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NO FRAUD? NO PROBLEM: OUTSIDE DIRECTOR  
LIABILITY FOR SHELF OFFERINGS UNDER SECTION 11  
OF THE SECURITIES ACT OF 1933

DAVID I. MICHAELS<sup>1</sup>

*“The strictest law often causes the most serious wrong.”*

- Marcus Tullius Cicero, 106 BC – 48 BC

**I. Introduction**

The Securities Act of 1933 (“1933 Act”) and the Securities and Exchange Act of 1934 (“1934 Act”) are pieces of New Deal legislation enacted in the wake of the Great Depression. Both Acts’ primary concern is adequate disclosure to investors—the public needs as much detail about a company as possible in order to make informed investment decisions.<sup>2</sup> The 1933 Act governs the initial

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<sup>1</sup> J.D., UCLA School of Law (2008). Articles Editor, UCLA Law Review. Special thanks to Lynn Stout, Paul Hastings Professor of Corporate and Securities Law at UCLA School of Law, for her guidance and mentoring; her approach to legal scholarship was an inspiration throughout writing this article. I also thank Joe Zujkowski and the editors of the *Annual Review of Banking and Financial Law*. This article is dedicated to my family—my parents, Karen and Alvin, my brothers, Sam and Fred, and my sister, Mimi.

<sup>2</sup> See *infra* notes 30, 40-46 and accompanying text.

offering of securities, while the 1934 Act governs securities that are already trading on the market. An essential element to the extensive regulatory scheme envisioned under both Acts is the imposition of liability for failing to comply with the Acts' disclosure requirements. Most notably, Section 11 of the 1933 Act imposes liability for false or misleading information disclosed to investors when a company sells its securities for the first time,<sup>3</sup> and Rule 10b-5 of the 1934 Act imposes liability for fraudulent or deceptive practices in connection with the purchase and sale of securities trading in secondary markets.<sup>4</sup>

Section 11 liability applies to parties involved in the preparation of a misleading registration statement of securities. However, for parties who conducted thorough due diligence, Section 11 provides an affirmative defense called the "due diligence defense."<sup>5</sup> Historically, courts construed this defense as mandating various levels of due diligence based on the particular defendant's involvement in the offering.<sup>6</sup> For parties intimately involved in the offering—such as inside directors and underwriters—the standard of due diligence was stringent, while the standard for outside directors was not. This makes sense (and is consistent with Congress's and the Securities and Exchange Commission's ("SEC") interpretation of what constitutes adequate due diligence)<sup>7</sup> because the more involved a party is in a given offering, the more thorough we want them to be and, thus, the more liability we want to impose in order to deter them from neglecting their duties. However, when it enacted the 1933 Act, Congress cautioned that liability for deterrence purposes should not extend so far that it would interfere with honest business practices.<sup>8</sup> Enter the problem of shelf offerings. Shelf offerings are a relatively new<sup>9</sup> means of selling securities to the public. A shelf offering is a method by which large public companies can sell securities on the

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<sup>3</sup> 15 U.S.C. § 77k (2000).

<sup>4</sup> 17 C.F.R. § 240.10b-5 (2006).

<sup>5</sup> 15 U.S.C. § 77k(b)(3).

<sup>6</sup> See *Weinberger v. Jackson*, No. C-89-2301-CAL, 1990 WL 260676 (N.D. Cal. Oct. 11, 1990); *Laven v. Flanagan*, 695 F. Supp. 800, 811-12 (D.N.J. 1988); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 577-78 (E.D.N.Y. 1971); *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643, 682-701 (S.D.N.Y. 1968).

<sup>7</sup> See *infra* notes 227-30.

<sup>8</sup> See *infra* Part V.

<sup>9</sup> The SEC formally began permitting shelf offerings in the early 1980s. See *infra* text accompanying notes 74-78.

market without having to jump through many of the 1933 Act hoops typically associated with an initial public offering.<sup>10</sup> As a consequence, shelf offerings happen much faster and require significantly less disclosure than traditional offerings. Thus, there is less time to conduct due diligence and less information that needs to be reviewed as a part of the due diligence process. The benefit for issuers, of course, is that it gives them the ability to raise capital quickly and at opportune pricing. However, this benefit is not without a corresponding burden; the de minimis due diligence in a shelf offering runs the risk of frustrating the 1933 and 1934 Acts' aim at ensuring disclosure of quality information to investors.

Because of this risk, the SEC has maintained that shelf offering due diligence is to be "equally thorough" to that of a traditional offering.<sup>11</sup> It therefore repeatedly rejected requests by scholars and industry professionals that it adopt a Section 11 safe harbor for underwriters when a company conducts a shelf offering.<sup>12</sup> Perhaps this rejection was reasonable in light of the fact that underwriters can invest in developing sophisticated techniques to adjust their due diligence for the shelf offering market.<sup>13</sup> Moreover, underwriters can self-insure Section 11 risk by raising their fees.<sup>14</sup>

Outside directors, however, cannot self-insure, and, yet, few scholars have made a case for an outside director Section 11 safe harbor for shelf offerings. This is not surprising considering that most scholars assumed outside directors were subject to very little (if any) liability under Section 11.<sup>15</sup> *In re WorldCom, Inc. Securities Litigation*,<sup>16</sup> the most recent case—and probably most important in

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<sup>10</sup> See *infra* Part III.B.

<sup>11</sup> See *infra* notes 252-54 and accompanying text.

<sup>12</sup> *Id.*

<sup>13</sup> See *infra* Part V.C.2.

<sup>14</sup> See *id.*

<sup>15</sup> See, e.g., Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45, 56 (2000) ("Outside directors may be harder to reach under . . . [the 1933 and 1934 acts], but that is probably appropriate given the limited involvement such directors usually have."); *id.* at 65 ("[O]ne would expect that few judges or juries would assign much of the [Section 11] liability load to non-complicit outside directors. In this light, should they have any liability exposure at all, absent knowledge of the fraud or perhaps reckless disregard? My sense is that *little justification exists for doing so.*") (emphasis added).

<sup>16</sup> 2005 WL 638268 (S.D.N.Y. 2005).

the last 3 or 4 decades—construing the due diligence defense, challenges this assumption. *In re WorldCom* held, in essence, that all parties involved in the preparation of a registration statement are subject to the same stringent standard of due diligence.<sup>17</sup> As discussed above, this is inappropriate because the due diligence inquiry must take into account the defendant's level of involvement in the offering (i.e., insiders, who are intimately involved in an offering, should be subject to a higher standard of due diligence than an outsider who was not involved to a similar degree).

This creates a perfect-storm environment for outside directors. First, by holding them to the same standard as insiders, outside directors are now subject to an unrealistic standard of due diligence because they lack the time and resources that insiders have.<sup>18</sup> Second, while Section 11 has minimal pleading requirements,<sup>19</sup> the court in *In re WorldCom* has, at the same time, made it virtually impossible for an outside director to successfully assert Section 11's due diligence defense.<sup>20</sup> Plaintiffs asserting a Rule 10b-5 fraud-on-the-market claim, on the other hand, will be subject to an elevated standard of pleading that will be difficult to overcome.<sup>21</sup> And for reasons that will be elaborated below, Rule 10b-5, although a 1934 Act provision, applies to shelf offerings under the 1933 Act.<sup>22</sup> Moreover, when a plaintiff seeks to assert a claim based on a materially misleading registration statement, a cause of action under both Rule 10b-5 and Section 11 typically exists because both rest on the same set of facts (the same misstatements or omissions in a registration statement). Thus, Section 11 claims will run rampant because plaintiffs will elect to assert Section 11 claims (that will now almost certainly get past summary judgment), as opposed to Rule 10b-5 fraud claims (because of the heightened pleading requirements).

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<sup>17</sup> See *infra* text accompanying notes 185-93.

<sup>18</sup> See *infra* Parts IV.B.2., V.B.

<sup>19</sup> See *infra* note 129 and accompanying text (noting that “Section 11 places a relatively minimal burden on a plaintiff” because all she must show is “a material misstatement or omission to establish [her] prima facie case.” (quoting *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983))).

<sup>20</sup> See *infra* text accompanying notes 190-93.

<sup>21</sup> See *infra* notes 115-20 and accompanying text.

<sup>22</sup> Because shelf registration statements incorporate by reference 1934 Act filings, they are within Rule 10b-5's reach. See *infra* Parts III.A., B., & IV.A.

Because of *In re WorldCom* and the significant problem of outside director Section 11 liability for shelf offerings, I argue in this article that the SEC should adopt a safe harbor for outside directors. Currently, a safe harbor for directors' substantive decisions exists under state law: the business judgment rule. It awards directors with a shield from liability provided they follow certain procedures in informing themselves of all material information about a given matter.<sup>23</sup> The procedural requirements of the business judgment rule mirror what has historically been considered the due diligence requirements for outside directors under Section 11. Previous scholars have defended the business judgment rule on behavioral and economic grounds.<sup>24</sup> Because of the congruity of the business judgment rule and Section 11 liability, I draw on this previous scholarship and argue that a Section 11 safe harbor for outside directors is justifiable based on a similar rationale.

The article proceeds as follows. Part II provides an overview of the 1933 and 1934 Acts. Part III discusses the mechanics of shelf offerings and the integrated disclosure system between the 1933 and 1934 Acts. Part IV discusses the principal liability provisions of the Acts; it focuses on Rule 10b-5 of the 1934 Act and Section 11 of the 1933 Act. Part V outlines the problems with holding outside directors to the same standard of liability of an insider. It then proposes a solution: a business judgment rule-like safe harbor for outside directors who follow procedural requirements in informing themselves of all material information surrounding an offering. Finally, it describes the perverse incentives the SEC will be endorsing if it does not create such a safe harbor. A brief conclusion follows.

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<sup>23</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); see also *infra* text accompanying notes 238-41.

<sup>24</sup> See, e.g., Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 675 (2002).

## II. *Background on the Securities Act of 1933 and the Securities Exchange Act of 1934*

Prior to the stock market crash of 1929 and the Great Depression<sup>25</sup> that followed, Congress had been reluctant to regulate publicly traded securities.<sup>26</sup> However, President Roosevelt, who recognized that corporate law reform was necessary in order to restore investor confidence in the capital markets, urged Congress to take legislative action.<sup>27</sup> As a result, the Senate Committee on Banking and Currency conducted a series of investigations into stock market practices that were thought to have caused the 1929 crash.<sup>28</sup> These investigations uncovered scores of irresponsible and unscrupulous practices pervasive in the stock markets that required remediation. In response, Congress enacted, among other things, the 1933 Act and the 1934 Act.<sup>29</sup>

The New Deal legislation, including the 1933 Act, “was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing.”<sup>30</sup> Although the 1934 Act has similar objectives—to

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<sup>25</sup> During the great depression (between 1929 and 1932) the stock market lost over 83 percent of its value. See LOUIS LOSS AND JOEL SELIGMAN, *SECURITIES REGULATION* ch. 1-F (3d. ed. 1989).

<sup>26</sup> See *id.*

<sup>27</sup> See *id.* (citing H.R. REP. NO. 73-85 at 1-2 (1933)). See also James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) (discussing President Roosevelt’s message to Congress).

<sup>28</sup> See S. REP. NO. 73-1455, at 1-4 (1934).

<sup>29</sup> See LOSS AND SELIGMAN, *supra* note 25, at ch. 1-F. For an in depth discussion of the legislative history of the Securities Act of 1933, see Landis, *supra* note 27, at 29-49.

