance with the statute of limitations and element of plaintiff's claim-in-chief).

²⁸See *Dodds v. Signa Sec., Inc.*, 12 F.3d 346, 352 (2^d Cir. 1993).

²⁹See *In re Complete Management Inc., Sec. Litig.*, 153 F. Supp. 2d 314 (S.D.N.Y. 2001).

that the Sarbanes-Oxley Act, which changed the 1 year/3 years statute of limitations to a 2 years/5 years structure for Rule 10b-5 claims, did not alter the statute of limitations in Section 11 (or Section 12(a)(2)).³⁰ That holding related to thirty-seven individual actions involving claims under Section 11 and Section 12(a)(2), in connection with WorldCom's bond offerings.³¹ Specifically, that court held that Section 13's shorter limitations period continues to apply to Section 11 claims because these claims do not involve "fraud, deceit manipulation or contrivance."³² The court noted, in an earlier ruling, that the text of the Sarbanes-Oxley Act parallels the language used for private causes of action for securities fraud and includes terms not found in Section 11, which refers only to material omissions or misrepresentations.³³ Therefore, because the plaintiffs had filed their complaint more than four years after the effective date of the registration statement and the issuance of the prospectus, all of their Section 11 claims were time-barred.³⁴

Finally, Section 11 claims may also fail where a plaintiff is unable to trace its purchase to the registration statement. Tracing is not an explicit statutory requirement but rather a judicial creation, grounded in Section 11's application to "any person acquiring such security." Tracing, in jurisdictions that have adopted

³⁰See *In re WorldCom, Inc. Sec. Litig.*, Nos. 02 Civ. 3288 (DLC), 03 Civ. 9499 (DLC), 2004 WL 1435356, at *3 (S.D.N.Y. June 28, 2004); see also *In re Merrill Lynch Research Reports Sec. Litig.*, 272 F.Supp.2d 243, 265 (S.D.N.Y. 2003) (holding Section 11 claim, brought post-Sarbanes Oxley Act, time barred pursuant to Section 13's one year/three year scheme).

³¹See *In re WorldCom, Inc. Sec. Litig.*, 308 F. Supp. 2d 214, 221 (S.D.N.Y. 2004).

³²*Id.*

³³See *id.* at 221.

³⁴See *In re WorldCom, Inc. Sec. Litig.*, 2004 WL 1435356, at *3. An interesting question is whether the Sarbanes-Oxley Act's change in the limitations period would apply where a Section 11 complaint is permeated by fraud. Courts addressing this issue have largely rejected this argument; however, at least one court has held that the Sarbanes-Oxley Act might apply to Section 11 claims sounding in fraud. See *In re Enron Corp. Sec. Deriv. & ERISA Litig.*, Nos. MDL-1446, CIV. A. H-01-3624, 2004 WL 405886, at *10-*11 (S.D. Tex. Feb. 25, 2004).

the doctrine, allows aftermarket (*i.e.*, post-IPO) purchasers to link their claims to the registration statement containing the alleged misstatement or omission.³⁵ For example, in *Dignity Partners, Inc.*, investors who purchased their shares in the open market more than twenty-five days after an IPO, but before damaging news broke regarding the company's business, had standing to initiate Section 11 claims. The Ninth Circuit so concluded because the company had held only one IPO and there was thus no dispute as to whether the plaintiffs purchased their stock pursuant to the faulty registration statement.³⁶ Thus, it was of no moment whether the plaintiffs "bought in the initial offering, a week later, or a month after that."³⁷

However, not all jurisdictions have recognized tracing. For example, a New Jersey court refused to apply the tracing doctrine, concluding that stock purchased on the open market is, by definition, not an IPO (*i.e.*, stock purchased in connection with the registration statement), and therefore did not give rise to a Section 11 claim.³⁸ In addition, a plaintiff might not have standing to sue under Section 11 where the securities at issue were not clearly connected to the registration statement, as where a later registration or amendment was issued.

