THE IRREPRESSIBLE MYTHS OF *BARCHRIS*

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ABSTRACT

Nearly forty-five years after it was decided, Escott v. BarChris Construction Corp. *remains the landmark case on the due diligence defense under the Securities Act of 1933.*

BarChris *is universally understood to require that underwriters independently verify all material facts in the issuer's registration statement if independent verification is practicable. No judge or scholar has ever challenged this holding.* BarChris *also opined that an underwriter who markets the issuer's securities to the public must nonetheless take an adverse role to the issuer during due diligence. Courts have deemed underwriters well suited for this role, despite the obvious conflict; recent commentators have, with one notable exception, ignored this conflict.*

This Article analyzes both BarChris's *mandate that underwriters perform independent verification whenever practicable and* BarChris's *dictate that underwriters be impartial in due diligence. As it turns out, both are "irrepressible" myths – fundamentally flawed, but deeply entrenched in the jurisprudence.*

BarChris's *unyielding independent verification requirement was never correct, because sometimes it is reasonable to trust rather than verify.* BarChris's *demand that underwriters play "devil's advocate" to the issuer may have made sense years ago, but no longer – and particularly not for the global banks that underwrite securities for massive corporations. Underwriters today are mostly dependent "gatekeepers."*

As a result, the law of due diligence ought to change. So long as an underwriter concludes, after a reasonable investigation, that the issuer is objectively trustworthy or sufficiently solvent to cover a judgment under the Securities Act, the underwriter should not be required to check every

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material fact in the registration statement. What's more, courts ought to consider an underwriter's independence when assessing the reasonableness of its due diligence investigation. In some cases, regulators (or courts) should require that an independent underwriter be hired to perform due diligence. Yet, in many cases, unconflicted due diligence may not be worth the price.

> [U]nderwriters must make some reasonable attempt to verify the data submitted to them [by the issuer]. They may not rely solely on the company's officers . . . . A prudent man in the management of his own property would not rely on them.[1]

In a sense, the positions of the underwriter and the company's officers are adverse.[2]

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[1]Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968).
[2]*Id.* at 696.

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I. INTRODUCTION

Nearly forty-five years after it was decided, *Escott v. BarChris Construction Corp.*[3] remains the definitive decision on the due diligence defense under Section 11 of the Securities Act of 1933 ("Securities Act").[4] *BarChris* held that, in order to escape Section 11 liability, an underwriter must independently verify material facts in the offering document filed with the Securities and Exchange Commission ("SEC").[5] *BarChris* also opined that an underwriter must take an adversarial role to the issuer in due diligence.[6] Since *BarChris* was decided, no court has questioned either proposition.[7] Nor has any commentator doubted that underwriters must independently verify the issuer's material statements.[8] A few writers have suggested that underwriters are no longer well suited to play "devil's

[3]283 F. Supp. 643 (S.D.N.Y. 1968).

[4]Securities Act of 1933 § 11, 15 U.S.C. § 77k (2006); *see infra* note 94 and accompanying text (citing recent authorities describing *BarChris* as the "leading case" on due diligence).

[5]*See infra* Part III.A.1.

[6]*See infra* Part III.B.4.

[7]*See infra* Part III.A.2.

[8]*See infra* Part III.A.2.

advocate" to the issuer in due diligence,[9] but not one has urged that the underwriter who is hired by an issuer to market its securities is simply too dependent on the issuer to protect the investing public via due diligence.[10]

Upon reflection, both of *BarChris*'s holdings are fundamentally flawed.[11] Or, to put a finer point on it, one holding was never right[12] and the other no longer is.[13] They are just myths. Yet, left unchecked for decades, both myths are now deeply entrenched in the Section 11 jurisprudence.

This Article describes and dispels *BarChris*'s two "irrepressible" myths:[14] the "Myth of Independent Verification"[15] and the "Myth of Independent Underwriters."[16]

The *Myth of Independent Verification*: Under Section 11, an underwriter is strictly liable for material inaccuracies in the offering document (which is known as the "registration statement") unless the underwriter successfully raises the "due diligence defense."[17] This affirmative defense requires that an underwriter perform a "reasonable investigation" of the issuer.[18] The standard of reasonableness used to assess the adequacy of an underwriter's investigation is that of a prudent person in the management of her own money.[19] Such a person, *BarChris* held, would *independently* verify material (i.e., important)[20] factual statements the issuer makes in the registration statement.[21] Subsequent cases have applied this independent verification requirement to all material facts stated in the registration statement, regardless of the type of offering or type of issuer, so long as independent sources of verification are reasonably available to the underwriter.[22]

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[9]*See infra* Part III.B.7.

[10]*See infra* Parts III.A.2, V.A, V.B.2.

[11]*See infra* Parts IV.C,V.B.3.

[12]*See infra* Part IV.

[13]*See infra* Part V.

[14]With apologies to John Hart Ely, *The Irrepressible Myth of* Erie, 87 HARV. L. REV. 693 (1974).

[15]*See infra* Part IV.

[16]*See infra* Part V.

[17]*See infra* notes 60-63 and accompanying text.

[18]*See infra* notes 62-63 and accompanying text.

[19]*See infra* note 65 and accompanying text.

[20]*See infra* note 55.

[21]*See infra* Part III.A.1. To the *BarChris* court, "independent" verification meant that oral statements made by the issuer's management should be checked against the company's written records. *See infra* notes 130-33 and accompanying text. More recently, the term has been interpreted by experienced underwriters' counsel to mean that sources *outside* of the issuer must be consulted, if possible, to confirm the internal data. *See infra* Part III.A.3.

[22]*See infra* notes 269-80 and accompanying text.

However, it appears that no court or commentator has ever asked whether a prudent person investing in securities might, under some circumstances, *decline* to independently verify a material fact in the registration statement, even when sources of independent verification *are* readily available.[23] That is to say, no one has analyzed whether there are some circumstances in which even a prudent investor would conclude that there is simply *no need* for independent verification.

Yet, a little probing suggests that there are situations where the prudent person probably would *not* bother to independently verify a material statement of fact in the registration statement. Most likely, a prudent investor would not bother to perform her own investigation of the issuer's statements if (1) there were good, objective reasons for the investor to trust the issuer's statements in question;[24] or (2) the issuer had effectively warranted the statements.[25] Under such circumstances, a prudent investor probably would either simply (1) make sure that the issuer was objectively trustworthy;[26] or (2) independently verify whether the issuer could likely make good on its express warranty.[27]

These two conditions are present in many securities offerings today, because (1) underwriters often rely on an established relationship of trust with the issuer or the issuer's past history of truthful disclosure to the market (if the issuer is a public company), in deciding whether to participate in an offering in the first place; and (2) an issuer effectively warrants its statements to investors because it is strictly liable under Section 11 for material misstatements or omissions in the registration statement *and has no due diligence defense*.[28]

Thus, if we take the prudent person standard seriously, *BarChris*'s admonition is overbroad: sometimes independent verification is unnecessary, either because a prudent investor would trust the issuer or because (so long as the issuer reasonably seems to be solvent) the issuer *insures* the accuracy of the registration statement.[29]

For this reason, contrary to *BarChris*'s teaching, in many securities offerings, an underwriter ought *not* be required to independently verify all of the issuer's material statements in the registration statement, because a prudent person would not do so. Rather, for many of the issuer's statements,

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[23] *See infra* Part IV.C.
[24] *See infra* Part IV.C.1.i.
[25] *See infra* Part IV.C.2.i.
[26] *See infra* Part IV.C.1.ii.
[27] *See infra* Part IV.C.2.ii.
[28] *See infra* Parts IV.C.1.ii-2.i.
[29] *See infra* Parts IV.B-C. The same is true for *outside* verification. *See infra* Parts IV.B-C.

all that an underwriter should be required to do is: (1) confirm that the issuer is *objectively trustworthy* rather than just *subjectively trusted* (i.e., to confirm that its trust in the issuer is broadly shared by reasonable investors and investment professionals); or (2) make a reasonable, independent investigation of whether the issuer can satisfy a judgment under Section 11.[30]

The *Myth of Independent Underwriters:* In a public offering of securities, Section 11 forces an underwriter to play the role of "gatekeeper" or "reputational intermediary."[31] A gatekeeper's job is to deter wrongdoing by the issuer.[32] A reputational intermediary does this by performing verification or certification services for investors, thereby reducing their research costs.[33] The massive financial frauds of a decade ago led prominent scholars to propose increased regulation of gatekeepers.[34]

Yet, until recently, few scholars focused on gatekeepers' independence from the issuer or ramifications of a gatekeeper's dependence on the issuer.[35] Recent scholarship suggests that *independent* gatekeepers, like auditors, are better positioned to protect investors than *dependent* gatekeepers, like the issuer's counsel.[36] Furthermore, there should be little doubt that (most) underwriters are *dependent* gatekeepers.[37] An issuer is an underwriter's client; the issuer hires the underwriter and (unlike with regard to its auditor) may fire its underwriter without serious repercussions. Indeed, an underwriter's job is to *sell* the issuer's securities—and its story—to investors.[38]

If underwriters are inherently dependent gatekeepers, then the investment banks that underwrite the securities of the largest, most well-established issuers of securities are *particularly* dependent.[39] Such underwriters traditionally have longstanding business relationships with the

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[30]*See infra* Part IV.C.1.ii-2.i.

[31]*See infra* Part III.B.6.

[32]*See infra* Part III.B.6.

[33]*See infra* Part III.B.6.

[34]*See infra* Part V.B.4.

[35]*See infra* Part V.A. Eminent scholars who write about gatekeepers certainly are aware of the underwriter's basic conflict of interest (i.e., its dual role as marketer of securities for, and investigator of, the issuer). *See infra* Part V.B.4. Yet, it appears that no scholar has asked whether an underwriter's allegiance to the issuer ought to, in some cases, disqualify the underwriter from due diligence, or has argued that underwriters should be as independent as auditors. *See infra* Part V.B.4.

[36]*See generally* Arthur B. Laby, *Differentiating Gatekeepers*, 1 BROOK. J. CORP. FIN. & COM. L. 119, 123-34 (2006) (discussing the inherent differences between independent versus dependent gatekeepers). For a more in-depth discussion of Laby's analysis, see *infra* Part V.B.1.

[37]*See id.* at 132-34 (categorizing securities underwriters as dependent gatekeepers).

[38]*See infra* Part V.B.2.

[39]*See infra* Part V.B.2.

issuers they represent.[40] Moreover, the underwriters for the largest corporations are typically massive, "global banks" that provide many different types of services to their issuer clients – not just securities underwriting.[41] As such, by nature of its relationship with the issuer, a global bank underwriter is dependent upon the issuer for a substantial amount of business. An underwriter in such a position cannot be expected to be an effective "devil's advocate" to its issuer-client.[42] An auditor in this position certainly would not be deemed "independent," simply because it is subject to strict liability under Section 11 (subject, like an underwriter, to a due diligence defense).[43]

Yet, even though the underwriter who markets an issuer's securities may be too dependent on the issuer to adequately investigate the issuer, this error is not fatal to the Section 11 due diligence regime. Nothing in Section 11 requires that the underwriter who markets the issuer's securities perform the due diligence investigation on its own.[44] As such, a *different* underwriter that does not have a business relationship with the issuer could potentially function as an independent gatekeeper.[45] The broker-dealer industry's self-regulatory agency, the Financial Industry Regulatory Authority ("FINRA"), already has regulations in place that require the participation of a "qualified independent underwriter" in due diligence in limited circumstances where underwriters are deemed to have a "conflict of interest."[46] The definition of conflict of interest under these rules easily could, and should, be expanded. Either FINRA or the SEC ought to mandate that, in some circumstances, an issuer must hire an *unconflicted* underwriter to perform due diligence, just as it must hire an independent auditor.[47] Such a rule undoubtedly would reduce the structural bias in due diligence.

Absent a new SEC or FINRA rule expanding the definition of underwriter conflicts of interest, courts applying Section 11 should judicially impose an underwriter independence requirement.[48] Whenever an underwriter raises the due diligence defense, the court should consider, when evaluating the quality of the underwriter's due diligence, whether the

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[40] *See infra* Part V.B.2.

[41] *See* Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters' Continuous Due Diligence After* Worldcom, 30 CARDOZO L. REV. 2001, 2045-47 (2009).

[42] *See infra* Part V.B.3.

[43] *See infra* Part V.B.3.

[44] *See infra* note 266.

[45] *See infra* Part V.C.

[46] *See infra* Part V.C.

[47] *See infra* Part V.C.

