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Elena Marty-Nelson

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Cover Page Footnote

Professor of Law, Nova Southeastern University Shepard Broad Law Center; J.D., Georgetown University Law Center, 1983; LL.M., Georgetown University Law Center, 1986. The author acknowledges with gratitude Professors Lynn Epstein, Angela Gilmore, and Eloisa Rodriguez-Dod, for their insightful comments on an earlier draft of this Article. The author is also grateful for the outstanding research assistance of Rita Dew, Matthew Herman, and Jacquelyn Trask.

NON-MANAGING UNDERWRITERS' ROLE IN SECURITIES OFFERINGS: JUST EYE CANDY?

Elena Marty-Nelson[*]

ABSTRACT

While there is considerable scholarship on the due diligence defense of lead underwriters in defective corporate securities offerings, there is surprisingly little analysis of the due diligence defense of non-managing underwriters. This article challenges the common perception that lead and non-managing underwriters necessarily "sink or swim" together for purposes of due diligence. An analysis of the statutory structure of Section 11 of the Securities Act of 1933 reveals that non-managing underwriters are not inextricably tethered to the lead. Rather, non-managing underwriters who actively question the lead's due diligence investigation should be able to meet their own affirmative defense even when the lead ultimately fails to meet its burden. Moreover, despite protestations from some in the investment banking community, it is also clear that to succeed in their separate affirmative defense, non-managing underwriters cannot simply be passive participants. To meet their separate defense, they must actively supervise the lead's investigation of the financial health of the corporate issuer. Finally, this article addresses some of the practical issues involved in non-managing underwriters monitoring the lead underwriter's investigation.

I. INTRODUCTION

If securities lawyers were asked to describe the due diligence role of non-managing underwriters in securities offerings, many would

[*] Professor of Law, Nova Southeastern University Shepard Broad Law Center; J.D., Georgetown University Law Center, 1983; LL.M., Georgetown University Law Center, 1986. The author acknowledges with gratitude Professors Lynn Epstein, Angela Gilmore, and Eloisa Rodriguez-Dod, for their insightful comments on an earlier draft of this Article. The author is also grateful for the outstanding research assistance of Rita Dew, Matthew Herman, and Jacquelyn Trask.

probably admit that, while they are well versed in the responsibilities of lead underwriters, they have not focused on the role of non-managing underwriters. If pressed, the lawyers might add some pithy comment such as non-managers will "sink or swim" with the lead underwriter's investigation.[1] Beyond that helpful tidbit, however, it is unlikely that the lawyers would have at the ready any further guidance. While there is considerable practitioner and academic commentary on the due diligence role of underwriters in corporate securities offerings, that scholarship focuses almost exclusively on the responsibilities of lead underwriters.[2] This article, by contrast, analyzes the role of non-managing underwriters ("NMUs")[3] in relation to the lead and challenges the perception that

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1. The shorthand term "sink or swim" appears fairly regularly in guidelines on due diligence. *See e.g.*, Jack C. Auspitz & Susan E. Quinn, *Litigators' View of Due Diligence*, 1348 PLI/CORP. 107, at 151 (2003); J. William Hicks, *Misleading Registration Statements: Section 11*, 17 CIVIL LIABILITIES: ENFORCEMENT AND LITIG. § 4:106 (2009).

2. *See, e.g.*, William F. Alderman, *Due Diligence in the Post-Enron Era: A Litigator's Practical Tips on Mitigating Underwriter Risk*, 1746 PLI/CORP. 87 (2009); Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters' Continuous Due Diligence After WorldCom*, 30 CARDOZO L. REV. 2001, 2012 (2009); Jonathan K. Youngwood, *Due Diligence as a Defense in Securities Litigation*, 1746 PLI/CORP. 57, 67–69 (2009); William J. Whelan, III, *Civil Liabilities*, 1734 PLI/CORP. 635, 640–41 (2009); 6 BROMBERG & LOWENFELS ON SECURITIES FRAUD § 13:13, at 1–3 (2d ed. 2009). Very generally, an underwriter serves as a middle man. The underwriter buys securities from the corporate issuer and "resells them to the public, or performs some act . . . that facilitates the issuer's distribution." *In re* WorldCom Sec. Litig., 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004). Positioning underwriters between corporate issuers and prospective investors is designed to protect the investors from defective offerings. *Id.* As the court in *WorldCom* explained, the statutory structure envisions that underwriters will serve "as 'the first line of defense' with respect to material misrepresentations and omissions in registration statements." *Id.*

3. The term non-managing underwriter is borrowed from *In re* ZZZZ Best Sec. Litig. (*ZZZZ Best I*), 864 F. Supp. 960 (C.D. Cal. 1994). In this article, the term "non-managing underwriters" refers to all of the underwriters named in the registration statement as participating in the securities offering other than the lead underwriter. This article also borrows the moniker "NMU" for non-managing underwriters from the opinion in *ZZZZ Best I*. *Id.* The *ZZZZ Best I* court explained that it used the term non-managing underwriters solely as an effective and easy term of reference. *Id*. Similarly, this article uses the term non-managing underwriter as a useful way of referring to all the various non-lead participating underwriters. There are, of course, various other terms routinely used to refer to non-managing underwriters who participate in an underwriting syndicate such as non-lead underwriters and participating underwriters. *See* Leahy, *supra* note 2, at 2012. There are also varying terms used to refer to the lead

NMUs are powerless to protect themselves from the lead's failure. It also rejects the view that NMUs need not do anything to meet their affirmative defense of due diligence found in Section 11 of the Securities Act of 1933 ("Securities Act" or "1933 Act").[4]

There are in general four possible relationships between lead underwriters and NMUs. In two scenarios, the lead and the NMU succeed or fail together. In the other two they diverge. The first scenario, referred to here as "Lead fails/NMU fails," arises when the lead underwriter failed its due diligence investigation and the NMU did nothing. This scenario is the one famously described in *Escot v. BarChris Construction Corporation*.[5] Courts and scholars generally agree that in this scenario all the underwriters fail to meet their affirmative due diligence defense.[6]

The second scenario where the underwriters are in concert is on the opposite end of the spectrum. In this scenario, referred to as "Lead wins/NMU wins," the lead met its due diligence affirmative defense and the NMU proved that it monitored and questioned the lead's

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underwriter including lead manager, book runner, or book running manager. *Id.* Typically, public securities offerings are underwritten by not just one underwriter, but by an underwriting syndicate comprised of lead underwriters and non-managing underwriters. *Id.*

4. The United States Code cite for the Securities Act of 1933 is 15 U.S.C. §§ 77a-77mm. The specific United States Code cite for § 11 of the Securities Act is 15 U.S.C. § 77k. The custom in securities law is to refer to the statutory section as enacted and published in the Statutes at Large, not the sections as codified in the United States Code. Securities Act of 1933, ch. 38, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)). Accordingly, this article refers to § 11 of the Securities Act as § 11. Similarly, this article refers to provisions of the Securities Exchange Act ("Exchange Act" or "1934 Act") in the text of the article by reference to sections of the Exchange Act. Securities Exchange Act of 1934, ch. 404, Pub. L. No. 73-291, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a–78oo).

5. 283 F. Supp. 643 (S.D.N.Y. 1968).

6. *See* Youngwood, *supra* note 2, at 68. "If a court concludes that the lead underwriter conducted an insufficient investigation, and the non-managing underwriters did nothing but rely upon the lead underwriter, the non-managing underwriters will be held liable as well." *Id.* *But see* Memorandum of Law of Amicus Curiae The Securities Industry and Financial Markets Association in Opposition to Lead Plaintiffs' Motion for Partial Summary Judgment in *In re Refco, Inc. Sec. Litig.*, Master File No. 05 Civ. 8626, at 5 (GEL), *available* at http://www.sifma.org/Issues/item.aspx?id=1502 (last visited Feb. 1, 2010) [hereinafter *SIFMA Refco Amicus*]. The SIFMA amicus would absolve the NMUs of responsibility in Lead fails/NMU does nothing scenarios. *Id.* Such a position is a significant departure from current law.

investigation. In this scenario, even though the registration statement is defective, both the lead and the NMU would be able to meet their respective affirmative due diligence defenses.[7]

The two remaining scenarios arise when the lead and the NMU are no longer in concert. The first of these split scenarios, the "Lead fails/NMU wins" case, arises when the lead failed its due diligence investigation but the NMU can demonstrate that it had appropriately questioned the lead's investigation. This could happen, for example, where problems with the issuer were well hidden or where the lead was in collusion with the issuer. This article explains that an accurate reading of Section 11 supports an NMU's affirmative defense in these scenarios even though the lead failed to establish its own defense. Thus, this article recommends that NMUs should monitor the lead's investigation in all public offerings. By doing so, NMUs protect themselves even if the lead should fail.

The last scenario, the "Lead wins/NMU fails" case, arises when the lead is able to demonstrate sufficient due diligence but the NMU did nothing. Although some commentators and some cases suggest that the NMU's affirmative due diligence defense should succeed in these scenarios, a careful reading of the statute and its legislative history indicates that such a view is incorrect. Rather, this article posits that even when the lead meets its due diligence burdens, the NMUs do not meet their affirmative defense unless they monitored the lead.

Part II of this article demonstrates that an analysis of the role of NMUs in securities offerings is not just theoretical. This section discusses an amicus brief recently filed by the Securities Industry and Financial Markets Association ("SIFMA")—a lobbying group for the financial industry—asserting that a subset of NMUs[8] could meet their Section 11 due diligence defense without any independent investigation

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7. The NMU would be able to meet its defense if it properly supervised the due diligence of its delegate the lead. *See* discussion *infra* Part IV.

8. Within an underwriting syndicate there are often several "tiers" of underwriters and the various underwriting firms in the syndicate often vie for position in the higher tiers. Leahy, *supra* note 2, at 2058. Within a syndicate, the term "junior underwriters" sometimes refers to all the underwriters except for the lead underwriters and sometimes the term is used to refer to only the lowest tier in the syndicate. *Id.* at 2013. This article does not need to differentiate among the various tiers. Nor does this article need to spend any time parsing through the various terms because, as discussed below, the due diligence analysis applies to all the non-managing underwriters regardless of their labels. *See infra* Part II.

or any monitoring of the due diligence investigation performed by the lead underwriters.[9] This part also discusses what appear to be typical practices by NMUs and briefly describes the parameters of Section 11.

Part III of this article analyzes the due diligence required of underwriters under both the plain language of Section 11 and its legislative history. This analysis reveals that the language of due diligence in Section 11 employs terms borrowed from the common law of trusts.

Accordingly, Part IV then analyzes trust law for guidance on the proper scope of trustee delegation and applies those trustee delegation concepts in the context of delegation by NMUs.

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9. *See SIFMA Refco Amicus*, *supra* note 6, at 5. *See infra* Part III as to why those factors are insufficient. The salient facts of Refco's registered offering problem can be summarized as follows. On August 16, 2005, Refco Inc. announced the completion of its initial public offering. United States Sec. & Exch. Comm'n, Form 8-K, Refco Inc., *available at* http://sec.gov/Archives/edgar/data/1321746/000110465905039844/a05-14370_48k.htm (Aug. 16, 2005). The offering was for $583 million. John C. Coffee Jr., *Securities Law: The Refco Meltdown*, 28 NAT'L L.J. 9, 4 (2005). Approximately two months later, on October 10, 2005, Refco disclosed that "it had discovered through an internal review a receivable owed to the Company by an entity controlled by Phillip R. Bennett, Chief Executive Officer and Chairman of the Board of Directors, in the amount of approximately $430 million . . . which may have been uncollectible." *See* Press Release, SEC, *Refco Announces Undisclosed Affiliate Transaction* (Oct. 10, 2005) *available at* http://sec.gov/Archives/edgar/data/1321746/000110465905048112/a05-17426_1ex99d1.htm. One week after the public disclosure, on October 17, 2005, Refco filed for bankruptcy and Phillip Bennett was indicted for various fraudulent actions. Press Release, United States Attorney Southern District of New York, *U.S. Indicts Former Owner of Refco and Expands Charges in Refco Fraud* (Jan. 16, 2007), *available at* http://www.usdoj.gov/usao/nys/pressreleases/January07/bennetttrosten-grantrefcoS3indictmentpr.pdf. The court determined that Refco had been fraudulently concealing "hundreds of millions in uncollectible trading losses and other operating expenses." Kirshner v. KPMG LLP (*Kirschner II*), 590 F.3d 186, 188 (2d Cir. 2009). The process of concealing these losses was effected by a using a complicated system of subsidiaries and third party loans to make it appear as if Refco had significantly more assets than liabilities, which was not the case. *Id.* The purchasers of the securities offered pursuant to Refco's public offering sued the underwriters, among others, under § 11. *Id.* In addition, the SEC filed an action against an individual who was a senior partner at Refco's outside counsel, and the Justice Department brought concurrent criminal charges. SEC v. Collins, 07 CV 11343, slip op. at 1 (S.D.N.Y. June 10, 2010). The partner eventually reached a plea agreement. *Id.* The investors also tried to bring a private claim for aiding and abetting against outside counsel as a group, which was dismissed on the grounds that a private right of action for aiding and abetting did not exist. *In re* Refco Sec. Litig. (*Refco III*), 609 F. Supp. 2d 304, 306 (S.D.N.Y. 2009).

Part V examines the relatively few cases discussing the role of NMUs in registered offerings. It also reviews how the Securities and Exchange Commission ("SEC") has addressed the due diligence responsibilities of underwriters over the years. It finds that the SEC requires at least some monitoring of the lead by the NMUs.