Moreover, even where a jurisdiction might allow for tracing in some instances, there may be limits on the doctrine. For instance, the Fifth Circuit recently rejected the standing of aftermarket purchasers who had sought to trace their claims to a registration statement based on a statistical probability model.³⁹

³⁵See *In re AES Corp. Sec. Litig.*, 825 F. Supp. 578, 592 (S.D.N.Y. 1993) (plaintiffs had standing to bring Section 11 claims because they could trace their purchases to the relevant offerings).

³⁶See *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1080 (9th Cir. 1999).

³⁷*Id.*

³⁸See *Gannon v. Continental Ins. Co.*, 920 F. Supp. 566, 576 (D.N.J. 1996).

³⁹See *Krim v. pcOrder.com, Inc.*, 402 F.3d 489 (5th Cir. 2005).

In that case, plaintiffs had purchased shares in both an initial public offering and a secondary offering of securities.⁴⁰ Despite the fact that one plaintiff purchased 99.85 percent of his shares in the initial IPO, the court concluded that allowing such statistical tracing would impermissibly expand the statute to encompass almost any aftermarket purchase.⁴¹ As a result, it may now be more difficult for plaintiffs (at least in the Fifth Circuit) to meet the standing requirements of Section 11.

C. Section 11 - Due Diligence Defense at Summary Judgment

If a claim were to survive a motion to dismiss and the various defenses discussed above, directors may have an additional affirmative defense, called the due diligence defense, which may be available at the summary judgment phase.⁴²

Due diligence involves the reasonableness of a defendant's investigation of those portions of the registration statement that he helped to prepare. The standard for reasonableness is that "required of a prudent man in the management of his own property."⁴³ This standard is applied on a sliding scale. Hence, inside directors may have higher duties than outside directors, who have less day-to-day responsibility for the company.⁴⁴

Courts also distinguish between the expertised and non-expertised

⁴⁰*Id.* at 491–92.

⁴¹*Id.* at 495–502.

⁴²Subject to specific conditions, officers and directors who resign their positions may also be exempt from liability. 15 U.S.C. § 77k(b)(1). In addition, if the challenged portion became effective without the director's knowledge and, upon becoming aware, he advises the SEC and the general public of this occurrence, he may avoid liability. 15 U.S.C. § 77k(b)(2).

⁴³15 U.S.C. § 77k(c).

⁴⁴*See Laven v. Flanagan*, 695 F. Supp. 800, 812 (D.N.J. 1988) (outside directors are under "lesser obligation to conduct a painstaking investigation than an inside director with intimate knowledge of the corporation").

portions of the registration statement in evaluating a due diligence defense. The expertised sections are those prepared by a professional expert such as financial statements prepared by certified public accountants. Directors may rely on the expert's opinion as long as there is no reasonable ground to allege that they knew or should have known that there were inaccuracies in the expertised sections.⁴⁵ Significantly, the financial expert appointed to the corporation's audit committee, as now required by Sarbanes-Oxley, will not be considered an expert for Section 11 purposes and therefore will not be exposed to greater liability on that basis.⁴⁶

With respect to the non-expertised parts of the registration statement, directors are under an obligation to conduct a reasonable investigation prior to concluding that the registration statement is complete and accurate. Thus, for instance, it may be a failure of due diligence to rely solely on management representations as to the financial condition of a company, where those representations can be verified through reasonable independent investigation.⁴⁷

One noteworthy example of the level of diligence required by Section 11 for a director to succeed at summary judgment *is In re Avant-Garde Computing, Inc. Secs. Litig.*⁴⁸ That case involved a contention by plaintiffs that, following a securities offering, a company attempted to list certain transactions as sales instead of leases, enabling itself to state unjustifiably high sales and income figures in its registration statement. An outside director succeeded in establishing a due diligence defense by proving that he had, among other things: 1) participated in four board meetings prior to the offering, and had several

⁴⁵15 U.S.C. § 77k(b)(3)(C).

⁴⁶See Disclosure Required by Section 406 of the Sarbanes-Oxley Act of 2002, Rel. No. 33-8177 (Jan. 23, 2003), 68 Fed. Reg. 5110, 5116-17 (Jan. 31, 2003).

⁴⁷See *Glassman v. Computervision Corp.*, 90 F.3d 617, 628 (1st Cir. 1996).

