Looking Back on WorldCom: Addressing Underwriters' Due Diligence in Shelf Registration Offerings and the Need for Reform.

Shelf registration offerings have become an essential part of the capital raising markets in the United States, but the future of such offerings would be put in jeopardy if the Court were to issue a ruling that required an underwriter to perform the same due diligence for a shelf offering as it would for an offering involving a pre-effective waiting period. If underwriters were required to utilize the same time-consuming diligence procedures with respect to offerings off of a shelf registration as they use for non-shelf deals, then either underwriters would have to be willing to proceed without the statutory diligence defense Congress intended them to have or issuers would not be able to have the benefit of underwritten financing off of a shelf registration, as the SEC intended they should.[1]

I. INTRODUCTION

The nature of the capital market in the United States is such that participants, namely underwriters and issuers, need the opportunity to make timely offerings to seize advantageous market situations.[2] In addressing the influence of

1. Brief for Sec. Indus. Ass'n & Bond Mkt. Ass'n as Amici Curiae Supporting Underwriter Related Defendants, *In re* WorldCom Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y 2004) (No. 02 Civ. 3288(DLC)) [hereinafter Brief of Sec. Indus. Ass'n] (footnote omitted) (arguing for summary judgment based on underwriter's due diligence defense). The Securities Association and the Bond Market Association filed a joint brief in the United States District Court for the Southern District of New York, urging Judge Denise Cote to grant the underwriter defendants' motion for summary judgment in the *WorldCom* case. *See id.*

2. *See* Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 135-36 (1984) (highlighting capital market demands and importance of Rule 415). The statute defining the term "underwriter" states:

> The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.

15 U.S.C. § 77b(a)(11) (2000). The statue defines an issuer as:

> every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons

technological advances and the widespread availability of information on the capital markets, the Securities and Exchange Commission (SEC) continues to reform the rules of securities offering.[3] Adopted in response to the issuers' demand for rapid access to the capital markets, shelf registration reformed the offering process to allow for procedural flexibility so as to limit the impact of market volatility.[4] The increase in technology and rapid access to the capital markets, however, places underwriters in a predicament, as there is no guide establishing the requisite due diligence for preparing for such offerings.[5]

In an era marked by massive accounting scandals and high profile cases such as WorldCom and Enron, Wall Street investment banks, operating as underwriters, are re-evaluating their approach to due diligence requirements to limit their potential liability.[6] In 2005 alone, underwriters paid out some twelve

performing similar functions) or of the fixed, restricted management, or unit type . . . .

15 U.S.C. § 77b(a)(4) (2000).

3. *See* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722, 44,770 (Dec. 1, 2005) (adopting rules to advance new registration and offering processes); Shelf Registration, Securities Act Release No. 6499, Exchange Act Release 20,384, 26 SEC Docket 138 (Nov. 17, 1983) (outlining reasoning behind adopting Rule 415); DAVID B. MILLER, FAEGRE & BENSON LLP, CURRENT LEGAL DEVELOPMENTS: SEC ADOPTS SIGNIFICANT SECURITIES OFFERING REFORMS AFFECTING INVESTMENT BANKS (Sept. 2005), *available at* http://www.faegre.com/articles/article_1461.aspx (highlighting changes to customary underwriting practices following Securities Offering Reform). *See generally* Cynthia M. Krus, Harry S. Pangas & Christopher Zochowski, *To Market, To Market: As SEC Steps Back, New Pressure Falls on Private Counsel for Offerings*, LEGAL TIMES, Nov. 21, 2005 (stating Securities Offering Reform allows issuers quicker access to capital markets); Michael Hyatte, *SEC Publishes Comprehensive Changes to Securities Act Rules*, MONDAQ BUS. BRIEFING, Aug. 9, 2005, *available at* http://194.88.95.39/article.asp?articleid=34222&searchresults=1 (reviewing Securities Act Reform).

4. *See* Shelf Registration, Securities Act Release No. 6499, Exchange Act Release 20,384, 26 SEC Docket 138 (Nov. 17, 1983) [hereinafter Shelf Registration] (listing benefits of shelf registration).

5. *See* John C. Coffee, Jr., *Corporate Securities: A Section 11 Safe Harbor?*, N.Y.L.J., Sept. 15, 2005, at 5 col. 1 [hereinafter Coffee, *Section 11*] (describing SEC failure to address due diligence issue raised in *WorldCom*); Cleary, Gottlieb Steen & Hamilton LLP, *Diligence in Securities Offerings After* WorldCom, 1516 PRACTISING LAW INSTITUTE, CORPORATE LAW AND PRACTICE COURSE HANDBOOK 1185, 1214 (2005) [hereinafter Cleary Gottlieb, Steen & Hamilton, *Diligence*] (listing considerations needing attention for underwriters to comply with due diligence requirements); *see also* Cleary Gottlieb Steen & Hamilton LLP, *Client Memo: SEC Adopts Securities Offering Reforms*, 1510 PRACTISING LAW INSTITUTE, CORPORATE LAW AND PRACTICE COURSE HANDBOOK 695, 704 (2005) [hereinafter Cleary Gottlieb, Steen & Hamilton, *Securities Reform*] (indicating SEC reforms provide no guidance on due diligence).

6. *See* Peter Ruhlin, *United States: Doing the Due*, LAW., May 9, 2005, at 18 (reviewing approach to due diligence following *WorldCom* decision); Robin Sidel, *Scared Straight: Wall Street May Do More "Due Diligence"*, WALL ST. J., Apr. 7, 2005, at C1 (discussing *WorldCom* decision's impact on underwriters); *Debt Issuers, Street: Big Changes Loom. (WorldCom Inc.)*, INV. DEALERS' DIGEST, Apr. 11, 2005, *available at* 2005 WLNR 8722753 (underscoring underwriter's need to ramp up due diligence). *See generally* GARY M. LAWRENCE, DUE DILIGENCE IN BUSINESS TRANSACTIONS, § 1.01 (2003) (noting changes in due diligence for underwriters in post WorldCom and Enron era); William F. Alderman, *Due Diligence in the Post-Enron Era: Practical Tips from Litigators on Mitigating Underwriter Risk*, 1450 PRACTISING LAW INSTITUTE, CORPORATE LAW AND PRACTICE COURSE HANDBOOK 461 (2004) (elaborating on need for underwriters to reassess due diligence techniques); Oxford Analytica, *Banks Face Clashing Imperatives*, http://www.forbes.com/business/2005/06/30/us-investment-banks-cz_0630oxan_financialservices.html (last

billion dollars to settle the claims of investors who lost money due to the undisclosed and fraudulent activity of company officers and accountants.[7] The impact of these scandals reverberated through the investment banking industry and significantly impacted the due diligence defense that affords underwriters protection from liability.[8] As a consequence, the lack of guidance for underwriters making a timely offering became clear in the wake of the WorldCom scandal and highlighted the dilemma underwriters must confront in conducting business.[9]

There has been little judicial guidance as to underwriter due diligence requirements, and thus the securities industry expected the recent decision in *In re WorldCom, Inc. Securities Litigation*[10] to resolve this issue.[11] This decision, however, denied underwriters the protection of the due diligence defense and

visited Feb. 25, 2007) (noting underwriters forced to review due diligence procedures since *WorldCom*).

7. Jonathan Weil & Robin Sidel, *WorldCom Investors Settle Lawsuits*, WALL ST. J., Oct. 27, 2005, at A3 (stating settlement amounts for underwriters in *WorldCom*); *see also* Gretchen Morgenson, *Judge in* WorldCom *Action Sides with Plaintiffs on Issue of Due Diligence by Banks*, N.Y TIMES, Dec. 16, 2004, at C4 (describing Citibank's WorldCom settlement as $2.65 billion); Bernstein Litowitz Berger & Grossmann, *Cases:* In re WorldCom, Inc. Securities Litigation, http://www.blbglaw.com/cases/worldcom_securities.html (last visited Feb. 25, 2007) (highlighting timeline and outcome of *WorldCom* Cases).

8. *See* John C. Coffee, Jr., *Corporate Securities: Due Diligence After* WorldCom, N.Y.L.J., Jan. 20, 2005, at 5 col. 1 [hereinafter Coffee, *Due Diligence*] (discussing impact of *WorldCom* decision on underwriter's due diligence requirements); THACHER PROFITT & WOOD LLP, UNDERWRITERS' DUE DILIGENCE OBLIGATIONS IN THE WAKE OF IN RE WORLDCOM, CORP. SEC. BULL., Mar. 15, 2005, *available at* http://www.tpw.com/PublicDocs/Doc_ID_4217_31720051040375.pdf (highlighting impact of *WorldCom* on underwriters' due diligence); Thomas A. Zaccaro, Jesse Z. Weiss & Michelle A. Reed, *Due Diligence Standards for Underwriters after* WorldCom, CORP. GOVERNANCE ADVISOR, Mar./Apr. 2005, at 21-25 (outlining how *WorldCom* redefines aspects of underwriters' due diligence). *See generally* Ruhlin, *supra* note 6 (discussing change in due diligence following *WorldCom*). *But see* Alix Nyberg Stuart, *False Alarm?: For Better or Worse*, WorldCom *Hasn't Done Much to Raise the Bar for Underwriters' Due Diligence*, CFO MAGAZINE, Oct. 15, 2005,
available at http://www.cfo.com/article.cfm/5010009/c_5038012?f=magazine_alsoinside (stating *WorldCom* has not impacted underwriters' due diligence requirement).

9. *See* Michael Bobelian, *Post*-WorldCom *Liability: Underwriters Look for Guidance from Courts, SEC*, N.Y.L.J., Mar. 17, 2005, at 5 (claiming underwriters face lack of guidance concerning due diligence requirements); Coffee, *Due Diligence*, *supra* note 8, at 5 (reviewing basic mismatch between legal responsibility and due diligence requirements in condensed time frame); *see also* Christopher O'Leary, *The Underwriter Conundrum*, INV. DEALERS' DIGEST, Dec. 19, 2005 (outlining underwriters' dilemma between legal adherence and business interest); Marc Rossell & Andrew Stemmer, *Underwriters Due Diligence Obligations in the Wake of* In re WorldCom, WALL ST. LAW., June 2005,
available at http://www.realcorporatelawyer.com/wsl/wsl0605.html (highlighting issues with underwriter due diligence in timely offerings); Ruhlin, *supra* note 6, at 18 (stating *WorldCom* requires underwriters to review approach to due diligence); Zaccaro, Weiss & Reed, *supra* note 8, at 21 (exposing discrepancy between underwriters' duties and actual practices). *See generally* Ben Maiden, *Due Diligence Proposal Sparks Controversy*, INT'L FIN. L. REV., Oct. 2005, *available at*
http://www.iflr.com/includes/magazine/PRINT.asp?SID=588601&ISS=20632&PUBID=33 (noting importance placed on due diligence and liability of parties involved in offerings).