Part VI addresses some of the practical issues in terms of timing and costs involved in requiring NMUs to conduct some supervision of their delegates in order to earn their due diligence defenses. This part also discusses some of the ethical issues involving potential conflicts for the attorneys involved. Finally, the article concludes that all underwriters, including NMUs, must take responsibility. If NMUs do not investigate themselves, they must monitor those who do in order to satisfy their burden for a due diligence defense. Alternatively, NMUs should recast their role in a way that removes false comfort to purchasers who may believe that the firms have been involved in due diligence. The article ends with the standard admonition to the industry to refrain from pushing the envelope too far.[10]

II. NON-MANAGING UNDERWRITERS' DUE DILIGENCE PRACTICES AND DESCRIPTION OF SECTION 11

This section first describes current characterizations of the due diligence activities of NMUs. Then, in order to put the NMUs' responsibilities in context, this section briefly describes the parameters of Section 11.

A. CURRENT DUE DILIGENCE PRACTICES BY NMUS: JUST SIT THERE AND LOOK PRETTY

One reason the role of NMUs in due diligence has remained relatively unexplored may be that commentators assumed that participating NMUs were at least minimally questioning and reviewing the work of the lead underwriter.[11] It appears, however, that extreme passivity by NMUs may actually be the norm. SIFMA's recent amicus

10. In consideration to the readers, this author refrained from using the clichéd "pig theory."

11. Another reason for confusion on the appropriate due diligence role of NMUs may stem from an overreliance by commentators on dicta in a handful of cases. *See infra* Part IV.

brief filed in litigation involving now-bankrupt Refco Inc. takes the position that a tier of NMUs could meet their Section 11 due diligence defense without questioning the due diligence investigation performed by the lead underwriters.[12]

SIFMA's argument on behalf of passive NMUs appears to rest primarily on reliance on reputational factors.[13] The crux of the claim is that NMUs can meet their due diligence burden in a registered offering by relying on the reputation of, and their previous experiences with, the lead underwriters and underwriters' counsel.[14] Under this view, the passive NMUs do not need to undertake even minimal monitoring of the lead underwriter's due diligence activities with regard to the particular issuer or the actual securities offered in the upcoming registration statement.[15]

Unfortunately, reputational-based factors ring particularly hollow in light of recent analytical and empirical studies demonstrating the failures of gatekeepers, particularly auditors and underwriters, in registered offerings. Professor Coffee has been particularly prolific in his gatekeeper scholarship and has questioned whether the term "gatekeeper" is apt.[16] Other scholars have been similarly dismissive of reliance on the reputation of gatekeepers.[17] According to Professor Partnoy, "Professor Coffee and others have demonstrated that reputation alone is a suboptimal constraint."[18] Both Professor Coffee and Professor Partnoy have envisioned replacing the current system of due diligence with some variant of a modified strict liability system in which gatekeepers ensure the reliability of the work they oversee.[19] Alternatively, Professor Fox, an influential scholar in corporate

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12. *See SIFMA Refco Amicus*, *supra* note 6, at 5; *see also infra* note 14 and accompanying text.

13. *SIFMA Refco Amicus*, *supra* note 6, at 5.

14. *Id*.

15. *Id.*

16. *See, e.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004); John C. Coffee, *A Section 11 Safe Harbor*, N.Y.L.J., Sept. 15, 2005, at 5 col.1; John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002).

17. *See* Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365 (2004).

18. *Id.* at 375.

19. *See* Coffee , *supra* note 16, at 349-351; Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001).

governance and civil liability, has argued for replacing the public offering gatekeeper with an external "certifying entity."[20] Until these reforms take hold, it is important to recognize that recent studies reveal that gatekeepers' reputational concerns have not served as sufficient incentives for underwriters to screen and police issuers.[21] Rather, recent empirical studies suggest that "underwriters' concerns about generating revenues appear to override their concerns about reputation."[22]

The justification for the total delegation position appears to be that it conforms to current industry practice. According to SIFMA, it is typical for certain NMUs to delegate all investigative duties to the lead underwriter and not to monitor the delegate.[23] Moreover, the amicus suggests that certain underwriters customarily agree, simply in order to be invited to join the syndicate, to give up even minimal abilities to review the work of the lead underwriters.[24] While SIFMA's amicus particularly refers to junior underwriters,[25] Section 11 does not

20. Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 240 (2009).

21. *Id.*

22. Anup Agrawal & Tommy Cooper, *Accounting Scandals in IPO Firms: Do Underwriters and VCs Help?* 39 (European Fin. Ass'n, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1009782. In their interesting recent empirical study, Professors Agrawal and Cooper come to the troubling conclusion that an IPO issuer was actually *more likely* to have to issue a financial restatement to correct violations of generally accepted accounting principles after its IPO, if the lead investment bank underwriter for the IPO was one with a supposedly better reputation than other investment banks. *Id.* The authors explain that bulge-bracket banks appear, perhaps because of their size and power, to be able to tolerate "reputational risks posed by low-quality issuers" without effect. *Id.* They note, for example, that Goldman Sachs has been "referred to as the 'Teflon' investment bank because its reputation has not suffered from its involvement in various scandals over the past decade." *Id.* at 9.

23. *See infra* Part IV. The SIFMA amicus uses the term lead underwriters or lead managers to refer to the "firms that have been working for some time with the issuer, and have developed a working relationship with the issuer." *SIFMA Refco Amicus*, *supra* note 6, at 3. The amicus notes that generally, it is the lead managers who decide "whether and when to invite other securities firms to join the syndicate as co-managers." *Id*. The amicus also explains that the lead managers also "retain counsel to act for all the underwriters." *Id*.

24. *Id.*

25. *Id*. Similarly, the underwriter defendants in Refco use the term "junior underwriters" to mean a subset of NMUs. Underwriters' Mem. of Law in Opp'n to Pls.' Mot. for Partial Summ. J. in *In re Refco, Inc. Sec. Litig.*, Master File No. 05 Civ. 8626, at 4 (GEL) [hereinafter *Underwriters' Memorandum in Opposition*]. The term

distinguish among the various tiers of participating underwriters.[26] Accordingly, this article analyzes the due diligence responsibilities of non-managing participating underwriters.

This article recognizes that NMUs in a syndicate[27] routinely cede the bulk of the due diligence investigation to the lead underwriters, so that the work is not duplicative.[28] Such delegation to the lead is neither new nor controversial and, in fact, is logical and prudent. What is troubling, however, and where this article parts ways with SIFMA's characterization of current industry practice, is for NMUs to cede the ability to supervise their delegate—a step that is neither logical nor prudent.

While concerns with this system of total delegation by NMUs to lead underwriters could be analyzed through the prism of *Refco*, commentators have already explored the spectacular Refco collapse, including the embarrassing failures of the various underwriters as gatekeepers.[29] Thus, this article does not focus on the *Refco* litigation or

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"junior underwriter" is sometimes used as shorthand to refer to "small to mid-size investment firms, each offering investment banking and underwriting services through their capital markets division." *Id*. The *Underwriters' Memorandum in Opposition* further notes that "IPO underwriting syndicates usually consists of lead managers, co-managers, and junior underwriters, each of which serve different roles and have different responsibilities." *Id.* at 5. According to the *Underwriters' Memorandum in Opposition*, "[j]unior underwriters are typically not invited into an IPO underwriting syndicate until the final days before the shares are priced and distributed, after the preliminary prospectus has been distributed and the marketing of the IPO has begun." *Id.* While the timing of junior underwriters joining the syndicate may differ from the timing of other non-lead participants joining, § 11makes no substantive distinction among non-lead participating firms for purposes of due diligence. *Id.*

26. *Id*.

27. *See In re* Activision Sec. Litig., 621 F. Supp. 415, 434 (N.D. Cal. 1985). The court describes a typical underwriting syndicate for a public offering as follows:

> The underwriters, or members of the syndicate, enter into an agreement commonly referred to as an agreement among underwriters. The managing or lead underwriters are given authority to act on behalf of all syndicate members with respect to underwriting the issue and getting it to market. They are responsible for negotiating and contracting with the issuer, preparing the registration statement and participating in the "due diligence" meeting. The warranties and representations of the company contained in the agreement between the underwriters and the issuer run to all members of the syndicate; the obligations of the syndicate to the company are shared by all its members.

Id.

28. *Id*.

29. Emily Thornton, *Refco: The Reckoning*, BUS. WK. ONLINE, Nov. 7, 2005,

the amicus SIFMA filed in the case. Rather, this piece solely uses the *Refco* litigation and SIFMA's amicus as a springboard to explore the legal basis for the total delegation position.[30]

Admittedly, the amicus also tees up a number of broader questions regarding the role of all underwriters, not just NMUs. First, is due diligence a quaint relic that can be disregarded with impunity? Or, is due diligence a remaining justification for paying underwriters their hefty gatekeeper prices?[31] Second, if some underwriters do not serve as true gatekeepers, because they perform no evaluative underwriting functions, is it misleading to refer to them as underwriters and tout their reputations in an offering? In other words, is it illusory to list a firm who performs no due diligence at all as an "underwriter" in an offering?[32]

Third, if underwriters complain that they have trouble performing due diligence because issuers move too quickly, is the answer that they should find creative ways to perform under pressure? Finally, when underwriters argue that they cannot be expected to uncover fraud because it is too well hidden, is the answer that they should give up and attempt to convince courts to ignore the existing statutory framework?[33]

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available at http://www.businessweek.com/magazine/content/05_45/b3958095.htm. "In theory, Wall Street has gatekeepers—the major investment banks—to scrutinize dubious deals. But in practice, the banks are hungry for fees and sometimes appear to take this critical job more lightly than the public expects." *Id*. *See generally* Coffee, *Refco Meltdown*, *supra* note 9.

30. *SIFMA Refco Amicus*, *supra* note 6, at 2-3. According to the SIFMA Refco amicus brief, junior underwriters can meet their affirmative defense of due diligence without any review at all of the due diligence performed by the lead underwriters. The brief provides that "it [is] sufficient for purposes of the Section 11 due diligence defense for [the junior underwriters] to rely on the reputations of the lead underwriters and underwriters' counsel and on their experience in dealing with the lead underwriters and counsel in prior transactions." *Id*.

31. Underwriting fees in registered public offerings can be quite substantial. Reports estimate that in initial public offerings, for example, underwriters typically obtain commissions of "between four to ten percent of gross offering proceeds." William K. Sjostrom, Jr., *The Birth of Rule 144A Equity Offerings*, 56 UCLA L. REV. 409, 435 (2008). Moreover, issuers typically pay the underwriters' legal, due diligence, and marketing expenses of the offering. *Id.*

32. By analogy, in Walk-In Medical Ctrs. Inc. v. Breuer Capital Corp., the court found it illusory to describe an offering as a firm commitment underwriting when the underwriters "were entitled to terminate the agreement due to *any* unfavorable market decline." 818 F.2d 260, 264 (2d Cir. 1987).

33. Several articles analyzing the lead underwriters' role in modern offerings call

In other words, are underwriters underperforming? All of these questions are logically raised when underwriters, or their surrogates, advocate extreme positions such as the one proffered by SIFMA in its amicus brief in the *Refco* litigation. One way to ponder these bigger questions is to return to basic principles regarding underwriters. Careful review of those principles shows that the total delegation position flies in the face of the plain language of Section 11, its legislative history, and its interpretations in SEC releases and cases.[34]

B. STRUCTURE OF SECTION 11 AND UNDERWRITERS: A UNIQUE POSITION

Before turning to the role of NMUs in due diligence, it is helpful to describe briefly the structure of Section 11 and its requirements. Section 11 is a meticulously crafted private liability statute. It differs from other federal securities statutes where Congress left the specifics to be fleshed out by the SEC or the courts.[35]

Section 11 provides a private right of action under certain carefully prescribed conditions. The plain language of Section 11 denotes precisely who has the right to bring a suit, which violations are covered, lists the possible defendants, articulates various affirmative

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for legislative changes. *See, e.g.*, John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1211 (1997). As Judge Cote explained in *WorldCom*, these calls for changing the statute serve to emphasize that the existing statutory structure creates certain responsibilities for underwriters and that deviations from these responsibilities would require legislative changes. *See In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 671 (S.D.N.Y. 2004). "Implicit in these calls for a legislative change is the recognition that current law continues to place a burden upon an underwriter to conduct a reasonable investigation . . ." *Id.* An interesting recent empirical study argues that in "an era of high-profile corporate scandals, the ability of issuers to side-step due diligence could have severe consequences for investors." Don M. Autore et al., *Accelerated Equity Offerings and Firm Quality* 2 (2009), *available at* http://ssrn.com/abstract=1265148. The authors examined recent shelf equity offerings and found that higher quality issuers signaled their quality to the market by allowing more time for underwriters to perform due diligence (by using bookbuilt shelf offers) than lower quality issuers who instead used accelerated shelf offers that limited time for underwriter due diligence to prevent exposure of their true quality. *Id.* at 3.

34. *See infra* Part V.

35. Less precise statutes may be deliberately bare bones to allow courts to handle future and unforeseen schemes that violate the general prohibitions and purposes of the statute. In addition, less specific statutes may be political compromises where Congress was willing to allow the relevant administrative agencies or the courts to fill in the gaps.

defenses that may be raised, and even addresses damages.[36]

Because of the detail provided in the statute, the substantive legal parameters of Section 11 are generally well established. Although complaints involving Section 11 are filed each year, the cases typically do not involve challenges to the substantive legal parameters of the statute. Rather, Section 11 cases are often confined to factual questions, such as whether, in a particular case, a registration statement actually contains a material misstatement or omits a material fact. Other Section 11 cases involve procedural issues, such as whether the plaintiff or defendant's class should be certified,[37] or whether a complaint alleging a Section 11 violation is so interwoven with a fraud claim that it "sounds in fraud," thereby triggering the higher pleading requirements of 9(b) of the Federal Rules of Civil Procedure.[38] Accordingly, the substantive parameters of Section 11 can be summarized without difficulty.