[48] *See infra* Part V.D.

underwriter was so dependent on the issuer that its entire investigation was tainted.[49] Although implementing an independence requirement for underwriters on a case-by-case basis is fraught with peril, it is better than ignoring the issue of independence altogether.

Whichever way the new underwriter independence requirement is imposed—judicially or by SEC/FINRA rule—the new requirement will lead to additional costs for underwriters and issuers. Ultimately, investors will bear these costs. As a result, both regulators and courts addressing underwriter independence will be forced to decide whether (and under what circumstances) *unconflicted* due diligence is worth the price to investors.

In light of considerable scholarship suggesting that an underwriter's role as gatekeeper serves little purpose in follow-on offerings by large, well-established issuers,[50] this Article urges that due diligence by an independent underwriter ought to be required only for an initial public offering where the underwriter has an established relationship with the issuer that casts serious doubt on the underwriter's independence.[51]

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The remainder of this Article is organized into five parts and a brief conclusion. Part II provides the necessary background, describing Section 11 of the Securities Act, the due diligence defense, and the seminal *BarChris* decision. Part III details, from prologue to progeny, the two "irrepressible myths" that arose from *BarChris*. Parts IV and V dispel, in turn, the "Myth of Independent Verification" and the "Myth of Independent Underwriters." Part VI analyzes some of the ramifications of discrediting *BarChris*'s two myths, and proffers an opinion concerning the circumstances under which an independent underwriter ought to be required.

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[49] *See infra* Part V.D.
[50] *See infra* Parts III.B.2, III.B.7.
[51] *See infra* Part VI.B.

II. BACKGROUND: SECTION 11, THE DUE DILIGENCE DEFENSE AND *BARCHRIS*

A. *Underwriter Liability under Section 11*

1. Strict Liability with a "Due Diligence" Defense

Typically, the "underwriter"[52] for a public offering of securities is a syndicate of investment banks.[53] One or two prestigious investment banks typically serve as "lead" underwriter(s) to the syndicate, and perform most of the heavy lifting for the offering—including the due diligence.[54]

Under Section 11 of the Securities Act, underwriters are strictly liable for any material—i.e., important[55]—inaccuracies[56] in the "registration

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[52]As commonly understood, an underwriter organizes and facilitates an issuer's offering of securities to the public. *See* Leahy, *supra* note 41, at 2010. The Securities Act defines "underwriter" as "[a]ny 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." Securities Act of 1933 § 11, 15 U.S.C. § 77b(a)(11) (2006).

[53]Securities offerings in the United States are usually underwritten by a syndicate of investment banking firms. *See* CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS § 2.01, at 2-4 to 2-6 (4th ed. Supp. 2009). Today such banks typically are affiliates of large, international commercial banks. *See* George J. Papaioannou, *Commercial Banks in Underwriters and the Decline of the Independent Investment Bank Model*, 9 J. Int'l Bus. & L. 79, 80-82 (2010). These massive financial institutions, which provide "one-stop shopping" to their clients, are known as "global banks." *See* Leahy, *supra* note 41, at 2046. This is a recent phenomenon: Prior to 1987, the Glass-Steagall Act prohibited commercial banks from underwriting securities offerings; then, from 1987 to 1999, the Act allowed affiliates of commercial banks to perform some underwriting, but the amount of such business was limited. *See id.* at 2045-46 & nn. 252 & 253.

[54]*See* Leahy, *supra* note 41, at 2012-13.

[55]"Material" essentially means that the inaccurate information, if accurately disclosed, probably would have been important to a reasonable investor's decision to purchase the security. *See In re* Metro. Sec. Litig., 532 F. Supp. 2d 1260, 1290 (E.D. Wash. 2007) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)) ("A statement or omission is material if there is a 'substantial likelihood that the disclosure of the omitted [or misstated] fact would have been viewed by a [sic] reasonable investor as having significantly altered the total mix of information made available.'") (alteration in original).

[56]This Article uses the term "inaccuracy" to encompass both misstatements and actionable omissions. The actual phrasing of Section 11 is far more cumbersome. *See* 15 U.S.C. § 77k(a) (creating liability when a registration statement contains an "untrue statement of . . . fact or omitted to state a . . . fact required to be stated therein or necessary to make the statements therein not misleading"). The author recognizes that "inaccuracy" may not capture every nuance of the actual statutory language. For the purposes of this Article, however, the pithiness of "inaccuracy" more

statement"[57] that is filed with the SEC in connection with a public offering.[58] (An underwriter also faces similar liability as an "offeror" or "seller" of the issuer's securities under Section 12(a)(2) of the Securities Act.)[59]

However, Section 11 provides underwriters with an important affirmative defense,[60] known colloquially as the due diligence defense.[61] An underwriter is *not* liable for any part of the registration statement not made "on the authority of an expert"[62] if the underwriter establishes that it "had, after reasonable investigation, reasonable ground to believe and did believe" that there were no material inaccuracies in that part of the registration statement.[63] (Section 12(a)(2) provides for essentially the same defense[64] and as such, this Article will focus on Section 11.)

2. A "Reasonable" Investigation: What Would a "Prudent" Person Do?

In order to successfully assert the due diligence defense, an underwriter must show that it performed a diligent investigation of the issuer. But just *how* diligent? Section 11 tells us: the standard for assessing

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than makes up for any loss of precision that results from its use.

[57]The term "registration statement" refers to the documents that must be filed to register an offering of securities under Sections 5 and 6 of the Securities Act. 15 U.S.C. § 77b(a)(8). The key component of the registration statement is the "prospectus," which contains most of the information that the SEC requires to be disclosed in the registration statement. *See* Larry D. Soderquist, *Securities Act Registration Process*, *in* UNDERSTANDING THE SECURITIES LAWS 2005, at 206 (PLI Corp. Law & Practice, Course Handbook Series, No. B-1509, 2009).

[58]*See* 15 U.S.C. § 77k(a)(5).

[59]An "underwriter" under Section 11 will also qualify as an "offer[or]" or "sell[er]" of securities "by means of a prospectus" under Section 12(a)(2) of the Act. Section 12(a)(2) holds offerors and sellers of securities strictly liable for material inaccuracies in the prospectus subject to certain affirmative defenses. *See* 15 U.S.C. § 77l(a)(2); *infra* notes 62-63.

[60]*See* Leahy, *supra* note 41, at 2011.

[61]*See id.*

[62]Section 11 provides an additional affirmative defense, premised on reliance, for statements made by an expert or public official. *See* 15 U.S.C. §§ 77k(b)(3)(C)-(D). The reliance defense does not require an affirmative investigation. *See* Leahy, *supra* note 41, at 2011 n.50 (citing *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 663 (S.D.N.Y. 2004)). This Article does not address the reliance defense.

[63]15 U.S.C. § 77k(b)(3)(A). Section 11 also provides for three other affirmative defenses that apply in more limited factual circumstances. *See* 15 U.S.C. § 77k(b)(1) (affirmative defense for underwriter who resigns from offering and disavows registration statement); 15 U.S.C. § 77k(b)(2) (affirmative defense that registration statement became effective without underwriter's knowledge); 15 U.S.C. § 77k(a) (affirmative defense that plaintiff knew of the material inaccuracy in the registration statement at the time she purchased the security).

[64]Section 12(a)(2) provides offerors or sellers with an affirmative defense if they "did not know, and in the exercise of reasonable care could not have known" of the inaccuracies. 15 U.S.C. § 77l(2). Since this "reasonable care" defense probably is substantially similar to Section 11's due diligence defense, this Article follows the convention of lumping the two defenses together. *See* Leahy, *supra* note 41, at 2011-12.

whether the underwriter's actions and beliefs in the context of due diligence are "reasonable" is that of a "prudent man in the management of his own property."[65]

In order to satisfy this "prudent person" standard,[66] underwriters traditionally performed an *extensive* investigation of the issuer for *every* securities offering.[67] This included "a thorough and time-consuming review of the issuer's industry, its reputation and the reputation of its principal officers, the issuer's business, and its financial position (and the financial statements in particular)."[68] In connection with this investigation, underwriters consulted sources "both inside and outside of the issuer."[69] This investigation was particularly painstaking for a company's initial offering of securities to the public ("IPO"); the investigation for a "secondary" offering[70] of securities by an established public company was slightly less extensive, but was nonetheless substantial and time-consuming.[71]

However, the advent of new types of securities offerings—"shelf"-registered offerings in the early 1980s,[72] and more recently, "automatic" shelf-registered offerings[73]—has permitted some issuers to offer securities to the public far more quickly than before.[74] Traditional offerings lasted *weeks or even months*.[75] By contrast, today a shelf-registered offering

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[65]15 U.S.C. § 77k(c); *WorldCom*, 346 F. Supp. 2d at 663.

[66]"Originally called a prudent 'man' standard [under the Law of Trusts], it was renamed a prudent person standard during the 1970s to achieve gender-neutrality." 30 AMY MORRIS HESS, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS & TRUSTEES § 612, at 9-10 n.5 (3d ed. 2000) [hereinafter BOGERT'S TRUSTS]. Although Section 11 has not been similarly amended to achieve gender-neutrality, this Article will follow the Bogert treatise's lead and use the term "prudent person" throughout.

[67]*See* Leahy, *supra* note 41, at 2013-14 & nn.57-61 (summarizing several sources describing the scope of such extensive investigations and the rationale behind them).

[68]*Id.* at 2013-14 (footnotes omitted).

[69]*Id.* at 2014 (footnote omitted).

[70]A secondary securities offering is the issuance of shares of the company's stock after having already been offered to the public in an IPO. *See id.* at 2005 n.14.

[71]Leahy, *supra* note 41, at 2015.

[72]17 C.F.R. § 230.415 (2011). Shelf registration allows issuers to register securities (i.e., to place them "on a shelf") quickly, by permitting the issuer to file the basic offering documents in advance. Subsequently, the issuer can then issue the securities (i.e., to perform a "take down"), at any time. *See* Leahy, *supra* note 41, at 2015-16.

[73]For an explanation of "automatic" shelf registration, *see generally* Leahy, *supra* note 41, at 2036-37; *see also* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 195-96 (6th ed. 2009).

[74]*See* Leahy, *supra* note 41, at 2014-21 & 2036-39.

[75]*See* Merritt B. Fox, *Shelf Registration, Integrated Disclosure and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1025-26 (1984) [hereinafter Fox, *Shelf Registration*].

by an established public company known as a "seasoned issuer,"[76] or an "automatic" offering by a massive "well-known-seasoned issuer" ("WKSI")[77] can be completed in *days or even hours*.[78]

Offerings by seasoned and WKSI issuers also require far less underwriter involvement in drafting the registration statement than traditional offerings did. Historically, underwriters played a major role in drafting every aspect of the registration statement.[79] However, around the time that the SEC introduced shelf registration it also implemented the "integrated disclosure" system.[80] Integrated disclosure means that, instead of drafting a registration statement out of whole cloth, seasoned or WKSI issuers may incorporate information from their periodic public reports (e.g., 10Ks and 10Qs) into the registration statement simply by referring to those reports.[81] Thus, most company-specific information in a registration statement can be incorporated by reference from prior public filings; only new or updated information must actually appear in the registration statement.[82] Since underwriters do not typically participate in drafting an issuer's quarterly reports[83]—and since issuers are loathe to contradict their prior public filings[84]—integrated disclosure has greatly diminished

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[76]Leahy, *supra* note 41, at 2017 ("[T]here is little need for large, seasoned corporations to make the same disclosures in a lengthy registration statement that are already contained in the issuer's public filings.").

[77]*Id.* at 2037 n.209 (listing the requirements a public corporation must meet in order to qualify as a WKSI).

[78]*Id.* at 2037 ("When WKSI issuers file an 'automatic' registration, the company's registration becomes effective immediately. Hence, there is no waiting, and the WKSI can start offering the classes of securities listed in the 'automatic' registration immediately—and sell an unlimited number of those classes of securities, at any time in the next three years.") (footnotes omitted).

[79]*See* Fox, *Shelf Registration*, *supra* note 75, at 1025-26 n.61 (describing the underwriter's traditional duties when drafting the registration statement as being completed on a "line-by-line basis").

[80]*See id.* at 1025-26; Leahy, *supra* note 41, at 2016-18.

[81]*See* Leahy, *supra* note 41, at 2017.

[82]*Id.*; *see also* Eric Seitz, Comment, *Underwriter Due Diligence: "It's [Not] a Whole New Ballgame"*, 61 SMU L. REV. 1633, 1648 (2008) ("Normally, the only 'new' information contained in the registration statement pertains to details about the offering itself, the use of the proceeds, and any necessary updates on incorporated information.").