<sup>30</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (“A fundamental purpose . . . was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in securities industry.”); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 563 (E.D.N.Y. 1971) (“The keystone of the Securities Act of 1933, and of the entire legislative scheme of the securities laws, is disclosure.”).

promote full disclosure, prevent fraud, and impose civil liabilities<sup>31</sup>—it governs the purchase and sale of securities already trading on an open exchange, while the 1933 Act deals primarily with the securities' initial distribution.<sup>32</sup>

Section 5<sup>33</sup> of the 1933 Act sets forth the Act's general disclosure requirements in the negative by prohibiting the public sale of securities unless a registration statement is filed with the SEC<sup>34</sup> and furnished a prospectus along with the registration statement.<sup>35</sup> To illustrate, the registration process is separated into three statutorily prescribed parts: the pre-filing period,<sup>36</sup> the waiting period,<sup>37</sup> and the post-effective period.<sup>38</sup> The company must furnish a prospectus when the registration statement becomes effective and must meet the requirements of Section 10<sup>39</sup> of the 1933 Act. Section 10(a) requires that the prospectus “contain the information contained in the registration statement”;<sup>40</sup> including all the relevant details about the issuer<sup>41</sup> an investor needs to make a fully informed investment decision.<sup>42</sup> Section 5's prohibition thus imposes the 1933 Act's

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<sup>31</sup> See *Ernst & Ernst*, 425 U.S. at 195.

<sup>32</sup> See LOSS AND SELIGMAN, *supra* note 25, ch. 1-H-2.

<sup>33</sup> Codified at 15 U.S.C. § 77e (2000).

<sup>34</sup> 15 U.S.C. § 77e(a) (2000).

<sup>35</sup> *Id.* § 77e(b)(1).

<sup>36</sup> *Id.* §§ 77e(a)(1), (a)(2), (c); see THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION ch. 2.3 (5th ed. 2002 & Supp. 2006).

<sup>37</sup> 15 U.S.C. §§ 77e(a)(1), (a)(2), (b)(1), 77h(a); see also HAZEN, *supra* note 36, ch. 2.4 (stating that the waiting period begins with the filing of the registration statement).

<sup>38</sup> 15 U.S.C. §§ 77e (b)(1), (b)(2); see also HAZEN, *supra* note 36, ch. 2.3 - 2.5 (discussing the numerous requirements and restrictions governing each of the three periods).

<sup>39</sup> 15 U.S.C. § 77j.

<sup>40</sup> *Id.* § 77j(a)(1) (referencing Schedule A of the 1933 Act which sets out a list of information to be provided in the registration statement); see *id.* § 77aa.

<sup>41</sup> A company that has or will issue (sell) its securities on an exchange is referred to as an “issuer.” See *id.* § 77(a)(4).

<sup>42</sup> *Id.* § 77aa; see also HAZEN, *supra* note 36, ch. 2.2[1] (discussing Section 5's general purpose of full disclosure to investors). The SEC recently enacted Rule 421(d), the new “plain English” rule, for the purposes of “enhanc[ing] the readability of the prospectus.” 17 C.F.R. § 230.421(d) (2006). Rule 421(d) requires issuers to “use plain English principles” in the preparation of certain portions of the prospectus. *Id.*; see also HAROLD S.

disclosure obligations on issuers because they cannot sell their securities without making a registration statement and prospectus available to investors.

Investor need for full disclosure of material information about an issuer is no less present in the context of the purchase and sale of securities already trading on an open exchange than it is in the securities' initial distribution. Thus, the 1934 Act's disclosure requirements pick up where the 1933 Act's disclosure requirements leave off,<sup>43</sup> requiring issuers to make periodic disclosure. Periodic disclosure under the 1934 Act is comprised of filing with the SEC an annual report on Form 10-K,<sup>44</sup> a quarterly report on Form 10-Q,<sup>45</sup> and a report of any significant company development on Form 8-K.<sup>46</sup>

### ***III. Shelf Offerings and the Integrated Disclosure System***

This article focuses on outside director liability under the 1933 and 1934 Acts in the context of shelf offerings. This Part provides a necessary overview of the mechanics of shelf registration and offering. A discussion of shelf offerings, however, would be deficient without some background on the integrated disclosure system. Thus, Section A provides a brief summary of integrated disclosure between the 1933 and 1934 Acts. Section B follows with an in-depth look at shelf offerings.

#### **A. The Integrated Disclosure System**

Under the old system, issuers were required to comply with all 1933 Act and 1934 Act disclosure rules even though both Acts separately mandated disclosure of essentially the same information.<sup>47</sup> As a result, issuers incurred substantial and unnecessary costs.<sup>48</sup> Moreover, because the 1933 and 1934 Acts had divergent disclosure

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BLOOMENTHAL, *SECURITIES LAW HANDBOOK*, §§ 6:9-6:17 (2006 ed.) (discussing the "plain English" rule).

<sup>43</sup> 15 U.S.C. § 78m (2000).

<sup>44</sup> 17 C.F.R. § 249.310 (2006).

<sup>45</sup> *Id.* § 249.308a.

<sup>46</sup> *Id.* § 249.308.

<sup>47</sup> See Michael McDonough, Comment, *Death in One Act: The Case for Company Registration*, 24 PEPP. L. REV. 563, 584-87 (1997); BLOOMENTHAL, *supra* note 42, § 3:2.

<sup>48</sup> See generally BLOOMENTHAL, *supra* note 42, § 3:2; McDonough, *supra* note 47, at 587-88.

procedures, the information was being disseminated in two different formats<sup>49</sup> which resulted in investors receiving duplicative and, thus, confusing information.<sup>50</sup> In a landmark article, Milton Cohen pointed out that the majority of information companies were required to disclose under the 1934 Act<sup>51</sup> was the same information included in a 1933 Act registration statement.<sup>52</sup> He therefore argued that the SEC should emphasize 1934 Act periodic reporting as opposed to the initial 1933 Act registration statement, which is a mere one-time event unlikely to be useful on an ongoing basis.<sup>53</sup>

In 1982, the SEC realized Cohen's vision by adopting an integrated disclosure system.<sup>54</sup> The new system's most significant innovation permitted issuers to "incorporate by reference" 1934 Act filings into a 1933 Act registration statement.<sup>55</sup> Some examples of filings that may be incorporated by reference are: "summary information, risk factors, use of proceeds, plan of distribution, descriptions of the company's business, property and legal proceedings, financial statements, selected financial data and ratios of earnings to fixed charges, and management's discussion and analysis (MD&A)."<sup>56</sup>

Of course, the integrated disclosure system did not significantly alter the amount of disclosure a company must make when it sells its shares for the first time on an open exchange (known as an "initial public offering" ("IPO")), since they have never made disclosures under the 1934 Act.<sup>57</sup> However, for companies that *have*

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<sup>49</sup> See Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1350-53 (1966) (discussing the method of 1933 Act disclosure under the old system); *id.* at 1359-61 (discussing the method of 1934 Act disclosure under the old system).

<sup>50</sup> See *id.*; McDonough, *supra* note 47, at 587-88. The problem of duplicative information was especially problematic because the whole purpose of the federal securities laws is to protect investors by imposing disclosure obligations on issuers. See *supra* Part II. Duplicative information thus frustrates this purpose because it can confuse investors.

<sup>51</sup> 15 U.S.C. § 78m (describing periodic reporting under the 1934 Act).

<sup>52</sup> Cohen, *supra* note 49, at 1368.

<sup>53</sup> *Id.* at 1341-42, 1367.

<sup>54</sup> See 17 C.F.R. §§ 229.10-229.915 (2006).

<sup>55</sup> See LOSS AND SELIGMAN, *supra* note 25, ch. 2-D-1.

<sup>56</sup> HAZEN, *supra* note 36, ch. 3.4[4][A].

<sup>57</sup> See *supra* Part II. (noting that the 1934 Act governs the purchase and sale of securities already trading on an open exchange); LOSS AND SELIGMAN, *supra* note 25, ch. 1-H-3 (providing an overview of the 1934 Act).

made periodic disclosure under the 1934 Act, incorporating by reference substantially decreased the amount of information to be disclosed in a 1933 Act registration statement.<sup>58</sup>

### B. Shelf Registration and Offerings

In theory, when offering their shares to the public, issuers register a specific number of securities with the SEC for the purpose of selling the entire allotment when the registration statement becomes effective. However, in reality issuers often offer only a portion of the allotted shares, upon the registration statement becoming effective, and delay sale of the remaining shares for a future, unspecified date (known as a “delayed offering”). Pre-registration of securities that are not presently sold is known as “shelf registration”—the securities are figuratively “placed on the shelf” instead of being sold when the registration statement becomes effective.<sup>59</sup> An issuer may then take the securities off the shelf at a later date and sell them to the public; this is referred to as a “shelf take-down” or “shelf offering.” A shelf offering is a particularly attractive strategy because, by pre-filing with the SEC, the issuer is not bound by the myriad due diligence obligations associated with an IPO. The issuer can therefore “time the market”—sell securities rapidly at a time that best suits its capital needs or when the market would provide the most favorable pricing.<sup>60</sup> This strategy is especially advantageous in a sale of debt securities because a shelf offering’s speed enables the issuer to take advantage of fluctuating interest rates, which particularly affect the debt markets.<sup>61</sup>

Although shelf registration provides a clear benefit to issuers,<sup>62</sup> the 1933 Act contains a substantial obstacle to its use:

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<sup>58</sup> See HAZEN, *supra* note 36, chs. 3.4[4][A], [C].

<sup>59</sup> See Scott Hodes, *Shelf Registration: The Dilemma of the Securities and Exchange Commission*, 49 VA. L. REV. 1106, 1107 (1963).

<sup>60</sup> See HAZEN, *supra* note 36, ch. 3.11.

<sup>61</sup> See *id.* See generally Christopher B. Barry et al., Interest Rates and the Timing of Public Issues of Corporate Debt (Nov. 12, 2003) (unpublished report, on file with Texas Christian University), available at <http://groups.haas.berkeley.edu/wfw/papers/5.pdf>.

<sup>62</sup> See generally Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA L. REV. 135, 145-54 (1984) (discussing the benefits of Rule 415 to issuers).

Section 6(a) of the 1933 Act states in relevant part that “[a] registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered.”<sup>63</sup> For a long time the SEC interpreted this sentence to mean that a registration statement is only effective as to securities *presently* offered for sale because including more securities in a registration statement would be misleading in that it would “give[the] securities offered at some remote future date at least the appearance of a registered status.”<sup>64</sup> Thus, up until the mid 1950s, the SEC’s strict reading of Section 6(a) effectively prohibited shelf registration by proscribing the registration of securities that were not presently offered for sale.<sup>65</sup> To be sure, as a part of the 1954 Securities Acts’ amendment program, the Senate Committee on Banking and Currency clarified that “[S]ection 6(a) of the [1933] Act . . . does not permit ‘registration for the shelf.’”<sup>66</sup>

The SEC’s reluctance to permit shelf registration was well founded. As discussed, shelf offerings are offerings of securities that have been pre-filed with the SEC. By definition, then, the securities have been sitting on the shelf for a period of time.<sup>67</sup> Thus, the information contained in a shelf registration statement may include obsolete or outdated information at the time of sale,<sup>68</sup> potentially frustrating the 1933 Act’s aim to disclose accurate information to investors.<sup>69</sup> Moreover, due to the short time frame of a shelf offering, the issuer’s and its underwriter’s ability to conduct due diligence is

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<sup>63</sup> 15 U.S.C. § 77f(a) (2000).

<sup>64</sup> Hodes, *supra* note 59, at 1106 (quoting Shawnee Chiles Syndicate, 10 SEC 109, 113 (1941)).

<sup>65</sup> See LOSS AND SELIGMAN, *supra* note 25, ch. 2-A-5.

<sup>66</sup> S. REP. NO. 83-1036, at 10 (1954); *see also* Hodes, *supra* note 58, at 1113-15 (discussing the 1954 amendment program and the Senate Committee report).

<sup>67</sup> See *supra* text accompanying note 58.

<sup>68</sup> LOSS AND SELIGMAN, *supra* note 25, ch. 2A-5 (observing that Commission expressed concerns about “disclosure and ‘due diligence’” in limiting reach of Rule 415).