Perhaps the most significant limitation for investors attempting to pursue a claim under Section 11 is that Congress confined Section 11 liability to securities purchased pursuant to a defective registered public offering.[39] Thus, an investor who purchased securities through a

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36. Congress' desire for certainty in drafting such a detailed statute could be criticized for failing to allow flexibility in the law to address future developments. These criticisms are tempered, however, by other statutes allowing flexibility and, of course, by the ability of Congress to repeal or modify the statute, and detail has not, so far, made it irrelevant or inapposite.

37. *See, e.g.*, *In re* Gap Stores Sec. Litig., 79 F.R.D. 283 (N.D. Cal. 1978); *In re* Computer Memories Sec. Litig., 111 F.R.D. 675 (N.D. Cal. 1986); *discussion infra* Section IV.

38. The Eighth Circuit in *In re* NationsMart Corp. Sec. Litig. reasoned that "Rule 9(b) does not apply to claims under § 11 of the Securities Act, because proof of fraud or mistake is not a prerequisite to establishing liability under § 11." 130 F.3d 309, 314 (8th Cir. 1997). Other circuits, however, have applied Rule 9(b) to § 11 actions where there are allegations of fraud interwoven in the complaint. *In re* Stac Elecs. Sec. Litig., 89 F.3d 1399, 1404-05 (9th Cir. 1996). The Court in *In re Stac Electronics* found that "the particularity requirements of Rule 9(b) apply to claims brought under § 11 when . . . they are grounded in fraud." *Id.* at 1405-06. *See also* ACA Fin. Guar. Corp. v. Advest, Inc., 512 F.3d 46, 68 (1st Cir. 2008); Wagner v. First Horizon Pharm. Corp., 464 F.3d 1273, 1277 (11th Cir. 2006); Rombach v. Chang, 355 F.3d 164, 170-71 (2d Cir. 2004).

39. A person who buys pursuant to a defective registration statement can be a plaintiff. Securities Act § 11(a), (e). There is no reliance requirement imposed on the plaintiff unless the plaintiff purchased the securities after the issuer made available an earnings statement that covered at least a year beginning after the effective date of the registration statement. *Id.* Moreover, the plaintiff does not have the burden of proving causation or damages in a § 11 case. *Id.*

defective private non-registered offering cannot make a Section 11 claim.[40] Moreover, only purchasers who can trace their securities directly to the defective registration statement can make a claim.[41] While this tracing requirement is usually not difficult to meet for securities purchased in initial public offerings ("IPOs") or for debt offerings, it imposes problems for purchasers of securities where the

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40. Private offerings have become more attractive since the SEC's easing of resale restrictions for buyers. Rule 144, for example, now requires only a 6 month or 12 month holding period before resales —depending on whether the issuer is a reporting company or a non-reporting company. Sjostrom, *supra* note 31, at 419. Moreover, for offerings to qualified institutional buyers under Rule 144A there is no required holding period. *Id.* Estimates are that "over $1 trillion of debt and equity capital was raised in 2006 through Rule 144A offerings" alone. *Id.* at 412. While the purchaser of securities issued pursuant to a non-registered offering cannot bring a § 11 action, he might be able to obtain redress through Section 10(b) of the 34 Act and Rule 10b-5 thereunder. *Id.* at 438-39. Interestingly, Rule 144A played a supporting role in the Refco saga. *In re* Refco, Inc. Sec. Litig (*Refco II*), 05 Civ. 8626 (GEL), 2008 WL 3843343, at *1 (S.D.N.Y. Aug. 14, 2008). Shortly before issuing bonds under the defective registration statement, Refco had issued unregistered bonds using Rule 144A. *Id.* Some of the holders of the bonds issued through the 144A private placement then exchanged their bonds for bonds issued in the 2005 registered offering. *Id.* Those bond holders argued that they should be allowed to sue the underwriting firms involved in the Rule 144A offering under § 11. *Id.* Two primary arguments were advanced on behalf of the holders of the bonds. *Id.* First, the holders argued that § 11 applied because the privately placed bonds were issued as part of an "integrated financing scheme" with the publicly registered bonds that were issued pursuant to the defective registration statement. *Refco II*, 2008 WL 3843343, at *1. However, the court in *In re* Refco, Inc. Securities Litigation (*Refco I*), found that the two transactions were separate and, accordingly, that the holders of the unregistered bonds could not bring a § 11 action under an integration theory. 503 F. Supp. 2d 611, 627-28 (S.D.N.Y. 2007). The second argument raised by the holders of the Rule 144A bonds was that the underwriters in the 144A bonds were liable under § 11 because they "played a substantial role in drafting and editing" the defective registration statement. *Refco II*, 2008 WL 3843343, at *1. The court rejected this second argument as well. *Refco I*, 503 F. Supp. 2d. at 627-28. Tellingly, the court reasoned that participation by an underwriting firm in drafting, editing, or other behind the scene activity is not sufficient for purposes of § 11. *Id.* Rather, the lynchpin for defendant status as underwriters for § 11 is listing the firm as an as underwriter such that the firm hold itself "out as evaluating the registered bonds or endorsing the registration statement." *Refco II*, 2008 WL 3843343, at *5

41. Demaria v. Anderson, 318 F.3d 170, 178 (2d Cir. 2003). This is referred to as tracing. *Id.*; *see also*, Krim v. pcOrder.com, Inc., 402 F.3d 489 (5th Cir. 2005). In addition, the plaintiff would need to bring his § 11 claim within the statute of limitations period specified in Section 13, which is 1 year from the date the offense was or should have been discovered and 3 years from the offering. 15 U.S.C. § 77m.

issuer has various stocks outstanding.[42]

A registration statement is defective for purposes of Section 11 if it contains a material misstatement or omits a material fact necessary to make the statements therein not misleading.[43] Materiality for Section 11 purposes is analyzed under the standard framework of *TSC Industries v. Northway*.[44] Thus, a material misstatement or omission is one where there is a substantial likelihood that the fact would have been viewed by a reasonable investor as having significantly altered the total mix of information.[45] Moreover, the probability/magnitude test of *Basic v. Levinson*[46] applies as well.[47] Both materiality tests are tempered by the bespeaks caution doctrine.[48]

42. *See* Bloomenthal, *Securities Law Handbook* § 29.64 (2008). An investor who purchased securities issued pursuant to a defective registration statement in the secondary market has standing but that purchaser would have to trace his secondary market purchase to the offering statement. *See id.*

43. *See* § 11. In terms of who may sue and for which violations, § 11(a) provides as follows:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue . . . [list of defendants].

Id.

44. 426 U.S. 438, 449 (1976).

45. *Id.*; *DeMaria*, 318 F.3d at 180.

46. 485 U.S. 224 (1988).

47. *Id.* *Basic v. Levinson* requires an additional level of analysis for the TSC's materiality test, if the event is speculative. *Id.* at 232, 238. Under the probability/magnitude test of *Basic*, one assesses whether a speculative event or development needs to be disclosed by weighing the probability that the event will occur with the anticipated magnitude of the impact of the event. *Id*. at 238.

48. Under the "bespeaks caution" doctrine "forecasts, opinions, or projections do not amount to 'material misrepresentations' if 'meaningful cautionary statements' accompany the forward-looking statements." Ronald J. Colombo, *Buy, Sell, or Hold?: Analyst Fraud From Economic and Natural Perspectives*, 73 BROOK. L. REV. 91, 110 (2007). In *In re* NationsMart Corp. Sec. Litig., however, the Court noted that a § 11 claim cannot be dismissed under the "bespeaks cautions" doctrine where the cautionary language amounts to only "general risk warnings or mere boilerplate, they must be detailed and specific." 130 F.3d 309, 317 (8th Cir. 1997). See also *In re* Giant Interactive Grp., Inc. Sec. Litig., 643 F. Supp. 2d 562, 571 (S.D. N.Y. 2009) (explaining that in a § 11 case, defendants "cannot, as a matter of law, be absolved of liability pursuant to the 'bespeaks caution' doctrine where they failed to disclose the existence of facts known for many months that would negatively affect [the issuer's] business but

In addition to Section 11's plain language specifying precisely who has the right to sue and which violations are covered, the statute also explicitly lists potential defendants.[49] The list includes those who sign the registration statement,[50] which essentially means the issuer, the chief executive officer, the chief financial officer, the comptroller and a majority of directors.[51] Congress went beyond those who sign the registration statement, however. It also expressly listed as potential Section 11 defendants the remaining directors,[52] various experts who prepared or certified a part of the registration statement,[53] and, most importantly for purposes of this article, the underwriters.[54]

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only warned that the facts 'could' negatively affect their business").

49. Section 11(a) lists the defendants as follows:

> (1) every person who signed the registration statement;
>
> (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
>
> (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
>
> (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
>
> (5) every underwriter with respect to such security.

15 U.S.C. § 77k.

50. Section 11(a)(1) cross references to § 6 of the Securities Act of 1933 which provides in relevant part that a "registration statement . . . .shall be signed by each issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of its board of directors or persons performing similar functions . . . " 15 U.S.C. § 77f.

51. *Id.*

52. § 11(a)(2)-(3).

53. § 11(a)(4). The most commonly recognized experts for purposes of § 11(a)(4) are the accountants. *Id.* Other experts might include specialized experts such as geologists if the registration statement includes an expert report. *Id.*

54. § 11(a)(5). If a participant in the registered offering is not listed in §§11(a)(1) through (5), there is no § 11 liability, unless the participant is deemed to be a control person (under Section 15) of any of the defendants listed. *Id.* Moreover, a participant not subject to liability under § 11 (even after applying a control person analysis) could in circumstances involving fraud face liability under an anti-fraud provision such as Section 10(b) of the 1934 Act and Rule 10b-5 thereunder. *Id.*

III. DUE DILIGENCE REQUIRED OF UNDERWRITERS UNDER PLAIN LANGUAGE OF SECTION 11 AND LEGISLATIVE HISTORY

Clearly, underwriters are listed defendants in Section 11 actions. Just as clearly, underwriters have the affirmative defense of due diligence that they can use to avoid liability. A question arises, however, as to whether all the underwriters are liable and if they all have the affirmative defense. Again, turning directly to the statute helps to answer these questions.

A. PLAIN LANGUAGE OF SECTION 11 REQUIRES ACTION FROM ALL UNDERWRITERS: NOT JUST ANOTHER PRETTY FACE

As a natural starting point, the plain language of Section 11 provides that a purchaser of a security issued pursuant to a defective registration statement may sue "every underwriter with respect to such security."[55] The term "every underwriter" clearly means that each underwriter in an offering, not just the lead underwriter, is a proper Section 11 defendant.[56] The term "every" logically encompasses lead, managing, and junior underwriters as Section 11 defendants.[57] On this point, there does not appear to be any serious disagreement. However, there is disagreement as to what the NMUs must do to benefit from the affirmative defenses that Congress made available to defendants in Section 11(b)(3).[58] If a defendant underwriter can meet an affirmative defense as expressly provided for in Section 11(b)(3), that defendant can avoid liability even though the defendant served as an underwriter of

55. *Id.*

56. *Id.*

57. *Id.* Bolstering this reading is § 11(e), which limits an underwriter's liability to the total public offering price of the securities underwritten by such underwriter. § 11(e).

58. Congress also provided two other affirmative defenses for defendants other than the issuer. § 11(b)(1),(2). Section 11(b)(1) and (2) provide what can be referred to as whistle blower defenses. *Id.* Basically, a defendant can assert a (b)(1) defense if prior to the effective date of the registration statement the defendant resigned and advised the SEC and the issuer in writing about the issue and that the defendant was not responsible. *Id.* § 11(b)(1). A defendant can make an (b)(2) defense if after the effective date the defendant became aware of the problem and acted quickly and advised the SEC and the public and the problem was without this defendants' knowledge. *Id.* § 11(b)(2).

securities issued pursuant to a defective registration statement.[59]

In devising affirmative defenses,[60] Congress distinguished between

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59. *Id.* § 11(b)(3).

60. Defendants other than the issuer have the affirmative defenses specified in § 11(b), which provides as follows:

> (b) Persons exempt from liability upon proof of issues.
>
> Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—
>
> (1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or
>
> (2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or
>
> (3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, 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; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) 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, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy

material misstatements or omissions in the non-expert portion of the registration statement versus those in the expert portion of the registration statement.[61]

If the defect occurred in the non-expert portion of the registration statement (*e.g.*, management's discussion and analysis section), defendants must meet a three-prong requirement to avail themselves of the affirmative defense.[62] Section 11(b)(3)(A) provides that a non-expert defendant, such as an underwriter, meets its affirmative defense for defects in the non-expert portion only if the defendant proves that: (1) "he had, after reasonable investigation," (2) "reasonable grounds to believe" and (3) "did believe" that the registration statement did not contain a material misstatement or omission.[63] This is a three prong conjunctive test and all three prongs are vital.[64] Thus, if the defendant had objectively reasonable grounds to believe, and subjectively did believe there was no defect, but the defendant failed to investigate, it would not meet its burden.[65] Similarly, the defendant's investigation and a reasonable person's belief based on that investigation would not sufficiently establish the defense, if the defendant actually knew there was a material misstatement.[66]

By contrast, if the defect occurred in the portion of the registration statement prepared by the experts (*e.g.*, the financial statements prepared by the accountants), then a non-expert defendant, including an underwriter, could meet the affirmative defense by satisfying a less stringent two-prong test.[67] The underwriter would meet its affirmative

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> of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

Id. § 11(b).

61. *Compare id.* § 11(b)(3)(A) *with id.* § 11(b)(3)(B).

62. *Id.* § 11(b)(3)(A).

