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Nature of the Due Diligence Obligation

The Statutes

In 1933, Congress enacted new securities laws requiring full and accurate disclosure of material information to investors in order to prevent the return of the circumstances that precipitated the stock market crash of 1929. To increase the likelihood that investors would be provided with all material information, Congress imposed an obligation on participants in a securities offering, including underwriters, to conduct a reasonable investigation to detect material misstatements or omissions in the disclosure. This obligation is based in Section 11(a) of the Securities Act of 1933 (the “33 Act”), which imposes liability on certain participants in the offering for any material misstatement or omission in the registration statement relating to the offering. To encourage a reasonable investigation, Section 11 allows participants other than the issuer to escape Section 11 liability by showing that they conducted a reasonable investigation that failed to detect the misstatement or omission.

It is noteworthy that in drafting Section 11, Congress specifically singled out underwriters as offering participants with potential liability, apparently because Congress partially blamed underwriters for the 1929 debacle and believed that underwriters were uniquely situated to verify the future accuracy of registration statements through exercise of their strong bargaining power with issuers. True enough, underwriters have the unique ability to require issuers to provide them with access to information necessary to conduct an investigation of disclosure, and many times have the clout to require changes to the disclosure.

In addition, Section 12 of the 33 Act places similar liability on persons that sell a security, generally including underwriters, based on a communication that contains a material misstatement or omission. With respect to Section 12 liability, the misstatement or omission does not need to be traced to a registration statement. Thus, materials used in the selling process other than the prospectus contained in the registration statement and oral statements could lead to liability under Section 12.

The “Due Diligence” Defense

The Section 11 “due diligence” defense is the crux of the system implemented by Congress – to impose a duty on underwriters to use reasonable efforts to prevent material misstatements and omissions, but not to make underwriters guarantors of every aspect of the registration statement. Section 12 has a similar defense if the seller can show that “in the exercise of reasonable care” it did not have knowledge of the misstatement or omission. Since Section 11’s “reasonable care” standard, in practice, an underwriter should apply the same standards in its due diligence review.

What is Reasonable?

Section 11 states that the standard of reasonableness shall be that required of a prudent man in the management of his own property. While the due diligence obligation under this standard is not certain, guidance can be found in the interpretations of the courts, the SEC and the NASD. While the guidance provided by the courts indicates that the diligence conducted need only be reasonable, not perfect, the underwriter’s investigation should be thorough and not rely on the representations of management. Inexperience and lack of time have been held not to be adequate defenses. Courts have also looked at whether underwriters have (1) obtained an understanding of the issuer’s finances, management and operations, (2) obtained an understanding of the issuer’s industry, (3) conducted interviews with issuer employees, and (4) confirmed data with third parties.

SEC Rule 176 also provides guidance by presenting the following non-exclusive factors to be considered in determining the adequacy of a due diligence investigation:

- The type of issuer;
- The type of security;
- The type of person;

- The office held when the person is an officer
- The presence or absence of another relationship to the issuer when the person is a director or proposed director;
- Reasonable reliance on officers, employees and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing);
- When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registration; and
- Whether, with respect 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.

The NASD has taken the position that the standard of reasonableness under Section 11 depends to some extent on what constitutes commonly accepted commercial practice. Under this interpretation, it is important to be aware of what other people are doing in similar transactions. While an underwriter should not rely on this standard exclusively, doing less than other firms with respect to similar transactions may be evidence of lack of a reasonable investigation.

Materiality

An underwriter should also consider that Section 11 and Section 12 liability must be predicated on a misstatement or omission of a “material” fact. A fact is material if a reasonable investor would consider it important in determining whether or not to invest. In evaluating materiality, guidance can be found through sufficient knowledge of SEC disclosure regulations, current issues receiving attention by the courts and the regulators, and the disclosure considered material by comparable issuers.

Private Offerings

Since Section 11 applies to information contained in a registration statement, it is inapplicable to private offerings. While still one of the broadest sources

of potential 33 Act liability, the Supreme Court held in 1995 that Section 12 also did not apply to private offerings – generally those offerings made under Section 4 of the 33 Act, including Section 4(2) private placements. It is noteworthy that offerings made under Section 3 of the 33 Act typically are not considered private placements. Thus, Section 12 liability arguably applies to sales of securities exempt under Section 3, which include Regulation D Rule 504 and 505 offerings, but not to offerings exempt under Section 4, which include Rule 506 offerings.