<sup>69</sup> See, e.g., Hodes, *supra* note 59, at 1107 (“If securities are registered for *future* distribution, however, prospective investors who rely on the information in the registration statement may receive information that is no longer current . . . . Allowing registration long in advance . . . clearly frustrates the objective of the [42] act.”) (emphasis in original); *see also supra* text accompanying notes 30, 33-41 (observing that 1933 Act’s purpose is to provide full disclosure to potential investors).

limited<sup>70</sup>—potentially frustrating the 1933 Act’s aim of prohibiting the dissemination of false or misleading information to investors.<sup>71</sup> The concern regarding investors receiving up-to-date information was remedied in part by “post-effective amendments.” A post-effective amendment requires an issuer to update the shelf registration statement periodically if there has been a fundamental change to the information contained in it.<sup>72</sup> Consequently, a shelf registration statement combined with a post-effective amendment provides investors with current information. As a result of this innovation, over time, the SEC began permitting shelf registration, but it did so only in a limited set of circumstances.<sup>73</sup>

In 1982—right around the time the SEC overhauled the Securities Acts’ disclosure system by integrating disclosure under the 1934 Act with the 1933 Act<sup>74</sup>—the SEC yielded to market forces calling for wide availability of shelf registration and enacted Rule 415,<sup>75</sup> which permitted shelf registration, on an experimental basis.<sup>76</sup> Experimental Rule 415 proved to be a success in the eighteen months following enactment.<sup>77</sup> As a result, in 1983, the SEC adopted Rule

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<sup>70</sup> John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration*, WASH. & LEE L. REV. 1143, 1148 (1995) (“[T]here is clearly insufficient time in a shelf registration for traditional due diligence procedures to be conducted before each individual offering.”).

<sup>71</sup> See 15 U.S.C. § 77k (2000) (imposing civil liability for misstatements or omissions of material fact in the registration statement).

<sup>72</sup> 17 C.F.R. § 229.512(a)(1) (2006) (requiring issuer “[T]o reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement”).

<sup>73</sup> See LOSS AND SELIGMAN, *supra* note 25, ch. 2A-5 (stating that “[i]n 1968, the SEC published ‘Guide 4,’ summarizing the *exceptional circumstances* in which shelf registration would be permitted under the [1933] Act” (emphasis added)); John Paul Ketels, *SEC Rule 415—The New Experimental Procedures for Shelf Registration*, 10 SEC. REG. L.J. 318, 321 (1983).

<sup>74</sup> John Ketels observed that temporary Rule 415, 17 C.F.R. § 230.415 (1982), was a “logical extension of the integrated disclosure system.” Ketels, *supra* note 73, at 320.

<sup>75</sup> 17 C.F.R. § 230.415 (1982).

<sup>76</sup> See LOSS AND SELIGMAN, *supra* note 25, ch. 2-A-5.

<sup>77</sup> See Shelf Registration, Securities Act Release No. 6499, Exchange Act Release No. 20384, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶

415 permanently.<sup>78</sup> However, based on the concerns noted above—adequacy of disclosure and limited due diligence—the SEC limited the availability of shelf registration “to those offerings where the benefits of shelf registration are most significant and where the disclosure and due diligence concerns are mitigated by other factors.”<sup>79</sup> A principal mitigating factor persuading the SEC to permit certain kinds of issuers to register securities for the shelf was the extent to which a given issuer was followed by the investment community.<sup>80</sup> The theory was that the larger the company, the more widely it was followed by Wall Street, which tends to increase the quality of information disseminated to investors.<sup>81</sup> Hence, the SEC imposed a capitalization threshold: only companies with either a market float<sup>82</sup> of \$150 million or \$100 million combined with an annual trading volume of at least three million shares were eligible.<sup>83</sup> Moreover, because the integrated disclosure system permitted companies to incorporate by reference 1934 Act filings into 1933 Act registration statements, new due diligence methods were being developed in order to utilize 1934 Act due diligence when conducting 1933 Act due diligence.<sup>84</sup> Accordingly, shelf offerings were permitted for widely followed issuers.<sup>85</sup>

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83,449, at 86,335, 86,339 (Nov. 17, 1983) (“In the eighteen months since its adoption on a temporary basis, Rule 415 has operated efficiently and has provided registrants with important benefits in their financings, most notably cost savings.”) (footnote omitted).

<sup>78</sup> 17 C.F.R. § 230.415 (1983).

<sup>79</sup> Shelf Registration, *supra* note 77, at 2.

<sup>80</sup> See LOSS AND SELIGMAN, *supra* note 25, ch. 2A-5.

<sup>81</sup> See Shelf Registration, *supra* note 77 (“[F]or companies in the top tier, there is a steady stream of high quality corporate information continually furnished to the market and broadly digested, synthesized and disseminated.”).

<sup>82</sup> BLACK’S LAW DICTIONARY 670 (8th ed. 2004) (defining “float” as, *inter alia*, “the amount of a corporation’s shares that are available for trading on the securities market”).

<sup>83</sup> 17 C.F.R. § 239.13 (1982).

<sup>84</sup> See Shelf Registration, *supra* note 77, at 83,449 (“[P]rocedures for conducting due diligence investigations of [top tier] registrants, including continuous due diligence by means such as designated underwriters counsel, are being adapted to the intergrated [sic] disclosure system and shelf registration.”).

<sup>85</sup> 17 C.F.R. § 230.415 (1983). The standard used to determine which issuers qualify for shelf registration is simple: if the issuer is eligible to utilize a Form S-3 or F-3 registration statement, it is permitted to register

In 1992, the SEC expanded the types of permissible shelf registrations to include “unallocated” shelf registration.<sup>86</sup> This was a substantial expansion of shelf registration because, under the 1983 rules, an issuer had to *allocate* from the gross dollar value of the registration statement to the specific type of security being sold (i.e., debt or equity).<sup>87</sup> In an unallocated shelf registration, however, an issuer may pre-register “debt, equity and other classes of securities on a single shelf registration statement without a specific allocation of offering amounts among the classes of securities being registered.”<sup>88</sup> In addition, as a part of the 1992 expansion of shelf registration, the SEC lowered the eligibility threshold. Previously, only companies with either a market float of \$150 million, or \$100 million combined with an annual trading volume of at least three million shares, were eligible.<sup>89</sup> However, the SEC lowered the threshold to \$75 million, regardless of trading volume.<sup>90</sup>

In 2005 the SEC extended the shelf registration rules even further.<sup>91</sup> Of particular relevance to this article was the change in rules for what are known as “well-known seasoned issuers” (“WKSIs”).<sup>92</sup> Rule 405<sup>93</sup> sets forth the requirements that must be met

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securities for the shelf. 17 C.F.R. § 230.415(a)(1)(x) (1983). Form S-3, the short-form registration form for widely followed public companies, permits an issuer to incorporate by reference virtually all of its 1934 Act filings, requiring only a brief description of the transaction in the prospectus. *See HAZEN, supra* note 36, § 3.4[4][C]. In order to be eligible to utilize Form S-3 registration under the 1983 version of Rule 415, the issuer must have had either \$150 million float, or a \$100 million float and an annual trading volume of at least three million shares. 17 C.F.R. § 239.13 (1982).

<sup>86</sup> Simplification of Registration Procedures for Primary Securities Offerings, Sec. Act Rel. No. 6964, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,385, at 83,385 (Oct. 22, 1992).

<sup>87</sup> *See* LOSS AND SELIGMAN, *supra* note 25, ch. 2A-5 (“[T]he Commission addressed the market overhang problem of equity securities by amending Form S-3 to authorize “unallocated” or “universal” shelf registration by allowing companies to register debt, equity, or other securities without a specific allocation of offering amounts.”).

<sup>88</sup> Simplification of Registration Procedures for Primary Securities Offerings, *supra* note 86.

<sup>89</sup> 17 C.F.R. § 239.13 (1982).

<sup>90</sup> 17 C.F.R. § 239.13 (1992).

<sup>91</sup> *See* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, 70 Fed. Reg. 44,722 (Aug. 3, 2005).

<sup>92</sup> *See* 17 C.F.R. §§ 230.405, 239.13, 230.415 (2006).

<sup>93</sup> 17 C.F.R. § 230.405.

in order for an issuer to be deemed a WKSII. Generally speaking, a WKSII is a company that either has a market float of at least \$700 million<sup>94</sup> or has issued in the last three years at least \$1 billion in debt securities.<sup>95</sup> The difference, as it relates to shelf registration, between WKSII and issuers that otherwise meet the requirements for short-form registration<sup>96</sup> (meaning that they are eligible for shelf registration) is that WKSII are eligible for “automatic shelf registration.”<sup>97</sup> In an automatic shelf registration the securities become effective as soon as the registration statement is filed.<sup>98</sup> Thus, WKSII are able to “file a registration statement and sell securities in an immediate takedown on the same day.”<sup>99</sup>

What this means is that those associated with a WKSII shelf offering *have no time to conduct due diligence*.<sup>100</sup> The rationale for providing greater flexibility to WKSII was essentially the same as the rationale for adopting an expansive system of shelf registration in the first place: the more widely followed an issuer is, the greater the chance that quality information about the issuer has been disseminated,<sup>101</sup> and WKSII are the most widely followed issuers in the marketplace.<sup>102</sup>

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<sup>94</sup> 17 C.F.R. § 230.405(1)(i)(A).

<sup>95</sup> 17 C.F.R. § 230.405(1)(i)(B)(1) (“A well-known seasoned issuer is an issuer that . . . has a worldwide market value of its outstanding voting and non-voting common equity held by non-affiliates of \$ 700 million or more; or . . . has issued in the last three years at least \$ 1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Act”).

<sup>96</sup> See *supra* note 85 and accompanying text (noting that Form S-3 is the short-form registration statement for widely followed issuers).

<sup>97</sup> HAZEN, *supra* note 36, at § 3.11.

<sup>98</sup> See *id.* For WKSII, Rule 415 goes even further than automatic shelf registration. For example, WKSII do not have to specify the amount of securities being offered from the shelf, they do not need to provide as much detail in their registration statements as do other Form S-3 registrants, and they can add additional classes of securities after the effective date of the registration statement. See *id.*

<sup>99</sup> John C. Coffee, Jr., *A Section 11 Safe Harbor*, 234 N.Y. L. J. 5 (Sept. 15, 2005) (discussing Securities Act Release No. 33-8591).

<sup>100</sup> See *id.*

<sup>101</sup> See *supra* text accompanying notes 77-85 (explaining that the rationale behind the deferential treatment for WKSII is the fact that the market widely follows and understands them).

<sup>102</sup> In granting WKSII greater shelf registration flexibility, the SEC noted:

#### ***IV. Principal Civil Liability Provisions of the Securities Acts***

This section of the article discusses the most significant civil liability provisions of the 1933 and 1934 Acts. Section A provides an overview of liability under Rule 10b-5 of the 1934 Act. Because a more detailed discussion of Section 11 is needed, Section B discusses liability under Section 11, Section 11's due diligence defenses, and case law interpreting those defenses.

##### **A. Rule 10b-5 of the Securities and Exchange Act of 1934**

As mentioned above,<sup>103</sup> the 1934 Act's central focus is fundamentally the same as the 1933 Act's—to protect investors from corrupt practices in connection with the purchase and sale of securities by imposing thorough disclosure obligations on issuers.<sup>104</sup> However, the 1934 Act regulates securities that are already trading on an open exchange.<sup>105</sup> The 1934 Act, and rules promulgated thereunder, does this by imposing periodic reporting requirements<sup>106</sup>

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Overall, the issuers that will meet our thresholds for [WKSIs] are the most active issuers in the U.S. public capital markets. In 2004, those issuers, which represented approximately 30% of listed issuers, accounted for about 95% of U.S. equity market capitalization. They have accounted for more than 96% of the total debt raised in registered offerings over the past eight years by issuers listed on a major exchange or equity market. These issuers, accordingly, represent the most significant amount of capital raised and traded in the United States. As a result of the active participation of these issuers in the markets and, among other things, the wide following of these issuers by market participants, the media, and institutional investors, we believe that it is appropriate to provide communications and registration flexibilities to these [WKSIs] beyond that provided to other issuers, including other seasoned issuers.