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.* § 11(b)(3)(C). Although this two-prong due diligence test is sometimes referred to as the reliance test, this author does not find the alternative terminology particularly helpful. Accordingly, this article will refer to the alternative due diligence tests as the three-prong and the two-prong tests.

defense for a defect in the expert portion by proving: (1) that "he had no reasonable ground to believe" there was a defect and (2) that he subjectively "did not believe" there was a defect.[68] In these expert portion cases, the statute does not require the underwriters to undertake a due diligence investigation into whether the expert portion of the registration statement contains a material misstatement or omits a material fact.[69] Yet, merely proving one of the two required prongs is insufficient.[70] Again, the prongs are conjunctive.[71] Thus, even if an underwriter subjectively believed there was no problem with an offering, it would also have to prove there was no "reasonable ground to believe" otherwise.[72] If, for example, there were "red flags" indicating a problem with the expert portion, the defendant would be hard pressed to show he met the "no reasonable ground to believe" prong.[73] Rather, the "red flags" would suggest that there were reasonable grounds to believe there were significant problems. In those "red flag" cases, the underwriter could still meet its two-prong burden, but it would have to demonstrate that despite the red flags it was still reasonable to believe that there were no material defects. As a practical matter, when "red flags" are present, the underwriters will want to investigate the red flags in the expert's portion in order to be satisfied.

The plain language of Section 11, particularly the phrase "every underwriter" found in Section 11(a)(5), coupled with the phrase "he had, after reasonable grounds to believe" found in Section 11(a)(3)(A), clearly indicates that Congress required each underwriter, not just the lead, to meet its affirmative defense to avoid liability.[74] Section 11(d) bolsters this reading by setting forth different effective dates for those

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68. *Id.*

69. *Id.* Of course, if the same defect occurred in both the expert portion and the non-expert portion, then the defendant would have to meet the applicable affirmative defense for each portion. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 683 (S.D.N.Y. 2004).

70. § 11(b)(3)(C).

71. *Id.*

72. *Id.*

73. In *In re WorldCom* Judge Cote vividly described red flags as including "facts or circumstances that 'would suggest to an investor of ordinary intelligence the probability that she has been defrauded.'" *In re WorldCom*, 346 F. Supp. 2d at 672-73. (quoting LC Capital Partners, LP v. Frontier Ins. Grp., Inc., 318 F.3d 148, 154 (2d Cir. 2003)).

74. §§ 11(a)(5), (b)(3)(A).

underwriters who join in the offering later in the selling period. Section 11(d) provides the following:

> (d) Effective date of registration statement with regard to underwriters. If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.[75]

In Section 11(c), Congress provided guidance to defendants attempting to prove they had conducted a "reasonable investigation" and had "reasonable grounds" to believe.[76] Section 11(c) provides the following guiding principle:

> (c) Standard of reasonableness. In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.[77]

IV. TRUST LAW TERMINOLOGY USED IN SECTION 11

Discerning the contours of a defendant's responsibility under the "reasonable investigation" and "reasonable grounds" requirements of Section 11(c) demands a careful review of the plain language of Section

75. § 11(d). One expert in public finance explains that non-managing underwriters have more exposure in registered offerings than they do in municipal offerings because of the structure of § 11. "When the issue of the reasonableness of each participating underwriter is brought to light, the fundamental difference between liability for nonlead underwriters in public finance and nonlead underwriters in corporate finance becomes apparent." Robert A. Fippinger, The Securities Law of Public Finance § 7:9.1, *7-165 to 166 (2006). A plaintiff in a municipal financing offering would have to prove that the non-lead underwriters acted with scienter for a Rule 10b-5 claim whereas, a "corporate civil action under section 11 . . . has the benefit to the plaintiff of the statutory language making 'every underwriter' liable without distinction between the lead underwriter and the comanagers or syndicate members." Id. at *7-166.

76. § 11(c).

77. *Id.*

11(c) in the context of the statute.[78] Additionally, a review of the statute's legislative history further aids this search for guidance on the parameters of Section 11(c).[79]

A. BORROWING FIDUCIARY TERMS: ONE SIZE FITS ALL

In his March 29, 1933 transmittal message to Congress seeking Federal legislation regulating securities, President Franklin D. Roosevelt explained that what was needed was "a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others."[80] Much to the dismay of underwriters then and now, this trustee principle appears in Section 11 of the 1933 Act.[81]

Section 11(c) contains a well-understood phrase borrowed from trust law.[82] In this section, Congress wrote that a "reasonable investigation" is that of a "prudent man in the management of his own property."[83] The prudent man phrase is synonymous with the duty of a trustee.[84]

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78. *Id.*

79. The following reminder by Judge Landau of the Oregon Court of Appeals of the "messy realities" of statutory construction is apt: "Statutory construction is an inherently imprecise process and requires careful weighing of linguistic, logical, and historical evidence . . . ." Jack L. Landau, *Some Observations About Statutory Construction in Oregon*, 32 WILLAMETTE L. REV. 1, 68 (1996).

80. Franklin D. Roosevelt, *Message from the President of the United States* (Mar. 29, 1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at item 15:1 (compiled by J.S. Ellenberger & Ellen P. Mahar, 1973). Presidential transmittal letters, while obviously not written by Congress, "may be useful in discerning the original point of a statute." 2A SUTHERLAND STATUTORY CONSTRUCTION § 48A:11, at 6 (7th ed. 2003). For an authoritative analysis of the history of the debates and conflicting philosophies that gave rise to Federal securities legislation after the 1929 crash *see* 1 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION, 252–305 (4th ed. 2006). For an intriguing description of development of the Securities and Exchange Commission *see generally* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET, A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (3d ed. 2003).

81. Securities Act, § 11.

82. *Id.*

83. *Id.*

84. *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 267 (3rd ed.

By using this well-understood phrase, Congress clearly insisted on the same quality of investigation that would be required of a trustee—no more and certainly no less. Although this reading is clear, SIFMA, in the amicus it filed in the *Refco* litigation, suggests that the "prudent man in the management of his own property" phrase requires less care than would be required of a fiduciary.[85] SIFMA argues, "by expressly incorporating a 'prudence' standard, Section 11(c) necessarily requires courts and juries to measure the conduct of underwriters by the reasonable commercial standards of their day."[86] However, such a reading of the statute and the legislative history of Section 11(c) is mistaken.

The conference report for the 1933 Act explains that the fiduciary standard adopted in Section 11(c) was actually a compromise position.[87] The Senate wanted a stricter "insurer" standard for defendants, while the House wanted the fiduciary standard.[88] The compromise made at conference was to accept the "fiduciary" standard from the House version, but to include the additional defendants listed in the Senate version, such as underwriters and experts.[89] Also instructive is that civil

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2004). *See also* RESTATEMENT (SECOND) OF TRUSTS § 174 (1959) ("The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has . . . greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill."). The same language appeared in the RESTATEMENT (FIRST) OF TRUSTS § 174 (1935).

85. *See SIFMA Refco Amicus*, *supra* note 6, at 2.

86. *Id.*

87. H.R. REP. NO. 73-152 (1993) (Conf. Rep.) (to accompany H.R. 5480) [hereinafter *Conference Report*].

88. *Id.*

89. *Id.* The Conference Report explains this compromise as follows:

> A point of difference between the House bill and the Senate amendment concerned the civil liability of persons responsible for the flotation of an issue. The Senate amendment imposed upon the issuer, its directors, its chief executive, and financial officers a liability, which might appropriately be denominated as an insurer's liability. They were held liable without regard to whatever care they may have used for the accuracy of the statement made in the registration statement. The House bill, on the other hand, measured liability for these statements in terms of reasonable care, placing upon the defendants the duty, in case they were sued, of proving that they had used reasonable care to assure the accuracy of these statements. The standard by which reasonable care was exemplified was expressed in terms of a fiduciary relationship. A fiduciary under the law is bound to exercise diligence of a type commensurate with the confidence, both as to integrity and competence, that is placed in him. . . . . In choosing between these two standards of

liability under Section 12 of the 1933 Act, which also appeared in H.R. 5480, never used any fiduciary terminology,[90] thus making it clear that Congress intended a higher hurdle under Section 11.[91]

Perhaps confusion as to the required reasonable investigation necessary for the Section 11 due diligence defense arises because the original wording of Section 11(c) was revised the following year. The original version of Section 11(c), enacted in May of 1933 as part of the 1933 Act, provided:

> (c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness *shall be that required of a person occupying a fiduciary relationship*.[92]

However, when Congress passed the Securities Exchange Act of 1934 ("the 1934 Act"), it also amended portions of the then-recently enacted 1933 Act, including Section 11(c). Thus, in 1934, Congress restated Section 11(c) of the 1933 Act to provide that the standard of reasonableness is "that required of *a prudent man in the management of his own property*."[93]

The legislative history makes clear, however, that Congress did not intend any substantive change when it revised the language of Section 11(c).[94] The conference committee report for the 1934 Act explains that

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> liabilities, the Senate accepted the standards imposed by the House bill. Though the standards of the Senate amendment were more severe than those embodied in the House bill, the classes of persons upon whom liability was imposed were less. The House bill imposed liability upon the underwriters and also upon the experts, such as accountants, appraisers and engineers, who gave the authority of their names to statements made in the registration statement.

Id.

90. *Id.*

91. *Id*.

92. H.R. 5480, 73d Cong. § 11(c) (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at item 24:24 (compiled by J.S. Ellenberger & Ellen P. Mahar, 1973) (emphasis added).

93. Securities Act § 11(c) (emphasis added).

94. Ernest L. Folk, III, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 1, 19 (1969). Professor Folk notes that the revised "language chosen in 1934 precisely duplicates the wording of the standard of care in the contemporary Restatement of Trusts." *Id.* at 44. Professor Folk also observes that the fiduciary language adopted refers to a prudent man managing his own "property" – a measure that denotes the higher trustee standard not a prudent man managing his own "affairs," which would instead suggest the slightly lesser corporate director fiduciary

the language change in Section 11(c) was simply to clarify that Congress wanted the standard common law fiduciary language to apply.[95] According to the report, "[t]he amendment to section 11(c) removes possible uncertainties as to the standard of reasonableness by substituting for the present language the accepted common law definition of the duty of a fiduciary."[96] Significantly, in response to heavy lobbying by financial interests, Congress liberalized other parts of Section 11 through amendments enacted as part of the 1934 legislation, but it did not deviate from the fiduciary standard for defendants in Section 11(c).[97]

While Congress clearly intended the trustee standard, the trust analysis is not a perfect fit. A typical trustee relationship requires not just a fiduciary, but also a settlor and beneficiaries.[98] Here, Congress' fiduciary language requires some creative license. While the issuer could be deemed the settlor, the issuer is also a defendant under Section 11 by virtue of Section 6. Thus, any "trust" agreement between the issuer and the underwriters waiving any fiduciary duties on the part of the underwriters would seem self-serving at best. Trust law, however, allows settlors to serve as trustees.[99] Moreover, even when a settlor serves as a trustee, trust law allows the settlor, through a trust document, to waive certain of the trustee's duties.[100] On the other hand, certain trustee's duties are mandatory and cannot be waived by agreement between the settlor and the trustee.[101] Perhaps the "settlor" in a registered offering is in part the issuer but also in part the investors.

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standard. *Id.*

95. *See Conference Report*, *supra* note 87.

96. H.R. REP. NO. 73-1838. *See also* , 78 CONG. REC. 8716 (statement of Comm'r James M. Landis):

> The present section 11(c) fixes as the standard of reasonableness the standard required of a person occupying 'a fiduciary relationship.' This definition has apparently created considerable consternation, and I would be agreeable to a change which would state the meaning of a fiduciary relationship in commonly accepted terminology. I do not, however, believe that a definition of the standard of reasonableness as a fiduciary standard should be omitted from this section of the act.

Id. (asking Senator Fletchor to print the proposed amendments to § 11(c) of the 1933 Act in the Congressional Record).

97. *See Conference Report*, *supra* note 87.

98. RESTATEMENT (FIRST) OF TRUSTS §§ 3, 66 (1935).

99. *Id.* § 17.

100. *Id.* § 100.

101. *Id.*

Similarly, the intended beneficiaries of such a trust relationship are less than clear. From the legislative history, it appears that the intended "beneficiaries" of this imperfect trust relationship are the investors who purchase the securities pursuant to a defective registration statement. In that context, the trustee relationship is a hybrid private and public trust. It seems that Congress intended, at least in part, a quasi-public trust where the public (albeit, limited to the actual investors) are the intended beneficiaries of the fiduciary duty.[102] Although the conceptual fit of trust law is somewhat imperfect, it is clear that Section 11(c) holds underwriters to such a trust law fiduciary standard when attempting to meet their due diligence affirmative defense.[103] There are other fiduciary or quasi-fiduciary relationships, but it is the trust law fiduciary that Congress chose.[104]

B. DELEGATING RESPONSIBILITIES: JUST WATCH ME

Requiring a fiduciary standard for reasonable investigation does not mean, however, that an underwriter must personally perform the investigation. Rather, trustees today, and back when Congress passed Section 11(c), can assign or delegate certain responsibilities to others.

Undoubtedly, Congress recognized the ability of fiduciaries to delegate certain functions. An earlier draft of Section 11(c) confirms that Congress accepted some delegation, because it expressly eschewed unjustified delegation of responsibilities. Section 11(c), as contained in

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102. *Conference Report*, *supra* note 87.