[83]*See* Leahy, *supra* note 41, at 2017-18; Seitz, *supra* note 82, at 1648; ROBERT J. HAFT & MICHELE H. HUDSON, Due Diligence-Per Rep & Sec Offer § 5:3 (2011).

[84]Correcting a prior public filing apparently is viewed by some issuers as inviting a lawsuit. *See* Bruce H. Schwartz, Note, *Conflicting Standards of Liability in Short Form Registration: The Underwriter's Dilemma*, 36 WASH. & LEE L. REV. 868, 878 (1979) (attributing "issuers' reluctance to correct, clarify or modify earlier disclosures" to "the issuer's concern that the subsequent disclosure may be viewed as an admission that the prior document was materially false or misleading," which "might subject [the issuer] to . . . liability" for securities fraud under the

underwriters' influence on the content of large issuers' registration statements.[85]

Due to the time pressure of shelf-registered offerings and an underwriter's diminished role in drafting the registration statement under integrated disclosure, underwriters typically (at least until the recent *WorldCom* decision)[86] performed different levels of due diligence for each type of offering: a detailed and time-consuming investigation for an IPO, and a quick and superficial investigation for a shelf-registered, secondary offering by a seasoned issuer.[87] As this author previously wrote in summarizing the analysis of many prior commentators:

> An IPO still provided plenty of time for due diligence; as a result, underwriters commonly conducted a great deal of due diligence for an IPO, including visits to the client's plants or factories, calls to customers and competitors, etc. On the other hand, a follow-on, shelf takedown offering by a seasoned issuer moved so fast that underwriters did little if any due diligence for such offerings. Often as not, there was time only for a brief "updating" phone call with the issuer.[88]

As a result, underwriters for the largest companies arguably have little, if any, impact on the information that the corporation discloses to the public in its registration statement.[89]

Exchange Act). As a result, underwriters often are "unable to persuade issuers to revise or change information previously filed with the SEC." Roberta S. Karmel, *Assessment of Shelf Registration: How Much Diligence is Due Investors?*, 3 YALE J. ON REG. 401, 405-06 (1986) (book review).

[85] Leahy, *supra* note 41, at 2017-18; Seitz, *supra* note 82, at 1648.

[86] *See In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004). *WorldCom* was the first judicial decision to address an underwriter's due diligence defense in the context of a shelf-registered offering. *See* Leahy, *supra* note 41, at 2035. Some commentators have suggested that *WorldCom* raised the bar for due diligence in such offerings. *See id.* at 2006 n.20 (citing one such article, written by practicing lawyers).

[87] *See* Leahy, *supra* note 41, at 2019-20. Presumably due diligence for "automatic shelf" offerings by WKSIs is no more extensive than for shelf-registered offerings generally.

[88] *Id.* (internal citations omitted).

[89] HAFT & HUDSON, *supra* note 83, § 5.3 (quoting Simon M. Lorne, *Due Diligence Procedures of Issuers' Representatives in the Modern Underwriting Environment*, *in* 24TH ANNUAL INST. ON SEC. REG., at 391 (PLI Corp. Law & Practice Course Handbook Series, No. B4-7017, 1992)) (internal quotation marks omitted) ("[I]t is unquestionable that in the modern environment underwriters are in fact less able than they once were to affect issuers' disclosures meaningfully.").

B. *The* BarChris *Decision: Bad Facts Make Hard Law*[90]

BarChris was the first published judicial decision to interpret the substance of the due diligence defense under Section 11.[91] Upon its announcement, *BarChris* was immediately hailed as a landmark decision,[92] and is still widely viewed (along with *Feit v. Leasco Data Processing Equipment Corp.*[93]) as the definitive decision concerning the scope of an underwriter's due diligence obligation.[94]

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[90]*See generally* Harry Heller et al., BarChris: *A Dialogue on a Bad Case Making Hard Law*, 57 GEO. L.J. 221 (1968); *accord* Louis Loss, *The Opinion,* 24 BUS. LAW. 527, 528 (1969) ("[I]t seems to me a plaintiff could not have wanted a case that was more open and shut on the facts as they were painted by the judge.").

[91]*See* Claude P. Bordwine, Jr., Comment, Escott v. BarChris*–A New Standard for Civil Liability Under Section 11 of the Securities Act of 1933*, 6 HOUS. L. REV. 312, 318 (1968-69) ("Rarely has any defendant attempted to use the Section 11 'due diligence defenses.' *Escott v. BarChris* is, therefore, the first case fully to explore the importance of Section 11 liabilities.") (footnote omitted); *see also* Mark A. Evans, *The Impact of* BarChris*: An Analysis of the Practical and Legal Implications of* Escott v. BarChris Construction Corp.*–Section 11 Revisited*, 21 S.C. L. REV. 687, 687 (1969); Ernest L. Folk, III, *Civil Liabilities Under the Federal Securities Acts: The* BarChris *Case*, 55 VA. L. REV. 1, 4 (1969).

However, the SEC's own view on "the responsibility of the underwriter" in due diligence was set forth in two earlier administrative decisions that did not involve Section 11 claims. *See* Heller et al., *supra* note 90, at 233-34 (discussing *In re* Charles E. Bailey & Co., 35 S.E.C. 33 (1953) and *In re* Richmond Corp., 41 S.E.C. 398 (1963)).

[92]*See* Comment, BarChris*: Easing the Burden of "Due Diligence" Under Section 11*, 117 U. PA. L. REV. 735, 735-36 (1969) [hereinafter *Easing the Burden*] (quoting sources describing *BarChris* as, *inter alia*, a "landmark case" and a "legal blockbuster"); *see also* Folk, *supra* note 91, at 4 n.3 (noting a source characterizing *BarChris* as a "Wall Street Bombshell").

[93]332 F. Supp. 544 (E.D.N.Y. 1971).

[94]*In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 674 (S.D.N.Y. 2004) (citing John C. Coffee, Jr., *A Statutory and Case Law Primer on Due Diligence Under the Federal Securities Law*, *in* CONDUCTING DUE DILIGENCE 1995, at 17 (PLI Corp. Law & Practice Course Handbook Series, No. B-1740, 1995)) ("While there is a paucity of caselaw, 'two early cases,' *Escott v. BarChris Construction Corp.* . . . and *Feit v. Leasco Data Processing Equipment Corp.* . . . , 'remain the major polestars' in defining what constitutes a reasonable investigation."); *accord* HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 1 GOING PUBLIC HANDBOOK § 3:57 (2012) ("*BarChris* is regarded by practitioners and courts as the seminal case defining the scope of the underwriter's due diligence obligation as to the non-expertised portion of the registration statement."); *see, e.g.*, William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 573 (2006) (stating that *BarChris* "continues to be recognized as a leading case on the reasonable investigation standard"); Joseph McLaughlin & Andrew W. Stern, *Remedies in Securities Transactions and Sellers' "Due Diligence" Defenses*, *in* CONDUCTING DUE DILIGENCE 2002, at 150 (PLI Corp. Law & Practice Course Handbook Series, No. B0-01B1, 2002) (describing *BarChris* as "still [being] the classic case"). More recently, some commentators have described the *WorldCom* opinion as an extremely important decision concerning underwriter due diligence. *See* Leahy, *supra* note 41, at 2034-35 (citing a compilation of sources). This author does not necessarily agree. *See id.* at 2071-72.

The plaintiffs in *BarChris* were the purchasers of subordinated debentures issued in a public offering by a corporation that built and sold bowling alleys.[95] The defendants were the issuer (which went bankrupt shortly after the offering in question), its inside and outside directors, its independent auditor, and the underwriters of its public offering.[96]

In *BarChris*, the allegations against the independent professionals (i.e., the auditors and the underwriters) were founded on negligence, not fraud. There was no allegation that any of these professionals *knew* about the numerous material inaccuracies relating to the BarChris corporation's financial condition in the registration statement.[97] Rather, the *BarChris* court was tasked with determining whether the defendants had established that they conducted a reasonable investigation of the now-bankrupt issuer.[98]

The underwriters' due diligence in *BarChris* was anything but thorough: a partner at the investment bank that served as lead underwriter "read reports and prospectuses of competitors and made general inquiries of BarChris's banks and factor," and "attended three meetings with BarChris's officers" at which "the BarChris officers gave deliberately false answers to questions concerning various statements in the prospectus later found to be misleading."[99] Yet, the lead underwriter accepted these answers at face value "without investigation."[100]

While reviewing internal documents at the issuer's headquarters, underwriters' counsel also discovered facts suggesting that some data in the issuer's financial statements was materially false. When confronted with these facts, the issuer rebuffed counsel's questions. Yet, the underwriters "accepted assurances from the company's officers without investigating further."[101] In sum, the underwriters' due diligence was both cursory and shoddy, and they ignored red flags that should have put them on notice that the registration statement was inaccurate in material respects.

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[95]Countless commentators have already summarized the pertinent facts of *BarChris*. This Article will not undertake to improve on those prior accounts. Instead, the following summary is derived from a fine student note. *See Easing the Burden*, *supra* note 92, at 736-38 (summarizing Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968)).

[96]*BarChris*, 283 F. Supp. at 643, 654 & n.5.

[97]*Id.* at 655.

[98]*Id.* at 683 (stating that every defendant, excluding BarChris, asserted the affirmative defense that a reasonable investigation was conducted, and therefore each defendant claimed and had the burden of proof of showing it was reasonable to believe and did so in fact believe that the registration statement was accurate and that no material fact was omitted).

[99]*Easing the Burden*, *supra* note 92, at 742.

[100]*Id.*

[101]*Id.*

III. *BARCHRIS* AND ITS TWO "IRREPRESSIBLE" MYTHS

A. *Independent Verification:* BarChris *Sets the Bar for Due Diligence*

1. "Some Reasonable Attempt to Verify"

In evaluating the aforementioned due diligence "efforts" by the underwriters, the *BarChris* court, per Judge Herman McLean, contemplated a critical threshold question: Is it a "reasonable investigation" by a "prudent person" to simply "ask questions, [and] to obtain answers which, if true, would be . . . satisfactory, and to let it go at that, without seeking to ascertain from the records whether the answers in fact are true and complete?"[102] The court answered its question thusly:

> [Allowing underwriters to escape their due diligence obligation] by taking at face value representations made to them by the company's management . . . affords the investors no additional protection. To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more . . . than the mere accurate reporting . . . of "data presented" to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters' participation . . . of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. *A prudent man in the management of his own property would not rely on them.*[103]

The court cited no authority whatsoever for this proposition.[104]

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[102] *BarChris*, 283 F. Supp. at 696.

[103] *Id.* at 697 (emphasis added).

[104] *See id.* However, leading up to this conclusion, the *BarChris* court cited to the two aforementioned SEC broker-dealer license revocation decisions, *In re* Charles E. Bailey & Co., 35 S.E.C. 33 (1953) and *In re* Richmond Corp., 41 S.E.C. 398 (1963), in which the SEC concluded that an underwriter cannot rely exclusively (or nearly exclusively) on the issuer's representations. *See BarChris*, 283 F. Supp. at 696 n.25. But neither decision dealt directly with Section 11, the due

2. The Rise of "Independent" Verification

Seizing on Judge McLean's strong language, commentators writing in the immediate aftermath of *BarChris* described the holding as requiring *independent* verification of the issuer's material statements in the registration statement.[105] For example, according to an oft-cited student note, the "basic lesson" of *BarChris* is that "a reasonable investigation cannot stop with the questioning of company officials but must include independent verification of their answers."[106] Thus, "[c]ross-examination of the issuer's officers . . . or belief in their truthfulness and reliability does not constitute a reasonable investigation," explained another student.[107] Rather, "an underwriter must go beyond and behind the representations of management."[108]

Indeed, *all* commentary at the time—scholarly articles,[109] bar journal and bar meeting presentations by lawyers,[110] and student notes[111]—described

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diligence defense, or the prudent person standard. *See* Comment, BarChris*: Due Diligence Refined*, 68 COLUM. L. REV. 1411, 1417-18 (1968) [hereinafter *Diligence Refined*]. In *Bailey & Co*., a broker revocation proceeding under Section 15(g) of the Exchange Act, the SEC merely stated without further explanation that the defendant's exclusive reliance on the issuer's representations "did not constitute discharge of the duty to exercise reasonable care that rested on registrant as underwriter." *Bailey & Co.*, 35 S.E.C. at 42.