Securities Offering Reform, *supra* note 91, at 19.

<sup>103</sup> See *supra* Part II.

<sup>104</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976).

<sup>105</sup> See *id.*

<sup>106</sup> 15 U.S.C. § 78m (2000).

and liability for failure to comply with those requirements.<sup>107</sup> Of all the investor protections contained in the 1934 Act, however, none is more encompassing than Section 10(b)<sup>108</sup> and Rule 10b-5<sup>109</sup> promulgated thereunder.<sup>110</sup> Section 10(b), the 1934 Act's general antifraud provision, makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors."<sup>111</sup> Rule 10b-5 "prohibits: (1) fraudulent devices and schemes, (2) misstatements and omissions of material fact, and (3) acts and practices which operate as a fraud or deceit."<sup>112</sup> Rule 10b-5's coverage is broad: *any* person who makes an untrue statement or omission of a material fact in connection with the purchase or sale of a security can be made a defendant in a Rule 10b-5 action (also referred to as a "fraud-on-the-market" action);<sup>113</sup> and "*any* oral or written communication, or manipulative or deceptive practice, in connection with the purchase or sale of a security whether or not the offering is registered under the [1933] Act" is within Rule 10b-5's reach.<sup>114</sup>

As broad as Rule 10b-5's coverage is in terms of permissible defendants and conduct, it does have its limitations, one of particular significance. Because a Rule 10b-5 action is premised on fraudulent or deceptive practices, the Supreme Court has held that in order to

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<sup>107</sup> *E.g.*, 17 C.F.R. § 240.10b-5 (2005).

<sup>108</sup> 15 U.S.C. § 78j(b) (2000).

<sup>109</sup> 17 C.F.R. § 240.10b-5 (2005).

<sup>110</sup> *See* Chiarella v. United States, 445 U.S. 222, 226, 234-35 (1980) (noting that Section 10(b) and Rule 10b-5 are the Securities Acts' "catch-all" antifraud devices); *see also* Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir. 1984) ("The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions — to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.").

<sup>111</sup> 15 U.S.C. § 78j(b).

<sup>112</sup> HAZEN, *supra* note 36, ch. 12.3[2] (citing 17 C.F.R. § 240.10b-5).

<sup>113</sup> *See* John J. Clarke, Jr., *How to Prepare an Initial Public Offering 2006: Potential Liabilities in Initial Public Offerings*, 1568 PLI/CORP. 165, 193 (2006).

<sup>114</sup> *Id.*

violate Rule 10b-5 a person must have acted with “scienter”<sup>115</sup> —“a mental state embracing intent to deceive, manipulate, or defraud.”<sup>116</sup> By holding that scienter is an element of a Rule 10b-5 action, the Supreme Court placed a formidable procedural hurdle in a plaintiff’s path: Rule 9(b) of the Federal Rules of Civil Procedure requires that averments of fraud must be pleaded with particularity.<sup>117</sup> Although Rule 9(b) does not require a plaintiff to plead with particularity a defendant’s state of mind<sup>118</sup>—which would seem to suggest that scienter, a state of mind, may be pleaded generally—in 1995, in an attempt to curtail frivolous shareholder suits, Congress enacted the Private Securities Litigation Reform Act<sup>119</sup> (“PSLRA”) which imposed an even higher standard than Rule 9(b) particularity for pleading scienter under Rule 10b-5: plaintiffs are required to “state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind.”<sup>120</sup>

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<sup>115</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); *see also* *Aaron v. SEC*, 446 U.S. 680, 691, 695 (1980) (noting that scienter is an element of a Rule 10b-5 action).

<sup>116</sup> *Ernst & Ernst*, 425 U.S. at 193 n.12.

<sup>117</sup> FED. R. CIV. P. 9(b). *Compare* FED. R. CIV. P. 8 (the more liberal notice pleading requirements do not require pleading with particularity).

<sup>118</sup> FED. R. CIV. P. 9(b).

<sup>119</sup> Private Securities Litigation Reform Act of 1995, PUB L. NO. 104-67, 109 Stat. 737 (1995).

<sup>120</sup> 15 U.S.C. § 78u-4(b)(2) (2000) (emphasis added) (Arguably, the PSLRA did not heighten the standard for pleading scienter but merely adopted existing Second Circuit precedent. Prior to the enactment of the PSLRA, the Second Circuit imposed the higher standard: plaintiffs were required “to plead the factual basis which gives rise to a strong inference of fraudulent intent.” *O’Brien v. Nat’l Prop. Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991) (internal quotation marks omitted). Conversely, the Ninth Circuit permitted scienter to be averred generally—consistent with the plain language of Rule 9(b). *See In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1546-47 (9th Cir. 1994) (en banc). Finally, other circuits simply applied Rule 9(b)’s standard particularity requirement to averments of scienter. *E.g.*, *Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 361 (1st Cir. 1994). Thus, at least for some circuits, it is not clear whether the PSLRA did in fact heighten the pleading standards. What is clear is that Congress *intended* to elevate the standards for pleading scienter in order to curb frivolous lawsuits. *See, e.g.*, *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 973 (9th Cir. 1999) (“Congress enacted the PSLRA to deter opportunistic private plaintiffs from filing abusive securities fraud claims, in part, by raising the pleading standards for private securities fraud plaintiffs.” (citing

### B. Section 11 of the Securities Act of 1933

Section 11<sup>121</sup> of the 1933 Act “was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering.”<sup>122</sup> Unlike Rule 10b-5 (which, as noted, applies to *any* person who makes an untrue statement or omission of a material fact), Section 11 imposes liability for a limited class of persons;<sup>123</sup> it applies to parties involved in the preparation of a registration statement and to directors, regardless of whether they were involved in the preparation.<sup>124</sup> In addition to being more limited than Rule 10b-5 with regard to covered persons, Section 11 is also more limited with regard to covered conduct—instead of applying to *any* oral or written communication, it imposes liability only for

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H.R. REP. CONF. NO. 104-369, at 32-41 (1995))). For a detailed discussion on the standards for pleading scienter under Rule 10b-5, *see* HAZEN, *supra* note 36, ch. 12.8[4].)

<sup>121</sup> 15 U.S.C. § 77k.

<sup>122</sup> *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983) (citing H.R. REP. NO. 85, 73d Cong., 1st Sess. 9 (1933)).

<sup>123</sup> Section 11(a) states in relevant part that the following types of parties are permissible Section 11 defendants:

- (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(a).

<sup>124</sup> *Id.*

untrue statements of material fact in the registration statement (or omitting material facts from it).<sup>125</sup>

Any purchaser of a security at the time it was offered can assert a claim under Section 11.<sup>126</sup> Purchasers who acquire their shares in the open market can also assert Section 11 claims as long as they can “trace” their securities to those covered by the registration statement that contained the alleged misleading information.<sup>127</sup> “Tracing” is another area in which Rule 10b-5’s coverage is broader than Section 11’s: Rule 10b-5 has no tracing requirement.<sup>128</sup>

“Section 11 places a relatively minimal burden on a plaintiff” because all she must show is “a material misstatement or omission to establish [her] prima facie case.”<sup>129</sup> This marks another significant distinction between Rule 10b-5 and Section 11, but here it is Section 11 that is more plaintiff friendly. Recall that plaintiffs asserting a Rule 10b-5 claim are subject to the rule’s burdensome pleading standard—the scienter requirement.<sup>130</sup> Plaintiffs asserting a Section 11 claim, on the other hand, are not required to plead scienter because it appears only in Section 11’s affirmative “due diligence” defenses (discussed below). Thus, Section 11 shifts the burden of (dis)proving scienter to the defendants.

Although Section 11 is negligence based, federal circuit and district courts are split on exactly what its pleading requirements

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<sup>125</sup> *Id.* The Supreme Court in *TSC Industries, Inc. v. Northway, Inc.* set forth the standard for materiality under Section 14 of the 1934 Act. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” *Id.* See also *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (adopting the *TSC* materiality standard for Rule 10b-5 claims). The same test for materiality applies to Section 11 claims. See, e.g., *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 273 (3d Cir. 2005); see also *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 569-75 (E.D.N.Y. 1971) (applying the materiality test to Section 11).

<sup>126</sup> 15 U.S.C. § 77k(a).

<sup>127</sup> *Id.* See also *In re Sterling Foster & Co., Inc., Sec. Litig.*, 222 F. Supp. 2d 216, 247 (E.D.N.Y. 2002).

<sup>128</sup> See, e.g., Hillary A. Sale, *Disappearing Without a Trace: Section 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429, 469 (2000).

<sup>129</sup> *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983)

<sup>130</sup> See *supra* text accompanying notes 115-20.

are.<sup>131</sup> Fraud is not an element of a Section 11 action,<sup>132</sup> yet some courts have held that when an action “sounds in fraud,” the heightened pleading standards of Rule 9(b) of the Federal Rules of Civil Procedure<sup>133</sup> apply.<sup>134</sup> Other courts have held that because Section 11 claims do not require proof of fraud, they are subject to Rule 8(a) of the Federal Rules of Civil Procedure<sup>135</sup>—standard notice pleading.<sup>136</sup>

### 1. Section 11’s Due Diligence Defenses

The issuer of securities is strictly liable under Section 11 for material misstatements or omissions in the registration statement.<sup>137</sup> Section 11 does, however, provide affirmative defenses to the other

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<sup>131</sup> See generally, BLOOMENTHAL, *supra* note 42, §§ 29:58-29:60 (discussing the pleading requirements for a Section 11 claim and the various approaches taken by federal district and circuit courts).

<sup>132</sup> See 15 U.S.C. § 77k(a).

<sup>133</sup> FED. R. CIV. P. 9(b).

<sup>134</sup> See *In re Daou Sys., Inc., Sec. Litig.*, 411 F.3d 1006, 1027 (9th Cir. 2005), *as amended* (“Although section 11 does not contain an element of fraud, a plaintiff may nonetheless be subject to Rule 9(b)’s particularity mandate if his complaint ‘sounds in fraud.’”); *Rombach v. Chang*, 355 F.3d 164, 170 (2d Cir. 2004) (“[T]he heightened pleading standard of Rule 9(b) applies to Section 11 . . . claims insofar as the claims are premised on allegations of fraud.”); *Cal. Pub. Employees’ Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 161 (3d Cir. 2004) (“[S]ection 11 1933 Act claims that are grounded in allegations of fraud are subject to Fed.R.Civ.P. 9(b).”); *Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994) (“When 1933 Securities Act claims are grounded in fraud rather than negligence . . . Rule 9(b) applies.”); *Sears v. Likens*, 912 F.2d 889, 893 (7th Cir. 1990) (applying Rule 9(b) to a plaintiff’s Section 11 claim). Rule 9(b) states that “[i]n all averments of fraud . . . , the circumstances constituting fraud . . . shall be stated with particularity.” FED. R. CIV. P. 9(b).

<sup>135</sup> FED. R. CIV. P. 8(a).

<sup>136</sup> See *Romine v. Acxiom Corp.*, 296 F.3d 701, 704 (8th Cir. 2002) (“[Section] 11 claims do not require proof of fraud and therefore the notice pleading requirements of Rule 8(a) apply.”); *In re Sirrom Capital Corp. Sec. Litig.*, 84 F. Supp. 2d 933, 937 (M.D.Tenn. 1999) (“To establish a prima facie case under Section 11, a plaintiff need only show that he bought the security and that there was a material misstatement or omission in the registration statement.”).