103. Securities Act § 11.

104. *See* LOSS & SELIGMAN, *supra* note 84, at 4260 (quoting the RESTATEMENT OF TRUSTS (SECOND) § 174 (1959)). Other fiduciary relationships abound but differ substantively from the trustee relationship. For example, an agent is in part a fiduciary, but unlike a trustee, an agent serves only his principal whereas a trustee serves the beneficiaries. RESTATEMENT (THIRD) OF TRUSTS § 5. The different fiduciary responsibilities of agents and trustees is not new. It was quite clear when Congress elected to use the trustee standard in § 11(c). *See generally* RESTATEMENT (FIRST) OF AGENCY (1933); RESTATEMENT (FIRST) OF TRUSTS (1935). Thus, arguments, such as the one proffered by the underwriters in Refco (*Underwriters' Memorandum in Opposition*, *supra* note 2, at 19) suggesting that agency law rather than trust law determine the due diligence and supervision responsibilities of NMUs are not persuasive. Of course, Congress only borrowed an aspect of trust law and did not intend to create a trust. *Conference Report*, *supra* note 87. Beyond a trustee with duties and identifiable beneficiaries, a true trust requires the substantive elements of trust intent, trust property, and purpose. RESTATEMENT (FIRST) OF TRUSTS § 66.

H.R. 5480, provided:

> (c) In determining for purposes of paragraph (3) of subsection (b) of this section what constitutes a reasonable investigation and reasonable grounds for belief, the standard of reasonableness shall be that required of a person occupying a fiduciary relationship. While subsections (b) and (c) permit a person who has conscientiously and with competence met the responsibilities of his trusteeship to be relieved of liability, they prevent any person who has not fulfilled his trust from escaping liability by any trick of procedure or *unjustified delegation* of his duties (emphasis added).[105]

Moreover, the conference committee report for the version of Section 11(c) that passed as part of the 1933 Act[106] explains that the fiduciary standard imposed on a Section 11 defendant "does not, of course, necessitate that he shall individually perform every duty imposed upon him."[107] That conference report clarifies allowable delegation as follows:

> Delegation to others of the performance of acts which is unreasonable to require that the fiduciary shall personally perform is permissible. Especially is this true where the character of the acts involves professional skill or facilities not possessed by the fiduciary himself. In such cases reliance by the fiduciary, if his reliance is reasonable in the light of all the circumstances, is a full discharge of his responsibilities.[108]

This delegation language is borrowed from standard trust common law.[109] Thus, an examination of the parameters of acceptable delegation by trustees may provide insight on the parameters of acceptable delegation by underwriters.

Two interrelated fiduciary delegation issues require consideration. The first issue is which activities a fiduciary can delegate to its agents, as opposed to which activities a fiduciary must perform personally. In the context of underwriters and due diligence, this requires an understanding of when underwriters can delegate certain investigative responsibilities to their own lawyers, advisors, or other agents. The

105. *Conference Report*, *supra* note 87, at 23.
106. *See id.*
107. *Id.*
108. *Id.* at 26.
109. LOSS & SELIGMAN, *supra* note 84, at 4260.

second fiduciary delegation issue requires an analysis of when a co-fiduciary can delegate responsibilities to other co-fiduciaries. In the underwriters' framework, this entails an analysis of when NMUs can delegate investigative responsibilities, not to their own agents, but rather to the lead underwriter.[110] An analysis of fiduciary delegation in the context of underwriters requires an amalgamation of both the agent issue and the co-fiduciary issue. Moreover, since the agents of the lead underwriter (including its legal counsel) perform many tasks of the due diligence investigation, the inquiry must also include an analysis of when a co-fiduciary's agent can properly serve as another co-fiduciary's agent.

What was the prevailing law in the 1930s regarding a trustee's ability to delegate under the common law of trusts when Congress borrowed the concept for purposes of a "reasonable investigation" under Section 11? Could one co-trustee delegate all responsibilities to another? Guidance on delegation by co-trustees is found in an influential 1921 Harvard Law Review article written by Professor George Gleason Bogert, an eminent authority on trusts.[111] Professor Bogert explains that the co-trustee situation arises because a settlor may desire multiple trustees in order to benefit from the combined "skill and judgment of several" in managing a large estate.[112] "One trustee may be selected on account of his reputation for honesty and acumen, another because of business association with the settlor, and still a third from motives of relationship."[113] Professor Bogert notes, however, that such co-trustees will also commonly have "inequality of experience, ability, prudence and initiative,"[114] which, in turn, often leads to an "inequality of participation" in managing the trust.[115]

The extreme version of "inequality of participation" occurs when one co-trustee is completely in charge and the others are inactive.[116] If

110. As a practical matter these issues are often intertwined.

111. George Gleason Bogert, *The Liability of an Inactive Co-Trustee*, 34 HARV. L. REV. 483, 483 (1921).

112. *Id.*

113. *Id.* There are similar varied reasons for inviting certain distinct underwriters to join the syndicate for a registered offering.

114. *Id.* A corollary in the underwriting syndicate context is that some underwriters might have significantly less experience in underwriting sizable offerings than other underwriters or the various underwriting firms have different expertise.

115. *Id.*

116. Bogert, *supra* note 111, at 483.

the trust funds are administered properly under the sole administration of the managing trustee and the value of the trust is not adversely affected, there is no concern. Issues arise, however, when, for example, due to the "inaptitude of the managing trustee the trust fund has been reduced or altogether dissipated."[117] In that case, the question is whether an inactive trustee can be held liable "when the trust estate has been diminished by the negligence or defalcation of an active co-trustee."[118]

Professor Bogert admonishes that any analysis of the liability of inactive co-trustees in these cases must take into account certain fundamental principles of trust law.[119] He specifically notes the following well-established trust principles: (1) a "trustee may not delegate the exercise of discretionary powers, but may leave to agents the performance of ministerial duties or mere mechanical acts" and (2) a "trustee is required to use the care which an ordinarily prudent man would use in the conduct of his own affairs." [120]

The first rule, restricting delegation of a trustee's discretionary powers is based, in part, on the assumption that each co-trustee has particular qualifications and abilities and is expected to use those abilities—whatever they are—on behalf of the trust.[121] The delegation restriction is also explained as serving "to prevent the trust estate from paying twice for the same service."[122] Moreover, an extreme delegation—say of all responsibilities—is viewed as inconsistent with acceptance of the trusteeship. Professor Bogert explains, "a trustee who accepts a trust impliedly promises to assume his full share of control and responsibility."[123] He further reasons that "[n]onfeasance where there is a duty to act ought to be regarded as the equivalent of misfeasance."[124] Thus, once a trustee accepts the role, he must be active.[125] An inactive

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. Jerome J. Curtis, Jr., *The Transmogrification of the American Trust,* 31 REAL PROP. PROB. & TR. J. 251, 253 (1996).

122. *Id.* at 254.

123. Bogert, *supra* note 111, at 503.

124. *Id.*

125. *See also* RESTATEMENT (FIRST) OF TRUSTS § 171 (1935). That section provides that the "trustee is under a duty to the beneficiary not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform." *Id.* Comment k thereof provides with regard to supervision of delegated functions the following: "In

co-trustee could be liable for total delegation of his responsibilities. Professor Bogert reasons that beneficiaries "have a right to expect that trustees who accept the trust will give the estate the benefit of their skill and honesty and not merely of their names."[126] He counsels that trustees who expect not to participate actively should decline to serve as trustee rather than mislead others by attaching their names to the trust.[127]

Whether an inactive co-trustee who allows a co-trustee to be the sole actor also violates Professor Bogert's second fundamental principle of trust law, requiring the care of "an ordinary prudent man in the conduct of his own affairs," requires more analysis.[128] If the managing co-trustee has a superb reputation, is the co-trustee justified in his inaction? Would a prudent man conducting his own affairs cede to another all authority without vigilance? Professor Bogert explains, "an inactive trustee is not bound to presume that his co-trustee is a rogue, but he is presumed to know the frailties of human nature," and thus must supervise the co-trustee.[129] He explains that a prudent man managing his own affairs would inspect and supervise the actions of even a reputable actor.[130] Professor Bogert adds, however, that if the otherwise passive co-trustee effectively supervises the acts of his managing co-trustee, "he may be said to make the acts of the managing co-trustee his own acts."[131] On the other hand, if he fails to supervise, he breaches the prudent man requirement.[132]

Professor Bogert's analysis of the inactive co-trustee proved influential in an important 1927 New York case, *Brown v. Phelan*.[133] In that case, the trust was to be managed by three co-trustees, two sons of the settlor and his good friend.[134] One of the sons lived outside of New York City and the friend was quite elderly, so only the remaining co-

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matters which a trustee has properly delegated to agents or co-trustees or other persons, he is under a duty to the beneficiary to exercise a general supervision over their conduct." *Id*. cmt. k.

126. Bogert, *supra* note 111, at 507.

127. *Id.*

128. *Id.* at 501.

129. *Id.* at 502.

130. *Id.*

131. *Id.*

132. *Id.*

133. 224 N.Y.S. 391 (N.Y. Sup. Ct. 1927).

134. *Id.* at 393.

trustee managed the trust.[135] Unfortunately, the managing co-trustee looted the trust and disappeared.[136] The beneficiaries of the trust—primarily the settlor's other children—sought to charge the inactive co-trustees for breach of their prudent man duty to the trust.[137] The court accepted that the two inactive co-trustees had no knowledge of the failures of the manager and that there were legitimate reasons for allowing the managing trustee to take the lead.[138] The court explained, however, that "acceptance of a trust imposes certain positive responsibility which the trustee cannot evade," and "if he is not inclined to meet them, he should not accept."[139] Citing Professor Bogert's 1921 law review article on inactive co-trustees, the court determined that the two inactive co-trustees were liable.[140] The court reasoned that "judged by the measure of care of the ordinary prudent man, the inactive trustee is guilty of a fault of failing to supervise."[141] With regard to the disappearance of certain securities, the co-trustees argued that the court should not hold them liable to the trust beneficiaries for failure to inspect and supervise the managing co-trustee because the beneficiaries also had the right to inspect and similarly failed to do so.[142] The court found, however, that the co-trustees responsibilities could not be discharged by the "mere failure of the beneficiaries to exercise a like duty."[143]

Of course, that was then—this is now. In the 1930s, Congress borrowed a well understood common law trustee standard and inserted it into the securities statute.[144] Since then, however, the trust laws governing trustee delegation have changed. When Congress imports a well understood common law term into a statute, does the term bring with it its then existing meaning and case law, or does the meaning of the common law term in the statute evolve as the common law for that term develops? Thus, should the prudent man standard imported into Section 11(c) be analyzed in accordance with its common law

135. *Id.*
136. *Id.*
137. *Id.*
138. *Id.* at 394.
139. *Id.* at 396.
140. *Id.* at 397.
141. *Id.*
142. *Id.* at 398.
143. *Id.*
144. *See* Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

meaning when the term was inserted into Section 11 ("original intent") or should it instead be analyzed as the term is currently understood for trust law purposes ("dynamic intent")?

Section 11(c) was designed to deter and curtail certain Wall Street behaviors that led to an economic collapse of the financial markets. Thus, it seems unlikely that Congress would have desired the term "prudent man" in the securities context to incorporate modifications to its meaning as the common law of trusts evolved, if such modifications would reopen the door to abuses of the sort Congress sought to prevent. This article does not, however, need to determine whether the original or dynamic intent model of interpretation is better suited for Section 11(c) analysis.[145] Even under the more lenient rules of fiduciary delegation applicable today, trustees continue to have the fiduciary responsibility to supervise and review the activities of their delegates.

Clearly, modern trust law allows trustees considerably more latitude in delegating than earlier trust law. Presuming that trust settlors chose particular trustees for a reason, earlier trust laws charged trustees with personally performing virtually all trust tasks. Those laws prohibited trustees from delegating "discretionary" functions and allowed for the delegation of only ministerial duties.[146] As trust investing and

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145. William D. Araiza, *Text, Purpose and Facts: The Relationship Between CERCLA Sections 107 and 113*, 72 NOTRE DAME L. REV. 193, 216 n. 124 (1996). One commentator has explained that even Justice Scalia appears to vacillate between both approaches. *Id.* Professor Araiza observed that in some cases Justice Scalia has interpreted an older term by reference to its meaning when first inserted into a statute. *Id.*; *see e.g.*, MCI Telecomms. Corp. v. Am. Tel. & Tel. Co., 512 U.S. 218 (1994). In *MCI* Justice Scalia referred to a 1934 dictionary for the analysis of a particular term in the statute. *Id.* In other cases, however, Justice Scalia has used a dynamic model. Business Elecs. v. Sharp Elecs., 485 U.S. 717, 732 (1988). In *Business Electronics* Justice Scalia allowed that sometimes a borrowed common law term is dynamic. *Id.*

> The Sherman Act adopted the term 'restraint of trade' along with its dynamic potential. It invokes the common law itself, and not merely the static content that the common law had assigned to the term in 1890 . . . [i]f it were otherwise, not only would the line of per se illegality have to be drawn today precisely where it was in 1890, but also case-by-case evaluation of legality (conducted where per se rules do not apply) would have to be governed by 19th-century notions of reasonableness. It would make no sense to create out of the single term 'restraint of trade' a chronologically schizoid statute, in which a 'rule of reason' evolves with new circumstances and new wisdom, but a line of per se illegality remains forever fixed where it was.

Id.

146. RESTATEMENT (THIRD) OF TRUSTS § 80 cmt. g (2007).

administration became more complicated, however, it became evident that the discretionary/ministerial dichotomy was not only vague, but that it also deprived trusts of desirable expertise from third parties. Accordingly, over time, what was once viewed as the no delegation duty evolved into a prudent delegation rule.

The modern common law of trusts allows trustees to delegate even certain discretionary functions.[147] Moreover, it is clear now that if a trustee prudently selects the agent and properly monitors and supervises that agent, the trustee is not liable even if the agent ultimately fails to perform in the interests of the beneficiaries.[148] Nevertheless, the supervision and monitoring function remains critical. The Restatement (Third) of Trusts, Section 80, admonishes that after prudent selection of the agent, the trustee "has a further duty to act with prudence in supervising or monitoring the agent's performance and compliance with the terms of the delegation."[149] Similarly, newer statutory-based trust laws, such as those based on the Uniform Trust Code ("UTC"), allow trustees to delegate "duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances,"[150] yet require the prudent trustee to supervise and monitor the agent's actions.[151]

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147. *Id.* § 80.