⁴⁸CIV. No. 85-4149 (AET), 1989 WL 103625 (D.N.J. Sept. 5, 1989).

independent conversations with other board members in which the proposed public offering was discussed; 2) he received and reviewed a draft preliminary prospectus, the filed preliminary prospectus, and the final prospectus; and 3) to assure himself that, as an outside director, he understood the company's business, he interviewed company personnel, including members of senior management, inquired into the company's organizational structure, marketing programs, advertising plans, sales force, field service, product development, hardware and software engineering capabilities, product documentation, production methods, and financial controls ultimately concluding that the company was well positioned for future growth and believing that the prospectus accurately described the company's business and affairs.⁴⁹ The court concluded that plaintiffs' "wholly speculative" assertions about what the director knew and when he knew it under those circumstances was insufficient to rebut his defense that he had acted prudently in his investigation of the truth of the financial statements in question, and that he had an honest belief in their accuracy.⁵⁰

Thus, a pro-active inquiry by the outside director, prior to the issuance of the securities, made the due diligence defense available even when material omissions were later revealed.

Considering the increased focus on director conduct, their due diligence requirement has obviously been elevated. In addition to considering the steps undertaken by the outside director in *Avant-Garde*, a current or prospective inside or outside director would do well to consider, among other things, the issuer's cash flow position, whether more debt will be necessary, and whether another public offering of securities is likely. Moreover, a director should become familiar with the issuer's history and structure, including its relationship with its auditors, and its executive compensation structure. A director should also

⁴⁹*Id.* at *8.

⁵⁰*Id.*

evaluate whether a sufficient number of board members are truly independent. This may be time consuming and labor intensive, especially for an outside director; however, such a commitment seems most prudent given the courts' increased scrutiny both under Section 11 and Delaware state law.

D. Section 11 – Causation

Finally, a defendant may perhaps avoid or limit liability by establishing that the damages suffered by plaintiffs were caused by something other than the allegedly inaccurate statement or omission in the registration statement. Although loss causation is not an element that plaintiffs must plead under Section 11, defendants can nonetheless reduce their liability by demonstrating that depreciation in the value of the relevant stock is attributable to factors other than the alleged misstatement or omission.⁵¹ For example, a court granted summary judgment for the defendants on a Section 11 claim, where the defendants proffered an expert report establishing that because none of the public announcements, on statistically significant trading days, made any mention of the particular agreement that was the source of the alleged misstatement, any price declines were unrelated to the announcement of a write-off of that agreement.⁵² Thus, a causation defense based on the impact of unrelated market forces may relieve a director from liability for some or all of the alleged damages.⁵³

E. Section 11 – Damages

Given that IPOs and other securities registrations often involve hundreds of millions of dollars, damages under Section 11 – measured by the amount

⁵¹See *Akerman*, 810 F.2d at 340.

⁵²See *Goldkrantz v. Griffin*, No. 97 Civ. 9075 (DLC), 1999 WL 191540, at *3 (S.D.N.Y. Apr. 6, 1999), *aff'd*, 201 F.3d 431 (2d Cir. 1999).

⁵³15 U.S.C. § 77k(e); *Griffin*, 1999 WL 191540, at *3.

representing the difference between the purchase price of the security and its value at the time the lawsuit was commenced, the price at which plaintiff previously sold the security, or the price at which the security was sold after suit but before judgment – can be enormous. As discussed above, liability under Section 11 is generally joint and several, although certain defendants may seek contribution from co-defendants. Notably, the PSLRA somewhat relieved the burden on outside directors. The PSLRA shifted their liability from joint and several to proportionate, where no intentional wrongdoing is present.⁵⁴

II. SECTION 11 — RECENT DEVELOPMENTS

A. SEC Regulations

In June 2005, the SEC adopted significant reforms to the securities registration and offerings process under the Securities Act of 1933. Pursuant to Securities Act Release No. 33-8591, large, established corporations labeled “Well-known Seasoned Issuers” will qualify for simplified registration procedures, effectively allowing them instant access to the capital markets. These procedures include automatic effectiveness for shelf registrations upon filing without prior SEC review and the ability to use “free-writing prospectuses,” which need not comply with traditional prospectus requirements. Note, however, that directors, who already had a limited time between filing and an offering in which to conduct due diligence, may now, in many cases, have almost no time at all.⁵⁵ It will be interesting to see how the due diligence defense is treated by courts in the context of these simplified registration procedures.