10. 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

11. *See* Rossell & Stemmer, *supra* note 9 (outlining underwriters' search for guidance on due diligence issue).

failed to provide any further guidance.[12] The court, in allowing the issue to go to the jury, required underwriters to conduct full scale investigation and due diligence into issuers in timely offerings, such as a shelf registration.[13]

Although the comprehensive *WorldCom* opinion of Judge Denise Cote closely examined the sparse case law regarding underwriter due diligence, it failed to address the near impossibility of meeting the traditional due diligence requirements under a shelf registration.[14] Moreover, the SEC has done little to remedy the lack of guidance for underwriters conducting offerings under a shelf registration.[15] In recently adopted securities reforms, the SEC granted well-capitalized companies almost instantaneous access to the market, but failed, however, to outline the amount of due diligence that is required of underwriters.[16] As time is of the essence in a securities offering, underwriters are in an unenviable position between complete liability and unachievable due diligence requirements.[17]

12. *WorldCom*, 346 F. Supp. 2d at 697 (denying in part underwriter defendants' motion for summary judgment); *see also* 15 U.S.C. § 77k(b)(3)(C) (2000) (providing statutory basis for "due diligence defense"). Section 77k requires a defendant to demonstrate that there was no reasonable ground to believe and no actual belief that the portions of the registration based on the expert's authority were untrue. 15 U.S.C. § 77k(b)(3)(C); Dan Shirai, *Underwriters Face Potential Rise in Due Diligence Costs; A Can of Worms?*, 31 CORP. FIN. WEEK., Jan. 31, 2005, at 1 (stating decision provides no definition of appropriate due diligence).

13. *See WorldCom*, 346 F. Supp. 2d at 677 (holding due diligence requires "meaningful investigation"); Coffee, *Section 11*, *supra* note 5, at 5 (discussing traditional standards of due diligence implicated in *WorldCom*); Jeremy W. Dickens, Paul Dutka & Joshua S. Amsel, *Underwriter Due Diligence:* WorldCom *and Beyond*, INSIGHTS, Apr. 2005 (highlighting impact of *WorldCom* on due diligence defense). *See generally* John C. Coffee, Jr., *Securities Law: The Refco Meltdown*, NAT'L L.J., Oct. 31, 2005, at 23 (noting controversial decision of *WorldCom* and comparing to Refco situation).

14. *See WorldCom*, 346 F. Supp. 2d at 671-77 (summarizing case history involving underwriter due diligence); Coffee, *Section 11*, *supra* note 5, at 5 (describing Judge Cote's decision as unrealistic); *see also* Shirai, *supra* note 12, at 1 (attributing added due diligence cost to *WorldCom* decision). *But see* Jeffrey A. Barrack, *Securities: What's Become of Underwriting Due Diligence Since* WorldCom?, THE LEGAL INTELLIGENCER, Jan. 23, 2006 (stating Judge Cote's decision in *WorldCom* clarified and developed law for underwriters).

15. Securities Offering Reform, Securities Act Release No. 33-8591, Exchange Act Release No. 34-52056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722, 44,770 (Dec. 1, 2005) (outlining adopted rules regarding registration and offerings); *see also* Cleary Gottlieb Steen & Hamilton, *Securities Reform*, *supra* note 5, at 704 (stating SEC reforms do not address problems with due diligence requirements). *See generally Coffee*, *supra* note 13 (suggesting SEC repair discrepancies in due diligence law).

16. *See* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722, 44,770-71 (Dec. 1, 2005) (explaining amendments to Rule 415). *See generally* Krus, *supra* note 3 (outlining impact of reform on due diligence requirements for both underwriters and their counsel).

17. *See* Brief of Sec. Indus. Ass'n, *supra* note 1 (arguing traditional due diligence requirements in time sensitive offers create difficulties for underwriters); Bobelian, *supra* note 9, at 5 (describing underwriters' potentially conflicting choices between due diligence and client's demands); Powerpoint presentation entitled Selected Capital Raising Issues: Underwriter Due Diligence Comfort Letters, http://www.realcorporatelawyer.com/programs/sec_spring_ht_2005/ph_Justin_Chairman.PPT (last visited Sept. 25, 2006) (listing changes to underwriter procedures and impact of *WorldCom*). *See generally* Steven Amen, WorldCom *Case Could Limit Protections of Underwriters & Directors*, KUTAK ROCK LLP CORPORATE NOTES, Mar. 23, 2005,
available at http://www.kutakrock.com/publications/corporate/corporate%20notes%203.23.05.pdf (outlining

This note will first discuss in Part II.A the cases and reasoning that shaped the due diligence defense and requirements.[18] Part II.B will examine the SEC rules that impact underwriters and their ability to decipher and meet the due diligence requirement.[19] Part II.D will describe the *WorldCom* facts necessary for Judge Cote's decision and will also address Judge Cote's reasoning in denying the underwriter defendants' motion for summary judgment. [20] Part III will analyze the dilemma of underwriter due diligence and the proposed due diligence techniques advanced by the SEC to balance the need for quick access to the capital markets with rigorous fact-checking requirements necessary to prevent fraud.[21] This section will also analyze the SEC's effort to reform registration and offering processes and will outline potential underwriting issues and methods for appropriately addressing such issues.[22] Finally, this section will offer solutions for underwriters to mend the rift between the competing needs for speedy access to the market and due diligence.[23] This note will then conclude that the SEC should address the issue of underwriter due diligence and provide sufficient guidance to allow for efficiency in registration of offerings.[24]

II. HISTORY

A. Due Diligence in Underwriting

1. The Development of Securities Regulation

In the wake of the 1929 market crash and the Great Depression, Congress passed the Federal Securities Act of 1933 (Act), which established the regulation of the public offering process and the sale of securities.[25] After witnessing the devastating effects resulting from the sale of fraudulent securities, Congress implemented the Act to prevent further hardship by

impact of *WorldCom* decision); Sandra Rubin, *Due Diligence Defence Crumbles*, ZSA, Apr. 21, 2005, *available at* http://zsa.ca/index.php?fuseaction=main.post_articles_item&id=47 (discussing underwriters' position between demand for efficiency and time consuming due diligence procedures).

18. *See infra* Part II.A (outlining securities regulation and reform background).

19. *See infra* Part II.B (discussing impact of shelf registration and integrated disclosure on due diligence).

20. *See infra* Part II.D (describing *WorldCom* decision and detailing reasoning employed by Judge Cote in *WorldCom* decision).

21. *See infra* Part III.3 (analyzing problematic position of underwriters).

22. *See infra* Part III.3 (indicating SEC failed to resolve underwriter due diligence issue).

23. *See infra* Part III.3 (proposing due diligence guidelines and possible solution for underwriters).

24. *See infra* Part IV (concluding underwriters require standards enabling them to establish appropriate due diligence procedures).

25. *See* Securities Act of 1933, 15 U.S.C. §§ 77a-77z (2000) (codifying securities law); JAMES D. COX, ROBERT W. HILLMAN & DONALD LANGEVOORT, SECURITIES REGULATION, CASES AND MATERIALS 3 (4th ed. 2004) (outlining history of Federal Securities Act of 1933).

requiring disclosure of essential elements of the issuer's financial health.[26] Through the implementation of the registration process, Congress sought to reveal the issuer's business, property, and management for the protection of investors.[27] The goal of this process was the creation of a prospectus, which provides the "material information necessary for investors to fully assess the merits of their purchase of the security."[28] Consequently, the prospectus serves to level the playing field for investors, issuers, and underwriters.[29] The fact that the prospectus potentially subjects underwriters to liability for misstatements and omissions from the registration statements highlights the desire for disclosure and honesty regarding the registration process.[30] Underwriters, as a result, must exercise honesty and diligence in determining and disclosing all

26. H.R. REP. NO. 73-85, at 2 (1933) (discussing need for financial disclosure in sale of securities). This report reveals that prior to the Federal Securities Act of 1933 there was "little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security," and that this clearly demonstrated underwriters' and issuers' lack of honesty in selling fraudulent securities. *See id.*; COX, HILLMAN & LANGEVOORT, *supra* note 25, at 3-4 (explaining congressional intent behind enacting Securities Act of 1933). In *SEC v. Capital Gains Research Bureau, Inc.*, the court recognized that the purpose of the full disclosure objective of the Federal Securities Act of 1933 was to "achieve a high standard of business ethics in the securities industry." 375 U.S. 180, 186 (1963) (comparing 1933 Act's full disclosure standard to caveat emptor); *see also* SEC v. Zandford, 535 U.S. 813, 819 (2002) (reaffirming 1933 Act's purpose in requiring full disclosure).

27. *See* 15 U.S.C. § 77f (2000) (listing information required for effective registration statement); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 4 (explaining information necessary to supply in registration statements). Investor protection is a key objective behind implementing a system of disclosure that reveals extensive financial information about an issuer. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 4 (stating 1933 Act designed to protect investors). One of Congress' established purposes for enacting the 1933 Act and the disclosure requirement was to protect investors against fraudulent securities. Ernst, 425 U.S. at 195; *see also* SEC v. Chinese Consol. Benevolent Ass'n, 120 F.2d 738, 741 (2d Cir. 1941) (noting 1933 Act protects investors by providing them with adequate financial information).

28. 15 U.S.C. § 77b(10) (2000) (defining prospectus); 15 U.S.C. § 77j (2000) (outlining information required in prospectus). A prospectus is defined as "an offering document that includes the information required by Section 10(a) of the Securities Act (15 U.S.C. 77j(a))." 12 C.F.R. § 16.2(l) (2005); *see also* COX, HILLMAN & LANGEVOORT, *supra* note 25, at 4 (discussing prospectus as purpose of registration system). A prospectus allows investors to determine the actual risk that they will undertake in purchasing securities. COX, HILLMAN & LANGEVOORT, *supra* note 25, at 4.

29. COX, HILLMAN & LANGEVOORT, *supra* note 25, at 4 (indicating information given to investors increases their decision-making power by allowing them to determine risks). By providing investors with information regarding the issuer's business, underwriters and issuers hold no advantage over investors, as the investor can determine whether the investment is worthless or too risky. *Id.*; *see also* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 550 (E.D.N.Y. 1971) (stating 1933 Act demands disclosure of material facts relating to sale of securities). In the *Feit* decision, the court explained that "the prospective purchaser of a new issue of securities is entitled to know what the deal is all about." *Feit*, 332 F. Supp. at 549.

30. 15 U.S.C. § 77k (2000) (indicating underwriter liability for false or misleading registration statements); *see also* Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288 (2d Cir. 1969) (stating purpose of including civil liability in 1933 Act to encourage disclosure). The *Globus* court decision maintained that the purpose of 15 U.S.C § 77k was to "promote enforcement of the Act and deter negligence by providing a penalty for those who fail in their duties." *Globus*, 418 F.2d at 1288; *see also* Akerman v. Oryx Commc'ns, Inc., 609 F. Supp. 363, 367 (S.D.N.Y. 1984) (restating civil liability purpose explained in *Globus*).

matters pertinent to the issuer's business.[31]

2. Underwriters and Liability Under Section 11

Issuers employ underwriters, typically investment banks, to facilitate the sale of securities to the public.[32] Underwriters operate by purchasing, either directly or indirectly, all or part of an issuer's securities for distribution to the public.[33] As a result, underwriters attach their reputation to the issuance in hopes that it serves as a certification for public distribution.[34] It is, therefore, the responsibility of the underwriter investment banks to conduct reasonable investigations to ensure that an issuer has made accurate representations to potential investors concerning its financial health.[35]

Section 11 of the Act establishes underwriter liability and serves as a protective measure for investors.[36] Under this section, an underwriter may be liable if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ."[37] Section 11 mandates that underwriters inspect

31. *Feit*, 332 F. Supp. at 582 (discussing care and investigation required of underwriters). The expectation is that all underwriters will "exercise a high degree of care in investigation and independent verification of the company's representations." *Id.*; *see also In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662 (S.D.N.Y 2004) (defining role of underwriters in sale of securities); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 4 (indicating potential liability as impetus behind underwriter compliance with 1933 Act).