In *Richmond Corp*., a stop order proceeding, the SEC simply concluded that the underwriter's near-exclusive reliance on the issuer's representations did not "measure up to the degree of care, reasonable under the circumstances, necessary for and required of an underwriter to satisfy himself as to the accuracy and adequacy of the representations in the prospectus." *Richmond Corp*., 41 S.E.C. at 405. In support of this conclusion, the SEC did refer to Section 11's reasonable investigation standard; however, the SEC made no attempt to explain why it was unreasonable to rely on management under the circumstances of that case (or any other case). *See id.* at 405-06. Instead, the SEC buttressed its argument by noting the "well established practice" of underwriters analyzing the issuer for their *own* business purposes. *Id.* at 406 & n.12.

[105] *See, e.g.*, Note, Escott v. BarChris: *"Reasonable Investigation" and Prospectus Liability Under Section 11 of the Securities Act of 1933*, 82 HARV. L. REV. 908, 910 (1969) [hereinafter *Reasonable Investigation*] ("The basic lesson of *BarChris* is that in most circumstances a reasonable investigation cannot stop with the questioning of company officials but must include independent verification of their answers.").

[106] *Id.* at 911. However, this student note did suggest the existence of some "possible exceptions," such as when facts are "difficult to verify." *Id.*

[107] Schwartz, *supra* note 84, at 876 n.45 (citing *BarChris*, 283 F. Supp. at 697).

[108] *BarChris*, 283 F. Supp. at 696 n.25; *accord* Theodore Warren Lenz, Note, *The Underwriter's Duty of "Due Diligence" Under Section 11 of the Securities Act: Reflections on* BarChris, 22 VAND. L. REV. 386, 403 (1969) (explaining that prior methods of verifying the registration statement—for example, "officers' and directors' questionnaires"—were "cast in doubt" by the *BarChris* decision because "Judge McLean indicated that dependence on the answers of the issuer is not satisfactory"); Symposium, *The* BarChris *Case: Prospectus Liability*, 24 BUS. LAW. 523, 668 [hereinafter *Prospectus Liability*] ("*BarChris* makes it clear that counsel [for the underwriter] cannot act simply as a scribe to record the statements of management.") (remarks of Harry Heller).

[109] *See, e.g.*, Folk, *supra* note 91, at 57 ("*BarChris* properly held that the participating underwriters, who made no independent investigation of their own, were bound by the lead

BarChris as requiring *independent* verification. And none questioned whether this was a correct interpretation of Section 11.[112]

A few years after *BarChris* was decided, another court was called upon to evaluate an underwriter's due diligence in *Feit v. Leasco Data Processing Equipment Corp.*[113] That case arose out of the acquisition of an insurance company by Leasco Data Processing Equipment Corporation ("Leasco") via an offer to exchange Leasco's shares for the insurance company's shares.[114] The registration statement in *Leasco* was materially inaccurate because it omitted any estimate of the insurance company's large amount of excess capital (known as "surplus surplus").[115]

In *Leasco*, the district court, per Judge Jack Weinstein, held that successful assertion of the due diligence defense under Section 11 required "independent verification" of material facts in the registration statement.[116] Quoting a student comment on *BarChris*, Judge Weinstein reasoned that an underwriter may "not merely . . . listen[] to management's explanations of the

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underwriter's failure to carry out his investigatory functions. Thus, the participating underwriters were liable both for the failure to conduct an investigation and for the lack of a reasonable belief—although they in fact believed—in the truth of the prospectus.") (footnote omitted).

[110]*See, e.g.*, Evans, *supra* note 91, at 730 ("Judge McLean . . . made it crystal clear that . . . no reliance could be placed on any of the representations of the issuer's officers. Thus, it is reasonable to assume that in order to follow the court's mandate a complete independent investigation must be made by the underwriters.") (footnote omitted); Dom H. Wyant & Robert W. Smith, BarChris*: A Revaluation of Prospectus Liability*?, 3 GA. L. REV. 122, 138-40 (1968).

[111]*See, e.g.*, Note, *Section 11 and Underwriter Liability: A Case of Statutory Misconstruction*, 7 RUTGERS-CAM L.J. 741, 745 (1976) [hereinafter *Statutory Misconstruction*] ("Reliance on management assertions and unquestioning belief in the accuracy of the financial statements presented to the underwriter is not sufficient."); *Diligence Refined*, *supra* note 104, at 1421 ("The duty of the underwriter, then, is not merely limited to listening to management's explanations of the company's affairs. Rather he must make an investigation reasonably calculated to reveal all of those facts which would be of interest to a reasonably prudent investor."); *Easing the Burden*, *supra* note 92, at 743 ("[T]he common theme that emerges [from *BarChris*] is that a Section 11 defendant must not accept management's representations without verification."); Recent Developments, Escott v. BarChris Construction Corporation: *Section 11 Strikes Back,* 21 STAN. L. REV. 171, 180 (1968) [hereinafter *Section 11 Strikes Back*] ("The key word in *BarChris* is verification.").

[112]One commentator in the immediate aftermath of *BarChris* criticized the court's holding that underwriters must independently verify financial data in unaudited financial statements included in the registration statement. Jack M. Whitney, II, *Underwriters' Counsel-Advice to My Client: "That Which is Impossible Must Go Away!"*, 24 BUS. LAW. 585, 587 (1969) ("The underwriter should not be expected . . . to go into the issuer's books of account to verify unaudited data. It is not an impossible assignment but it is certainly an unreasonable one!"). However, this commentator did not challenge the independent verification requirement generally. *See id.* at 587-89.

[113]332 F. Supp. 544 (E.D.N.Y. 1971).

[114]*Id.* at 549-51.

[115]*Id.* at 572.

[116]*Id.* at 582.

company's affairs."[117] Rather, the underwriter must perform an investigation that is "reasonably calculated to reveal those facts which would be of interest to a reasonably prudent investor."[118]

Ever since *BarChris* and *Leasco*, authors analyzing the due diligence defense have spoken with one voice about what constitutes a reasonable investigation. Some forty years later, courts[119] and commentators[120] still agree that Section 11 requires exactly what Judges McLean (in *BarChris*) and Weinstein (in *Leasco*) demanded of the underwriters: *independent* verification.[121] For example, Professor William Sjostrom writes that a "fundamental point" of *BarChris* is that a "lead underwriter may not simply rely on assurance by management, but must independently verify the accuracy . . . of the registration statement."[122] Further, Professor Robert Haft, in his treatise on due diligence, explains that the underwriters' "mistake in *BarChris*" was that "[m]anagement's statements should have been examined critically and verified through outside sources."[123] Similarly, prominent securities lawyer Joseph McLaughlin[124] describes *BarChris* as holding that

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[117] *Leasco*, 332 F. Supp. at 581 (quoting *Diligence Refined*, *supra* note 104, at 1421).

[118] *Id.* at 582 (quoting *Diligence Refined*, *supra* note 104, at 1421).

[119] *See* cases cited *infra* note 126.

[120] 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD § 13:11 (2d ed. 2011) ("The lessons of *BarChris* . . . with respect to . . . the 'reasonable investigation' standard . . . [is that] underwriters must make a reasonable attempt to independently verify information contained in the registration statement by a careful examination of records, documentation, and other independent sources."); BLOOMENTHAL & WOLFF, *supra* note 94, § 3:57 ("The underwriter's obligation under *BarChris* is to verify that which is reasonably verifiable . . . . The underwriter cannot accept factual representations of the issuer . . . without taking reasonable steps to verify that information . . . ."); DAVID A. LIPTON, 15 BROKER-DEALER REG. § 3:67 (2011) ("Underwriters cannot accept, without independent verification, information provided to them by company officers . . . . To satisfy their responsibilities, underwriters must conduct their own verification of the information in the registration statement.").

[121] *See* sources cited *supra* 120; *accord* ARNOLD S. JACOBS, 5 DISCLOSURE & REMEDIES UNDER THE SEC. LAWS § 3:58 (2012) ("A 'reasonable investigation' presupposes that the defendant does more than merely ask questions of management, notwithstanding the defendant's belief that the answers are truthful and reliable . . . . In other words, defendants must make some attempt to verify data the issuer submits to them.").

[122] Sjostrom, *supra* note 94, at 588. Professor Sjostrom later notes that this obligation "is not absolute," because courts have absolved underwriters from the independent verification requirement when such verification is essentially impossible, i.e., when the information to be verified is "solely in the possession of the issuer" where no third party can verify it. *Id.* at 588-89 (discussing *In re* Software Toolworks, Inc. Sec. Litig., 789 F. Supp. 1489 (N.D. Cal. 1992) and *In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615 (9th Cir. 1994)).

[123] HAFT & HUDSON, *supra* note 83, § 7.6.

[124] McLaughlin was co-chair of the Task Force on Sellers' Due Diligence & Similar Defenses under the Federal Securities Laws from 1989-92. SIDLEY AUSTIN LLP-OUR PEOPLE-JOSEPH MCLAUGHLIN, http://www.sidley.com/mclaughlin_joseph (last visited Jan. 30, 2012). McLaughlin also served as Chairman of the Federal Regulation Committee for the Securities

"it is not reasonable to rely on management for key data without double checking. The key is independent investigation."[125]

The few courts that have addressed an underwriter's due diligence under Section 11 also have uniformly concluded that underwriters must perform an independent investigation of the issuer.[126] For example, the *WorldCom* court opined that recent Section 11 case law "shows no signs of abandoning the early courts' demand that underwriters employ 'a high degree of care . . . and independent verification of the company's representations.'"[127]

However, to this author's knowledge, no court or commentator has *ever* pointed out that the *BarChris* court offered no support—no citation to any legal authority whatsoever—for its holding that a prudent person would (and therefore an underwriter must) *always* engage in independent verification.[128] Nor has this author found a single published article or decision that second-guesses Judge McLean and Judge Weinstein, simply by asking whether, in *some* circumstances, a prudent person might *not* bother to perform such verification.[129]

Industry Association ("SIA", now the Securities Industry and Financial Markets Association, "SIFMA"). *Id.*

[125]McLaughlin & Stern, *supra* note 94, at 150; *see also* Edward Greene, *Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System*, 56 NOTRE DAME L. REV. 755, 797 (1981) (noting McLaughlin's observation that the role of the underwriter has evolved into one that makes it harder to perform a reasonable investigation but nevertheless more likely to become involved in litigation).

[126] *See In re* HealthSouth Corp. Securities Litigation, 261 F.R.D. 616, 643-44 (N.D. Ala. 2009) (quoting *Leasco*, 332 F. Supp. at 582) ("Underwriters must 'exercise a high degree of care in . . . independent verification of the company's representations.'"); *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004) (quoting *Leasco*, 332 F. Supp. at 582); Glassman v. Computervision Corp., 90 F.3d 617, 628 (1st Cir. 1996) ("[I]t . . . may be a failure of due diligence to rely solely on management representations as to the state of the company where those representations can reasonably be verified."); *In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 625-26 (9th Cir. 1994) (concluding that the underwriters should not have solely relied on the issuer's assurances concerning its financial condition where the underwriters had access to relevant information to independently verify its status); Endo v. Albertine, 863 F. Supp. 708, 732 (N.D. Ill. 1994) (quoting *In re* Software Toolworks, Inc. Sec. Litig., 789 F. Supp. 1489, 1496 (N.D. Cal. 1992)) ("Underwriters may rely on management's [sic] representations when it is reasonable to do so under the circumstances. 'It would be unreasonable . . . to solely rely on management's representations when . . . [they] could have been reasonably verified.'").

[127]*In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004) (quoting *Leasco*, 332 F. Supp. at 582).

[128]One commentator *did* note Judge McLean's general failure to cite any legal authority in support of his application of the prudent person standard generally. *See Prospectus Liability*, *supra* note 108, at 622 ("Nowhere in the opinion . . . is there any reference to legal precedent . . . which establishes the standards of conduct of a prudent man in the handling of his own affairs.") (remarks of Kenneth J. Bialkin). However, this writer did not address this lack of precedent in the context of independent verification. *See id.* at 622-23.

[129]One early student comment on *BarChris* carefully analyzed the historical antecedents for Section 11's reasonableness standard and *BarChris*'s interpretation of that standard. *See* Bordwine,

3. "Independent" Comes to Mean "Outside"

In holding that underwriters must "independently" verify facts in the registration statement, the *BarChris* court clearly meant that *oral* statements by management should be checked against the company's own internal *documents*.[130] "The way to prevent mistakes," Judge McLean expounded, "is to test oral information by examining the original written record."[131] In *BarChris*, had this been done, the misrepresentations would have been discovered.[132] Accordingly, *BarChris* simply did not address whether, and to what extent, underwriters must look *outside* of the issuer for independent verification.