⁵⁴For a somewhat mathematical explanation of this change in the securities laws and its effect on plaintiffs’ efforts to reach settlements with outside directors, see John C. Coffee, *Why the WorldCom Settlement Collapsed*, 231 N.Y. LAW J. 5 (Mar. 17, 2005).

⁵⁵See John C. Coffee, *A Section 11 Safe Harbor?*, 234 N.Y. LAW J. 5 (Sept. 15, 2005).

B. Enron and WorldCom Settlements

The recent settlements in the WorldCom and Enron cases, which required personal contributions by outside directors to settle Section 11 claims, raise a number of interesting issues for the future of director obligations and the role of Section 11 in securities cases. First, as discussed above, Section 11 (unlike Section 10b-5) does not require a plaintiff to prove scienter or, in most cases, reliance. As a result, in most cases, the burden is on defendants to avoid liability by establishing a due diligence defense. Thus, in the event of fraud, plaintiffs can use Section 11's relaxed requirements to target outside directors, where a 10b-5 claim may not stand because of a lack of scienter. Moreover, the outside directors do not ordinarily have the opportunity to demonstrate their affirmative defenses until well into the litigation, at the summary judgment phase. In cases with tremendous potential liability, outside directors, including those who may well have performed diligently and in good faith, may be under heavy pressure to settle rather than risk losing at summary judgment, even if they have to pay, in part, out of their own pockets.

The second development arising from the WorldCom and Enron settlements is out-of-pocket liability itself. Historically, directors facing Section 11 liability would be covered by the director and officer insurance policies held by the company and/or would be entitled to indemnification by the company. That protection may, however, be eroding as a result of, among other things, the increased involvement by political officials and large state retirement or pension funds (who often serve as lead plaintiffs) in securities class actions suits. In both WorldCom and Enron, the lead plaintiffs were large, public institutional investors – the University of California in Enron and the New York State Common Retirement Fund in WorldCom. Unlike the typical securities plaintiff, who merely seeks redress for the loss of a personal investment, these institutions have constituencies that may be interested in pursuing a supposed public or social purpose. Additionally, in the WorldCom case, the trustee of the

New York State Common Retirement Fund, Alan Hevesi was an elected official. Hevesi, openly stated that his purpose in requiring personal payments by settling, outside directors was to: “send[] a strong message to the directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent.”⁵⁶ In addition to social concerns, public officials may well have more politicized motives for seeking personal contribution from directors. Thus, directors must now be cognizant not only of their own obligations as board members, but also who may be pursuing claims against them.

CONCLUSION

In the frenzy of articles and speeches surrounding Sarbanes-Oxley and Delaware independence standards, Section 11 should not be forgotten. Indeed, as recent developments suggest, Section 11 remains both a source of significant liability for current and potential directors. Directors, inside or outside, current or prospective, must therefore continually ask themselves several important questions: Am I thoroughly educated about the function and finances of the company? Does the company have strong auditors? Do I have access to senior management? Are the other board members independent? Am I independent? Do I have the time and expertise to understand the issues that may confront the company? What capital needs will the company likely have? The answer to these and other important questions may ultimately spell out the differences between Section 11 liability, or not.

⁵⁶See “Hevesi Announces Historic Settlement, Former WorldCom Directors to Pay From Own Pockets,” Press Release from the Office of the New York State Comptroller, Jan. 7, 2005, available at <http://www.osc.state.ny.us/press/releases/jan05/010705.htm>. However, lest this be viewed as strictly a populist movement, it should be noted that lead plaintiffs’ counsel in the Enron matter stands to make as much as \$300 million in 2005. See Liz Moyer, *Biggest Enron Payday: The Lawyers*, Forbes.com, June 16, 2005, available at http://www.forbes.com/work/2005/06/16/enron-class-action-lawsuit-cx_lm_0616lawsuit.html.