32. 15 U.S.C. § 77b(a)(11) (2000) (defining term "underwriter"); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 339 (clarifying definition of underwriter); *see also* BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 628 (4th ed. 1995) (explaining definition of securities underwriter); BLACK'S LAW DICTIONARY 1562 (8th ed. 2004) (defining underwriter).

33. *See WorldCom*, 308 F. Supp. 2d at 343 (describing underwriter's role in sale of securities); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 339 (narrowing definition of underwriter). The statutory definition of underwriter is broad; however, an underwriter is essentially classified by one of four possible roles:

> (1) any person who purchases from an issuer with a view to the distribution of a security; or (2) any person who offers or sells for an issuer in connection with a distribution; or (3) any person who participates or has a direct or indirect participation in the activities covered by 1 or 2 above; or (4) any person who participates or has a participation in the direct or indirect underwriting of any such undertaking.

COX, HILLMAN & LANGEVOORT, *supra* note 25, at 445.

34. *WorldCom*, 308 F. Supp. 2d at 343 (explaining underwriter's role in issuance of securities). The legislative history suggests that Congress did not intend for underwriters to serve as insurers of securities issuance. *See* H.R. CONF. REP. NO. 73-152, at 277. Investment banks typically conduct underwriting, which facilitates the issuance of securities. *Id.*

35. Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 582 (E.D.N.Y. 1971) (stating need for underwriter investigation and verification); *see also WorldCom*, 346 F. Supp. at 662 (quoting *Feit* on issue of investigation and verification).

36. 15 U.S.C. § 77(k) (establishing civil liability for material misstatements and omissions in registration statement); *see also* Allan Horwich, *Section 11 of the Securities Act: The Cornerstone Needs Some Tuckpointing*, 58 BUS. LAW. 1, 1 (Nov. 2002) (discussing importance of disclosure for relying on § 11).

37. 15 U.S.C. § 77k(a) (2000) (codifying § 11 civil liability).

issuer's financial statements and disclose all material information in order to protect themselves from liability.[38] Congress's intent was to establish adherence to the philosophy of full disclosure for the protection of investors.[39]

Due diligence, though not directly stated in the Act, is a term of art that refers to the investigation and independent verification necessary for an underwriter to prepare a registration statement for a securities offering.[40] Under § 11, liability revolves around whether an underwriter conducted the requisite amount of due diligence to prevent an investor from relying on misstatements and omissions when making an investment decision.[41] To determine the sufficiency of an underwriter's due diligence, courts apply a reasonableness standard and ask whether a "prudent man in the management of his own property" would have acted similarly.[42]

B. Due Diligence Defense for Underwriters

Though § 11 places liability on underwriters, it also affords them an affirmative defense, known as the "due diligence defense."[43] This defense is actually split into two discernible defenses—the "due diligence defense" and the "reliance defense"—and the application of one over the other depends on whether it was an "expertised" or "non-expertised" portion of a registration

38. *Id.* (codifying underwriter liability); *see also Feit*, 332 F. Supp. at 582 (stating underwriters must inspect and verify issuer's statements). The court in *Feit* held that underwriters use "a high degree of care in investigations and independent verifications of a company's representations." *Feit*, 332 F. Supp. at 582; *see also* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 370 (2nd Cir. 1973) (indicating underwriters responsible for investigation and verification). There is reliance upon underwriters because their skill set and familiarity with the company places them in a unique position to determine the value of a securities issuance. *Chris-Craft*, 480 F.2d at 370. The court in *Chris-Craft* further stated that "no greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter." *Id.*; *see also In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004) (referring to cases dealing with underwriter's traditional role).

39. *WorldCom*, 346 F. Supp. 2d at 657-58 (discussing standards and purpose behind § 11 liability); *see also* Gustafson v. Alloyd Co., 513 U.S. 561, 571 (1995) (indicating underwriters' level of responsibility for disclosure in prospectus); Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82 (1983) (explaining § 11 liability standard for parties involved in registered offerings). By holding underwriters liable for potential lapses in due diligence, Congress implied that underwriters carry a particularly heavy moral burden to investigate for the public. *Gustafson*, 513 U.S. at 581.

40. *See* Dennis J. Block & Jonathan M. Hoff, *Underwriter Due Diligence In Securities Offerings*, N.Y.L.J., May 27, 1999, at 5, *available at* http://www.cadwalader.com/assets/article/052799.html (discussing term due diligence and its application to section 11); GARY M. LAWRENCE, DUE DILIGENCE IN BUSINESS TRANSACTIONS § 2.03A (2004) (stating underwriters serve as "first line of defense" against misstatement and omission).

41. *WorldCom*, 346 F. Supp. 2d at 657-58 (discussing history behind § 11 liability); *see also Gustafson*, 513 U.S. at 571 (indicating importance of preventing misstatements and omissions); *Huddleston*, 459 U.S. at 381-82 (elucidating § 11 liability and standards).

42. 15 U.S.C. § 77k(c) (2000) (setting forth reasonableness standard); *see also WorldCom*, 346 F. Supp. 2d at 663 (applying standard of reasonableness).

43. *See* 15 U.S.C. § 77k(b)(3)(A) & (3)(C) (2000) (establishing reliance and due diligence defense); Dickens, Dutka & Amsel, *supra* note 13, at 3-4 (discussing § 11 and due diligence defense).

statement.[44] The material that the underwriter reviewed, therefore, determines the level of reasonableness that applies to the underwriters' actions.[45]

As the name suggests, a "non-expertised" portion of a registration statement is prepared without the authority of an expert.[46] An underwriter, therefore, must conduct an investigation and independent verification of all statements and information the issuer revealed in that portion.[47] To demonstrate the existence of reasonable belief that the registration statement is accurate and truthful, underwriters must scrutinize the "non-expertised" portions of the statement and demonstrate that they did not overlook any questionable practices or materials indicated in such documents.[48]

For registration portions made under the authority of an expert or "expertised" portions, the underwriter—after conducting a reasonable investigation—may establish a reliance defense, provided no reasonable grounds existed to indicate that any material information was omitted or misstated.[49] Beyond the determination of a reasonable reliance, courts struggle to define expert status for the purpose of determining whether portions of a registration statement are "expertised."[50] Underwriters cannot simply rely on

44. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662-63 (S.D.N.Y 2004) (labeling and discussing both standards under § 11); *see also* Escott v. BarChris, 283 F. Supp. 643, 682-83 (1969); LAWRENCE, *supra* note 40, at § 2.03A (explaining two defenses available for underwriters under § 11); Note, Escott v. BarChris: *"Reasonable Investigation" and Prospectus Liability Under Section 11 of the Securities Act of 1933*, 82 HARV. L. REV. 908, 909 (1969) (distinguishing between liability standard under "expertised" and "non-expertised"). *See generally* John J. Huber, Thomas C. Sadler & Joel H. Trotter, *An Underwriter's Due Diligence in the Permitted Absence of an Expert's Consent*, INSIGHTS, Aug. 2002 (explaining terms "expertised" and "non-expertised" as used in due diligence defense and § 11 liability).

45. *WorldCom*, 346 F. Supp. 2d at 663 (discussing due diligence standards and respective level of investigation required under each); *see BarChris*, 283 F. Supp. at 682-83; LAWRENCE, *supra* note 40, at § 2.03A (reviewing expertised materials and reasonable reliance standard); Note, *supra* note 44, at 90 (outlining level of reasonableness required under "expertised" and "non-expertised" registration portion). *See generally* Huber, *supra* note 44 (highlighting difference between "expertised" and "non-expertised" standards regarding due diligence defense and § 11 liability).

46. 15 U.S.C. § 77k(b)(3)(a) (2000) (codifying use of non-expertised portion of registration statement); *see also WorldCom*, 346 F. Supp. 2d at 663 (addressing statements not made in reliance on expert's authority); Note, *supra* note 44, at 909 (outlining due diligence for statement made by non-expert).

47. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 370 (2d Cir. 1973) (discussing importance of underwriter verification and investigation); *WorldCom*, 346 F. Supp. 2d at 662 (reiterating previous discussion on independent verification and investigation); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 581-82 (E.D.N.Y. 1971) (establishing level of investigation and verification expected from underwriter).

48. *See WorldCom*, 346 F. Supp. 2d at 662 (expressing degree of care required of underwriters investigating "non-expertised" registration statements); *Chris-Craft Indus., Inc.*, 480 F.2d at 370 (discussing underwriters' investigation requirements for "non-expertised" registration statements); *Feit*, 332 F. Supp. at 581-82 (articulating underwriters' duty in reviewing "non-expertised" registration statement).

49. *See* 15 U.S.C. § 77k(b)(3)(c) (2000) (codifying use of "expertised" portion of registration statement); *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 663 (S.D.N.Y. 2004) (discussing "expertised" portions of registration statements); Note, *supra* note 44, at 908-09 (explaining § 11 and due diligence required for expert-based registration portions).

50. *See* Block & Hoff, *supra* note 40, at 5 (discussing expert status for due diligence and its application to § 11); *supra* note 49 and accompanying text (explaining "expertised" portions of registration statements).

expert opinion, as suggested by the reliance defense, and thus they must educate themselves in the issuer's business, enabling them to detect any discrepancies financially or otherwise.[51] Blind reliance on the expert subjects the underwriter to liability for any actionable misstatements or omissions.[52] Underwriters have sought guidance from the SEC regarding the necessary due diligence to shield themselves from liability.[53] To date, however, there remains no concrete steps for ensuring the availability of the due diligence defense.[54]

In the seventy-three years since Congress passed § 11 of the Act, there has been little judicial consideration of the due diligence defense.[55] *Escott v. BarChris Construction Corp.*[56] was one of the first cases that discussed the requirements of underwriter due diligence.[57] The BarChris Corporation filed a registration statement with the SEC and issued a series of convertible debentures through an underwritten offering.[58] The company struggled financially and ultimately filed for bankruptcy protection.[59] When the BarChris Corporation failed to meet the requirements attached to the debentures, the investors sued several parties affiliated with the company and the offering, including the underwriters.[60] Addressing the issue of underwriter liability under § 11, the court concluded that the reasonable investigation element of due diligence must consist of an independent underwriter verification beyond simply questioning the company's management.[61] The court noted Congress's

51. *Feit*, 332 F. Supp. at 581-82 (stating underwriters need to investigate and verify information contained in registration statement). The underwriter has a duty conduct an investigation "reasonably calculated to reveal all of those facts which would be of interest to a reasonably prudent investor." *Id.* The court recognizes that it is difficult to ascertain the criteria for a reasonable investigation, but suggested that "the underwriter should read minutes and important contracts and check out any inconsistencies in the representations of management." *Id.*; *see also* Comment, BarChris: *Due Diligence Refined*, 68 COLUM. L. REV. 1411, 1421-22 (1968) (discussing impact of *BarChris* on due diligence).

52. *See supra* note 51 and accompanying text (implying underwriters cannot simply rely on statements of issuers).

53. Block & Hoff, *supra* note 40, at 5 (discussing difficulty in determining criteria for expert).

54. Block & Hoff, *supra* note 40, at 5 (discussing difficulty in determining criteria for expert).

55. Feit v. Leasco Data Processing Corp., 332 F. Supp. 544, 576 (E.D.N.Y 1971) (noting absence of judicial opinions applying due diligence defense); *see also* Rossell & Stemmer, *supra* note 9 (explaining relative paucity of case law involving § 11 and due diligence).

56. 283 F. Supp. 643 (S.D.N.Y. 1968).