The *Leasco* court used the term "independent" verification to mean the same thing: checking management's *oral* statements by reference to internal *documents*. As Judge Weinstein reasoned:

> The key to reasonable investigation . . . [in *BarChris*] is independent verification of the registration statement by reference to original written records. The facts in *BarChris* revealed a consistent pattern of directors and underwriters who relied on the oral word of management regarding the accuracy of the registration statement. They made little, if any, effort to verify management's representations by reference to materials readily available such as corporate minutes, books, loan agreements, and various other corporate agreements.[133]

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supra note 91, at 321-22 (introducing a discussion on the fiduciary trust standard, English precedent, and corporate common-law as a basis for the *BarChris* reasonableness standard). This comment also engaged in a lengthy examination of the *BarChris* court's holdings concerning the reasonableness of a *director's* reliance on others, *id.* at 323-24, and a *director*'s due diligence investigation, *id.* at 326-28. With regard to directors, the student concluded that "*BarChris*'s interpretation of the investigation requirement is overly severe." *Id.* at 328. By contrast, this author turned a far less skeptical eye on *BarChris*'s application of the prudent person standard to an underwriter. *Id.* at 330-31. Instead, the comment simply opined that *BarChris*' holding with regard to the underwriters was "probably correct" because the lead underwriter's due diligence investigation was "shabby at best"—and concluded by repeating the *BarChris* court's mantra that an underwriter "cannot rely on information furnished by the issuer." *Id.* at 331 (citing *In re* Richmond Corp., 41 S.E.C. 398, 405 (1963)).

[130]Lenz, *supra* note 108, at 405 ("*BarChris* should stand for the proposition that, in so far as possible, suspicious facts must be checked against the original written record."); *Prospectus Liability*, *supra* note 108, at 667 ("What is required . . . is a checking against the company's records or other outside sources of material facts stated by the management to the extent that such facts are capable of external verification.") (remarks of Harry Heller).

[131]Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 690 (S.D.N.Y. 1968).

[132]Lenz, *supra* note 108, at 398.

[133]Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 576-77 (E.D.N.Y. 1971).

Understood this way, *BarChris*'s "independent verification" requirement (which caused an uproar among bankers)[134] was nothing new. Reviewing the issuer's internal documents was a well-accepted practice at the time.[135] The underwriters in *BarChris* just failed to take this basic step.[136]

Yet, since *BarChris* and *Leasco* were decided, the meaning of "independent verification" may have changed. Today, according to some experienced underwriters' counsel, "independent verification usually means referencing information *outside* the issuer."[137] This includes:

> [S]peaking with the issuer's customers, lenders, manufacturers, distributors, licensees . . . and reviewing news articles and industry publications regarding the issuer, its market and competition. The courts are favorably impressed by such palpable efforts to "cross-check" the issuer's representations.[138]

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[134] *See, e.g.*, *Easing the Burden*, *supra* note 92, at 736 (citing Felix Kessler, *Getting at the Truth: Court Decision Prods Prospectus Preparers to Check Facts Better*, WALL ST. J., May 14, 1968, at 1, col. 6).

[135] *See, e.g.*, *Prospectus Liability*, *supra* note 108, at 620 (describing *BarChris* as requiring "the obvious good sense of reading all corporate documents including minutes; having them read by a responsible attorney, of course, and the same with the company's contracts") (remarks of Graham L. Sterling, Jr.); *accord Prospectus Liability*, *supra* note 108, at 666 ("*BarChris* does not require anything more in my judgment than the investigatory practices now commonly carried out by counsel for the company and counsel for the underwriter.") (remarks of Harry Heller); Loss, *supra* note 90, at 527-28.

[136] *See, e.g.*, Comm. on Fed. Regulation of Sec., *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, 48 BUS. LAW. 1185, 1193 (1993) [hereinafter *Task Force Report*] ("*BarChris* involved a situation where a manageable amount of information was available for the asking, but no one asked."); *Prospectus Liability*, *supra* note 108, at 665-66 ("As I read [*BarChris*], it was not the investigatory processes commonly employed by counsel for the issuer or the underwriter which were at fault. What was at fault, basically, was the failure of counsel adequately to carry out the processes which all counsel normally use . . . . [I]n my judgment, if counsel had followed adequately the normal investigatory processes of counsel in the preparation of a Registration Statement these material facts would have been detected.") (remarks of Harry Heller).

[137] William F. Alderman, *Due Diligence In The Post-Enron Era: A Litigator's Practical Tips On Mitigating Underwriter Risk*, *in* CONDUCTING DUE DILIGENCE IN M&A AND SECURITIES OFFERINGS 2009, at 97 (PLI Corp. Law & Practice Course Handbook, Series No. B-1746, 2009) (emphasis in original); *see also* Julia K. Cowles, *Due Diligence For Securities Offerings: A Roadmap For Effective Document Review*, *in* CONDUCTING DUE DILIGENCE IN M&A AND SECURITIES OFFERINGS 2009, at 212 (PLI Corp. Law & Practice Course Handbook Series, No. B-1746, 2009) ("'Independent verification' refers to sources outside the issuer."). *But cf.* Alderman, *supra*, at 137 ("Independent verification can also be achieved, at least in part, by accessing information sources *within* the issuer itself.").

[138] Alderman, *supra* note 137, at 97; *see also* Cowles, *supra* note 137, at 212-13 (stating that "independent verification" by sources outside the issuer may include interviews "with third parties

Professor Haft, the underwriters' due diligence expert in the *WorldCom* litigation, agrees: a lesson of *BarChris,* he writes, is that an issuer's statements should be "verified through outside sources."[139] Recent decisions, in which courts were favorably impressed with the underwriter's outside verification attempts, provide support for the advice of these experienced counsels.[140]

Although no court has squarely held that "independent" verification necessarily means "outside" verification, plaintiffs' lawyers have so argued in the past[141] and presumably will do so again in the future. Thus, the view that "independent" verification requires consultation of sources *outside* the issuer seems to have substantial support among lawyers on both sides of the issue.

B. *Independent Underwriters:* BarChris *Crystalizes the Prevailing Sentiment*

History provides two different but related justifications for holding underwriters of a public offering strictly liable under Section 11 for material inaccuracies in the registration statement.[142] First, underwriters were widely

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such as customers, suppliers and other business partners" and the issuer's independent public accountants; receipt of an accountant's comfort letter; and review of documents that includes "corporate records; court documents; other public records; research reports, industry publications and news reports; representations made to third parties (such as regulators); consistency of statements made by employees across the organization; and observations made on visits to company premises").

[139] HAFT & HUDSON, *supra* note 83, § 7.6.

[140] *See* Alderman, *supra* note 137, at 97-98 (describing several cases where the courts concluded the underwriters conducted adequate due diligence defense in part because they had engaged in *outside* verification of the issuer's statements by, *inter alia*, speaking with customers of the issuer); *see also, e.g.*, Weinberger v. Jackson, 1990 WL 260676, at *3 (N.D. Cal. Oct. 11, 1990) (granting summary judgment for underwriters whose investigation included contacting "many of [the issuer's] suppliers, customers and distributors, who were asked extensive questions about the company's operations").

Of course, the defense bar's broad reading of *BarChris*'s independent verification requirement could be purely self-serving (since a more extensive investigation undoubtedly would require more lawyer time) or, less cynically, the result of defense lawyer overcaution.

[141] For example, plaintiffs in the *WorldCom* litigation regularly argued that the underwriters' failure to consult outside sources in verifying the registration statements at issue constituted a failure of independent verification. *See generally* Lead Plaintiff's Memorandum of Law in Opposition to the Underwriter-Related Defendants' Motion for Summary Judgment, *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp 2d 628 (S.D.N.Y. 2004) (No. 02 Civ. 3288), 2004 WL 2386818.

[142] Liability for underwriters *qua* underwriters was "a startling innovation" of the Securities Act. George J. Feldman, *The New Federal Securities Act*, 14 B.U. L. REV. 1, 12 (1934). Underwriters had, on occasion, been sued as sellers of securities under the common law, but simply being an underwriter did not in itself lead to liability. *See id.* As a result, underwriters were "accustomed to immunity" from suit even if they sponsored a largely worthless issue. *See id.* at 31-32.

believed to "sponsor" the securities.[143] Second, underwriters, as dealers, were required to deal fairly with the public under the "shingle theory."[144]

1. Underwriters as "Sponsors" of an Issuance of Securities

Around the time of the passage of the Securities Act (and even well before that),[145] the investment house that originated an issue of securities, i.e., the lead underwriter, was understood to "sponsor" those securities.[146] According to commentators of that day, investors looked to the lead underwriter's reputation, rather than to the issuing corporation's reputation, when deciding whether to purchase the issuer's securities in an offering.[147] As Professor Merrick Dodd explained in 1935:

> It has long been customary in this country, particularly in the case of the larger corporations, for prospectuses to be issued by investment bankers, commonly known as originating houses, rather than by the corporations themselves, and for the public to rely to a large extent upon the reputation of these

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[143] *See infra* Part III.B.1.

[144] *See infra* Part III.B.2.

[145] *See, e.g.*, ARTHUR STONE DEWING, CORPORATION FINANCE 74 (1922) (discussing, more than a decade prior to enactment of the Securities Act, the importance of the investment banker's reputation to purchasers of securities).

[146] *See* William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 201 (1933) (stating that originating houses—i.e. the lead or managing underwriter—"sponsors" the issuance of securities); *see also* E. Merrick Dodd, Jr., *Amending The Securities Act—The American Bar Association Committee's Proposals*, 45 YALE L.J. 199, 204 (1935) ("[A]n [underwriter's] . . . sponsorship of an issue may carry great weight with the public . . . ."); Bernard Flexner, *The Fight on the Securities Act*, THE ATLANTIC MONTHLY, Feb. 1934, at 246 (describing the originating underwriter as the "sponsor" of the security). This was particularly true for IPOs. *See* Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 713 (2005) ("Historically, taking a company public was the equivalent of receiving the Good Housekeeping Seal of Approval; not only was the company a success story, but Wall Street was vouching for its potential for all the investing public to see."). The legislative history of the Securities Act is also replete with references to underwriters as "sponsors" of an issuance of securities. *See, e.g.*, S. REP. NO. 73-1455, at 85, 89, 109, 112, 117, 123, 124, 164-67 (1934) [hereinafter denoted, as is customary, as the "Pecora Report"], *reprinted in* 5 J.S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 21 (1973); House Comm. on Interstate & Foreign Commerce, *Federal Supervision of Traffic in Investment Securities in Interstate Commerce*, H.R. REP. NO. 73-85, at 5 (1933) (underwriters "sponsor an issue"), *reprinted in* 3 ELLENBERGER & MAHAR, *supra*, Item 18.

[147] Dodd, *supra* note 146, at 203-04.

> bankers rather than upon that of the corporate management in purchasing securities.[148]

Having a reputable investment bank serve as lead underwriter was therefore viewed as critical to the success of any securities offering.[149] This was especially true for an IPO.[150]

As the sponsor of an issuance of securities, the lead underwriter also was quite literally responsible for the content of the offering document, or "prospectus."[151] As such, underwriters (or at least, their counsel) were heavily involved in drafting every aspect of the registration statement.[152]

In adopting Section 11 of the Act, Congress seems to have accepted the then-prevailing view that an underwriter's reputation was critical to an issuer's ability to sell its securities to the public.[153] The legislative history of the Act contains many references—both by Members of Congress and Congressional witnesses—to the importance of the underwriter's reputation in selling the issuer's securities.[154] For example, according to one

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[148] *Id.* at 203; *see also* Paul P. Gourrich, *Investment Banking Methods Prior to and Since the Securities Act of 1933*, 4 LAW & CONTEMP. PROBS. 44, 46-47 (1937) ("Th[e] [underwriter's initial] investigation [of the issuer] was of great importance because, of the reliance placed upon the name of the originating bankers and their judgment . . . by the buying public.").

[149] *See* Dana B. Klinges, Note, *Expanding the Liability of Managing Underwriters Under the Securities Act of 1933*, 53 FORDHAM L. REV. 1063, 1082-83 (1985). "[A]n investor may reasonably rely on the reputation of the managing underwriter in deciding to buy securities." *Id.* at 1082. "This reliance was probably a factor in the enactment of the Act itself." *Id.* at 1082 n.133 (citations omitted). *See also* Dodd, *supra* note 146, at 204 (stating that an underwriter's name on a prospectus "may carry great weight" with investors).