Thus, within the limits of the 33 Act and the Securities Exchange Act of 1934 (the “34 Act”), a Rule 506 private placement investor’s only apparent remedy for material misrepresentations or omissions is under Section 10(b) of the 34 Act, with its much higher standard generally requiring intentional misconduct. However, underwriters should remember that investor recourse might also be found under common law negligent misrepresentation laws, state securities laws or other state or federal laws. For example, some state statutes similar to Section 12 may not be limited to public offerings. With these other possible causes of action, and to generally avoid underperforming transactions, an underwriter would be well advised to conduct a reasonable due diligence investigation for private placements as well as private offerings.

General Considerations

Customized Investigations

As the adequacy of a due diligence investigation has historically been evaluated by courts passed on the particular facts and circumstances, each due diligence investigation should be tailored to the particular issuer and offering. In this regard, a due diligence investigation should consider:

- The type of offering,
- The SEC form with which the securities are being registered (or in the case of a private offering, the form that would be used if registered),
- The potential legal, financial and business risks,
- The size of the issuer,
- The availability of public information about the company,
- The issuer’s operating and business history,

- The type of business conducted by the issuer,
- The capabilities and experience of management,
- The nature of the legal structure of the issuer and the securities being offered, and
- Industry regulation.

The underwriter should focus its attention on the particular risks associated with the offering and the issuer. Lastly, the underwriter's investigation should be made in light of a determination of the competency of the company's management and inside counsel.

Checklists

While helpful, no single checklist can address each different offering. In addition to this inflexibility, general checklists may themselves create potential liability. If the checklist ends up being inadequate, a court probably will not give much weight to the argument that it was reasonable to rely on the checklist. On the other hand, if the checklist is not strictly adhered to, failure to perform all items on the list may be used as evidence that the investigation was inadequate.

Competency of Legal Counsel and other Agents

Courts have held that reliance on legal counsel is only reasonable if the counsel is competent. This principal should also apply to other experts retained to provide due diligence services for the underwriter. Since third parties act as agent for the underwriter, the underwriter is responsible for the third parties' failures. Underwriters should make sure that their agents possess the requisite competency in the area they are being hired to review, whether it is legal, accounting, financial or some other specialized area such as petroleum engineering. Shortcomings of agents could be used as evidence of the lack of care by the underwriter in the due diligence investigation.

Trust but Verify

President Reagan coined the phrase "trust but verify" for other purposes, but it too applies to due diligence. Underwriters should not be afraid to ask for support for information or statements – this is the obligation of the underwriter. Knowing that some issuers may misrepresent or withhold

information, the courts are very willing to impose liability on an underwriter that merely relies on facts provided by an issuer. Further, an underwriter should attempt to ascertain the willingness of members of management to conceal information or make misstatements, and adjust its due diligence investigation accordingly.

Identify Risks

Adequate disclosure should include a discussion of material risks. While some risks are easily apparent, the most threatening risks can be those that are not contemplated. Underwriters should obtain a thorough understanding of the business of the issuer and apply varying economic, business and regulatory scenarios to identify any hidden risks. Underwriters should try to foresee what would happen if the business does not go as planned or if management becomes hostile. Structures and agreements should be read with many potential scenarios in mind to make sure that the potential risks are adequately disclosed. Tax and other risks, such as compliance with offering exemptions specifically associated with many private placements, should be considered.

Adapt to Results

During an investigation, if issues arise, an underwriter should think carefully about the implications. The due diligence investigation should consider whether misstatement of a certain fact is indicative of lack of a system to ensure accuracy of other information. Financial irregularities should be thoroughly investigated to understand whether there are any more far reaching implications.

Conclusion

In the end, adequate due diligence means that if an underwriter is reasonable in its investigation, generally it will avoid liability. Whether involved in a public offering or a private placement, a savvy underwriter should develop its due diligence investigation based on the particular facts and circumstances of each offering. The key to developing an adequate investigation is obtaining an understanding of the business, legal and financial aspects of the offering and using that knowledge to plan and implement a customized and thorough investigation.