<sup>137</sup> See 15 U.S.C. § 77k(b) (2000) (providing affirmative defenses to Section 11 defendants “other than the issuer”).

enumerated defendants,<sup>138</sup> including officers who sign the registration statement, inside and outside directors, underwriters, and accountants.<sup>139</sup> These defendants can escape liability by establishing either the “whistle-blower” defense<sup>140</sup> or the “due diligence” defense.<sup>141</sup> Two defenses collectively make up the due diligence defense: the reasonable investigation defense and the reasonable reliance defense.<sup>142</sup> Thus, in order for a defendant to successfully assert the due diligence defense, she must either show that she conducted a reasonable investigation into the information contained in the registration statement<sup>143</sup> or, with regard to misstatements or omissions in “expertized” portions of the registration statement, that she reasonably relied on an expert’s opinion or work product.<sup>144</sup>

Under the reasonable investigation defense, a non-expert defendant can escape liability with regard to “any part of the registration statement not purporting to be made on the authority of an expert”<sup>145</sup> if the defendant “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.”<sup>146</sup> The same standard for reasonable investigations applies to

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<sup>138</sup> *See id.*

<sup>139</sup> *See id.* §§ 77k(a)(1)-(5).

<sup>140</sup> *Id.* §§ 77k(b)(1), (2); *see also* HAZEN, *supra* note 36, ch. 7.4[1].

<sup>141</sup> *Id.* § 77k(b)(3). The due diligence defense is the most commonly used Section 11 defense.

<sup>142</sup> Although both defenses collectively make up the due diligence defense, it is common to refer to the reasonable investigation defenses as the due diligence defense. This is because where a party is investigating, it is actually conducting “due diligence” (i.e., it is affirmatively taking action) as opposed to relying on the opinion of another. However, for the purposes of this article, I will refer to both collectively as the due diligence defense and, where necessary, refer to the two defenses separately as the reasonable investigation defense and the reasonable reliance defense.

<sup>143</sup> *Id.* § 77k(b)(3)(A), (B) (reasonable investigation defenses for experts and non-experts).

<sup>144</sup> *Id.* § 77k(b)(3)(C) (reasonable reliance on an expert defense).

<sup>145</sup> *Id.* § 77k(b)(3)(A). An example of an expert and its corresponding expertized portion of a registration statement is the accountant and the audited financial statements. *See* John Nuveen & Co., Inc. v. Sanders, 450 U.S. 1005, 1010 (noting that the reasonable reliance provision in Section 11 exists “because, almost by definition, it is reasonable to rely on financial statements certified by public accountants.”) (Powell, J., dissenting).

<sup>146</sup> 15 U.S.C. § 77k(b)(3)(A).

expert defendants.<sup>147</sup> However, Section 11 provides an expert defendant with an additional defense—she can escape liability if the misstatements or omissions in the registration statement “did not fairly represent [her] statement as an expert or was not a fair copy of or extract from [her] report or valuation as an expert.”<sup>148</sup>

The reasonable reliance defense applies to expertized portions of the registration statement.<sup>149</sup> Under this defense, a defendant can escape liability—provided that she was not an expert involved in the preparation of the portion of the registration statement at issues—is she demonstrates that she “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.”<sup>150</sup>

## 2. What Constitutes Reasonable Due Diligence?

As discussed above, determining what the plaintiff must prove to establish her prima facie case is simple given Section 11’s strict language.<sup>151</sup> However, determining what the defendant must prove in order to establish a due diligence defense is far less clear. Specifically, what constitutes a *reasonable* investigation or *reasonable* reliance? The statute provides a first step in answering this question: the standard for “reasonableness” is “that required of a prudent man in the management of his own property.”<sup>152</sup> However, this is hardly a clear standard. As Richard Sauer noted, it “is the familiar standard of care imposed on a trustee under the common law, and *notoriously subjective*.”<sup>153</sup>

In response to this problem the SEC enacted Rule 176, “Circumstances affecting the determination of what constitutes reasonable investigation and reasonable grounds for belief under

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<sup>147</sup> *Id.* § 77k(b)(3)(B)(i).

<sup>148</sup> *Id.* § 77k(b)(3)(B)(ii).

<sup>149</sup> *Id.* § 77k(b)(3)(C).

<sup>150</sup> *Id.*

<sup>151</sup> All the plaintiff must show is “a material misstatement or omission to establish [her] prima facie case.” *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983); *see supra* text accompanying note 129.

<sup>152</sup> 15 U.S.C. § 77k(c) (2000).

<sup>153</sup> Richard C. Sauer, *The Changing Dimensions of Director Liability Under the Federal Securities Laws*, 37 SEC. REG. & L. REP. 413, 414 (2005) (emphasis added).

section 11 of the Securities Act.”<sup>154</sup> The rule sets forth a list of factors a court may consider when making a reasonableness determination. Pursuant to Rule 176, a court may consider, among other things, “[t]he type of issuer”;<sup>155</sup> “[t]he type of security”;<sup>156</sup> “[t]he type of person”;<sup>157</sup> “[t]he office held when the person is an officer”;<sup>158</sup> “[t]he presence or absence of another relationship to the issuer when the person is a director . . . .”;<sup>159</sup> and “[r]easonable reliance on officers [and] employees . . . .”<sup>160</sup> However, Rule 176 has failed to provide directors with clear guidance. First, it can be considered or disregarded, and there is no requirement to give certain factors greater weight than others. Moreover, the SEC did not intend for the list to be exclusive, adding further uncertainty into the mix.<sup>161</sup> Second, many of the factors are notably vague.<sup>162</sup> For example, what does it mean to consider “the type of issuer,” “the type of security,” or “the type of person?”

What is more troubling is the lack of case law dealing with the due diligence defenses. For roughly 35 years subsequent to the enactment of the 1933 Act, not a single Section 11 due diligence case was decided.<sup>163</sup> *Escott v. BarChris Construction Corporation*<sup>164</sup> was the first; it commenced Section 11 jurisprudence with a stringent standard of liability for directors. At the same time, however, the *BarChris* court recognized that a case-by-case approach was

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<sup>154</sup> 17 C.F.R. § 230.176 (2006).

<sup>155</sup> *Id.* § 230.176(a).

<sup>156</sup> *Id.* § 230.176(b).

<sup>157</sup> *Id.* § 230.176(c).

<sup>158</sup> *Id.* § 230.176(d).

<sup>159</sup> *Id.* § 230.176(e).

<sup>160</sup> *Id.* § 230.176(f).

<sup>161</sup> Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Belief Under Section 11 of the Securities Act, Securities Act Release No. 6335, Exchange Act Release No. 18,011, Investment Company Act Release No. 11,889, 46 Fed. Reg. 42,015, at 42,021 (Aug. 18, 1981) [hereinafter Reasonable Investigation and Reasonable Belief] (“The explanation of the specific circumstances in . . . [Rule 176] is not intended to be exhaustive . . . .”); Sauer, *supra* note 153, at 414 (“The [SEC’s] implementing release makes clear that th[e] list of relevant factors [in Rule 176] is not exclusive.”).

<sup>162</sup> *See id.* (noting that “[m]ost [of the factors] are generic.”).

<sup>163</sup> *See Escott v. BarChris Const. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968); Sauer, *supra* note 153, at 414.

<sup>164</sup> *Id.*

necessary when making a due diligence inquiry because not all directors will be equally involved in a given offering.<sup>165</sup> The court therefore adopted a flexible approach: what constitutes reasonable due diligence depends largely on the degree of the defendant's involvement in the preparation of the defective registration statement.<sup>166</sup>

For *inside* directors—that is, directors with “intimate knowledge of corporate affairs and of the particular transactions”<sup>167</sup>—this standard was intensified three years later by *Feit v. Leasco Data Processing Equipment Corporation*.<sup>168</sup> The court in *Feit* held that inside director liability “approaches that of the issuer as guarantor of the accuracy of the prospectus.”<sup>169</sup> Pursuant to the court's holding, inside directors are virtually strictly liable under Section 11.<sup>170</sup> The court did note, however, that the due diligence standard for *outside* directors—that is, directors who do not have “intimate knowledge of corporate affairs and of the particular transaction”<sup>171</sup>—was probably something less, though it did not state what it was.<sup>172</sup>

Following *BarChris* and *Feit*, courts began to put some meat on the bones of the due diligence standard for outside directors.<sup>173</sup> For example, in *Weinberger v. Jackson* the court held that an outside director “is not obliged to conduct an independent investigation into the accuracy of all the statements contained in the registration statement . . . [and can] rely upon the reasonable representations of management, if his own conduct and level of inquiry were reasonable

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<sup>165</sup> *Id.* at 684-701 (applying a case-by-case approach to the due diligence defense asserted by each of the defendants).

<sup>166</sup> *Id.* at 697 (“It is impossible to lay down a rigid rule suitable for every case defining the extent . . . [of a defendant's due diligence]. It is a question of degree, a matter of judgment in each case.”).

<sup>167</sup> *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 578 (E.D.N.Y. 1971).

<sup>168</sup> *See id.* at 577.

<sup>169</sup> *Id.* at 578.

<sup>170</sup> *See supra* text accompanying note 137.

<sup>171</sup> *See Feit*, 332 F. Supp. at 578; *infra* Part V.A. (discussing the actual definition of “outside director”).

<sup>172</sup> *Id.* at 577-78.

<sup>173</sup> *See, e.g., Weinberger v. Jackson*, No. C-89-2301-CAL, 1990 WL 260676 \*4 (N.D. Cal. Oct. 11, 1990); *Laven v. Flanagan*, 695 F. Supp. 800, 812 (D.N.J. 1988).

under the circumstances.”<sup>174</sup> The types of conduct the court found to be reasonable under the circumstances were: regular attendance at board meetings and reasonable familiarity with the company’s business, operations, and financials.<sup>175</sup> In *Laven v. Flanagan* the court similarly held that outside directors are “under a lesser obligation to conduct a painstaking investigation than an inside director” and, thus, may rely solely on representations of the company’s management, external auditors, or underwriters in order to satisfy their due diligence defenses.<sup>176</sup> Taken together, *Feit, Weinberger*, and *Laven* stand for the principle that outside directors, by virtue of their more limited role in the company, can satisfy their due diligence defenses by doing what outside directors typically do—attend board meetings, review and understand company financials, and rely on the representations by the various parties who are intimately involved in company affairs.

The most recent pronouncement from the judiciary regarding Section 11 due diligence comes from two decisions in the WorldCom litigation.<sup>177</sup> In 2002, WorldCom announced a massive restatement of its financials based on accounting irregularities.<sup>178</sup> A subsequent investigation uncovered a fraudulent scheme implemented by a small group of WorldCom’s senior executives for the purposes of artificially inflating WorldCom’s stock price.<sup>179</sup> The scheme was aimed at reducing WorldCom’s largest single operating expense: its “line costs.”<sup>180</sup> “Line costs” represent the fees telecommunications carriers—such as WorldCom—pay to local third party providers for the right to access the third parties’ networks.<sup>181</sup> Pursuant to generally accepted accounting principles (“GAAP”), these line costs are to be recorded as expenses. Instead of following GAAP,

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<sup>174</sup> *Weinberger*, 1990 WL 260676, at \*4.

<sup>175</sup> *Id.*

<sup>176</sup> *Laven*, 695 F. Supp. at 812.

<sup>177</sup> See *In re WorldCom, Inc., Sec. Litig.*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004); *In re WorldCom, Inc. Sec. Litig.*, 2005 WL 638268 (S.D.N.Y. 2005).

<sup>178</sup> See generally *In re WorldCom*, 346 F. Supp. 2d at 635-55.

<sup>179</sup> REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATION COMMITTEE OF THE BOARD OF DIRECTORS OF WORLD COM, INC. 9-12 (Mar. 31, 2003), <http://f11.findlaw.com/news.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf>.

<sup>180</sup> *Id.*

<sup>181</sup> See *In re WorldCom, Inc.*, 346 F. Supp. 2d at 640.