[150] *See* Thomas A. Halleran & John N. Calderwood, *Effect of Federal Regulation on Distribution of and Trading in Securities*, 28 GEO. WASH. L. REV. 86, 89 (1959) ("Origination of an issue has always carried with it the implied endorsement by the originating banker of the financial integrity of the issuer and the merits of the security."); Klinges, *supra* note 149, at 1082-83 ("The inclusion of a highly respected investment banking firm's name at the top of a . . . list of underwriters increases the credibility of an issuer previously unknown to the public.") (footnote omitted).

[151] *See* Jennifer O'Hare, *Institutional Investors, Registration Rights, and the Specter of Liability Under Section 11 of the Securities Act of 1933*, 1996 WIS. L. REV. 217, 253-54. Underwriters generally have the right to "sign off" on the content of the registration statement before it goes effective. *Id.* Typically, the underwriting agreement allows an underwriter to walk away from the offering if it is not satisfied with the disclosure contained the registration statement. *Id.* at 253-55. Yet, whether underwriters actually have the independence to walk away from their issuer clients is a separate question. *See* Laby, *supra* note 36, at 132-34 (describing underwriters as dependent gatekeepers who rely heavily on the issuer for different facets of its own business).

[152] *See* Leahy, *supra* note 41, at 2005.

[153] *See* Klinges, *supra* note 149, at 1082 n.133 (citing 77 CONG. REC. 2929 (1933) (statement of Rep. Pettengill)) (noting that the small investor predominantly relies on the knowledge and judgment of the investment banker to gauge the security's quality).

[154] *See generally* John H. Walsh, *A Simple Code of Ethics: A History of the Moral Purpose*

Representative, simply placing the name of a reputable investment bank on the prospectus was sufficient to instill "confidence in the public" about that particular security.[155] Another Representative, quoting Justice Brandeis, urged that the "small investor relies almost exclusively upon the [investment] banker for his . . . judgment as to the quality of the security."[156] Further, witnesses (mainly bankers) testifying during the hearings held in connection with the Pecora Investigation frequently opined that an investment banker's reputation was vital to his ability to sell securities to the public.[157] In light of the underwriter's critical importance to an offering, the framers of the Securities Act concluded that underwriters should be strictly liable for any material inaccuracies in the registration statement, avoiding liability only if it could show that it had diligently investigated the issuer.[158]

Forty years later, in the epoch of *BarChris*, the view that the originating firm "sponsored" an issuance of securities still held great sway among courts and commentators.[159] Writing shortly after the *BarChris*

Inspiring Federal Regulation of the Securities Industry, 29 HOFSTRA L. REV. 1015, 1043-44 (2001) (quoting the remarks of members of both the House and Senate regarding the importance of an underwriter's reputation).

[155] *Id.* at 1043 (quoting 77 CONG. REC. 2930 (1933) (statement of Rep. McFadden)). By the same token, many members of Congress criticized the banks for "sell[ing] out" their reputations for an "immediate gain" as a major cause of the financial crisis that resulted in the Great Depression. *See id.* at 1019, 1042-44 (footnotes omitted).

[156] 77 CONG. REC. 2929 (1933) (statement of Rep. Pettengill) (quoting Louis D. Brandeis, Other People's Money and How the Bankers Use It 102 (1914), *available at* http://www.law.louisville.edu/library/collections/brandeis/node/191)), *reprinted in* 1 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at Item 7 (1973).

[157] *See*, *e.g.*, *Securities Act: Hearings Before the Comm. on Banking and Currency on S.875,* 73rd. Cong. 295-96, 301, 304 (1934) (statement of Penn Harvey, investment banker) (explaining that a reputation for honesty is critical to an investment banker's success and ability to sell securities to the public), *reprinted in* 2 ELLENBERGER & MAHAR, *supra* note 146, Item 21; *Stock Exchange Practices: Hearings Before the Banking and Currency Comm. on S. Res. 84*, 73rd Cong. 7077, 7080-81 (1934) (statement of Oliver J. Troster, investment banker); Pecora Report, *supra* note 146, at 117 (stating that a banker's advice is "greatly valued by the investor who has come to rely upon the tried and tested thoroughness and competence of experienced and highly reputed bankers to protect the interests of the investing public in respect of not only the intrinsic goodness of a security for which they become sponsors"). A banker must "stand behind the securities for which he is recognized as sponsor, just as it is his duty and to his own self-interest to satisfy himself by careful investigation as to the soundness of such securities, because the banker whose clients suffer loss through following his advice will very soon lose his reputation and the confidence and patronage of his clients." Pecora Report, *supra* note 146, at 117

[158] *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696 (S.D.N.Y. 1968) ("The underwriters say that the prospectus is the company's prospectus . . . . But the Securities Act makes no such distinction. The underwriters are just as responsible as the company if the prospectus is false. And prospective investors rely upon the reputation of the underwriters in deciding whether to purchase the securities."); Walsh, *supra* note 154, at 1046 ("The moral purpose animating this duty of investigation, now known as 'due diligence,' can be seen in the provision's legislative history.").

[159] *See Task Force Report*, *supra* note 136, at 1199 ("The premise of the 1933 Act—that the underwriter was a 'sponsor' of the issue, and . . . had a major influence on the contents of an issuer's

decision, Professor Ernest Folk urged that "underwriters vouch for the quality of the issuer" and that "the standing of the underwriter probably influences many investors."[160] As a result, Professor Folk opined, an underwriter's reputation "is staked on each issue it underwrites" and protecting that reputation thorough due diligence is critical.[161] Just a few years later, the Second Circuit opined that: "No greater reliance . . . is placed on any single participant in the issuance of securities than upon the underwriter. . . . Prospective investors look to the underwriter . . . to pass on the soundness of the security and the correctness of the registration statement."[162] Hence, at the time *BarChris* was decided (and probably until the advent of shelf registration),[163] underwriters undoubtedly still sponsored an offering.

2. Due Diligence as a Variation on the "Shingle Theory"

A variation on "shingle theory" provides a second rationale for the underwriter's due diligence defense.[164] According to the shingle theory, an underwriter, like any other securities dealer, has a duty to its customers even if the dealer is not strictly acting as a broker (i.e., as an agent) for the customers.[165] Under this theory, a dealer makes certain implied

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registration statement—remained valid for many years after 1933. Underwriters had an important voice [in the] . . . due diligence effort. The prospectus was a primary source of information about most issuers . . . . Rating agencies had relatively little influence. . . . The name of a prominent underwriter on the cover page of the prospectus was looked upon as a seal of approval.").

[160]Folk, *supra* note 91, at 54.

[161]*See id*.

[162]Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 370 (2d Cir. 1973) (citing *Reasonable Investigation*, *supra* note 105, at 908). *See also* Sanders v. John Nuveen & Co., 524 F.2d 1064, 1070 (7th Cir. 1975) ("[T]he public relies on the integrity, independence and expertise of the underwriter.") (footnote omitted), *vacated*, 425 U.S. 929 (1976).

[163]Certainly the SEC viewed underwriters as "sponsors" of an offering at least until the early 1980s. *See* Greene, *supra* note 125, at 771-72 (including that the then Director of SEC's Division of Corporate Finance, opining, albeit in a personal capacity, that "[t]he Commission staff believes that by associating his name with an offering as an underwriter, the underwriter 'sponsors' the offering and . . . makes an implied representation that he has investigated the affairs of the issuer"). Perhaps it still does.

[164]*See Task Force Report*, *supra* note 136, at 1198-99 (discussing how the court in the *In re Richmond Corp.* opinion characterized due diligence as a "variation" on the shingle theory); *see also* Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1275-76 (1995) (stating that, among the "variations" on the "shingle theory," is the theory that "[b]ecause a broker-dealer impliedly represents that he has a reasonable basis for investment recommendations, it is a breach of duty to fail to investigate the securities that he recommends for sale").

[165]2 LOUIS LOSS ET AL., FUNDAMENTALS OF SECURITIES REGULATION 1422-23 (6th ed. 2011) (describing the implied representations a broker-dealer makes merely by virtue of being a broker-dealer, stating that "even a dealer at arm's length implicitly represents when he or she hangs out a shingle that he or she will deal fairly with the public"); *see also* Karmel, *supra* note 164, at

representations to its clients simply by going into business and offering its services to the public.[166] For example, by selling securities, a dealer makes implied recommendations that, *inter alia*, the securities are suitable for the customer and that the dealer has an adequate basis for this recommendation.[167] As applied to underwriters, the theory similarly holds that, by participating in an offering, the underwriter implicitly recommends the securities being offered and also implies that it has an adequate basis for this recommendation.[168]

Over the years the SEC has often successfully pursued dealers for defrauding their customers under the shingle theory.[169] The theory apparently postdates enactment of the Securities Act, but not by much: The SEC first employed the theory against broker-dealers as early as 1939 in an administrative proceeding.[170] The underwriter variation of the theory also predates *BarChris*.[171] As early as 1963, in *In re Richmond Corp.*,[172] the SEC explained that:

> By associating himself with a proposed offering, an underwriter impliedly represents that he has made such an investigation in accordance with professional standards. Investors properly rely

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1273, 1275-76 (discussing the consequences a broker-dealer could face for violating the implied representations inherent in the shingle theory).

[166] *See* 14B GUY P. LANDER, U.S. SECURITIES LAW FOR INT'L FIN. TRANSACTIONS AND CAPITAL MARKETS § 13:160, at 13-297 (rev. 2d ed. 2010) ("When a broker-dealer opens its business (i.e., hangs out a shingle) it implicitly represents that it will deal fairly with the public."); 25 MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRAC. FED. & STATE ENFORCEMENT § 2:29 (2011) ("[T]he 'shingle' theory . . . . provides that a broker-dealer, by hanging out its shingle, impliedly represents that its conduct . . . will be fair . . . .").

[167] *See* 14B LANDER, *supra* note 166, § 13:160, at 13-297 to -298; 25 STEINBERG & FERRARA, *supra* note 166, § 2:29.

[168] *Task Force Report*, *supra* note 136, at 1198 (citing Municipal Securities Disclosure, Exchange Act Release No. 26,100 [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84, 326, at 89,454 (Sept. 22, 1988)).

[169] 25 STEINBERG & FERRARA, *supra* note 166, § 2:29 ("In many of the cases alleging 'fraud,' the SEC has traditionally relied upon the 'shingle' theory."); *see, e.g.*, 14B LANDER, *supra* note 166, § 13:160, at 13-299 to -300 (discussing Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), where the court opined it was fraud for a broker-dealer to sell securities to a customer without divulging that the sale price did not reflect the then-current market price).

[170] *See* Louis Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 518 (1948). The SEC first employed the theory in *In re Duker & Duker*, 6 S.E.C. 386 (1939). *See* Loss, *supra*, at 518. The theory was later affirmed by the Second Circuit in Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943). *See* Loss, *supra*, at 518; *see also* Alexander Hamilton Frey, *Federal Regulation of the Over-The-Counter Securities Market*, 106 U. PA. L. REV. 1, 40 (1957). For a thorough history of the shingle theory, *see* LOSS ET AL., *supra* note 165, at 1420-31.

[171] *Compare In re* Richmond Corp., 41 S.E.C. 398 (1963), *with* Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

[172] 41 S.E.C. 398 (1963).

> on this added protection . . . . The underwriter who does not make a reasonable investigation is derelict in his responsibilities to deal fairly with the investing public.[173]

Courts during this era also invoked the shingle theory to justify the underwriter's due diligence obligation.[174] For example, in 1973 the Second Circuit expounded the view that:

> An underwriter by participating in an offering constructively represents that statements made in the registration materials are complete and accurate. The investing public properly relies upon the underwriter to check the accuracy of the statements and the soundness of the offer; when the underwriter does not speak out, the investor reasonably assumes that there are no undisclosed material deficiencies. The representations in the registration statement are those of the underwriter as much as they are those of the issuer.[175]

Scholars of that day also employed the theory to explain the underwriter's due diligence requirement. For example, Professor Folk wrote in 1969 that "the commonly accepted norms of the investment community imply that the underwriter regards the issue as suitable for public ownership, that the underwriter has assured itself that the issuer meets the firm's standards."[176]

Hence, at the time *BarChris* was decided, the "shingle theory" was regularly invoked as a complimentary reason for an underwriter's due diligence obligation.

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[173] *Id.* at 406.