148. *Id.* cmt. g.

149. *Id.* cmt. d(2). *Anton v. Anton* is instructive as to a modern court's analysis of an inactive co-trustee's fiduciary duties. 815 So. 2d 768 (Fla. Dist. Ct. App. 4th DCA 2002). In that case, a dishonest co-trustee had converted funds from the trust for his own personal use. *Id.* at 769. The beneficiary of the trust sued the other co-trustee named in the trust for breach of his fiduciary duty. *Id.* The co-trustee argued that he should be relieved from his fiduciary responsibility to the trust because the dishonest co-trustee was an attorney and, accordingly, he was justified in delegating the complete administration of the trust to him. *Id.* The court rejected that argument. *Id.* The court recognized that certain trusts are managed by co-trustees, but reasoned that where "there are several trustees, each is under a duty to participate fully in the administration of the trust." Id. at 769. In addition, the court stressed that "co-trustees are required to maintain an attitude of vigilant concern." *Id*. at 770. The court then noted that the inactive co-trustee had "paid no attention whatsoever to the manner in which the co-trustee administered the trust." *Id.* In light of the complete failure to review or supervise the delegate, the court found the co-trustee liable for the loss caused by the dishonest co-trustee. *Id.*

150. U.T.C. § 807 (2004).

151. U.T.C. § 807(a)(3). In addition, § 806 provides that if a trustee has special skills or expertise, or is named in reliance upon the trustee's representation that the trustee has special skills or expertise, that trustee is expected to use those skills. U.T.C.

In her perceptive article about professional trustees' responsibilities, Professor Melanie Leslie analyzes a modern professional trustee's continued responsibilities to beneficiaries after a proper delegation to agents.[152] She reasons that after a proper delegation there are three options for implementing the trustee's continued responsibilities:

> 1) a rule that relieves the trustee from all liability if the agent harms the trust, 2) a rule that holds the trustee liable only if its failure to carefully select and supervise the agent contributes to the trust's losses, or 3) a rule that makes the trustee liable for losses caused by its agent.[153]

The first option allows for total inactivity by the delegating fiduciary.[154] The second option—the current modern trust law requirement—allows prudent delegation but requires monitoring by the trustee of the delegate.[155] The last option imposes strict liability on professional trustees for their delegates' failures.[156]

Professor Leslie quickly dismisses the non-supervision option,[157] stating that the "first option is unwise for obvious reasons."[158] She then carefully analyzes the current system that allows a trustee who properly monitors his delegate to avoid liability even though the beneficiaries are harmed.[159] Professor Leslie compares the current system to a system that would impose strict liability on the professional trustee.[160] She ultimately advocates for imposing strict liability on the delegating professional trustee when beneficiaries are harmed.[161]

How does trust law analysis tie into an NMU's duties after delegating a due diligence investigation to the lead? Should Professor

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§ 806. Moreover, with regard to co-trustees, § 703 provides that functions which a settlor reasonably expected the trustees to perform jointly are non-delegable. U.T.C. § 703(e).

152. Malanie B. Leslie, *Common Law, Common Sense: Fiduciary Standards and Trustee Identity*, 27 CARDOZO L. REV. 2713, 2736 (2006).

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

Leslie's strict liability system for professional trustees also apply to underwriters? Professor Coffee, among others, has promoted such a strict liability system for offerings.[162] There is some appeal in such a straightforward system. However, a strict liability system requires Congress to change the statute and suggests that underwriters are, in effect, insuring against misstatements. This article, instead, more modestly suggests that the industry and the courts return to fundamental principles and recognize all underwriters' responsibilities under the wording of the statute.

Clearly, under the law of trusts in the 1930s and presently, trustees who delegate must monitor their delegates. Similarly, participating NMUs who delegate investigative responsibilities must supervise or review their delegate's actions to meet their statutory affirmative defense under the "prudent man" standard of Section 11. A careful reading of the statutory scheme suggests that an inactive underwriter, like an "inactive trustee," would fail to meet the prudent man requirement if it failed to supervise its delegate.[163]

V. CASE LAW AND SEC GUIDELINES ON NON-MANAGING UNDERWRITERS' DUE DILIGENCE

The case law and SEC guidance support this monitoring analysis for non-managing underwriters.

A. DUE DILIGENCE CASES AND SEC GUIDELINES DESCRIBE UNDERWRITERS' ROLE: WORTH A CLOSER LOOK

The leading case construing the due diligence affirmative defense under section 11 remains the decades-old *BarChris*.[164] The *BarChris*

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162. Coffee, *Safe Harbor*, *supra* note 16.

163. Securities Act § 11 (1933).

164. Escott v. BarChris Constr. Corp, 283 F. Supp. 643 (S.D.N.Y. 1968). BarChris Construction Corporation was engaged in the business of constructing bowling alleys. *Id.* at 653. Under BarChris' business model, BarChris made substantial expenditures before receiving reimbursement from customers. *Id.* at 654. Consequently, BarChris was in constant need of cash to finance its operations. *Id.* In early 1961, BarChris decided to issue debentures, and in March, 1961, BarChris filed an initial registration statement with the SEC. *Id.* The registration statement became effective on May 16, 1961. *BarChris*, 283 F. Supp. at 654. By that time, BarChris was experiencing

court carefully examined the prudent man requirement of the statute and noted that, under the statutory scheme, a defendant could "escape liability only by using that reasonable care to investigate facts which a prudent man would employ in the management of his own property."[165] In terms of reliance on others to perform the investigation, the court admonished that "a prudent man would not act in an important matter without any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case."[166]

With regard to underwriters, while the court recognized that the level of required investigation "is a question of degree, a matter of judgment in each case,"[167] the court also explained that, under the applicable statutory scheme, underwriters "are made responsible for the truth of the prospectus."[168] It acknowledged that if underwriters "may escape that responsibility by taking at face value representations made to them . . . then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection."[169] Accordingly, the court reasoned that to "effectuate the statute's purpose, the phrase 'reasonable investigation' must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of 'data presented' to them."[170]

Applying this standard to the investigation performed by the lead underwriter, Drexel & Co. ("Drexel"), the court found that Drexel did not fulfill the reasonable investigation requirement and thus failed to establish due diligence.[171] The court then found that the NMUs also failed to meet their burden.[172] It explained that the "other underwriters, who did nothing and relied solely on Drexel and on the lawyers, are

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substantial cash flow difficulties. *Id.* at 653. On October 29, 1962 BarChris filed for bankruptcy. *Id.* On November 1, it defaulted on the payment of interest on the debentures. *Id.* The purchasers of the debentures offered pursuant to BarChris' public offering sued the underwriters, among others, under § 11. *Id.* at 652.

165. *Id.* at 688.
166. *Id.*
167. *Id.* at 697.
168. *Id*.
169. *Id.*
170. *Id*.
171. *Id.*
172. *Id.*

bound" by Drexel and the lawyers' failure to make an adequate examination.[173] The court did not find that any of the underwriters knew that the prospectus was defective.[174] Rather, it explained that the underwriters' defense failed because "although Drexel and the other underwriters believed that [the non-expert] portions of the prospectus were true, they had no reasonable ground for that belief, within the meaning of the statute."[175] Notably, the court recognized that its holding did not address "whether the underwriters other than Drexel would have been protected if Drexel had established that, as lead underwriter, it made a reasonable investigation."[176] In other words, *BarChris* left unresolved the issue of whether NMUs meet their burden if the lead establishes that it had made a reasonable investigation.[177]

A couple of years after the *BarChris* case, the SEC issued Release No. 9671.[178] Significantly, the SEC stated that the "release places the investment banking community on notice as to the need to diligently investigate the disclosure provided to the public in connection with the securities they are distributing . . . ."[179] Essentially, Release No. 9671 elaborated on the basic framework for due diligence obligations imposed on the investment banking community "who participate as members of the underwriting group."[180] The SEC explained that the underwriters' role in a public offering is unique for purposes of due diligence,[181] reasoning that the underwriter is in a particularly powerful position.[182] On the one hand, the underwriter can walk away from an offering if it does not obtain satisfactory access to information or if it does not receive appropriate responses to the questions it poses to the issuer.[183] On the other hand, the issuer is unlikely to risk the underwriter walking because the issuer needs the underwriters' participation for the offering

173. *Id.*
174. *Id.*
175. *Id.*
176. *Id.*
177. *Id.* at n.26.
178. Obligations of Underwriters, Brokers and Dealers, Exchange Act Release No. 9671, 1972 WL 125474 (July 27, 1972) [hereinafter SEC Release 9671].
179. *Id.* at 1.
180. *Id.* at 6.
181. *Id.* at 5.
182. *Id.* at 4-5.
183. *Id.*

to succeed.[184] Thus, the underwriter has the power to "demand access to information."[185]

With regard to NMUs, the Release explains that "Section 11 does not by its terms distinguish between managing underwriters (managers) and underwriters who participate as members of the underwriting group (participants)," but rather that Section 11 "speaks only of 'every underwriter' of whatever type."[186] Accordingly, it reinforces that every underwriter has responsibilities under the statute.[187] Nevertheless, the Release recognizes that NMUs "need not duplicate the investigation made by the [lead]" and "may delegate the performance of the investigation" to the lead.[188]

In keeping with the statutory scheme's focus on every underwriter, however, the Release admonishes that delegation to the lead does not absolve the NMUs of their own independent responsibilities.[189] It expressly provides that while "the participant may relieve himself of the task of actually verifying the representation in the registration statements . . . he must satisfy himself that the managing underwriter makes the kind of investigation that the participant would have performed if he were the manager."[190] Accordingly, NMUs must assure themselves not only that the lead's "program of investigation" is adequate, but also that the lead's "actual investigative performance" is adequate.[191] Thus, supervision of the actual investigation requires more than a review of generic procedures typically followed by the lead underwriters.[192] The Release expects the NMU to check the managing underwriters' actual investigation of the issuer and of the particular offering.

Moreover, the SEC did not intend the supervision of the lead underwriter's investigation to be a formality or an exercise in futility.[193] Rather, the SEC expects that the NMU's supervision of its delegate will add value.[194] The Release provides that the "participants' checks on the

184. *Id.*
185. *Id.* at 5.
186. *Id.* at 6.
187. *Id.*
188. *Id.*
189. *Id.*
190. *Id.*
191. *Id.*
192. *See id.*
193. *Id.*
194. *Id.*

manager are vital since they may provide additional assurance of verification of the statements in the registration statement."[195] Thus, consistent with the statutory framework and the prudent man requirement, SEC Release No. 9671 requires NMUs who delegate the investigation to the lead to conduct some monitoring and supervision of the lead's investigation in order to meet their due diligence burden.[196]

The SEC further clarified its view of what constitutes a reasonable investigation in light of changes to the offering process implemented through Rule 176,[197] and it identified "what circumstances may bear upon the determination of what constitutes a reasonable investigation and reasonable ground for belief as these terms are used in Section 11(b) of the Securities Act."[198] Particularly relevant, the SEC recognizes a sliding scale application of the level of due diligence an underwriter must conduct in meeting the reasonable investigation standard. This interpretation acknowledges industry concerns of underwriters regarding

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195. *Id.* at 4.

196. *Id.*

197. Adoption of Integrated Disclosure System, SEC Release No. 33-6383; 47 FR 11433 (Mar. 16, 1982) [hereinafter SEC Release 33-6383]. Rule 176 provides the following guidance:

> In determining whether or not the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in section 11(c), relevant circumstances include, with respect to a person other than the issuer:
> 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;
> 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 registrant; 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.

Id.

198. Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of Securities Act Treatment of Information Incorporated by Reference Into Registration Statements, Exchange Act Release No. 33-6335, 23 SEC Docket 1 (Aug. 6, 1981) [hereinafter SEC Release 33-6335].

their ability to "conduct what would be deemed to be a reasonable investigation, pursuant to Section 11."[199] The SEC makes clear that NMUs may "not have as heavy a burden as that of the managing underwriters" in fulfilling their Section 11 due diligence duties; nonetheless, a pro-active role of vigilance by participating underwriters is required.[200] Significantly, the SEC "strongly affirms the need for due diligence and its attendant vigilance and verification" on behalf of underwriters.[201]

In December of 2005, the SEC adopted significant registration and offering reforms to the offering processes under the Securities Act of 1933.[202] Among other things, these reforms further eased the restrictions on shelf offerings for well-known issuers, commonly known as WKSIs.[203] In the adopting release, the SEC addressed a number of issues, including "whether adjustments to the roles and responsibilities of traditional 'gatekeepers' in the . . . securities offering process, such as underwriters . . . should be made in light of increases in the speed of and other evolutions in the offering process."[204] It recognized that some commentators wanted the SEC to modify Rule 176 and to narrow the due diligence requirements for underwriters in light of the unlimited shelf registrations for WKSIs.[205] The SEC, however, declined "to propose modifications to Rule 176," and, thus, maintained its position on due diligence standards for underwriters.[206]

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199. *Id.* at 5. "In view of the compressed preparation time and the volatile nature of the capital markets, underwriters may elect to apply somewhat different, but equally thorough, investigatory practices and procedures. *Id*. at 11; § 11(c). Reasonable investigation is measured by "that required of a prudent man in the management of his own property." *Id.* at 9.

200. SEC Release 9671, *supra* note 178, at 6.

201. SEC Release 33-6335, *supra* note 198, at 11.

202. Securities Offering Reform, SEC Release No. 33-8591, 85 SEC Docket 2871 (Dec. 1, 2005) [hereinafter SEC Release 33-8591].