<sup>181</sup> See Corrected First Amended Class Action Complaint at 34, *In re WorldCom*, 346 F. Supp. 2d 628 (No. 02-Civ-3288).

however, WorldCom directed a sizeable portion of its line costs to its capital accounts.<sup>182</sup> The net result of this practice was a reduction in WorldCom's line cost expense-to-revenue ("E/R") ratio—a financial ratio used by Wall Street to measure telecommunication companies' operating performance, and one that appeared in the financial statements incorporated by reference into WorldCom's debt securities' shelf registration statements—which made WorldCom appear to be in a better financial condition than it was.<sup>183</sup>

WorldCom's financial woes eventually led to its demise and a great deal of litigation thereafter.<sup>184</sup> Of relevance is the opinion by Judge Denise Cote of the Southern District of New York in *In re WorldCom Securities Litigation*, regarding Bert Roberts's ("Roberts", the former chairman of WorldCom's board) motion for summary judgment based on Section 11's due diligence defenses.<sup>185</sup> In that case, the plaintiffs' Section 11 claim stemmed from WorldCom's financial statements incorporated by reference into two sizeable shelf offerings of WorldCom debt securities.<sup>186</sup>

In denying Roberts's motion for summary judgment, the court held, as a matter of law, that WorldCom's low E/R ratio constituted a "red flag."<sup>187</sup> This placed Roberts on inquiry notice thereby foreclosing summary judgment based on the due diligence defenses.<sup>188</sup> Thus, pursuant to the court's holding, the existence of a "red flag" means that a director's due diligence—that is, the director's reliance on an expert or investigation into the material contained in unexpertized portions of the registration statement—is per se unreasonable at the summary judgment stage. This holding represents a significant departure from the line of due diligence cases previously discussed<sup>189</sup> for two reasons.

First, while those cases may differ on what constitutes reasonable due diligence, they all share a common framework for the

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<sup>182</sup> *Id.* at 35.

<sup>183</sup> *See In re WorldCom*, 346 F. Supp. 2d at 640.

<sup>184</sup> *See, e.g., In re WorldCom*, 2005 WL 638268 at \*1 ("The facts underlying WorldCom's [financial restatement] spurred numerous lawsuits").

<sup>185</sup> *See In re WorldCom*, 2005 WL 638268.

<sup>186</sup> *Id.* at \*1, \*2.

<sup>187</sup> *Id.* at \*17.

<sup>188</sup> *See* William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 608-09 (2006) (suggesting a "smoking gun" alternative to the red flag approach).

<sup>189</sup> *See supra* text accompanying notes 164-77.

reasonableness inquiry: a reasonableness determination involves a fact intensive inquiry that must take into account the defendant's relationship to the issuer. According to the court in *In re WorldCom*, however, the defendant's relationship to the issuer is irrelevant because the court declined to decide whether Roberts was either an inside or outside director, but assumed for the purposes of its analysis that he was an outside director.<sup>190</sup> The problem with this holding, which will be elaborated below in Part V.A, is that inside directors are virtually strictly liable under Section 11.<sup>191</sup>

Second, the due diligence inquiry in all of the prior Section 11 cases was made at the summary judgment stage of the litigation. Although the court in *In re WorldCom*, on a motion for summary judgment, held that WorldCom's low E/R ratio was a red flag, it also held that the true red flag determination is inappropriate at the summary judgment stage because it involves a fact intensive inquiry.<sup>192</sup> The effect of this holding is that going forward the due diligence defenses "can be outflanked to the extent that a plaintiff [can] credibly allege that a 'red flag' existed that required the defendants to make further inquiry."<sup>193</sup>

#### V. *The Problem with Section 11 Liability for Outside Directors in the Context of Expedited Shelf Offerings*

Holding an outside director to the same standard of due diligence for an expedited shelf offering as an inside director imposes an undue burden on industry and does not achieve any of the 1933 Act's objectives. Based on the previous discussion of Section 11 liability<sup>194</sup> and the purpose of the 1933 Act in general,<sup>195</sup> it might seem that Section 11 was designed to provide an investor with a remedy; that is not the case. "Civil liability under [S]ection 11 . . .

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<sup>190</sup> *In re WorldCom*, 2005 WL 638268, at \*12; see *infra* Part V.A. (discussing why this holding is problematic).

<sup>191</sup> See *supra* text accompanying notes 167-70.

<sup>192</sup> *In re WorldCom*, 2005 WL 638268, at \*11.

<sup>193</sup> John C. Coffee, Jr., *Due Diligence After WorldCom*, N.Y. L. J., 5 (Jan. 20, 2005) (discussing *In re WorldCom, Inc. Sec. Lit.*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004), the case in the WorldCom litigation dealing with the underwriters' motion for summary judgment based on the due diligence defenses).

<sup>194</sup> See *supra* Part IV.B.

<sup>195</sup> See *supra* Part II.

was designed not so much to compensate the defrauded purchaser as to promote enforcement of the Act and to deter negligence by providing a penalty for those who fail in their duties. . . . [T]he [1933] Act is more concerned with prevention than with cure.”<sup>196</sup> Moreover, a principal aim of the 1933 Act was to deter directors from spreading themselves too thin by taking multiple board positions—disabling them from providing meaningful service to any or all of the companies on whose boards they sat.<sup>197</sup> As the Congress noted in 1933:

The picture of persons, assumed to be responsible for the direction of industrial enterprises, occupying 50 or more directorships of corporations is the best proof that some change is demanded. Directors should assume the responsibility of directing and if their manifold activities make real directing impossible, they should be held responsible to the unsuspecting public for their neglect.<sup>198</sup>

However, Congress continued with a caveat:

But to require [directors] to guarantee the absolute accuracy of every statement that they are called upon to make, would be to gain nothing in the way of an effective remedy and to fall afoul of the President’s injunction that the protection of the public should be achieved with the least possible interference to honest business.<sup>199</sup>

Taken together, these two paragraphs evince Congress’s intent to impose civil liability on directors in order to deter them from neglecting their duties to the corporations whose boards they sit on, and also its intent to achieve this goal with the “least possible interference to honest business.”<sup>200</sup> Imposing a stringent standard of

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<sup>196</sup> *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1288-89 (2d Cir. 1969).

<sup>197</sup> See Allan Horwich, *Section 11 of the Securities Act: The Cornerstone Needs Some Tuckpointing*, 58 BUS. LAW. 1, 10-11 (2002).

<sup>198</sup> H.R. REP. NO. 73-85, at 5 (1933).

<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

due diligence on an outside director in the context of a shelf offering is contrary to this principle.

#### A. Digression: Who is an Outside Director?

As an initial matter, the question “who is an outside director?” needs to be answered.<sup>201</sup> It might seem odd that this question is being posed here; odd because the Section 11 cases previously discussed—*BarChris*, *Feit*, *Weinberger*, and *Laven*—distinguished between inside and outside directors in order to determine whether the defendants have satisfied their due diligence defenses. Thus, logic would suggest that courts must first define “outside director” before applying the law. However, this is not the case. In both *Weinberger* and *Laven*, the courts simply stated that the defendants were outside directors without discussing the issue further.<sup>202</sup>

Perhaps there is an explanation for this, albeit a semantic one. It is likely that the courts in *Weinberger* and *Laven* were using the term “outside” director synonymously with “disinterested” or “non-executive” director—familiar corporate law terms used to describe directors who are not also executives (or employees) of, or have a financial interest in the company. Although the courts could properly define “outside” director as above since the due diligence inquiry necessarily takes into account the defendant’s relationship to the issuer, a problem still remains because “outside director” is a term of art under the securities code. For example, defendants who are found to have violated Section 11 are held jointly and severally liable.<sup>203</sup> Outside directors, on the other hand, can only be held severally liable for violations of Section 11.<sup>204</sup> Therefore, a court applying Section 11’s due diligence defenses first needs to determine

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<sup>201</sup> See *supra* text accompanying note 171 (providing a cursory definition of outside director, however, it was provided solely for the purposes of having a necessary working definition in the previous discussion. A more searching discussion of “outside director” for present purposes is necessary.).

<sup>202</sup> *Weinberger v. Jackson*, No. C-89-2301-CAL, 1990 WL 260676, at \*4 (N.D. Cal. Oct. 11, 1990) (noting that “[d]efendant Valentine was an outside director,” without providing any further discussion); *Laven v. Flanagan*, 695 F. Supp. 800, 812 (D.N.J. 1988) (treating three director defendants “[a]s outside directors,” without explaining why).

<sup>203</sup> 15 U.S.C. § 77k(f)(1) (2000).

<sup>204</sup> 15 U.S.C. § 77k(f)(2)(A) (2000) (cross-referencing 15 U.S.C.A. § 78u-4(f), proportionate liability under the PSLRA).

whether a director defendant fits within the statutory term of outside director. Of course, the problem is there is no statutory definition of “outside director”. Congress has explicitly instructed the SEC to adopt a definition but the SEC has failed to do so.<sup>205</sup> As the court in *In re WorldCom* recognized:

The lack of a uniform understanding of who is an outside director within the case law is exacerbated by the SEC’s failure to promulgate its own definition of inside and outside directors for the purposes of Section 11, despite Congress’s explicit instruction within the PSLRA that it define the term ‘outside director.’<sup>206</sup>

In sum, while it may be possible to identify an outside director as synonymous with “disinterested” or “non-executive” director, there is currently no statutory definition for “who is an outside director for Section 11 purposes?” This is a significant problem. As noted above, an inside director is virtually held strictly liable under Section 11.<sup>207</sup> An outside director, on the other hand, may successfully assert a due diligence defense to win a motion for summary judgment.<sup>208</sup> However, if a court cannot determine whether a director is an inside director or an outside one, defendant will not be able to obtain a summary judgment, and the case will likely settle;<sup>209</sup> a case-in-point is *In re WorldCom*.<sup>210</sup> Therefore it is crucial for the SEC to take action and define outside director.

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<sup>205</sup> 15 U.S.C. § 78u-4(f)(10)(D) (“the term ‘outside director’ shall have the meaning given such term by rule or regulation of the [SEC].”). This does not mean that *Weinberger* and *Laven* were wrong to not reference the lack of a statutory definition. The distinction between outside and inside director for Section 11 purposes was established when PSLRA was enacted in 1995. *Weinberger* and *Laven* were decided prior to that.

<sup>206</sup> *In re WorldCom, Inc. Securities Litigation*, 2005 WL 638268 \*10 (S.D.N.Y. 2005) (citing 15 U.S.C. §78u-4(f)(10)(D)).

<sup>207</sup> See *supra* text accompanying notes 168-69.

<sup>208</sup> 15 U.S.C. § 77k(b)(3) (2000).

<sup>209</sup> This is due in part to the tendency of securities class actions to settle. See Sauer, *supra* note 153, at 414.

<sup>210</sup> See *supra* text accompanying note 190 (noting that the court declined to decide whether Roberts was an inside or outside director).

## B. No Deterrence, Substantial Interference

An important concept to keep in mind is that Section 11 does not aim to punish, but rather to ensure, with minimal interference, that parties do not neglect their due diligence duties when issuing securities.<sup>211</sup> Therefore, it is necessary to closely examine exactly what outside directors do (i.e., what their duties are) or, perhaps more precisely, what they do *not* do, before determining whether a stringent standard of liability for outside directors is appropriate.

The role of outside director under Section 11 has been widely viewed as that of a “gatekeeper.”<sup>212</sup> Although scholars disagree as to the precise definition of “gatekeeper,”<sup>213</sup> a gatekeeper is generally understood as one who looks over company management’s shoulder.<sup>214</sup> Different types of gatekeepers serve different due diligence functions and at varying levels. For example, accountants and underwriters are what I call “institutional gatekeepers” by virtue of their “strong reputational stake to certify or ‘bond’ the accuracy of an issuer’s disclosure.”<sup>215</sup> These “institutional gatekeepers” must vigorously “play the role of ‘skeptic’ refusing to take management’s representations about the true state of affairs on face value.”<sup>216</sup> Institutional gatekeepers are well situated to perform this duty because they are “well-trained professionals”<sup>217</sup> who derive sizeable income from performing gatekeeping functions. On the other hand, outside director’s role as a gatekeeper is considerably more passive; it is best understood as a corollary of the duty of

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<sup>211</sup> See *supra* text accompanying notes 194-98.