57. *See* LAWRENCE, *supra* note 6, at § 2.03 (2003) (noting landmark *BarChris* case in defining § 11 liability); Block & Hoff, *supra* note 40 (describing *BarChris* as early case in history of due diligence defense). *See generally* Note, *supra* note 44 (discussing *BarChris* case and impact on underwriter liability).

58. *BarChris*, 283 F. Supp. at 654-55; *see also* LAWRENCE, *supra* note 6, at § 2.03 (2003) (discussing *BarChris* facts and decision); Note, *supra* note 44, at 909 (discussing BarChris bankruptcy and investors' class action suit).

59. *BarChris*, 283 F. Supp. at 654 (describing BarChris' financial troubles which led to bankruptcy); *see also* LAWRENCE, *supra* note 6, at § 2.03 (reviewing financial status of BarChris and resulting bankruptcy); Note, *supra* note 44, at 909 (elaborating on BarChris' insolvency following its debentures offering).

60. *BarChris*, 283 F. Supp. at 652 (listing underwriters as defendants in shareholder class action); *see also* LAWRENCE, *supra* note 6, at § 2.03 (noting plaintiffs filed claims against underwriters); Note, *supra* note 44, at 909 (discussing claims against underwriters).

61. *BarChris*, 283 F. Supp. at 696-97 (concluding underwriters need conduct more thorough due

previous recognition that underwriters hold a unique position that allows them to discover and compel disclosure of material facts about issuers and offerings.[62] In light of this, *BarChris* indicated that underwriters could only serve § 11's purpose if forced to utilize their access to corporate records.[63] Thus the *BarChris* Court held that the due diligence defense required a case-by-case analysis and refused to set forth a rigid due diligence standard.[64]

Following *BarChris*, the decision in *Feit v. Leasco Data Processing Equipment Corp.*[65] exposed the due diligence defense to further judicial scrutiny.[66] Leasco Data Processing Equipment Corporation (Leasco) issued an exchange offer to acquire a company based primarily on that company's cash surplus.[67] Leasco filed a registration statement with the SEC, as the structure of the acquisition was an exchange of shares with public shareholders; underwriters, however, failed to disclose the amount of the surplus because of the difficulty in obtaining the actual value.[68] The plaintiffs alleged that the underwriter violated § 11 by failing to disclose the amount of the surplus.[69] The court found that the underwriters were reasonable in their due diligence, and thus held that the due diligence defense provided protection from liability.[70]

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diligence); Comment, BarChris*: Easing The Burden of "Due Diligence" Under Section 11*, 117 U. PA. L. REV. 735, 735-36 (1969) (detailing *BarChris* facts and emphasizing significance of decision); Note, *supra* note 44, at 910 (discussing importance of *BarChris* decision); *see also* Block & Hoff, *supra* note 40, at 5 (discussing history of due diligence defense).

62. The Regulation of Securities Offerings, SEC Release No. 7606A, 63 Fed. Reg. 67,174, 67,230 (Dec. 4, 1998) (stating congressional intent in creating underwriter liability).

"Congress recognized that underwriters occupied a unique position that enabled them to discover and compel disclosure of essential facts about the offering. Congress believed that subjecting underwriters to the liability provisions would provide the necessary incentive to ensure their careful investigation of the offering." *Id.*

63. Escott v. BarChris Construction Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968) (stating underwriters must conduct independent investigation and cannot rely on company officers); *see also* Comment, *supra* note 53, at 1421 (discussing implications of and criticizing *BarChris* decision).

64. *BarChris*, 283 F. Supp. at 697 (describing difficulty with establishing due diligence rule). The court emphasized the variable nature of this area noting, "[i]t is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case." *Id.*

65. 332 F. Supp. 544 (E.D.N.Y. 1971).

66. *See id.* at 550-52 (addressing underwriter investigation and verification of information provided by issuer); Block & Hoff, *supra* note 40, at 5 (reviewing case law history of due diligence defense). *See generally* LAWRENCE, *supra* note 6, at § 2.04 (stating *Feit* case provided significant discussion of underwriters' liability and due diligence defense).

67. *Feit*, 332 F. Supp. at 549-50 (delineating procedural history of case); *see also* LAWRENCE, *supra* note 6, at § 2.04 (analyzing *Feit* facts with regards to underwriters' liability and due diligence defense).

68. *Feit*, 332 F. Supp. at 549-50, 552-54 (discussing exchange offer and difficulty underwriters faced in determining actual value of "surplus surplus"). Leasco sought to acquire Reliance because of its "surplus surplus," which the court defines as the extra amount of cash surplus or "highly liquid assets of an insurance company which can be utilized in non-regulated enterprises." *Id.* at 551; *see also* LAWRENCE, *supra* note 6, at § 2.04 (explaining reasons behind Leasco's acquisition of Reliance).

69. *Feit*, 332 F. Supp. at 549-50 (discussing plaintiffs' class action suit against underwriters and other parties to transaction); *see also* LAWRENCE, *supra* note 6, at § 2.04 (reviewing *Feit* and plaintiffs' claims).

70. *Feit*, 332 F. Supp. at 549-50, 582-83; *see also* LAWRENCE, *supra* note 6, at §2.04 (outlining plaintiffs'

Beyond the holding, the *Feit* court further discussed the fact that underwriters are in an adverse position to issuers.[71] An issuer's statements to an underwriter most likely serve the purpose of persuading the underwriter to underwrite the issuance. As such, underwriters must dig below the issuer's explanation of the corporate actions and affairs.[72] Reliance on management's statements, therefore, fails to meet the standard of reasonable investigation that Congress established to protect investors.[73] The court bemoaned the difficulty in determining an investigation's reasonableness, but stated that underwriters which possess the ability to protect investors through investigation must conduct an independent and thorough review of the material financial data.[74] As a result, underwriters must reveal all material facts of interest to a prudent investor.[75] Nevertheless, the court indicated that "what constitutes 'reasonable investigation' and a 'reasonable ground to believe' will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data."[76]

Recent cases and rules have refined this due diligence requirement.[77] For example, *In re Software Toolworks, Inc. Securities Litigation*,[78] outlined a set of investigation and verification procedures that help an underwriter meet the

claims and court's reasoning). The underwriters of the exchange offer asserted the difficulty in determining the actual value of "surplus surplus" and management's refusal to divulge the necessary information to calculate such values as the basis of their due diligence defense. *Feit*, 332 F. Supp. at 575-81 (recognizing and discussing underwriters' due diligence defense); *see also* LAWRENCE, *supra* note 6, at § 2.04 (addressing underwriters' affirmative due diligence defense in *Feit*). The *Feit* court concluded that the underwriters "just barely" established the requisite due diligence, thereby avoiding § 11 liability. LAWRENCE, *supra* note 6, at § 2.04 (reviewing court's decision and discussing underwriters' successful assertion of due diligence defense).

71. Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 581 (E.D.N.Y. 1971) (explaining adversarial role underwriters play in due diligence process); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696 (S.D.N.Y. 1968) (setting forth adversarial relationship between underwriter and issuer). The *BarChris* court stated that underwriters and issuers are adverse, because "statements made by company officers to an underwriter to induce him to underwrite may be self-serving." *BarChris*, 283 F. Supp. at 696.

72. *See supra* note 71 and accompanying text (explaining adverserial relationship between issuer and underwriter).

73. *See Feit*, 332 F. Supp. at 581-82 (requiring underwriter to utilize access to company information); *see also* Comment, supra note 51, at 1421 (speculating requirements to dispose of due diligence requirement).

74. *Feit*, 332 F. Supp. at 577, 581-82 (applying due diligence requirements to facts); *see also* LAWRENCE, *supra* note 6, at § 2.04 (suggesting underwriters searching for due diligence guidelines).

75. *See* Block & Hoff, *supra* note 40, at 5 (discussing adequacy of due diligence based on prudent person standard); *see also* 15 U.S.C. § 77k(c) (2003) (codifying use of prudent person standard necessary to establish reasonable due diligence).

76. *Feit*, 332 F. Supp. at 577 (establishing reasonableness analysis for determining sufficiency of underwriter's due diligence).

77. *See* Block & Hoff, *supra* note 40, at 5 (highlighting recent cases discussing due diligence requirements); *see also* 17 C.F.R. § 230.176 (2005) (providing guidance for underwriters in performaning proper due diligence); Int'l Rectifier Sec. Litig., No. CV91-3357-RMT (BQRX), 1997 WL 529600, at *1 (C.D. Cal. March 31, 1997); *In re* Software Toolworks, 789 F. Supp. 1489, 1497 (N.D. Cal. 1992); Weinberger v. Jackson, No. C-89-2301-CAL, 1990 U.S. Dist. LEXIS 18394, at *1 (N.D. Cal. Oct. 11, 1990).

78. 789 F. Supp. 1489 (N.D. Cal. 1992).

due diligence requirement.[79] Additionally, recognizing the lack of guidance under § 11, the SEC implemented Rule 176, in which it listed several factors affecting the determination of a reasonable investigation and reasonable grounds for belief.[80] This attempt by the SEC, however, does not provide concrete steps for underwriters to follow in performing proper due diligence.[81] Though there has been progress in providing guidance for underwriters, courts require a fact-specific analysis to determine whether an underwriter has performed the necessary due diligence to successfully assert the due diligence defense.[82]

C. Due Diligence and Shelf Registration

Recognizing a commercial need for rapid access to the capital markets, the SEC created Rule 415, which allows for offering the registration of securities on a continual or delayed basis.[83] Shelf registration, as this process is commonly known, allows for issuers to capitalize on advantageous market situations while minimizing the costs of registration.[84] Registrants—the issuers of securities—use the process to the benefit of existing shareholders by obtaining lower interest rates on debt and lower dividend rates on preferred stock.[85] For example, debt securities allow issuers to register bonds and wait to

79. *Id.* at 1497 (outlining practices to establish due diligence); *see also* Block & Hoff, *supra* note 40, at 5 (summarizing court's suggested approaches).

80. 17 C.F.R. § 230.176 (2005) (codifying Rule 176); *see also* Block & Hoff, *supra* note 40, at 5 (discussing SEC's reasons behind creating Rule 176); John J. Clarke, Jr. & William F. Alderman, *Potential Liabilities in Initial Public Offerings*, 1518 PRACTISING LAW INSTITUTE, CORPORATE LAW AND PRACTICE COURSE HANDBOOK 319, 337-38 (2005) (listing "relevant circumstances" for determining an underwriter's reasonableness under Rule 176).

81. *See* Block & Hoff, *supra* note 40, at 5 (explaining shortcomings of Rule 176); Clarke & Alderman, *supra* note 80, at 337-38 (countering plaintiffs' Rule 176 argument and stating due diligence must be reasonable and not perfect).

82. *See* Block & Hoff, *supra* note 40, at 5 (describing fact-based analysis necessary for determining sufficiency of due diligence).

83. 17 C.F.R. § 230.415 (2006) (codifying shelf registration at Rule 415). The SEC believes that all current information about well-known seasoned issuers, including the information that falls between offering dates and registration, impacts such issuers' market price. *See* 17 C.F.R. § 230.415(a)(1)(x) (indicating delayed or continuous offering for securities registered on Form S-3); Shelf Registration, Securities Act Release No. 6499, Exchange Act Release 20,384, 26 SEC Docket 138 (Nov. 17, 1983). *See generally* Wielgos v. Commonwealth Edison Co., 892 F.2d 509 (7th Cir. 1989) (explaining shelf registration and S-3 Form in context of casess factual circumstances). Large companies are allowed to register securities and place them "on the shelf" for up to three years after the filing of a registration statement. 17 C.F.R. § 230.415(a)(5) (2006); Shelf Registration, Securities Act Release No. 6499, Exchange Act Release 20,384, 26 SEC Docket 138 (Nov. 17, 1983); *Wielgos*, 892 F.2d at 510 (stating companies can hold stock for deferred sale); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 198 (discussing advantages of shelf registration).