[174] *See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 370 (2d Cir. 1973); Univ. Hill Found. v. Goldman, Sachs & Co., 422 F. Supp. 879, 898-99 (S.D.N.Y. 1976). This theory was also proposed as recently as 2010, but due to the SEC's untimeliness in raising the theory of liability, the en banc court considered the theory waived. SEC. v. Tambone, 597 F.3d 436, 450 (1st Cir. 2010) (en banc).

[175] *Chris-Craft Indus.*, 480 F.2d at 370; *see also* Sanders v. John Nuveen & Co., Inc., 524 F.2d 1064, 1069-70 (7th Cir. 1975) ("[T]he relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security. . . . [S]ince the underwriter is . . . aware of the nature of the public's reliance on his participation in the . . . [offering,] the mere fact that he has underwritten it is an implied representation that he has met the standards of his profession in his investigation of the issuer.") (citations omitted), *vacated*, 425 U.S. 929 (1976).

[176] Folk, *supra* note 91, at 54 (footnotes omitted); *see also* Evans, *supra* note 91, at 729 ("An underwriter, by lending his name and his reputation to the offering, solicits from the public reliance and trust. By his involvement the implication arises that an investigation has been made by the underwriter, an investigation sufficient to satisfy the underwriter as to the integrity and honesty of the issuer and as to the accuracy and adequacy of the prospectus.").

3. Before *BarChris*: An Implication of Independence

Underlying the "sponsor" theory is a critical, yet implicit assumption: *underwriters are independent from the issuer.* Such independence is not inherent in the underwriter-issuer relationship, because issuers hire underwriters and underwriters are therefore in theory dependent on issuers for business.[177] Instead, this implication of independence arose because underwriters were understood to be in the stronger position of the two parties in any given offering. According to the sponsor theory, the underwriter's reputation and imprimatur is critical to the success of an offering.[178] By contrast, the economics of underwriting traditionally were such that the business from any specific offering was not particularly important to the underwriter.[179] As a result, an issuer needed an underwriter to market its securities more than the underwriter needed the business of that particular issuer.[180]

Due to the underwriter's strong economic position, it had substantial leverage in due diligence and the issuer "had a strong incentive to cooperate."[181] An underwriter had the "ultimate weapon" up its sleeve: "a threat to withdraw" from the offering, which would likely tank the entire offering.[182] Underwriters were therefore "in a position to dictate policy to the issuer" and had a great deal of input on the content of the registration statement.[183] The underwriter's "leverage . . . to compel the issuer to fulfill its

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[177]Of course, the same could be said about auditors, who are hired by their corporate clients. However, unlike underwriters, who by definition sell securities on behalf of their issuer clients, auditors are "subject to strict rules preventing them from simultaneously providing auditing services and other services that may be seen to impair the auditor's independence of judgment." Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV 1583, 1598 (2010).

[178]*See supra* Part III.B.1.

[179]*See infra* notes 223-24 and accompanying text.

[180]*See, e.g.*, O'Hare, *supra* note 151, at 254-55 (explaining that underwriters traditionally had "tremendous" leverage over issuers because issuers depended on underwriters to market their securities and an underwriter would not do so "until it [was] satisfied with the registration statement"); Helen S. Scott, *Resurrecting Indemnification: Contribution Clauses in Underwriting Agreements*, 61 N.Y.U. L. REV. 223, 242 (1986) (explaining that due to the prestige that an underwriter lends to an offering, it has "unrivaled leverage over the issuer").

[181]*Task Force Report*, *supra* note 136, at 1199; *accord* Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 786 (1972) ("The managing underwriter occupies a position with respect to the issuer which is . . . not without clout, because withdrawal of the manager may effectively eliminate the chances of a successful offering. The managing underwriter can, and frequently does, use its position to compel disclosure of embarrassing facts uncovered during the course of its investigation.") (footnotes omitted); *see also* O'Hare, *supra* note 151, at 254-55; Scott, *supra* note 180, at 242.

[182]Folk, *supra* note 91, at 81.

[183]Feldman, *supra* note 142, at 12.

disclosure duties" to the investor was a key reason that *BarChris* imposed "a rigorous . . . degree of investigation upon underwriters."[184]

4. *BarChris:* Explicitly Pitting Underwriters Against Issuers

The *BarChris* case did not squarely present the question of whether and to what extent an underwriter of securities must be independent from the issuer of those securities. Nonetheless, the court addressed the issue in passing, stating that "[i]n a sense, the positions of the underwriter and the company's officers are adverse."[185] In so doing, the court evoked the underwriter-as-sponsor theory, reasoning that "prospective investors rely upon the reputation of the underwriters in deciding whether to purchase the securities."[186]

Academics quickly picked up on *BarChris*'s exhortation that underwriters must take an adversarial position to issuers. Notwithstanding Judge McLean's caveat "in a sense,"[187] one scholar wrote that the court had "made it crystal clear that the underwriters' position was adverse to the issuer."[188] Other scholars largely agreed.[189] Among them, a student writer's

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[184]MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW § 7.04, at 217 (5th ed. 2009).

[185]Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696 (S.D.N.Y. 1968). The *BarChris* court did not explicitly discuss the underwriter's adverse role in terms of independence, nor did it expand on exactly how adverse an underwriter must be. *See id.* at 696-97.

[186]*Id.* at 696.

[187]*Id.*

[188]Evans, *supra* note 91, at 730.

[189]*See* Folk, *supra* note 91, at 54-56; Clifton A. Lake, Comment, Escott v. BarChris*: How Much Diligence is Due?*, 17 U. KAN. L. REV. 651, 658 (1969) ("Only an essentially adversarial investigation by the underwriters will achieve the further increment of protection sought . . . by the separate provision for underwriter liability.").

One writer questioned this view, wondering whether Judge McLean "was suggesting that the relationship between the issuer and the underwriter is naturally adverse or whether he was indicating he felt it *should* be adverse." Comment, *The Expanding Liability of Securities Underwriters: From* BarChris *to* Globus, 1969 DUKE L.J. 1191, 1202 n.48 [hereinafter *Expanding Liability*]. This writer recognized the inherent conflict of interest in the court's position, because it arguably "fail[ed] to consider a strong common interest of the [underwriter and issuer] in the success of the offering, which may become dominant as the preparation nears completion." *Id.* Nevertheless, this student deemed the conflict "academic," because the unique "position of the underwriter . . . both permits and necessitates that the underwriter assume the role of skeptic . . . ." *Id.* Writing with hindsight unavailable to this student, *see infra* Part III.B.7, the underwriter's conflict of interest appears far less "academic."

Another early commentator opined that an underwriter's relationship with an issuer is not necessarily adversarial once a registration statement has been filed. *See Securities Regulation – Section 11 Liability – Directors, Underwriters, and Accountants Held Liable for Failure to Use Due Diligence in Preparing Registration Statement*, 43 N.Y.U. L. Rev. 1030, 1034 (1968) (allowing that an underwriter and issuer "may" be adversaries "when the underwriter makes its

account was the most catchy, urging that an underwriter should "play the devil's advocate" to the issuer in due diligence.[190]

The *BarChris* court offered little support for its assertion that underwriters must take an adversarial position to issuers. The court did not explain the link between its allusion to the sponsor theory and the underwriter's supposedly "adverse" position. Students and scholars filled in the gap using both the sponsor and shingle theories. For example, the student who first wrote that an underwriter must play devil's advocate in due diligence urged that an "underwriter sells not merely his services, but also his reputation."[191] Hence, "the use of an underwriter's name on the prospectus is an indication that he has investigated the statements made therein and has endorsed them."[192] The underwriter's important role in the offering, this student urged, left it "free to assume an adverse role" that was "not inconsistent with the underwriter-client relationship."[193]

Professor Folk heartily agreed with this argument. An "underwriter is uniquely able to adopt an . . . adverse posture towards the issuer regarding the accuracy of the registration statement," he wrote.[194] Indeed, Professor Folk saw "no reason why there should be the slightest reluctance for underwriters to press and probe the issuer, even to the point of rudeness."[195]

Like the *BarChris* court, none of these early commentators actually used the word "independent" to describe the underwriter's position *vis-à-vis* the issuer. Yet, by accepting Judge McLean's command that an underwriter must be "adverse" to the issuer,[196] and by invoking either the sponsor or shingle theory, all of these commentators implicitly wrote of independence.[197] Left unstated in each article written in the immediate aftermath of *BarChris* was the same assumption: only an underwriter that is *truly independent* of the issuer is in a position to be "adverse." Some degree of independence is necessarily the other side of the "devil's advocate" coin.[198]

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initial decision to undertake the issue," but opining that "by the time of the filing of the registration statement, the underwriter and the issuer have a common interest in selling the issue and in facilitating the registration procedure"). However, this commentator did not explore this issue any further. *See id.* (summarily concluding that Section 11's standard for due diligence remains the same whether an underwriter is an adversary or a fiduciary of the issuer).

[190] *Diligence Refined*, *supra* note 104, at 1420.

[191] *Id.* at 1417-18 (citing C. Israels & G. Duff, When Corporations Go Public 45-46 (1962)).

[192] *Id.* at 1418.

[193] *Id.* at 1420-21; *see also* Lake, *supra* note 189, at 665 ("The underwriter, unlike the director, because of his objectivity is in a far better position to ferret out unattractive facts or information from a recalcitrant management.").

[194] Folk, *supra* note 91, at 56.

[195] *Id.*

[196] Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696 (S.D.N.Y. 1968).

[197] *See supra* notes 187-95 and accompanying text.

[198] *Cf.* Fox, *Shelf Registration*, *supra* note 75, at 1006 n.5 ("There are good reasons to

5. *Leasco:* Underwriters as "Devil's Advocates"

A few years after *BarChris* was decided, in *Leasco*, Judge Weinstein adopted the term "devil's advocate" to describe the role that *BarChris* had imposed on underwriters.[199] Citing *BarChris* and quoting the aforementioned student note, Judge Weinstein wrote that an underwriter must "'not merely . . . listen[] to management's explanations of the company's affairs' . . . .' Tacit reliance on management assertions is unacceptable; the underwriters must play devil's advocate."[200]

According to the *Leasco* court, the underwriter's ability to take an adversarial posture with regard to the issuer, along with the importance of the underwriter's reputation to the success of the offering, was good reason to set the bar for an underwriter's due diligence high:

> [C]ourts must be particularly scrupulous in examining the conduct of underwriters since they are supposed to assume an opposing posture with respect to management. The average investor probably assumes that some issuers will lie, but he probably has somewhat more confidence in the average level of morality of an underwriter who has established a reputation for fair dealing.[201]

Ever since *Leasco* was decided, scores of students,[202] academics,[203] practitioners,[204] and judges[205] have used the term "devil's advocate" to

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believe that [Section 11's] imposition of liability results in the underwriter, because of its independence, playing a somewhat adverse or 'devil's advocate' role in the drafting of the registration statement.").

[199] Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 581-82 (E.D.N.Y. 1971) (quoting and citing *Diligence Refined*, *supra* note 104, at 1417-18, 1421).

[200] *Id.*

[201] *Id.* at 581.

[202] *See, e.g.*, *Statutory Misconstruction*, *supra* note 111, at 745 (citing *Leasco*, 332 F. Supp. at 581) ("In order to satisfactorily fulfill his statutory duty the underwriter must assume an adversary stance with respect to the management of the issuer.").

[203] *See, e.g.*, Stephen P. Ferris et al., *An Analysis and Recommendation for Prestigious Underwriter Participation in IPOs*, 17 J. CORP. L. 581, 583 (1992) ("The Securities Act was based on the premise that an underwriter is in a unique relationship with the issuer and can act as the devil's advocate to pressure the issuer for adequate and truthful disclosure.").

[204] *See, e.g.*, HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 10 INT'L CAP. MARKETS & SEC. REG. § 14:37 ("*BarChris* and [*Leasco*] require the underwriters to play the role of devil's advocate."); Alderman, *supra* note 137, at 101 ("[Underwriters] must play devil's advocate and question representations made to them. . . . Digging/probing is expected.") (citations omitted); LIPTON, *supra* 120, § 3.67 (citing Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696 (S.D.N.Y. 1968)) ("The positions of an underwriter and officers of the issuer are 'adverse.'"); McLaughlin & Stern, *supra* note 94, at 150 ("[D]ue diligence requires some degree of suspicion,

articulate *BarChris*'s requirement that an underwriter must take an adverse position to the issuer. This is "independence" by another name.[206]

6. Underwriter as "Gatekeeper"

In the 1980s, scholars developed the term "gatekeeper" to describe the role that Congress had envisioned for underwriters when it enacted Section 11. According to the classic article on gatekeeping by Professors Ronald Gilson and Reinier Kraakman, a gatekeeper's job is to deter corporate wrongdoing.[207] One type of gatekeeper, the "reputational intermediary," helps to deter corporate wrongdoing by providing "verification and certification services to investors."[208] In theory, "gatekeepers are *independent*

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some form of 'devil's advocacy.'").