<sup>212</sup> See, e.g., John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308 (2004).

<sup>213</sup> See generally Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 417 n.6 (2004) (discussing the various approaches scholars have taken in defining the term “gatekeeper”).

<sup>214</sup> Langevoort, *supra* note 15, at 58 (citing *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968)). For an in depth discussion on the definition of “gatekeeper,” see John C. Coffee, Jr., *supra* note 212, at 308-311.

<sup>215</sup> Langevoort, *supra* note 15, at 58.

<sup>216</sup> *Id.*

<sup>217</sup> Donald C. Langevoort, *Seeking Sunlight In Santa Fe’s Shadow: The SEC’s Pursuit Of Managerial Accountability*, 79 WASH. U. L.Q. 449, 485 (2001).

inquire and to monitor<sup>218</sup> under state law, collectively.<sup>219</sup> Pursuant to these duties, outside directors are required to “oversee the conduct of the corporation’s business,” “take reasonable steps to keep abreast of the information that flows to the board as a result of” the oversight, and “follow up reasonably on information that has been acquired and should raise cause for concern.”<sup>220</sup>

However, outside directors’ ability to monitor is constrained by several factors. As a number of leading corporate law professors have noted, outside directors typically rely on others—such as underwriters, inside directors, officers, and accountants—for information. Thus, by the time an outside director gets her hands on information that is to be disclosed in a registration statement, and assuming this information is materially misleading, the negligence, recklessness, or fraud involved would have already occurred. This puts the outside director in a worse position to discover the flaw than if she were an insider. Therefore, an outside director is in a worse position to discover the flaw than an insider.<sup>221</sup> As cogently expressed by Professor Laura Lin,

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<sup>218</sup> In fact, it has been argued that the role of the outside director of a public company can best be described as that of a “securities monitor.” Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 *BUS. LAW.* 1375 (2006).

<sup>219</sup> Professor Melvin Eisenberg has described the duty of corporate directors as a “moral obligation to exercise care in the performance of one’s role . . . . This moral obligation is an aggregate comprised of four relatively distinct duties: (1) the duty . . . to monitor . . . ; (2) the duty of inquiry . . . ; (3) the duty to employ reasonable decision making processes; and (4) the duty to make reasonable decisions.” Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 *U. PITT. L. REV.* 945, 948 (1990).

<sup>220</sup> *Id.*

<sup>221</sup> See Stephen M. Bainbridge, *A Critique of the NYSE’s Director Independence Listing Standards*, 30 *SEC. REG. L.J.* 370, 389 (2002) (noting that outside directors’ dependence on management for information is a factor that “impede[s] an independent director from monitoring management”); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 *J. CORP. L.* 1, 26 (2002) (“[Outside directors] must depend on insiders for critical information.”); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 *NW. U. L. REV.* 898, 914 (1996).

[i]n light of management's control over information, . . . outside directors merely receive selective information that would support management's desired position on [a] matter. As a result, instead of acting as a check against potential managerial indiscretion, outside directors may see major issues confronting the corporation through management's eyes.<sup>222</sup>

In addition to their deficient access to information, "outside directors lack the time to do more than review . . . business decisions."<sup>223</sup> According to one industry survey, *most companies conduct just six board meetings per year, with each meeting lasting only three to five hours.*<sup>224</sup> Further, Professor Stephen Bainbridge has observed that "most outside directors have full-time employment elsewhere, which commands a bulk of their attention . . ."<sup>225</sup> Given all these constraints, it should be clear that outside directors play a "very small role . . . in a public offering vis-à-vis the other participants."<sup>226</sup> How does the imposition of a stringent due diligence standard under Section 11 deter outside directors from negligently performing such a limited function? I argue that it does not; and I emphatically argue that it specifically does not in the context of a shelf offering. To illustrate, let us now revisit shelf offerings while thinking about outside director's limited role in such an offering.

As noted in Part III.B, the time-frame of a shelf offering as compared to that of an IPO has been substantially condensed. A typical IPO involves a considerable amount of due diligence by all parties involved, including inside and outside directors, underwriters, accountants, and lawyers.<sup>227</sup> The entire process generally takes

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<sup>222</sup> Lin, *supra* note 221, at 914.

<sup>223</sup> Ribstein, *supra* note 221, at 26.

<sup>224</sup> THE CONFERENCE BOARD, *DIRECTORS' COMPENSATION AND BOARD PRACTICES IN 2006* 22 (2006) (emphasis added).

<sup>225</sup> Bainbridge, *supra* note 221, at 388.

<sup>226</sup> Donald C. Langevoort, *The Reform of Joint and Several Liability under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights and Settlement Effects*, 51 *BUS. LAW.* 1157, 1164 (1996); *see also* Langevoort, *supra* note 15, at 56 (noting the limited involvement outside directors have in public offerings).

<sup>227</sup> *See* RICHARD W. JENNINGS & HAROLD MARSH, JR., *SECURITIES REGULATION: CASES AND MATERIALS* 129-33 (6th ed. 1987) (discussing the preparation of a registration statement for an IPO); CHARLES J. JOHNSON,

between three and six months to complete.<sup>228</sup> During this time, outside directors will certainly be aware of the IPO and are likely to be involved—if not intimately involved—in the offering’s due diligence. Thus, Section 11 liability in this context might deter outside directors from neglecting their due diligence obligations. Shelf offerings (or shelf takedowns), on the other hand, are “truly high velocity transactions. Assuming that no post-effective amendment [is] needed, the issuer [can] decide that the time [is] ripe for [a] takedown, obtain bids from underwriters and sell the securities, *all within a day or two.*”<sup>229</sup> It is unlikely that an outside director will have any time to conduct due diligence in this condensed time-frame; however, it *is* likely that an outside director will not even be aware that the company is conducting a shelf offering. Consequently, outside directors may not be responsible for conducting *any* due diligence in an expedited shelf offering. This is necessarily the case when the issuer is a WKSI because there is no time to conduct due diligence in a WKSI shelf offering.<sup>230</sup> Therefore, Section 11 liability for outside directors in this context serves no deterrent value because the shortened time frame renders it impossible for outside directors to conduct any due diligence, let alone do it negligently.

Thus, while it may be reasonable to impose elevated due diligence requirements on outside directors in the context of an IPO, it is untenable to presume that an outside director will likewise be in a position to conduct meaningful due diligence—that is, in order to win on a motion for summary judgment based on a Section 11 due diligence defense—in the condensed time-frame of a shelf offering. This conclusion is consistent with the SEC’s interpretation of what constitutes a reasonable investigation or reasonable reliance. When it

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JR. & JOSEPH MCLAUGHLIN, *CORPORATE FINANCE AND THE SECURITIES LAWS* 331-74 (3d ed. 2004) (providing an in-depth look at the due diligence procedures in an IPO).

<sup>228</sup> Stacy J. Kanter, *Deciding Whether to go Public: Certain Basic Considerations*, 1328 PLI/CORP. 9, 12 (2002).

<sup>229</sup> JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 198 (5th ed. 2006) (emphasis added) (discussing market windows for shelf offerings).

<sup>230</sup> See Coffee, *supra* note 99 (Prior to the adoption of the rule for WKSI, “directors had very little time between the filing and the offering to conduct due diligence; after it, those associated with . . . [WKSI] *have none.*” (emphasis added)).

proposed Rule 176,<sup>231</sup> the SEC noted, “Congress intended that there would be a variation in the thoroughness of the investigation performed by the different persons subject to Section 11 liability based on the importance of their place in the scheme of distribution.”<sup>232</sup> Further, the SEC included subsection (e)<sup>233</sup> in Rule 176 to clarify that “a director who has another relationship with the issuer involving expertise, knowledge or responsibility with respect to any matter giving rise to the omission or misstatement *will be held to a higher standard of investigation and belief than an outside director with no special knowledge or additional responsibility.*”<sup>234</sup> In addition to not serving any deterrent value, requiring an outside director to perform due diligence at the level of an insider constitutes a considerable interference with business practice, running afoul of the 1933 Act.<sup>235</sup> *In re WorldCom* serves as a good illustration of this notion. As discussed, the court denied Roberts’s motion for summary judgment for failing to make further inquiry into WorldCom’s declining E/R ratio.<sup>236</sup> If outside directors were required during an expedited shelf offering to scrutinize carefully every financial ratio in order to avoid Section 11 liability, this “due diligence” would impede the offering process. The whole purpose of the expedited shelf offering process is to take advantage of the expedited process.<sup>237</sup>

### **C. Proposed Solution: Section 11 Safe Harbor**

#### **1. The Business Judgment Rule and a Section 11 Safe Harbor**

The previous section outlined the problems with holding an outside director to the same standard of liability as an insider. This

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<sup>231</sup> 17 C.F.R. § 230.176 (2006).

<sup>232</sup> Reasonable Investigation and Reasonable Belief, *supra* note 161, at 408 (internal quotation marks omitted).

<sup>233</sup> Rule 176(e) states that a relevant circumstance a reviewing court should take into consideration when making a reasonableness determination is “[t]he presence or absence of another relationship to the issuer when the person is a director or proposed director.” 17 C.F.R. § 230.176(e).

<sup>234</sup> Reasonable Investigation and Reasonable Belief, *supra* note 161, at 408 (emphasis added).

<sup>235</sup> *See supra* text accompanying notes 196-200.

<sup>236</sup> *In re WorldCom, Inc. Securities Litigation*, 2005 WL 638268 \*11-12 (S.D.N.Y. 2005).

<sup>237</sup> *See supra* text accompanying notes 60-61.

section proposes a solution to this problem by applying Professor Lynn Stout's economic and behavioral defense of the "business judgment rule,"<sup>238</sup> a state law doctrine, to the Section 11 due diligence process. The business judgment rule is "a presumption that in making a business decision, the directors of a corporation acted on an *informed* basis, in good faith and with the honest belief that the action taken was in the best interests of the company"<sup>239</sup> In essence, this rule presumes that the directors acted with due care. This presumption prohibits judges from reviewing director decisions if, when making those decisions, the directors followed certain procedures in informing themselves of all material information surrounding the given matter.<sup>240</sup> The rule is recognition that judges are ill-equipped to second guess, after the fact, the reasonableness of a board's decision given the "extraordinarily complex" business world.<sup>241</sup>

In this section, I argue that a standard of review similar to the business judgment rule should apply to the outside director under a Section 11 due diligence scheme. Outside directors should be shielded from liability if they follow certain *procedures* in informing themselves of material information when conducting due diligence. As will be developed below, such a process of due care solves the deterrence and interference problems described above.

In her article, "*In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*,"<sup>242</sup> Professor Stout argues that the efficacy of the business judgment rule lies in its process due care requirements. She begins her analysis by presenting the two most common critiques of the business judgment rule. The first critique is that by shielding directors from liability for failing to follow process due care, the business judgment rule does not discourage director carelessness.

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<sup>238</sup> See generally Stout, *supra* note 24.

<sup>239</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (emphasis added) (internal quotation marks omitted).

<sup>240</sup> See *id.*

<sup>241</sup> Stout, *supra* note 24, at 681; See Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1441 (1985) ("Allowing shareholders to challenge business decisions on the basis that they were not 'informed' has the effect of substituting the business judgment of . . . [judges] on the issue of how much information should be acquired for the business judgment of those entrusted, by virtue of their superior expertise and incentives, with managing the firm's affairs.")

<sup>242</sup> Stout, *supra* note 24, at 676.