84. 17 C.F.R. § 230.415 (2005) (outlining reasons underlying SEC's adoption of shelf registration); *see also* COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200 (discussing ability of shelf registration to limit effect of market volatility, while minimizing costs).

85. COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200 (explaining benefits of shelf registration for bond offerings). The SEC issued the following statement in support of Rule 415:

offer them until there is a decline in the interest rate.[86]

Prior to the adoption of Rule 415, a significant amount of time elapsed between the preparation of registration statements and the offering, which allowed underwriters time to conduct sufficient due diligence into the issuers' financial health.[87] Shelf registration, though it met issuers' demands for quicker, more efficient market access, effectively reduced the time available for underwriters to conduct the requisite due diligence.[88] Underwriters expressed to the SEC their concerns about shelf registration and its effects on their ability to comply with § 11.[89] In turn, the SEC restricted shelf registration to issuers capable of registering under Form S-3.[90] This effectively limited shelf registration "to only certain well-capitalized and widely followed issuers about which a significant amount of public information is already available."[91] The SEC's action, however, only partially alleviated underwriters' concerns, as the demands of both due diligence and competition remained.[92]

In addressing the concerns of underwriters, the SEC noted the need for changes to due diligence techniques, as traditional methods were largely unsuited for shelf registration.[93] The SEC also acknowledged that there would be a lack of uniformity in the approach to due diligence among different

> The Rule enables a registrant to time its offering to avail itself of the most advantageous market conditions; that by being able to meet "market windows," [where the yield on issuing debt is at a relatively low point], registrants are able to obtain lower interest rates on debt and lower dividend rates on preferred stock, thereby benefiting their existing shareholders. The flexibility provided by the Rule also permits variation in the structure and terms of securities on short notice, enabling registrants to match securities with the current demands of the marketplace.

Id. (quoting SEC Sec. Act. Release No. 6499 (Nov. 17, 1983)).

86. *Supra* note 85 and accompanying text (describing beneficial impact of shelf registration on debt offerings).

87. COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200 (describing underwriters' concerns over time constraints for due diligence in shelf registration).

88. COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200 (explaining potential time reduction for underwriters to conduct due diligence).

89. *See* Shelf Registration, *supra* note 4, at *5 (outlining underwriters' concerns with due diligence investigations conducted for shelf registration); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200 (discussing underwriters' concerns regarding compliance with due diligence requirements for shelf registrations).

90. *See* Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1205 (1st Cir. 1996) (noting availability of S-3 form); Brief of Amici Curiae Sec. Indus. Ass'n, *supra* note 1, at 2-3 (discussing adoption of S-3 form to implement timely access to capital markets); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200 (describing underwriters' due diligence concerns and SEC's failure to fully address such concerns).

91. *Shaw*, 82 F.3d at 1205 (discussing SEC's adoption of Form S-3); *see also* 17 C.F.R. § 230.415(a)(1)(x) (2006) (limiting shelf registration to issuers qualified to use S-3 registration); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200 (describing SEC modifications to Rule 415 allowing well-qualified issuers to use shelf registration).

92. *See* COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200-02 (discussing shelf registration's impact on underwriters' due diligence requirements).

93. COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200-02 (discussing inadequacies of traditional due diligence as applied to shelf registrations); *see also* Rossell & Stemmer, *supra* note 9 (recognizing SEC's lack of guidance concerning due diligence in shelf registration).

registrants.[94] Rule 176 was part of the SEC's attempt to square the due diligence requirement with the changes to the registration process and provided assistance to underwriters in determining whether they have discharged their § 11 duty freeing them from liability.[95]

Upon the inclusion of Rule 415, the SEC anticipated that underwriters would develop new methods of investigation that would conform to the pressures of integrated disclosure and the shelf registration process.[96] Additionally, the SEC suggested two approaches that would allow underwriters to meet the due diligence burden.[97] The first is a system of continuous investigation, where the underwriter is kept apprised of the issuer's financial health during the two years that the shelf registration is effective.[98] The second suggestion the SEC made is quarterly due diligence sessions, through which the underwriters have the ability to discuss information contained in the periodic reports and any material facts that may have developed since the filing of the last report.[99] Despite these suggestions, underwriters have found adherence to either due diligence approach impractical.[100]

While shelf registration has reduced time and costs for issuers, it has also raised the level of competition among underwriters.[101] An underwriter's ability

94. *See* COX, HILLMAN & LANGEVOORT, *supra* note 25, at 201 (discussing absence of uniformity in conducting due diligence).

95. 17 C.F.R. § 230.176 (2005) (listing circumstances to consider in determining reasonable investigation). Rule 176 states that:

> In determining whether or not the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in section 11(c), relevant circumstances include, with respect to a person other than the issuer. . . . (f) Reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing); (g) When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant; and (h) Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

Id.; *see also* Block & Hoff, *supra* note 40, at 5 (describing purpose behind Rule 176); Rossell & Stemmer, *supra* note 9 (discussing enactment of Rule 176); *supra* note 80 and accompanying text (explaining purpose of Rule 176 to provide underwriters with some guidance on due diligence). See *generally* Clarke & Alderman, *supra* note 80 (addressing Rule 176 factors utilized in determining underwriter reasonableness).

96. *See* Smeeta S. Rishi, Note, *The Impact of the SEC's Rule 415 on Individual Investors*, 46 OHIO ST. L.J. 223, 233-34 (1985) (indicating SEC hoped issuers and underwriters would come to terms with due diligence requirements); *see also* Brief of Sec. Indus. Ass'n, *supra* note 1, at 6 (highlighting SEC's awareness of underwriters need to adopt new due diligence techniques).

97. *See* Rishi, *supra* note 96, at 234 (outlining suggested due diligence alternatives for underwriters).

98. *See* Rishi, *supra* note 96, at 235.

99. *See* Rishi, *supra* note 96, at 235.

100. *See* Dickens, Dutka & Amsel, *supra* note 13, at 5 (explaining prohibitive costs involved in adhering to proposed due diligence measures).

101. *See* Shelf Registration, *supra* note 4, at *5 (addressing issue of underwriter competition in shelf registration); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200 (indicating underwriters' concern with

to meet the demands of issuers is more important than ever because shelf registration allows an issuer to choose an underwriter close to the time of the offering.[102] The relationships that once existed between underwriters and issuers are now strained, and underwriters must work within the time restraints of a shelf registration or risk losing the issuer's business.[103] Such competition has impacted the underwriters' ability to conduct due diligence, and underwriters continue to struggle to comply with the SEC suggestions.[104]

D. WorldCom and Due Diligence

In re WorldCom, Inc. Securities Litigation[105] is a significant decision for underwriters and the scope of liability under § 11.[106] Underwriters hoped that Judge Denise Cote's opinion would establish clear guidelines on due diligence for shelf registration.[107] The *WorldCom* decision, however, proved unfavorable to underwriters' interest and left them without the guidance they expected from the case.[108]

1. WorldCom

The facts of *In re WorldCom* involve a large scale accounting scandal resulting in the financial collapse, and subsequent bankruptcy filing, of WorldCom, Inc.[109] WorldCom's two major debt offerings under a shelf registration, one in 2000 and one in 2001, were the focus of securities class action suits, which listed the underwriters of the offerings as defendants.[110] The underwriters subsequently moved for summary judgment, asserting the "reliance" and "due diligence" defenses of § 11.[111] The court's decision ultimately hinged on the amount of due diligence required of underwriters in conjunction with a shelf registration.[112]

competitive demands of shelf registration).

102. COX, HILLMAN & LANGEVOORT, *supra* note 25, at 201 (describing underwriter competition stemming from shelf registration).

103. *See* Dickens, Dutka & Amsel, *supra* note 13, at 5 (explaining underwriters' dilemma resulting from shelf registration).

104. *See* Dickens, Dutka & Amsel, *supra* note 13, at 5 (discussing underwriters' inability to conduct due diligence).

105. 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

106. *Id.* (holding underwriters must conduct traditional due diligence for shelf registrations); *see also* Dickens, Dutka & Amsel, *supra* note 13, at 1 (explaining significance of *WorldCom* decision); Rossell & Stemmer, *supra* note 9, at 1 (discussing importance of *WorldCom* decision).

107. *See* Rossell & Stemmer, *supra* note 9, at 1 (describing underwriters' hope for guidance from *WorldCom*).

108. *See* Rossell & Stemmer, *supra* note 9, at 1 (noting underwriters failed to obtain guidance for due diligence requirements).

109. *WorldCom*, 346 F. Supp. 2d at 634-35 (setting forth backdrop of *WorldCom* case).

110. *Id.* at 637 (describing plaintiff's action against underwriter defendants).

111. *Id.*

112. *See* Dickens, Dutka & Amsel, *supra* note 13, at 1 (explaining necessity of conducting due diligence

a. Underwriters and the 2000 Offering

In May 2000, WorldCom made a debt offering of approximately five billion dollars.[113] The company filed the offering's shelf registration on April 12, 2000, and a prospectus supplement dated May 19, 2000.[114] From May 15 to May 23, 2000, underwriters conducted due diligence, the only written record of which was a memorandum from the underwriters' counsel, Cravath, Swaine & Moore.[115] This memorandum listed a single telephone call between the underwriters and WorldCom's Chief Financial Officer (CFO).[116] The memorandum also stated that during this telephone call the CFO "predicted overall growth for the year 2000 would be about 14%, represented that the proceeds for the 2000 Offering would be used to repay 'commercial debt,' [and] reported that WorldCom was experiencing a very competitive environment but that there were no changes in that environment since 1999."[117] The CFO further indicated that there were no other material issues.[118]

b. Underwriters and the 2001 Offering

Almost one year after the 2000 offering, WorldCom experienced a tremendous slide in its financial health.[119] As a result, the underwriters downgraded WorldCom's credit rating, leaving them with a choice between working on restructuring WorldCom's massive credit facility or underwriting the substantial debt offering that WorldCom planned for the spring of 2001.[120] Recognizing that the underwriter's difficult choice, WorldCom informed the underwriters that their assistance in restructuring the credit facility was a

for shelf registration).

113. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 645 (S.D.N.Y. 2004) (describing value of 2000 debt offering).

114. *Id.* at 645 (discussing WorldCom registration process). The May 12 prospectus "incorporated by reference" the 10-K for 1999 and the 10-Q for the quarter ending March 31, 2000. *Id.*

115. *Id.* at 647 (listing memorandum as only written record of due diligence).

116. *Id.* at 647-48 (describing contents of memorandum). The telephone call occurred on May 17, 2000 and involved Scott Sullivan, the Chief Financial Officer of WorldCom. *Id.* The underwriter defendants, as reported in the memorandum, asked Mr. Sullivan questions about "the Sprint merger, whether WorldCom had experienced problems integrating either SkyTel or MCI, and whether there were any other material issues." *Id.*

117. *WorldCom*, 346 F. Supp. 2d at 648.

118. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 648 (S.D.N.Y. 2004). The memorandum then outlined WorldCom's board minutes, listed WorldCom's public filings, referred to its press releases, and discussed the failed merger attempt with Sprint. *Id.*

119. *See* Dickens, Dutka & Amsel, *supra* note 13, at 3 (elaborating on WorldCom's financial skid); *see also* Rossell & Stemmer, *supra* note 9, at 3 (highlighting circumstances surrounding WorldCom's collapse).