203. *Id.* at 6.

204. *Id.*

205. *Id.* at 97. The SEC explained that:

> An automatic shelf registration statement will become effective immediately and will cover an unspecified amount of securities. [Resulting from] the open-ended nature of such registration statements, [the SEC] adopt[ed] a requirement for issuers to file new automatic shelf registration statements every three years. As a result, an issuer's securities offerings under the registration statement can be uninterrupted.

Id.

206. *Id.* at 79.

Perhaps the most influential case interpreting underwriters' due diligence requirements in modern shelf offerings is *In re WorldCom Inc. Securities Litigation*.[207] In *WorldCom*, the court, after examining *BarChris* and the SEC Releases, held that the lead underwriter, Salomon Smith Barney, could not, for purposes of a summary judgment motion, prove that it was entitled to a due diligence defense under Section 11.[208] Throughout the opinion, the court favorably cites the SEC Releases, including Release No. 7606A, where the SEC explains that in enacting Section 11, "Congress "recognized that underwriters occupied a unique position that enabled them to discover and compel disclosure of essential facts about the offering."[209] According to the Release, "Congress believed that subjecting underwriters to the liability provisions would provide the necessary incentive to ensure their careful investigation of the offering."[210] The court further observed that when "district courts have granted summary judgment for underwriters in recent years, the underwriters have demonstrated extensive due diligence efforts."[211]

The court also dismissed arguments relying on the difficulty of discovering certain frauds.[212] It explained that, pursuant to the statutory framework of Section 11, "an underwriter must conduct a reasonable investigation to prevail on the due diligence defense, even if it appears that such an investigation would have proven futile . . . ."[213] It dismissed the argument that, since fraud is difficult to detect, underwriters should not even try.[214] Pointedly, the court reasoned that without "a reasonable investigation, of course, it can never be known what would have been uncovered or what additional disclosures would have demanded."[215]

The underwriters in *WorldCom* also argued that their investigation would have been duplicative of the auditors' investigation.[216] The court, however, highlighted an underwriter's obligation under the prudent man standard, and stressed that "underwriters should ask those questions and

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207. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004).
208. *Id.* at 634-35.
209. *Id.* at 662 (citing The Regulation of Securities Offerings, SEC Release No. 7606A, 1998 WL 833389 (Dec. 4, 1998)).
210. *Id.*
211. *Id.* at 676.
212. *Id.* at 683–84.
213. *Id.* at 683.
214. *Id.*
215. *Id.*
216. *Id.*

seek those answers that are appropriate under the circumstances."[217] It explained that underwriters "are not being asked to duplicate the work of auditors, but to conduct a reasonable investigation."[218]

Finally, the court indirectly dismissed the underwriters' lament about the difficulties of conducting due diligence under the time pressures of the integrated disclosure system and shelf registrations.[219] It noted that despite changing processes for offerings, "the prudent man standard in Section 11 has [not] been diluted . . . [and] the ultimate test of reasonable conduct in the specific circumstances of an offering remains unchanged."[220]

Unfortunately, for purposes of this article, the court did not provide specific analysis on the responsibilities of the NMUs. For purposes of the summary judgment motion, "[e]ach of the Underwriter Defendants involved in the offering . . . stated that it relied on the due diligence

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217. *Id.* at 684.

218. *Id.*

219. *Id.* at 684–85.

220. *Id*. at 685. To the extent underwriters' complaints based on time pressures have validity; they only apply to shelf offerings. An eminent authority on civil liability in securities cases, Professor Merrit Fox, observes that § 11 liability for misstatements is "still fully workable for a new issuer doing an initial public offering." Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 245 (2009). Even for shelf registrations, several creative workarounds have been suggested to compensate for time pressures. One commentator noted that unlike directors, "underwriters have the resources to invest in sophisticated systems in order to adjust their due diligence for the rapid nature of shelf offerings." David I. Michaels, *No Fraud? No Problem: Outside Director Liability for Shelf Offerings Under Section 11 of the Securities Act of 1933*, 28 REV. BANKING & FIN. L. 339, 379 (2008). Others, such as Professor Coffee, have argued that underwriters could self-insure their § 11 liability for shelf offerings. Coffee, *Safe Harbor*, *supra* note 16, at 9. Beyond academic theorizing, courts in Section 11 cases have rejected pleas to circumvent other parts of § 11's statutory language because of changed market conditions and practices. *See e.g.*, *Krim v. pcOrder.com, Inc.*, 402 F.3d 489, 498 (5th Cir. 2005). In denying § 11 standing to plaintiffs who argued for acceptance of statistical tracing, Judge Higginbotham noted that when "Congress enacted the Securities Act of 1933 it was not confronted with the widespread practice of holding stock in street name." *Id.* He acknowledged that "present market realities, given the fungibility of stock held in street name, may render Section 11 ineffective as a practical matter in some aftermarket scenarios." *Id.* Nevertheless, he refused to deviate from the statutory language in order to take into account changed market realities. He reasoned that such a deviation would be "an issue properly addressed by Congress" and that it was not within the court's "purview to rewrite the statute to take account of changed conditions." *Id.*

performed by SSB."[221] Nevertheless, the *WorldCom* case is instructive on the issue of NMUs' due diligence. First, obviously, *WorldCom* provides a stark reminder that arguments relying on custom will not sway a court to ignore the construct of the statutory scheme of Section 11. Similarly, arguments based on the complexity of uncovering fraud are not persuasive. Finally, arguments based on possible duplication of efforts or on the difficulties involving time constraints are not convincing.

B. CASES ADDRESSING NON-MANAGING UNDERWRITERS' ROLE: DON'T JUST SIT THERE

A handful of cases have addressed, in varying degrees, the role of NMUs in relation to the lead. Some commentators, in reliance on dicta in such cases, have asserted that NMUs do not need to investigate or supervise their delegate.[222] A careful review of the cases, however, shows that they should not provide comfort to NMUs who fail to supervise the lead.

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221. *In re WorldCom*, 346 F. Supp. 2d at 647.

222. One particularly broad overstatement of the cases dealing with NMUs is found in an otherwise thoughtful treatise. *See Robert J. Haft*, VENTURE CAPITAL AND SMALL BUSINESS FINANCING § 14:7 (2010). The treatise correctly describes *BarChris* but then incorrectly interprets later cases. *Id.* It provides:

> In BarChris the managing underwriter was thus held bound by its counsel's inadequate investigation, and the other underwriters were held bound by the managing underwriter's consequently inadequate investigation. (Later court decisions have held that all underwriters can obtain the benefits of adequate due diligence by the managing underwriter, thus establishing their own due diligence defense.)

Id. As support for the parenthetical sentence justifying passive NMUs, the authors cite two cases: *In re* Consumers Power Co. Sec. Litig., 105 F.R.D. 583 (E.D. Mich. 1985) and *In re* Activision Sec. Litig., 621 F. Supp. 415 (S.D.N.Y. 1985). *Id.* at n.4. As described below, neither of those two cases hold that the NMUs' affirmative defense is met automatically when the lead meets its affirmative defense. *In re* Consumers Power Co. Sec. Litig., 105 F.R.D. 583; *In re* Activision Sec. Litig., 621 F. Supp. 415. Those cases require a more careful read. In fairness to the authors of the treatise, the footnote justifying the parenthetical sentence does include a sentence noting that the SEC would require more from NMUs. VENTURE CAP. & BUS. FIN. § 14:7. "The SEC has suggested that each underwriter must satisfy itself that the lead underwriter's investigation was sufficient." *Id.* at n.4; See Obligations of Underwriters, Brokers and Dealers, Securities Act Release No. 5275, Spec. Ed. No. 434 (CCH) ¶ 4506B (July 27, 1972).

1. Lead Fails/NMU Fails Scenario

Recall that this article described generally four different due diligence relationships between the lead and the NMUs. On one end of the spectrum is the Lead fails/NMU fails scenario. This scenario refers to the situation where the lead underwriter does not meet its affirmative due diligence defense and the NMUs did nothing but rely on the lead. *BarChris* is a classic example of just such a scenario. The *BarChris* court held that in such cases, all the underwriters fail to have a due diligence defense.[223]

In re ZZZZ Best Securities Litigation (*ZZZZ Best II*)[224] also addresses this scenario. In that case, involving significant fraud, the plaintiff investors argued that if the "Defendant NMUs had made even a cursory inquiry" into either the issuer or the lead underwriter's investigation, "they would have uncovered serious problems with the Z Best public stock offering."[225] In an odd twist that ultimately backfired, the defendant NMUs countered that their extreme passivity in the fraudulent public offering should exonerate them from both Section 11 and Section 10(b)/Rule 10b-5 liability.[226] The NMUs tried to distance themselves from the failure of the lead underwriter in uncovering the fraud.[227] They expressly argued that the "NMUs had only a passive role in the Z Best offering and that they had nothing to do with the due diligence investigation."[228] The NMUs elaborated that "they completely relied on the due diligence investigation (allegedly) performed by [the lead], and that such total reliance was justified and 'customary in the industry.'"[229]

The court was not impressed by the NMUs' passivity argument for purposes of the Section 11 claim.[230] It explained that liability "under Section 11 is expressly imposed upon 'every underwriter with respect to such security.'"[231] The court also noted that the NMU defendants' "names all appeared on the final document disseminated to the

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223. *BarChris*, 283 F. Supp. at 697.
224. No. CV-87-3574-RSWL (BX), 1994 WL 746649 (C.D. Cal. Oct. 26, 1994)
225. *Id.* at *1. The court defined ZZZZ Best as Z Best. *Id.*
226. *Id.* at *1-*2.
227. *Id.* at *2.
228. *Id*.
229. *Id.*
230. *Id.* at *3-*4.
231. *Id.* at *3.

public."[232]

Perhaps even more interesting, and presumably troubling to passive NMUs, is the court's analysis of the passive NMUs' exposure in the Section 10(b)/Rule 10b-5 claim.[233] The court noted that the NMUs conceded that they failed to investigate the issuer or the lead underwriter's investigation.[234] In light of that extreme passivity, the court denied the NMUs' motion for summary judgment on the Section 10(b)/Rule 10b-5 claim.[235] The court reasoned that the "NMU Defendants' complete abdication [of] responsibility in investigating either Z Best or [the lead underwriter] provides a sufficient ground on which to assert a Rule 10b-5 violation" and that at trial, "the parties will have to present evidence as to whether it was 'at least reckless' for NMU Defendants to rely entirely on the due diligence investigation of [the lead underwriter]."[236]

Clearly, *BarChris* and *ZZZZ Best II* demonstrate that the Lead fails/NMU fails scenario in a Section 11 case is not a novel proposition. To the contrary, this is standard due diligence dogma.[237] Thus, it is somewhat jarring for SIFMA, in its amicus brief in the *Refco* litigation, to suggest a different result should apply when the lead failed and the NMUs did nothing.[238] No case law supporting the view that NMUs could meet their affirmative defense in such a scenario appears to exist. Moreover, that position stands contrary to the statutory scheme, the legislative history, and SEC guidance.[239]

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232. *Id.* at *1.

233. *Id.* at *8-*9.

234. *Id.* at *8.

235. *Id.* at *9.

236. *Id.*

237. "If a court concludes that the lead underwriter conducted an insufficient investigation, and the non-managing underwriters did nothing but rely on the lead underwriter, the non-managing underwriters will be liable as well." Jonathan K. Youngwood, *Conducting Due Diligence in M&A and Securities Offerings 2009: Due Diligence as a Defense in Securities Litigation*, 1746 PLI/CORP. 57, 68 (2009).

238. *SIFMA Refco Amicus*, *supra* note 6, at 8.

239. The SIFMA amicus is somewhat vague on this point. It is possible that the amicus is only arguing that passive NMUs should automatically succeed whenever the lead succeeds in its due diligence burden. While this position is also incorrect in light of the structure of the statute, it is certainly less radical and has some support from dicta in certain cases. *See infra* Part IV.B.

2. Lead Wins/NMU Wins Scenario

The opposite end of the spectrum is the Lead wins/NMU wins scenario. In this scenario, both the lead and the NMU meet their respective due diligence burdens. The lead meets its affirmative defense by virtue of its competent investigation. Admittedly, this investigation, while competent enough to establish the lead's due diligence defense, is not actually successful. If the investigation had been truly successful, there would be no material misstatements or omissions in the registration statement and the plaintiffs would have no cause of action. Nevertheless, in this Lead wins/NMU wins scenario, the lead wins because it meets the Section 11(c) standard under the due diligence defense and the NMUs win by demonstrating that they meet the standard by properly supervising their delegate as allowed by the prudent man standard for fiduciary delegation.

3. Lead Fails/NMU Wins Scenario

The remaining two relationships between lead underwriters and NMUs require more analysis. The two remaining scenarios arise when the due diligence activities of the lead and the NMU are no longer in concert. One such scenario is the Lead fails/NMU wins. In these cases, the lead fails to meet its due diligence burden, but the NMUs are able to prove that they appropriately questioned the lead's investigation.

Notably, this scenario is not just theoretical and may well arise in various situations. It could arise, for example, when there is collusion between the lead and the issuer, perhaps because of significant ongoing relationships. It could also arise because of misplaced faith by the lead on the issuer. Either way, the lead could intentionally, or negligently, misrepresent to the NMUs the thoroughness of its actual investigation of the issuer.

This article demonstrates, through analysis of the prudent man duties regarding delegation, that the lead's failure in such cases need not be the NMUs' failure. Rather, the NMUs should be protected as long as they demonstrate that they monitored the lead's investigation. Trust law would exonerate a trustee who properly attempted to supervise his delegate even when the delegate spectacularly failed. Similarly, NMUs who properly supervised the lead should be able to meet their due diligence defense even when the lead fails.