This is because so long as directors followed the requisite procedures in making a business decision, the director is protected regardless of how foolish the decision was. The second critique is that the business judgment rule only encourages directors to “adopt elaborate and costly decision-making routines.”<sup>243</sup>

Professor Stout challenges these critiques and defends the business judgment rule’s process due care requirement by applying behavioral and economic theory in the context of the corporate boardroom. She premises her argument on two basic assumptions: (1) a behavioral assumption that “corporate directors try to ‘do the right thing’—to serve the best interests of the firm and its shareholders,”<sup>244</sup> and (2) an economic assumption that this desire to “do the right thing” decreases as the amount of personal sacrifice involved increases.<sup>245</sup> The business judgment rule’s process due care requirements (which would shield from liability directors who inform themselves of all material information before they make a decision) operate to reduce the marginal personal sacrifice associated with doing the right thing.<sup>246</sup>

In particular, the business judgment rule can reduce an altruistic director’s *cost of comprehension* (that is, the cost of finding out what is going on at the firm and what available courses of action and likely consequences might be) and also can reduce a director’s *cost of confrontation* (that is, the cost of demanding more information from management or challenging a management-recommended course of action).<sup>247</sup>

Thus, as these costs are reduced, directors become more likely to “do the right thing” which, in turn, provides a benefit to the shareholders.

To illustrate, it is necessary to conduct a closer examination of these two types of costs—the cost of comprehension and confrontation. First, the business judgment rule reduces a director’s

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<sup>243</sup> *Id.* at 676.

<sup>244</sup> *Id.* at 683.

<sup>245</sup> *Id.* at 686. (“[W]hen plotted as a function of personal cost, the supply of altruistic behavior is downward sloping. The higher the price of behaving altruistically, the less altruism supplied.”).

<sup>246</sup> *Id.* at 678.

<sup>247</sup> *Id.*

marginal cost of comprehension by rewarding her with a shield from liability provided that she follow certain procedures in becoming informed of material information, including reading reports, listening to presentations, asking questions, and hearing answers.<sup>248</sup> Outside of this, “the only extra effort the director must make is to think.”<sup>249</sup> Thus, because the director’s marginal personal sacrifice associated with “thinking” is low, she is likely—because she is motivated to “do the right thing”—to be altruistic and think. Second, the business judgment rule reduces a director’s marginal cost of confronting company management.

The rule does this by giving a director an independent reason for asking questions and demanding further information—in other words, a reason other than pure distrust. In effect, it allows a director to say to the CEO: “It’s not that I doubt your judgment. It’s just that to protect myself, I must know all the facts.”<sup>250</sup>

If we accept Professor Stout’s argument, a solution to the problem of Section 11 liability for outside directors in the context of shelf offerings begins to emerge. Put simply, is not the business judgment rule’s procedural requirement that outside directors inform themselves before making a decision just a different way of saying, “outside directors must conduct due diligence?” Recall that outside director due diligence consists of attending board meetings, reviewing and understanding company financials, and relying on the representations by the various parties who are intimately involved in company affairs.<sup>251</sup> This is precisely what the business judgment rule requires. In fact, the SEC itself has stated that outside directors, in order to adequately provide protection to shareholders, must become “reasonably well informed.”<sup>252</sup> Moreover, both Section 11<sup>253</sup> and the

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<sup>248</sup> *Id.* at 689.

<sup>249</sup> *Id.*

<sup>250</sup> *Id.* at 690.

<sup>251</sup> See *supra* text accompanying notes 173-76.

<sup>252</sup> Sale, *supra* note 218, at 1382 (quoting Report of Investigation in the Matter of Stirling Homex Corporation Relating to Activities of the Board of Directors of Stirling Homex Corporation, Exchange Act Release No. 11516, 7 SEC Docket 298, 300 (July 2, 1975)); see also *id.* (Outside directors are required “to accept the ‘responsibility affirmatively to *keep themselves*

duty of care (and the business judgment rule's corresponding shield from liability for breaches of it)<sup>254</sup> attempt to impose liability in order to deter director carelessness, without causing undue interference with honest business practices. Thus, because process due care is essentially the same as Section 11 due diligence, and because Section 11 liability and the duty of care are both aimed at preventing the same type of harm (i.e., director carelessness), Professor Stout's analysis fits comfortably within the Section 11 due diligence scheme.

The solution to the problem outlined in Part V.B thus becomes clear: in the context of an expedited shelf offering, instead of requiring an outside director to carefully scrutinize every financial ratio to avoid liability (as was the case in *In re WorldCom*), the SEC should adopt a business judgment rule-like safe harbor for outside directors who follow the requisite procedures in informing themselves. This strikes the most efficient balance between the need to impose liability for issuing materially misleading information, and the desire to do so with the least possible interference with honest business practices. As opposed to imposing a draconian standard of liability that accomplishes little in deterrence, the reward of a business judgment rule-like safe harbor for outside directors would enable them to conduct meaningful due diligence by reducing the marginal personal sacrifice associated with it.<sup>255</sup>

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*informed* of developments within the company . . . ." (emphasis added) (quoting Report of Investigation in the Matter of National Telephone Co., Inc., Relating to Activities of the Independent Directors of National Telephone Co., Inc., Exchange Act Release No. 34-14380, 13 SEC Docket 1393 (Jan. 16, 1978)).

<sup>253</sup> A primary purpose of Section 11 was to deter director carelessness with the least possible interference with honest business. *See supra* text accompanying notes 196-200.

<sup>254</sup> The business judgment rule recognizes that judges are ill-equipped to second guess director decisions. However, courts will impose liability where a director was grossly negligent in failing to inform herself of all material information. *See supra* text accompanying notes 238-41.

<sup>255</sup> Recommending what procedural requirements should appear in a Section 11 safe harbor is outside the scope of this article. One prominent securities scholar has put forth some possible requirements of a safe harbor for outside directors. *See Coffee, supra* note 99.

## 2. Possible Criticism

Critics of providing a safe harbor for outside directors would perhaps point to the SEC's repeated refusal to adopt a similar safe harbor for underwriters.<sup>256</sup> In declining to grant a safe harbor for underwriters in shelf offerings, the SEC stated, "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 to integrated registration statements."<sup>257</sup> However, there is a marked difference between underwriters' due diligence and outside directors' due diligence. Underwriters, as institutional gatekeepers, can self-insure the risk associated with Section 11 liability by raising their fees across-the-board.<sup>258</sup> The premium clients pay for underwriters' services, which then operates as a pool of insurance money that can be used for funding Section 11 losses. Moreover, underwriters have the resources to invest in sophisticated systems in order to adjust their due diligence for the rapid nature of shelf offerings.

Outside directors, on the other hand, cannot avail themselves of these protective methods. First, outside directors cannot self-insure Section 11 risk. In order to self-insure, outside directors would have to obtain multiple board positions, and at increased salaries. This is hardly possible and certainly undesirable. Indeed, as noted, one of the primary purposes of the 1933 Act was to deter directors from assuming multiple board positions.<sup>259</sup> Second, although it may be possible for outside directors to put 1933 and 1934 Act compliance programs in place<sup>260</sup> in order to review the 1934 Act

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<sup>256</sup> See Adoption of Integrated Disclosure System, Securities Act Release No. 6383, [Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328, at 11,399 n.98 (Mar. 3, 1982) (noting that the SEC refused to adopt a safe harbor for underwriters in lieu of Rule 176).

<sup>257</sup> Reasonable Investigation and Reasonable Belief, *supra* note 161, at 406 (emphasis added).

<sup>258</sup> See Coffee, *supra* note 99 (noting that underwriters, unlike outside directors, can self insure the risk of Section 11 liability).

<sup>259</sup> See *supra* text accompanying note 197.

<sup>260</sup> Indeed, pursuant to the duty to monitor discussed above, one of the functions of outside directors is to "oversee the conduct of the corporation's business," and "take reasonable steps to keep abreast of the information that flows to the board as a result of" the oversight. *Supra* note 219 and accompanying text. Putting a "compliance program" in place has been recognized by the Delaware Supreme Court as part of the duty to monitor.

reports that get incorporated by reference into shelf registration statements, outside directors' access to information is still defective based on their role in the scheme of distribution.<sup>261</sup> Admittedly, if there existed a compliance program sophisticated enough to detect "red flags" then perhaps outside directors, like underwriters, could perform shelf offering due diligence that is different from, but still "equally thorough" as IPO due diligence.

#### **VI. *No Fraud? No Problem: Perverse Incentives Without a Safe Harbor***

It is widely assumed that outside directors "have relatively little to fear on the merits" of a Rule 10b-5 fraud-on-the-market action.<sup>262</sup> This is due in large part to the considerable procedural hurdles of a 10b-5 action. The highest, of course, is the scienter standard for pleading fraud.<sup>263</sup> Because outside directors are "less likely than their inside director counterparts to have the requisite 'knowledge' of the misstatement or omission required to meet the pleading standard,"<sup>264</sup> they "are rarely sued in securities fraud class actions."<sup>265</sup>

Section 11's pleading requirements, unlike Rule 10b-5 requirements, place a relatively minimal burden on a plaintiff. With *In re WorldCom* in place as the most current Section 11 case, outside directors have virtually no due diligence defense. As discussed, the

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*See In re Caremark Int'l, Inc. Derivative Litigation*, 698 A.2d 959, 970 (Del Ch. 1996) ("[I]t would . . . be a mistake to conclude that . . . corporate boards may satisfy their . . . duty to monitor, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide . . . to the board timely, accurate information sufficient to allow . . . the board . . . to reach informed judgments concerning the corporation's compliance with law . . .").

<sup>261</sup> *See supra* text accompanying notes 221-26 (discussing the inability of outside directors to fill a gatekeeping role to the same degree of thoroughness and effectiveness as an institutional gatekeeper).

<sup>262</sup> Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 822 (2001).

<sup>263</sup> *See supra* text accompanying notes 115-20.

<sup>264</sup> Sale, *supra* note 218, at 1389.

<sup>265</sup> John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1549 (2006).

due diligence defenses “can be outflanked to the extent that a plaintiff [can] credibly allege[] that a ‘red flag’ existed that required the defendants to make further inquiry.”<sup>266</sup> Given the scarcity of published Section 11 due diligence opinions,<sup>267</sup> this holding is likely to have wide influence and long lasting force. Thus, going forward, plaintiffs will likely pursue Section 11 claims to take advantage of its lenient pleading requirements.<sup>268</sup> This scenario should be troubling mostly because of its likelihood: shelf registration statements—vis-à-vis the incorporation by reference feature—contain the same information a plaintiff would use to assert a Rule 10b-5 claim. In other words, both causes of action rest on the same set of facts.

## VII. Conclusion

It has been long assumed that outside directors had little (if any) liability under Section 11. Because of this, previous scholarship on Section 11 due diligence focused on softening the standard for underwriters as opposed to outside directors. However, *In re WorldCom* has significantly altered the Section 11 landscape and calls into question the assumption that outside directors are subject to minimal liability. This article reflects the debate that will ensue concerning outsider directors in the aftermath of WorldCom. The article began by discussing the problem with holding outside directors to the same standard of due diligence as insiders, given that the stringent standard applied for insiders arguably does not serve any deterrent value when applied to outsiders. Such stringent standards may actually operate as an undue interference with normal business practice. This article proposes a reasonable solution to this problem: construction of a Section 11 safe harbor modeled off of the business judgment rule. The reward of this rule is that it will shield

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<sup>266</sup> Coffee, *supra* note 193.

<sup>267</sup> See *supra* Part IV.B.2.

<sup>268</sup> Of course, some jurisdictions require the plaintiff to meet Federal Rules of Civil Procedure Rule 9(b)'s particularity requirements for claims that “sound in fraud.” See *supra* text accompanying footnotes 131-35. However, this does not mean a plaintiff will not still be incentivized to bring a Section 11 claim. First, not all jurisdictions follow the “sounds in fraud” rule. See *supra* text accompanying notes 133-34. Second, a Rule 10b-5 claim requires the plaintiff to plead scienter which, as discussed, carries a more burdensome standard than regular fraud pleading under Rule 9(b). See text accompanying notes 115-20.

from liability outside directors who inform themselves of all material information surrounding an offering. This proposed rule incentivizes outside directors to conduct meaningful due diligence by reducing the marginal personal sacrifice associated with conducting such due diligence.