120. *WorldCom*, 346 F. Supp. 2d at 650-51 (discussing WorldCom's financial slide and need for credit facility restructuring); *see also* Dickens, Dutka & Amsel, *supra* note 13, at 3 (highlighting WorldCom's credit downgrade); Gretchen Morgenson, *3 Banks Had Early Concern on WorldCom*, N.Y. TIMES, Mar. 17, 2004, at A1 (noting three large investment banks' concern over WorldCom's financial status). As a result of the severe deterioration of WorldCom's financial condition, underwriters downgraded their credit rating of the company. Dickens, Dutka & Amsel, *supra* note 13, at 3 (noting financial decline of WorldCom).

prerequisite to participation in the 2001 debt offering.[121] The underwriters, however, recognized that assisting in the WorldCom credit facility restructuring would expose them to risk, and they attempted to limit that risk through hedging strategies.[122]

Described as "the largest public debt offering in American history," WorldCom's 2001 Offering distributed some $11.9 billion in notes.[123] From April 19 to May 16, 2001, underwriters conducted due diligence for the 2001 offering.[124] The underwriters' counsel outlined the details of the inquiry, which included two telephone calls, a review of WorldCom's board minutes, 1998 revolving credit agreement, SEC filings, and press releases from April 19 to May 16, 2001.[125]

Underwriters, along with their counsel, conducted the first of the two telephone calls on April 30, 2001, and spoke to the WorldCom CFO.[126] In this discussion, the underwriters discovered that WorldCom was planning on using half the proceeds generated from the offering "to repay the balance of its outstanding commercial paper, to retire debt and to fund a portion of the Company's negative free cash flow."[127] During the call, underwriters further elicited that WorldCom had a general reserve of $1.1 billion to cover for any bad receivables.[128] The WorldCom CFO reassured underwriters that competition in the industry had not been a problem and that the economic downturn was not materially impacting WorldCom's business.[129] In this same telephone call, underwriters also inquired about WorldCom's current financial

121. *Supra note* 120 and accompanying text (discussing circumstances surrounding WorldCom securities offering).

122. *WorldCom*, 346 F. Supp. 2d at 651 (evaluating underwriters' actions in debt offering). Judge Cote found that:

> [t]here is evidence that several of the Underwriter Defendants decided to make a commitment to the restructuring of the credit facility and to attempt to win the right to underwrite the 2001 Offering, while at the same time reducing their own exposure to risk from holding WorldCom debt by engaging in hedging strategies, such as credit default swaps.

Id.

123. *Id.* at 650, 652 (noting immensity of WorldCom's 2001 debt offering); *see also* Dickens, Dutka & Amsel, *supra* note 13, at 2 (discussing substantial nature of 2001 offering).

124. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 652-53 (S.D.N.Y. 2004) (discussing due diligence conducted for 2001 offering). A memorandum prepared for the 2001 offering described the methods and practices underwriters assumed to conduct the requisite amount of due diligence. *Id.*

125. *Id.* at 653-54 (addressing memorandum's contents as applied to due diligence requirement).

126. *Id.* at 653 (describing memorandum and details of underwriters' phone conversations with WorldCom CFO). With their counsel from Cravath Swaine & Moore, two investment bankers representing two underwriting banks participated in the telephone calls. *Id.* Scott Sullivan, who was still the CFO of WorldCom, also participated in the phone conversation. *Id.*

127. *Id.* (discussing memorandum detailing phone conversations during due diligence).

128. *WorldCom*, 346 F. Supp. 2d at 653 (noting telephone call revealed issues within written memorandum).

129. *Id.* (revealing WorldCom's deceit as demonstrated in memorandum).

condition.[130] The CFO assured them that the situation was positive and there were no further issues to discuss.[131]

The second telephone call followed on May 9, 2001, and involved underwriters, WorldCom, and Arthur Andersen representatives, WorldCom's accountants.[132] WorldCom reassured the underwriters that there had been no material changes since the April 30th call.[133] Arthur Andersen also indicated that WorldCom had no accounting problems.[134]

Although both of these telephone calls provided WorldCom and Arthur Andersen with the opportunity to disclose material facts to the underwriters, neither party revealed that WorldCom had engaged in a "capitalization scheme."[135] Arthur Andersen, in addition, distributed comfort letters for first quarter financial statements of WorldCom.[136] These letters asserted that there was no reason to question the financial statements of WorldCom.[137]

2. Denial of Underwriters' Motion

WorldCom investors suffering financial losses through these debt offerings

130. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 653 (S.D.N.Y. 2004) (discussing nature of questions asked of WorldCom to discover any deceit or wrongdoing).

131. *Id.* (describing questions asked and answered by Scott Sullivan). Mr. Sullivan, in response to the underwriters' questions, answered that "WorldCom was comfortable with the current earnings per share, that there were no issues that could affect the company's credit rating, and that the company had nothing material to disclose that had not been discussed with the investment bankers." *Id.*

132. *Id.* (discussing second call detailed in memorandum).

133. *Id.* (detailing memorandum information relevant to due diligence defense).

134. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 653 (S.D.N.Y. 2004) (describing Arthur Andersen's answers recorded in memorandum). Arthur Andersen assured the underwriters that there were no accounting discrepancies in any of WorldCom's financial statements. *Id.* Both WorldCom and Arthur Andersen informed the underwriters that there were no additional material facts that required further discussion. *Id.*

135. *Id.* at 641, 653 (pointing to WorldCom's scheme to conceal capitalization). As this was a clandestine plan by WorldCom, underwriters were unaware that WorldCom had capitalized $771 million of the company's line costs. *Id.* at 653; *see also* Dickens, Dutka & Amsel, *supra* note 13, at 3 (highlighting purpose behind scheme). WorldCom officers developed this scheme to "make the E/R ratio for the first quarter of 2001 'fairly consistent' with the E/R ratio for the prior quarter." *Id.* at 641 (elucidating purpose behind WorldCom's capitalization scheme); *see also* Dickens, Dutka & Amsel, *supra* note 13, at 3 (examining WorldCom's capitalization scheme). Consistent E/R ratios would make WorldCom appear more profitable and give the appearance that it was weathering an economic downturn better than its telecommunications competitors. *See* Dickens, Dutka & Amsel, *supra* note 13, at 3 (explaining WorldCom's hidden capitalization scheme).

136. *WorldCom*, 346 F. Supp. 2d at 653 (pointing to comfort letters submitted by Arthur Andersen); *see also* Zaccaro, Weiss & Reed, *supra* note 8, at 1-5. Quarterly financial statements, known as 10-Qs, are reviewed under the Generally Accepted Auditing Standards, but are not as rigorously audited as the annual reports. Zaccaro, Weiss & Reed, *supra* note 8, at 2. In addition to the 10-Q incorporation in the registration statement, independent auditors submit a comfort letter to the underwriters that represents the auditors' review of interim financial statements. *Id.*

137. *WorldCom*, 346 F. Supp. 2d at 653-54 (listing Arthur Andersen's assertions contained in comfort letter). Underwriters relied on the Arthur Andersen comfort letter for the unaudited quarterly financial statements without conducting further investigation. *See id.* at 654-55; Thacher, Profitt & Wood, *supra* note 8, at 10 (describing underwriters' reliance on comfort letters); Zaccaro, Weiss & Reed, *supra* note 9, at 1 (discussing underwriter reliance on unaudited financial statements).

filed a series of securities class action suits, and one of the most significant included the underwriters as defendants.[138] The underwriter defendants submitted a motion for summary judgment arguing that reliance on an expert under § 11(b)(3)(C) did not require an independent investigation of WorldCom's financial statements. Thus, the underwriters argued that "after reasonable investigation," they had "reasonable ground to believe" in the accuracy of the non-expertised portions of the registration statement, and could rely on the due diligence defense under § 11(b)(3)(A).[139] Judge Cote denied the underwriter's motion and held that because sufficient issues of material fact existed, underwriter liability was a question of fact for the jury to resolve at trial.[140]

Judge Cote noted the lack of case law dealing with § 11 defenses and focused her analysis on "red flags" present in the expertised portion of the registration and comfort letters related to the non-expertised portion.[141] In discussing the underwriters' reliance on WorldCom's audited financial statements, Judge Cote explained that blind reliance does not satisfy the due diligence requirement.[142] The underwriters further asserted that an expertised portion of a registration statement never constitutes a red flag and that a fact analysis determines whether there was clear and direct notice of the

138. *See WorldCom*, 346 F. Supp. 2d at 634 (providing background on securities claims against underwriters); Dickens, Dutka & Amsel, *supra* note 13, at 1 (inferring securities class action suits followed WorldCom dissolution); Rossell & Stemmer, *supra* note 9 (outlining plaintiffs allegations); Zaccaro, Weiss & Reed, *supra* note 8 (discussing basis of shareholder litigation). *See generally* Bernstein, Litowitz, Berger & Grossman, In re WorldCom, Inc. Securities Litigation *Background on the Litigation*, http://www.blbglaw.com/cases/worldcom_background.html (last visited Feb. 27, 2007) (outlining general background of all claims in *WorldCom*).

139. *WorldCom*, 346 F. Supp. 2d at 634 (setting forth *WorldCom* procedural history); *see also* Coffee, *Due Diligence*, *supra* note 8 (listing underwriters' grounds for summary judgment); Dickens, Dutka & Amsel, *supra* note 13, at 2 (outlining underwriters' summary judgment motion); Rossell & Stemmer, *supra* note 9 (describing basis for underwriters' summary judgment motion); Zaccaro, Weiss & Reed, *supra* note 8, at 1-2 (stating argument in underwriters' motion for summary judgment).

140. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 680 (S.D.N.Y. 2004) (invalidating underwriters' reliance on 2000 and 2001 offerings); *see also* Coffee, *Due Diligence*, *supra* note 8 (describing court's reasoning in denying motion for summary judgment); Zaccaro, Weiss & Reed, *supra* note 8, at 2 (interpreting factors behind court's denial of underwriters' motion); *see also* Bruce C. Bennett, In re WorldCom, Inc. Securities Litigation: *Due Diligence For Underwriters and Directors*, SEC. CLIENT ADVISORY (Covington & Burling), Mar. 7, 2005, at 1-5, *available at* http://www.cov.com/files/Publication/9e698e61-dd87-4839-b1e6-32d6ef8d9ffd/Presentation/PublicationAttachment/318a61c9-8a8a-4c26-ab9e-3b7a7976e824/oid8647.pdf (detailing court's decision in denying underwriters' motion); Shirai, *supra* note 12, at 1-2 (outlining court's ruling against underwriters' motion for summary judgment); Thacher, Proffit & Wood, *supra* note 8, at 2 (analyzing court's decision to deny underwriters' motion).

141. *WorldCom*, 346 F. Supp. 2d at 634, 672-73 (analyzing previous cases' "red flag" determination); Coffee, *Due Diligence*,, *supra* note 8 (reviewing court's analysis in determining "red flags").