The court in *In re Activision Securities Litigation*[240] discussed the relationship of lead and NMUs when addressing the plaintiffs' motion to certify the class of defendant underwriters in a Section 11 action.[241] The *Activision* court recognized that the NMUs might be able to protect themselves in such cases even when the lead fails to establish its affirmative defense.[242] Activision was in the business of designing, manufacturing, and marketing video game cartridges that were compatible with Atari 2600 and Mattel Electronics Intellivision systems.[243] The company had been successful in its early years.[244] However, shortly after its initial public offering, the company revealed a large pre-tax loss and its stock price plummeted.[245] The investor plaintiffs alleged that the defendants knew at the time of the initial public offering that the company was experiencing financial difficulties and losing market share but that the defendants did not disclose that information in the registration statement.[246] The investor plaintiffs made several motions, including one to certify the defendant underwriters as a class.[247] The underwriters, trying to prevent defendant class certification, argued that the due diligence defense of the lead underwriters was different from the due diligence defense of the other participating underwriters in the syndicate.[248]

The court held that underwriter class certification was appropriate in the given case, reasoning that, in many respects, the various underwriters' interests were aligned.[249] It explained that the underwriters, as a group, share certain defenses in Section 11 cases.[250] For example, all underwriters share the defense that the registration statement did not contain a material misstatement or omission.[251] If the lack of materiality argument succeeds, the investors would not meet their burden of showing a defective registration statement and their

240. 621 F. Supp. 415 (N.D. Cal. 1985).
241. *Id.* at 433.
242. *Id.* at 434.
243. *Id.* at 418.
244. *Id.*
245. *Id.* at 418–19.
246. *Id.*
247. *Id.* at 419.
248. *Id.* at 434.
249. *Id.*
250. *Id.* at 433.
251. *Id.*

Section 11 action would fall. Also, all the underwriters share the defense that the investors purchased their shares in the offering with prior knowledge of the misrepresentations or omissions.[252] If the prior knowledge defense succeeds as to all the plaintiff investors, it too would end the action against all the underwriters.

Finally, and most importantly for purposes of this analysis, the court noted that the underwriter defendants share the due diligence defense.[253] Here, however, the court recognized that the various underwriters' interests could diverge.[254] The court expressly recognized that the underwriting firms' interests diverge when the lead fails to meet its burden of proving its own due diligence.[255] While the court ultimately granted certification of the defendant underwriter class, it recognized that if the lead failed to prove its due diligence defense, the court might have to bifurcate the trial at that point to allow the non-lead underwriting firms to demonstrate their own investigation or supervision of the lead.[256] Thus, the court clearly recognized the possibility of a lead fails/NMU wins scenario, in which the separate due diligence activities, or appropriate monitoring of the lead, by the NMUs becomes significant.[257]

Similarly, in *In re Computer Memories Securities Litigation*,[258] the underwriters, trying to prevent class certification, posited that the due diligence defense of the lead differs from the due diligence defense of the NMUs in the syndicate.[259] The lead underwriters argued that the underwriter class should not be certified "because each underwriter will have an individual due diligence defense based on whether the particular underwriter, given its role in the offering, satisfied its due diligence obligation."[260] The court adopted the reasoning of the court in *Activision*. Thus, it granted the underwriter class certification, yet recognized that if the lead failed to prove its due diligence defense, the court might have to bifurcate the trial to allow the non-lead firms to

252. *Id.*
253. *Id.*
254. *Id.* at 434.
255. *Id.*
256. *Id.*
257. *Id.*
258. 111 F.R.D. 675 (N.D. Cal. 1986).
259. *Id.* at 687.
260. *Id.*

demonstrate their own due diligence defense.[261]

4. Lead Wins/NMU Fails Scenario

The final scenario is the one referred to here as Lead wins/NMU fails. This scenario arises when the lead is able to meet its due diligence burden, but the NMU did not attempt to supervise or question the lead's investigation. This is the scenario expressly left unresolved in *BarChris*.[262] While some commentators suggest that the NMU automatically wins when the lead wins, the statutory scheme, based on the prudent man analysis, does not support that result. It appears that confusion on this issue arises in part from dicta in *In re Gap*.[263] One commentator discussing the underwriters' defense in *In re Gap* relies on the case to conclude that "[s]hould the managing underwriter sustain a due diligence defense, all underwriters in the syndicate would escape liability."[264] However, a careful reading of *Gap* reveals that commentators may be relying too heavily on the case.

The court in *Gap*, much like the court in *Activision*, faced the procedural question of whether to certify the class of defendant underwriters.[265] Before deciding whether certification was proper, the court observed that the substantive questions of "[w]hether participating and lead underwriters will be held to the same standard of care and whether participating underwriters may delegate any or all of their investigatory responsibility to the lead underwriters" are open questions.[266] In determining whether to certify the underwriting class, it explained that there are two slightly differing views on NMUs' responsibilities in relation to the lead's investigation.

One view, according to the court, is that proposed by Professor Folk in a 1969 law review article examining Section 11 after

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261. *Id.* at 687-88.

262. Escott v. BarChris Const. Corp, 283 F. Supp. 643, n.26 (S.D.N.Y. 1968). ("In view of this conclusion, it becomes unnecessary to decide whether the underwriters other than [the lead] would have been protected if [the lead] had established that as lead underwriter, it made a reasonable investigation.").

263. *In re* Gap Sec. Litig., 79 F.R.D. 283, 302 (N.D. Cal. 1978).

264. William J. Whelan, III, *Securities Offerings 2009: What Counsel Need to Know to Get Deals Done in Challenging Markets*, 1734 PLI/CORP. 635, 644 (2009).

265. *In re* Gap Sec. Litig., 79 F.R.D. at 288.

266. *Id.* at 300.

BarChris.[267] The court notes that "Professor Folk argues on the basis of industry practice and public policy, that the cornerstone of due diligence lies in the activities of lead underwriter; therefore, participating underwriters should be allowed to delegate to the lead their investigatory responsibilities."[268] Another view, the court explains, is that held by the SEC, which espouses a "double-checking role" for participating underwriters.[269] The court compared the two views and determined that "Professor Folk would extend the *benefit* of the manager's due diligence to the participants no matter what they had done, whereas the Commission, theoretically, might penalize the participant who failed to double check the diligent manager's methods."[270] The court appears to prefer Professor Folk's argument as the more practical one and, in deciding to certify the underwriters class, stated that "proof of the due diligence of the managing underwriter will *most likely* exonerate the participants as well."[271]

Accordingly, while *Gap* provides some modicum of support for the proposition that when the lead wins the NMU automatically wins, it is based on practical considerations and academic arguments. The statutory scheme, however, does not support this reading. Rather, it requires supervision of the delegate. Thus, the better proposition is that NMUs should supervise their delegates.

VI. PRACTICAL ISSUES, CONFLICTS AND CONCLUSION

The foregoing provides both good news and bad news for NMUs. The good news is that under the statutory scheme, NMUs who properly monitor the lead's due diligence investigation can protect themselves from liability even when the lead fails to establish its own due diligence defense. Thus, NMUs do not have to be at the mercy of the lead. The bad news is that, in order to protect their separate affirmative defense, NMUs must actually supervise the lead's due diligence investigation.[272]

267. *Id.* at 299 n.19.

268. *Id.* at 300.

269. *Id.* at 301.

270. *Id.*

271. *Id.* at 302 (emphasis added).

272. This bad news is tempered, however, by a recognition that due diligence is an affirmative defense and not an affirmative duty. Thus, NMUs could, in particular offerings, make business decisions to forgo their ability to supervise the lead and give

Writing shortly after the *WorldCom* due diligence decision, one noted securities attorney commented on this risk for NMUs:

> Until *WorldCom*, non-lead members of the underwriting syndicate did not participate in diligence and simply relied on the diligence performed by the lead. Going forward, the non-lead who remains at a double remove from the investigation—relying on the lead, who relies on the auditor—has a double risk of losing its diligence defense. If the teaching of *WorldCom* is that leads may not rely blindly on auditors, then a fortiori non-leads may not rely blindly on leads.[273]

What guidance is available for NMUs who wish to maintain their ability to raise a separate due diligence defense? First, how much monitoring of the lead suffices to meet the fiduciary delegation standard? The traditional answer is that, as with any due diligence issue, the reasonableness of the supervision of the investigation depends on the particular facts regarding the issuer, the offering, and the role of the defendant in the offering. Second, how should NMUs determine the quality of the lead's investigation? It is helpful to recall that underwriting firms generally know how to conduct full blown due diligence investigations. Accordingly, they should, in turn, know which questions to ask the lead in order to assess the thoroughness of the lead's investigation. Moreover, lead underwriters routinely delegate some due diligence to auditors, attorneys, and others. Thus, supervision of delegates is not new to the investment banking community. The steps taken to supervise those third parties can be modified as needed in this context. Finally, sophisticated trustees have long known how to supervise myriad institutional delegates. Lessons from trustee delegation can be applied to supervision issues within underwriting syndicates.

Determining which questions to ask the lead, which NMUs' specialties and expertise should be tapped for particular facets of the investigation, and how to ask the questions is relatively easy. The harder questions remain. Are the current systems rigged so as to prevent NMUs from effectively monitoring the lead? Are there conflicts of

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up their ability to raise their separate § 11 defenses.

273. Gideon A. Schor, *The Due Diligence and Reliance Defenses in WorldCom: Retrospect and Prospect* at *9 (2006), *available at* http://www.wsgr.com/PDFSearch/Due_Diligence_after_WorldCom.pdf.

interests and unequal bargaining power between the lead and NMUs that hamper such monitoring?

Conflicts between the lead and the NMUs do exist but they should be managable by NMUs who wish to preserve their separate defense. In difficult economic times, might a lead underwriter agree to an easier and quicker due diligence investigation of a significant client's registered offering in order to maintain an ongoing client relationship? Would such a potentially compromised lead underwriter attempt to block questions from NMUs? The response by NMUs is to ensure that they remain vigilant. One commentator notes that because the lead is only liable for the amount of securities that it underwrote under section 11(e) and not for those of the other underwriters, the lead might make a judgment call that would allow in more misstatements, balancing only its own potential liability if a lawsuit ensues, and not the full liability of all the NMUs.[274] Similarly, an argument can be made that because NMUs are only responsible for the amount they underwrote, they do not have a tremendous incentive to expend sums on monitoring the lead. These arguments, however, do not take into account the significant monetary risks of covering one's underwriting. Thus, although these are interesting theoretical concerns, they are not terribly troubling.[275]

In some instances, attorney conflicts could become intertwined with the lead and NMU relationship. Generally, once the lead underwriter invites the NMUs to participate in the offering, counsel for the lead underwriter also becomes counsel for the NMUs.[276] To the extent the lead delegates some or all of the legal part of the due diligence to its counsel, a potential conflict arises. In that case, the lead's counsel

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274. Dana B. Klinges, *Expanding the Liability of Managing Underwriters Under the Securities Act of 1933*, 53 FORDHAM L. REV. 1063, 1067-70 (1985).

275. Another commentator notes conflicts between the lead and the NMUs because of § 11(f). J. William Hicks, *Misleading Registration Statements: Section 11*, 17 CIVIL LIABILITIES: ENFORCEMENT AND LITIG. § 4:52 (2009). The argument is that § 11(f)(1) "denies a right of contribution to any underwriter found guilty of fraud" thus non-managing underwriters would "benefit from a finding that the lead underwriter defrauded them" *Id.* at 1. The lead underwriter would want to avoid such as finding. Thus, the argument is that the "lead underwriter lacks any incentive as class representative to investigate its own fraudulent misrepresentations and might even settle to the case quickly to conceal self-incriminating information." *Id.*

276. *See In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 671 (S.D.N.Y. 2004). The court observed that the SEC "noted the increased designation of one law firm to act as underwriters' counsel." *Id.*

would be conducting the legal part of the due diligence.[277] Lead underwriter's counsel certainly would not be in a position to supervise the quality of its own investigation. Sorting out these possible intertwined layers is interesting, but is not the focus of this article. Potential conflicts can generally be waived and this article is not suggesting that each NMU hire its own counsel.[278] Moreover, this article is not suggesting that the NMUs engage in supervision that delays the offering process. Recently, very creative solutions have been suggested for underwriters to accomplish their due diligence role effectively and efficiently even when they are under significant time pressures.[279] Those same ideas could easily be adopted for NMUs' targeted monitoring of the lead's investigation.

In sum, in order to establish an affirmative defense under Section 11, a NMU must supervise the lead underwriter's investigation. This article recommends that NMUs pick up their game and perform targeted and thoughtful monitoring of the lead's due diligence investigation. Such targeted questioning could actually serve to find a problem and, in turn, save the NMUs, the lead, and perhaps even the investors.

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277. One expert on underwriter due diligence explains that generally the "components of due diligence include: background due diligence, business due diligence, financial due diligence, MD&A due diligence, legal due diligence, accounting due diligence, backup review, corporate governance/Sarbanes-Oxley due diligence, and audit committee due diligence." Valerie Ford Jacob, *Conducting Due Diligence in M&A and Securities Offerings 2008: The Due Diligence Process from the Underwriter's Perspective*, 1678 PLI/CORP. 89, at *97–*98 (2008). Legal due diligence, in turn, involves review of such things as reports to management from accountants, stockholder agreements, loan agreements, material business contracts, employment agreements, and outstanding litigation. *Id.* at *102–*03.

278. The purpose of this article is certainly not to create a jobs bill for securities attorneys. On the other hand, is it possible that fresh eyes from another law firm questioning the work of lead underwriter's counsel could spot a problem?

279. *See e.g.*, Leahy, *supra* note 2, at 2053-57 (discussing among other options "client relationship teams" for effective "continuous due diligence").