142. *WorldCom*, 346 F. Supp. 2d at 672-73 (discussing "red flags" and their impact on underwriters' ability to rely on financial statements). In her decision, Judge Cote asserted that "where 'red flags' regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability." *Id.* at 672; *see also* David A. Lipton, *Broker-Dealer Regulation*, 15 BROKER-DEALER REG. § 3:65 (Nov. 2005) (discussing *WorldCom* underwriters' reliance on accountants).

wrongdoing.[143] Judge Cote found this argument insufficient and stated that a red flag existed in two scenarios.[144] Judge Cote described the first type of red flag as "those facts which come to a defendant's attention that would place a reasonable party in the defendant's position 'on notice that the audited company was engaged in wrongdoing to the detriment of its investors.'"[145] Judge Cote, however, did not apply this type of red flag because the underwriters acted within the established customs and practices.[146] Judge Cote described the second type as events that "'[would] alert a reasonably prudent investor of wrongdoing,'" and found it more applicable to the underwriters' situation.[147]

In denying the underwriter's summary judgment motion, Judge Cote explained that the difference between WorldCom's financial situation and that of its telecommunication competitors presents a potential red flag best left for a jury to evaluate.[148] Judge Cote also explained that it was necessary for underwriters to have an awareness of a company's surrounding circumstances, which was a change in practice for the underwriting industry.[149] Judge Cote further held that the underwriters' reliance on the comfort letters constituted a failure to meet the requisite amount of due diligence for a public offering.[150] After the court issued the denial, the underwriters settled their claims and paid a significant sum to investors for their role in the WorldCom scandal.[151]

143. *WorldCom*, 346 F. Supp. 2d at 679 (arguing clear and direct notice required for audited financials to constitute "red flag").

144. *Id.* at 672-73 (describing two concepts defining "red flags").

145. *Id.* at 672 (quoting In re Sunterra Corp. Sec. Litig., 199 F. Supp. 2d 1308, 1333 (M.D. Fla. 2002)).

146. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 680 (S.D.N.Y. 2004) (holding underwriters' argument about "red flags" as insufficient); *see also* Dickens, Dutka & Amsel, *supra* note 13, at 3 (discussing Judge Cote's use of "red flag" to counter underwriter defendants' argument).

147. *WorldCom*, 346 F. Supp. 2d at 634, 673 (quoting Mosesian v. Peat, Marwick, Mitchell & Co., 727 F.2d 873, 877 (9th Cir. 1984)).

148. *Id.* at 679-80 (concluding underwriter failed to conduct sufficient due diligence). The court determined that based on this second "red flag," a jury could find that underwriters were on notice of discrepancies in the statements and reliance on such, without investigation, did not amount to sufficient due diligence. *Id.* Judge Cote held that there was insufficient evidence to grant the underwriters' summary judgment motion, and therefore a jury would have to decide whether the underwriters' satisfied due diligence requirement. *Id.*

149. *See id.* at 680 (indicating underwriters may need to look to issuers' competitors to satisfy due diligence); Dickens, Dutka & Amsel, *supra* note 13, at 7 (discussing competitor's activity as basis for jury to find due diligence "red flags").

150. *WorldCom*, 346 F. Supp. 2d at 665-66 (holding underwriter reliance on comfort letters as insufficient to establish due diligence). *See generally* Lipton, *supra* note 142 (noting Judge Cote's aversion to underwriters relying on auditors' comfort letters).

151. *See supra* note 7 and accompanying text (noting underwriters' settlement in *WorldCom*).

III. ANALYSIS

A. Due Diligence Defense for Shelf Offering

1. Take Traditional Due Diligence Off the Shelf

To satisfy traditional due diligence requirements as defined in *BarChris* and *Feit*, underwriters must perform lengthy analysis; changes are therefore necessary to accommodate underwriters in timely offerings.[152] Traditional due diligence procedures are incompatible with the escalating speed at which issuers access the markets.[153] It is not feasible to hold underwriters to such an exacting standard while drafting reforms that grant certain issuers almost instantaneous access to capital markets.[154] Shelf registration is a product of technology and increased demand for ready market access, and thus holding underwriters to standards that are not compatible with the speed with which issuers can reach the market is problematic.[155]

In light of shelf registration's impact on due diligence requirements, an underwriters obligation to conduct a reasonable investigation should be flexible and depend on the context of the offering.[156] Forcing underwriters to adhere to

152. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 10 n.5 (discussing insufficiency of *BarChris* and *Feit* due diligence standard in context of shelf offerings); *supra* notes 61-64 and accompanying text (explaining traditional due diligence techniques); *supra* notes 70-76 and accompanying text (discussing traditional due diligence procedures and elucidating requirements of underwriters for due diligence defense); *see also* Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act, Securities Act Release No. 33-6335, Exchange Act Release No. 34-18011, Investment Company Act Release No. 11,889 (Aug. 6, 1981), 1981 WL 31062, at *2 (setting forth proposed rule for due diligence under § 11). The release indicated that:

> Although the basic requirements of due diligence remain the same in an integrated system, the manner in which due diligence may be accomplished can properly be expected to vary in some cases . . . . Historical models of due diligence have focused on efforts during the period of activity associated with preparing a registration statement, but the integrated disclosure system requires a broader focus. Issuers, underwriters and their counsel will necessarily be reevaluating all existing practices connected with effectuating the distribution of securities to develop procedures compatible with integrated approach to registration.

Id. at *11.

153. *See supra* note 1 and accompanying text (arguing traditional due diligence techniques not possible in shelf offering).

154. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 11-12 (discussing difficulty in underwriters performing traditional due diligence in shelf offerings); Rossell & Stemmer, *supra* note 9 (comparing static nature of due diligence obligations with variable nature of offering process); Thacher, Proffitt & Wood, *supra* note 8, at 4 (noting unchanging nature of due diligence and continual evolution of offering process). *See generally* Bobelian, *supra* note 9 (noting lack of due diligence guidelines pertaining to shelf offerings).

155. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 11-12 (contrasting purpose behind shelf registration with traditional due diligence requirements); Bannoff, *supra* note 2, at 136 (remarking on benefits of shelf registration and purpose of Rule 415).

156. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 6 (asserting registration context should control

time consuming traditional due diligence requirements severely undermines the benefits of shelf registration.[157] One of the most important developments of shelf registration is that it gives large, well-capitalized companies the ability to "take advantage of transient market opportunities to sell securities without the delay inherent in the traditional offering process and related diligence procedures."[158] Thus, while the underlying goal of securities regulation is investor protection, traditional due diligence is not reasonable for a shelf offering.[159] In this context, traditional due diligence could unrealistically restrict capital market participants and jeopardize the efficiency of the capital markets, ultimately resulting in more broad-based economic harm than good.[160]

2. Impact of WorldCom on Due Diligence Requirements

The *WorldCom* decision significantly raised the level of due diligence an underwriter must perform.[161] Judge Cote's comprehensive and cogent opinion slightly overshadowed the difficulty of the decision.[162] Following Judge Cote's reasoning, red flags, which Judge Cote did not explicitly define, extend beyond the obvious financial misstatements and reach to external factors, such as competitors' financial situations and hidden corporate malfeasance.[163] The *WorldCom* court's definition of red flags denotes the end of underwriter reliance on audited financial statements.[164] Additionally, the court dispelled any notion that the rapid pace and strict demands of a shelf registration

reasonable investigation determination); Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under § 11 of the Securities Act, *supra* note 152, at *1 (noting approach to due diligence will vary depending on registrants).

157. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 11 (arguing utilization of traditional due diligence for shelf offerings will limit issuers ability to rapidly access market); Sidel, *supra* note 6, at C1 (reviewing difficulty underlying traditional due diligence as applied to shelf registration).

158. Brief of Sec. Indus. Ass'n, *supra* note 1, at 3 (discussing SEC's intent in adopting shelf registration); *see also* Bannoff, *supra* note 2, at 136 (noting benefits of shelf registration); COX, HILLMAN & LANGEVOORT *supra* note 25, at 198 (discussing purpose of shelf registration); *supra* note 3 and accompanying text (delineating advantages of shelf registration).

159. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, 11-12 (concluding demands of traditional due diligence not appropriate for shelf offerings); *supra* note 6 and accompanying text (outlining issues with shelf registration and due diligence requirements).

160. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 11-12 (discussing potential adverse impact of traditional due diligence on benefits of shelf registration).

161. *See supra* note 12 and accompanying text (discussing reasonable investigation standard set forth in *WorldCom*).

162. *See* Bennett, *supra* note 140, at 5 (noting *WorldCom* facts required Judge Cote to make difficult decision).

163. *See supra* notes 142-146 and accompanying text (indicating red flag analysis essential to *WorldCom* decision).

164. *See supra* notes 142-146 and accompanying text (explaining *WorldCom* definition of red flags); *see also* Coffee, *Due Diligence*, *supra* note 8, at 5 (describing blind reliance on audited financial statements as insufficient); Ruhlin, *supra* note 6, at 18 (stating red flags trigger duty to inspect audited financial statements); Thacher, Proffitt & Wood, *supra* note 8 (discussing impact of WorldCom red flag analysis).

mitigated an underwriters due diligence responsibilities.[165] Though this decision is not binding precedent on any other courts in the United States, it will establish an industry standard due to the lack of authority on the due diligence defense, which makes it likely that other courts will frequently cite the decision.[166] Thus, the future of shelf offerings has underwriters dedicating additional resources to satisfy due diligence requirements that trigger § 11 protection.[167]

The *WorldCom* decision, which serves to undercut the benefits of shelf registration, exemplifies the current legal and regulatory climate surrounding due diligence.[168] In the wake of *WorldCom*, underwriters must attempt to conduct traditional due diligence under an unreasonable time constraint.[169] This due diligence standard will not only raise the costs for underwriters, but will also deny issuers' shelf registration's guarantee of quick access to the capital market.[170]

3. The Underwriter's Dilemma

Underwriters are currently left with a difficult choice between meeting the demanding requirements of traditional due diligence, or succumbing to the demands of a competitive and time-sensitive industry.[171] Caught between the proverbial rock and a hard place, underwriters must confront increasing legal liability while regulators and issuers are encouraging them to close deals at lightning speed.[172] Lurking behind this dilemma is the underwriters awareness that if they pass on a deal because of due diligence, another less demanding

165. *See In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 667-69 (S.D.N.Y. 2004) (discussing reduction in time for underwriter to conduct due diligence in shelf registration). The court reiterated the importance of due diligence, and held underwriters to a standard that is incompatible with shelf registration. *Id.*; Selected Capital Raising Issues: Underwriter Due Diligence, *supra* note 17 (stating accelerated timetable in shelf offering fails to mitigate due diligence obligations).

166. *See* Ruhlin, *supra* note 6, at 18 (noting lack of due diligence case law gives *WorldCom* decision heightened precedential value).

167. *See supra* notes 8-9 (reviewing adverse impact on underwriters resulting from *WorldCom* decision).

168. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 11 (arguing traditional due diligence will defeat benefits and purpose of shelf registration). The Securities Industry and Bond Market Association Amicus Brief persuasively argues that underwriters' adherence to traditional due diligence, out of fear of liability, undermines the purpose of shelf registration, as it delays an issuers' ability to seize advantageous market situations. *Id.*

169. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 11 (concluding *WorldCom*'s due diligence decision destroys benefits of shelf-registration); *supra* notes 142-141 and accompanying text (explaining Judge Cote's denial of underwriters' summary judgment motion).

170. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 11-12 (arguing traditional due diligence undermines purpose of shelf registration's timely offerings); *see also Shelf Registration*, *supra* note 4, at *4 (defining benefits and purpose of shelf registration).

171. *See supra* notes 9, 17 and accompanying text (describing difficulty underwriters face with regard to due diligence and shelf offerings after *WorldCom*).

172. *See* O'Leary, *supra* note 9 (outlining underwriters' dilemma due to time constraints of shelf registration); *supra* notes 9, 17 and accompanying text (discussing demands placed on underwriters in offering process).

firm will acquire and complete the deal.[173]

Since the inception of shelf registration, underwriters have struggled with the concept of due diligence.[174] Underwriters face constant pressure to effectuate shelf offerings quickly, but they are no longer able to rely solely on audited financial statements and comfort letters.[175] In the competitive underwriting industry, investment banks will not have the weeks or months necessary to satisfy due diligence requirements because impatient and demanding issuers will look elsewhere.[176] Although there is currently a lack of conclusive evidence that traditional due diligence will stall an issuer's deal, such a result is foreseeable, and underwriters will face a choice between potential liability and cumbersome, lengthy due diligence.[177]

While there is an argument that underwriters can parlay the risks by raising client fees, investment banking is a competitive business in which underwriters jockey for position by offering incentives such as short deadlines and lower fees.[178] Pushing the risk off to underwriters, therefore, could hurt the economy and create an inferior product, resulting in an adverse effect on investors—the group the due diligence requirement seeks to protect.[179]

B. Rapid Access Versus Thorough Due Diligence

Reconciliation of the existing gap between the need for quick access to the capital market and the amount of due diligence demanded in offerings is necessary.[180] Through the *WorldCom* decision, Judge Cote crafted a new interpretation of existing case law but did not set out specific guidelines.[181]

173. *See supra* notes 9, 17 and accompanying text (highlighting competitive nature of underwriting business).

174. *See* Shelf Registration, *supra* note 4, at *5 (noting underwriters' concern in performing sufficient due diligence in shelf offerings); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 200-01 (indicating underwriters sought guidance from SEC following adoption of shelf registration).

175. *See supra* notes 8-9 and accompanying text (elaborating on modifications of underwriters' due diligence techniques following *WorldCom*); *see also supra* note 17 and accompanying text (discussing underwriters' difficulty in establishing due diligence defense for shelf registration after *WorldCom* decision).

176. *See* Bobelian, *supra* note 9, at 5 (describing demands on underwriters to perform quickly or risk losing business); Dickens, Dutka & Amsel, *supra* note 13, at 10 (stating underwriters should not complain about time available to conduct shelf registration due diligence).

177. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 11-12 (asserting traditional due diligence for shelf registration places underwriters in difficult position); *see supra* notes 9, 17 and accompanying text (discussing drawbacks of traditional due diligence with regard to shelf registration); Stuart, *supra* note 8, at 1 (stating no adverse impact resulting from demanding due diligence requirements of *WorldCom*).

178. *See* COX, HILLMAN & LANGEVOORT, *supra* note 25, at 201 (indicating competitive nature of underwriting clashes with implementation of shelf registration).

179. *See* Shelf Registration, *supra* note 4, at *5 (discussing underwriter concerns and indicating purpose of shelf registration); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 3-4 (discussing purpose behind securities regulations). *See generally* Brief of Sec. Indus. Ass'n, *supra* note 1 (outlining potential impact of traditional due diligence on shelf registration).

180. *See generally* Brief of Sec. Indus. Ass'n, *supra* note 1 (suggesting adherence to traditional due diligence requirements conflicts with rapid capital market access).

181. *See supra* note 15 and accompanying text (indicating lack of guidelines for underwriters to follow).

Finding that the SEC did not intend to diminish the underwriter's responsibility to conduct a reasonable investigation, Judge Cote's decision indicated that underwriters cannot seek safe harbor in Rule 176.[182] In fact, shelf registration might require underwriters to employ outside accounting experts to conduct audits of a company's financial records because they cannot rely blindly on audited financial statements.[183] The securities industry would like to continue conducting reasonable due diligence in the context of a shelf offering, but the *WorldCom* decision renders such an option impossible.[184]

In light of the *WorldCom* decision, resolution can only come from the SEC, which has the capability to redraft the rule to provide more reasonable due diligence requirements for a shelf offering.[185] First, the SEC must rectify the failure of Rule 176 to provide underwriters with a clear understanding of how to avoid liability.[186] A rule that provides a set of due diligence defense guidelines in the shelf offering context must replace the current rule, which lays out "relevant circumstances."[187]

Since the investment industry first expressed concerns over shelf registration, the SEC has pushed for underwriters to conduct continuous due diligence for issuers of such offerings.[188] Issuers, however, are largely

182. *See In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 669 (S.D.N.Y. 2004) (stating Rule 176 not constructed to change underwriters' due diligence responsibilities); Coffee, *Section 11*, *supra* note 5, at 5 (noting Rule 176 does not provide safe harbor for underwriters after *WorldCom*). The *WorldCom* court held that the "SEC at no time intended to diminish the underwriter's obligation to make a reasonable investigation." *In re* WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288DLC, 2005 WL 638268, at *5 (S.D.N.Y Mar. 21, 2005). As a result, the decision stated that Rule 176 was not intended as a safe harbor for underwriters. *See* Coffee, *Section 11*, *supra* note 5, at 5.

183. *See* Rossell & Stemmer, *supra* note 9 (determining information underwriters must review in wake of *WorldCom*).

184. *See* Coffee, *Section 11*, *supra* note 5, at 5 (discussing securities industry's desire to ignore *WorldCom* decision). *See generally* Brief of Sec. Indus. Ass'n, supra note 1 (arguing against application of traditional due diligence standard to shelf registration). In response to *WorldCom*, "The Securities Industry Association is apparently seeking to draft its own standards for a due diligence investigation, but its self-interest is palpably showing." Coffee, *Section 11*, *supra* note 5, at 5.

185. *See* Coffee, *Refco Meltdown*, *supra* note 13, at 23 (arguing Rule 176 failed and SEC needs to rewrite law). The *WorldCom* decision exacerbates the dilemma facing underwriters face, but courts are only able to interpret the laws and not rewrite them. *Id.* The courts, therefore, cannot resolve the "policy dilemma and liability crisis." *Id.* The SEC has to redraft the rule and provide a new more applicable safe harbor rule. *Id.*

186. *See* Coffee, *Refco Meltdown*, *supra* note 13, at 23 (describing failure of Rule 176); *supra* note 81 and accompanying text (noting shortcomings of Rule 176).

187. *See* Coffee, *Refco Meltdown*, *supra* note 13, at 23 (calling for repeal of Rule 176 and seeking new safe harbor rule).

188. *See* Shelf Registration, *supra* note 4, at *5 (addressing underwriters' concerns over shelf registration due diligence); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 339 (highlighting concerns underwriters discussed with SEC). The following is a non-exclusive list of considerations given by underwriters for continuing due diligence requirements after *WorldCom*: "(1)A designated underwriter's counsel, (2) Quarterly due diligence meetings, (3) Attendance at analysts' conferences, (4) Involvement in the preparation of significant information releases, [and] (5) Likely issuer reluctance to pay for or spend time and effort on this[.]" Cleary Gottlieb Steen & Hamilton, *Diligence*, *supra* note 5, at 1214 (listing concerns underwriters must address in continuous disclosure).

unwilling to subject themselves to continuous due diligence, and thus underwriters cannot be expected to conduct such due diligence.[189] The SEC should draft a new rule that provides underwriters a safe harbor and shifts much of the liability to auditors and directors.[190] Underwriters cannot avoid all liability, but because they serve as "reputational intermediaries" in the shelf offering timeframe, they must possess the ability to rely on information gathered from auditors and directors without conducting traditional due diligence.[191] Market efficiency applies to companies with access to shelf registration, and thus an underwriter's reasonable investigation should consist of auditors' statements regarding the company's financial status.[192]

While the SEC serves to protect investors, there must be a due diligence system that is commensurate with a shelf offering's time constraints.[193] Unreasonable and inefficient due diligence requirements should not undo the benefits of shelf registration.[194] Without reasonable guidance, the potential exists to affect investors adversly and expose underwriters to excessive liability.[195] Failing to supply underwriters with efficient shelf offering guidelines compounds the problem because the industry's exigencies will outweigh potential legal liability.[196]

IV. CONCLUSION

Since the adoption of Rule 415, underwriters and the SEC have debated shelf registration's effects on due diligence. Increasing judicial scrutiny into the underwriter's role, such as the *WorldCom* decision, exposes the need for change in both underwriter practice and SEC governance. The underwriter's role in a timely offering demands rules that allow them to function both effectively and efficiently. As access to the market becomes quicker and more

189. *See supra* note 188 and accompanying text (discussing system of continuous due diligence). There has been a great deal of pushback against this idea, as issuers are unwilling to cooperate with a system of continuous due diligence and underwriters are unwilling to place themselves at a competitive disadvantage.

190. *Compare* Coffee, *Refco Meltdown*, *supra* note 13, at 23 (stating need for new safe harbor rule for underwriters), *with* Coffee, *Due Diligence*, *supra* note 8, at 5 (arguing safe harbor rule to protect underwriters results in auditors suffering only partial liability).

191. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 1 (setting forth underwriters' role in offering and purpose of timely offerings).

192. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 3-4 (discussing market efficiency as major reason for shelf registration).

193. *See* Brief of Sec. Indus. Ass'n, *supra* note 1, at 11-12 (stating underwriters need to have alternative method to traditional due diligence for shelf offerings).

194. *See supra* note 168 and accompanying text (arguing traditional due diligence will cause artificial delays in market access).

195. *See* Shelf Registration, *supra* note 4, at *5 (noting underwriter concerns and indicating purpose of shelf registration); COX, HILLMAN & LANGEVOORT, *supra* note 25, at 3-4 (discussing purpose behind securities regulations). *See generally* Brief of Sec. Indus. Ass'n, *supra* note 1 (outlining potential impact of traditional due diligence on shelf registration).

196. *See* O'Leary, *supra* note 9, at 2 (stating underwriter's business interests overshadow legal issues).

efficient, the SEC must address the fact that traditional due diligence requirements for shelf offerings are overly regulatory and unproductive. Juxtaposing the recent reforms that allow issuers almost instant access to the market with the traditional due diligence requirements for underwriters demonstrates the difficulty for underwriters to establish the due diligence defense.

At the adoption of shelf registration, the SEC noted that the change required underwriters to find a due diligence practice that would work in the context of such timely offerings. In the wake of *WorldCom* and other financial scandals, the SEC must adopt a safe harbor rule that allows underwriters to undertake shelf registration offerings with the confidence that they conducted a reasonable investigation and satisfied the due diligence requirement. The rule must contain provisions that delineate the underwriter's adversarial role in a timely offering. As issuers will not subject themselves to continuous due diligence, the rule must provide underwriters with reasonable guidelines for determining what constitutes a sufficient amount of continuous due diligence, such as a quarterly review. The rule must also allow underwriters the ability to rely on an independent auditor's statement regarding the interim financials of the company because, under time constraints, underwriters cannot be expected to re-audit the financials. While there is an argument that underwriters will pushback against regulations, the SEC must outline clear guidelines to prevent underwriters from passing the risk onto their clients and investors.

Until a rule provides a safe harbor for underwriters, traditional due diligence, as advocated by the SEC, applies to all offerings. As a result, underwriters of timely offerings must attempt to establish due diligence procedures that not only bear out the financial status of the issuer, but also those of the issuer's competitors. Stemming from the interpretation of red flags in *WorldCom*, underwriters must consider conducting their own audits of the issuer's financials, which places them at odds with the issuer's independent auditor. Following the financial scandals and the major settlements against investment banks, the cost of shelf registration due diligence will rise as banks develop the appropriate procedures and programs to satisfy the existing due diligence defense. Applying traditional due diligence in timely offerings undermines the purpose of shelf registration, thus the SEC must address this issue to allow underwriters to operate effectively in bringing issuers to the market.

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