[205] *See, e.g.*, *In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 626 (9th Cir. 1994) (quoting *Leasco*, 332 F. Supp. at 582); *In re* HealthSouth Corp. Sec. Litig., 261 F.R.D. 616, 643-44 (N.D. Ala. 2009) (quoting *Leasco*, 332 F. Supp. at 581-82); *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 675-76 (S.D.N.Y. 2004) (quoting *Leasco*, 332 F. Supp. at 582); *see also In re* Gap Stores Sec. Litig., 79 F.R.D. 283, 300 n.19 (N.D. Cal. 1978) (stating that underwriters should take an "adverse posture" to the issuer in due diligence) (quoting Folk, *supra* note 91, at 54-56).

[206] Of course, the term "devil's advocate" probably does not, in itself, connote the same formal, economic separation from the issuer as the term "independent" when used to describe other gatekeepers (e.g., "independent" auditors). Yet, the "sponsor" theory, from which the term "devil's advocate" derives, was based in large part on the assumption that underwriters are not economically dependent on any particular issuer. *See infra* Part III.B.1.

[207] Ronald J. Gilson, *The Devolution of the Legal Profession*, 49 MD. L. REV. 869, 882-84 (1990); Reinier H. Kraakman, *Corporate Liability Strategies and the Cost of Legal Controls*, 93 YALE L.J. 857, 890-92 (1984); *see also* Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323, 327 (2007) (citing Gilson, *supra*, at 883) ("Gatekeepers work with an enterprise to correct misreporting before it occurs."); Tuch, *supra* note 177, at 1589 ("[Kraakman] conceived of gatekeepers as occupying a position within the larger legal framework and regarded liability as a mechanism to ensure the optimal deterrence of corporate wrongs.").

[208] John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1405 (2002) [hereinafter Coffee, *About the Gatekeepers*]; John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 302 n.1, 308 nn.13-14 (2004) [hereinafter Coffee, *Challenge of Fashioning Reforms*]. Another definition of gatekeeper is "one who is 'positioned at a critical point in the flow of events' where approval is needed before a transaction can close." Laby, *supra* note 36, at 122-23 (quoting GEOFFREY C. HAZARD JR. & ANGELO DONDI, LEGAL ETHICS: A COMPARATIVE STUDY 201 (2004)); *see also* Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. ECON. & ORG. 53, 53 (1986) (stating that gatekeepers are those who can "disrupt misconduct by withholding their cooperation from wrongdoers"); JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2 (2006) [hereinafter COFFEE, PROFESSIONS AND CORPORATE GOVERNANCE] (offering two definitions of "gatekeeper": the first, "a professional who is positioned so as to be able to prevent wrongdoing by withholding necessary cooperation" and "a second and superior definition . . . is an agent who acts as a reputational intermediary to assure investors as to the quality of the 'signal' sent by the corporate issuer . . . by lending or 'pledging' its reputational capital to the corporation, thus enabling investors or the market to rely on the corporation's own disclosures or assurances where they otherwise might not"). For a

professionals who are positioned that, if they withhold their consent [or] approval . . . the corporation may be unable to effect some transaction . . . .[209]

Under Section 11, underwriters are paradigmatic "gatekeepers."[210] The underwriter's role in a securities offering is to protect public investors from material inaccuracies in the registration statement.[211] As a reputational intermediary, the underwriter "rents the issuer its reputation": it "represents to the market . . . that it has evaluated the issuer's product and good faith and that it is prepared to stake its reputation" on it.[212] The more prestigious the underwriter, the better the certification.[213]

To its proponents, the gatekeeper role is "particularly important" for IPOs.[214] By contrast, the role is "less important" when investors can easily obtain information about an issuer and its securities, such as "where they purchase investment-grade debt securities of a reporting issuer."[215]

In theory, a reputational intermediary will carefully protect its most important asset—its reputation.[216] Supposedly, an underwriter will prefer to burnish its reputation for bringing good issues to market by performing thorough due diligence in every offering.[217] Due to the damage that could

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detailed explication of the theory of gatekeeping, *see id.* at 1-10.

[209]John C. Coffee, Jr., *The Attorney As Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1297 (2003) [hereinafter Coffee, *An Agenda for the SEC*] (emphasis added).

[210]*See* Coffee, *Challenge of Fashioning Reforms*, *supra* note 208, at 309 (allowing that an underwriter in an IPO is "probably" a gatekeeper, in that "its reputation is implicitly pledged and it is expected to perform due diligence services."); Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45, 58 (2000).

[211]Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968) ("The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus."); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 581 (E.D.N.Y. 1971) (quoting *Diligence Refined*, *supra* note 104, at 1421) (internal quotation marks omitted) ("[T]he underwriter is the only participant in the registration process who, as to matters not certified by the accountant, is able to make the kind of investigation which will protect the purchasing public.").

[212]Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984); *see also* John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1169 (1995) (noting that by associating itself with a securities offering, "a high prestige underwriter places its 'seal of approval' on the offering . . . . [it] pledges its reputational capital and thereby becomes a reputational intermediary").

[213]Ferris et al., *supra* note 203, at 587.

[214]Gilson & Kraakman, *supra* note 212, at 618.

[215]*Task Force Report*, *supra* note 136, at 1231.

[216]*See, e.g.*, Gilson & Kraakman, *supra* note 212, at 620.

[217]*See* O'Hare, *supra* note 151, at 255-56 ("If a[n] . . . underwriter has a reputation for selling 'good' securities, i.e., securities that appreciate in value, the public will be eager to invest in . . . [its] next offering. On the other hand, if [the underwriter sells] . . . securities that depreciate in value, it may be difficult for . . . [it] to sell its next offering. . . . To safeguard its reputation, the . . . underwriter wants to ensure the quality of the securities to be offered. Before the . . .

result to its reputation from having its name associated with an issuer whose stock tanks after the offering,[218] an underwriter supposedly has no incentive to be less thorough or "look the other way" to please any particular issuer.[219] Therefore, an underwriter's loyalties are supposed to lie with investors generally, not with any particular issuer.[220] Indeed, the SEC has explicitly described underwriters (albeit in passing) as "independent gatekeepers."[221]

Until recently, many commentators "seem[ed] persuaded" by these reputational arguments both as to gatekeepers generally and underwriters specifically.[222]

7. Economic Changes Undermine the Sponsor Theory

The view that underwriters had leverage over issuers, not vice versa, was dependent on certain assumptions about the economics of securities underwriting. Up until the time of *BarChris*, it was widely believed that the underwriting business was not very competitive, and was sufficiently lucrative so that underwriters could feel comfortable saying no to issuers if

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underwriter agrees to underwrite an offering, it will undertake an extensive review of the issuer. . . . The . . . underwriter's concern with its reputation leads it to conduct a thorough investigation of the issuer."); *see also* Seitz, *supra* note 82, at 1641 (stating that a gatekeeper under the "accountability" theory will not stake its reputation on the an issue to further the goals of a client); A. Arthur Davis & Donald J. Brown, *Developments Under Federal Securities Laws—* BarChris *and* Globus, 54 IOWA L. REV. 1038, 1045 (1969) (stating that *BarChris* reaffirmed that the underwriter, in buying and selling the security, is putting his name and net worth on the line).

[218] *See, e.g.*, Mitu Gulati, *When Corporate Managers Fear a Good Thing is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. Rev. 675, 710 (1999) (asserting that underwriters who are "negligent in their due diligence" are "subject to both to legal liability and reputational costs").

[219] *See* Coffee, *Challenge of Fashioning Reforms*, *supra* note 208, at 309-10 ("[T]he professional gatekeeper essentially . . . vouches for the corporate client's own statements about itself. . . . [T]he gatekeeper has a lesser incentive to deceive than does its client. . . . [T]he gatekeeper's relative credibility stems from the fact that it in effect pledges a reputational capital that it has built up over many years of performing similar services for numerous clients. In theory, the gatekeeper as an entity would not rationally sacrifice its reputational capital for a single client or a modest fee."). For what Professor Coffee has aptly called "a strong (and probably overstrong)" endorsement of this view (albeit with regard to an auditor rather than an underwriter), Coffee, *An Agenda for the SEC, supra* note 209, at 1298, *see* DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) (Easterbrook, J.).

[220] *See* Gilson & Kraakman, *supra* note 212, at 618.

[221] *See Securities Act Concepts and Their Effects on Capital Formation*, Sec. Act Release No. 33-7314, 61 Fed. Reg. 40,044, 40,048 (July 25, 1996) ("The civil liability provisions of the Securities Act . . . provide strong incentives for certain parties independent of the issuer (such as underwriters . . .) to take steps to ensure the quality of disclosure."); *id.* at 40,049 ("Can the independent 'gatekeepers' role be reconfigured in order to facilitate the issuer's ability to access the capital markets quickly while maintaining or enhancing investor protection?").

[222] Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 496 n.12 (2001) (citing Gulati, *supra* note 218, at 711).

the underwriters were not satisfied with the disclosure in the registration statement.[223] As Professor Folk explained:

> [Underwriters] have great flexibility and discretion regarding the final acceptance of an issue. . . . Moreover, the industry structure is not . . . so competitive, if it be such at all, that underwriters need fear being undercut by less scrupulous brethren. Indeed, an issuer's shopping around among underwriters is likely to be ineffective.[224]

All this changed after the early 1980s. At that time, the new integrated disclosure regime "permitted reporting companies to incorporate by reference their . . . 1934 Act reports into the registration statement" and shelf registration sped up the pace of offerings for seasoned issuers.[225] At the same time, economic changes wreaked havoc on the underwriting business, particularly with regard to shelf-registered debt offerings.[226] Issuers began to use "bid-like procedures" to shop offerings around, which purportedly "transformed shelf underwriting into a transaction-oriented business as opposed to a relationship-oriented business."[227] This led to "fierce" competition among underwriters,[228] and underwriting shelf-registered debt offerings became far less profitable.[229]

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[223] *See, e.g.*, Folk, *supra* note 91, at 81 ("The underwriter's ultimate weapon is a threat to withdraw from the issue—a strong threat if it comes from the lead underwriter, and one likely to hurt the issuer's chances of successfully marketing an issue."); O'Hare, *supra* note 151, at 254-55 (stating that underwriters traditionally had "a tremendous" amount of leverage over the issuer" because the issuer depended on the underwriter to market its securities, and the underwriter would not sell the securities "until it [was] satisfied with the registration statement"); Scott, *supra* note 180, at 242 (explaining that due to the prestige that an underwriter lends to an offering, the underwriter has "unrivaled leverage over the issuer").

[224] Folk, *supra* note 91, at 55; *see also supra* notes 179-85 and accompanying text.

[225] *Task Force Report*, *supra* note 136, at 1200.

[226] *See* Christian A. Young, Note, *Looking Back on* Worldcom*: Addressing Underwriters' Due Diligence in Shelf Registration Offerings and the Need for Reform*, 40 SUFFOLK U. L. REV. 521, 536 (2007) ("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. Such competition has impacted the underwriters' ability to conduct due diligence . . . . ") (footnote omitted).

[227] *Task Force Report*, *supra* note 136, at 1220.

[228] *Id.*

[229] *Id.* at 1200, 1210 ("Severe competition among underwriters led to a shrinkage in underwriting compensation. . . . Especially for investment-grade corporate debt securities . . . underwriters' spreads have contrasted sharply."); *see also* Lynn Nicholas, *The Integrated Disclosure System and Its Impact Upon Underwriters' Due Diligence: Will Investors Be Protected?*, 11 SEC. REG. L.J. 3, 24-25 (1983) (stating that, due to the newly incorporated competitiveness between underwriting firms, the long-standing relationship between issuer and underwriter is now the

The business also became "commoditized," in that investment grade debt securities were sold based largely "on the basis of name, rating, and yield," with the "investment-grade" certification by a supposedly independent and professional rating agency pushing underwriters into the background.[230] All this "negate[d] any reliance by investors on the underwriter's 'sponsorship' of the new issue," concluded an influential ABA Task Force on underwriters' due diligence in 1993. The result: investors came to rely "more heavily on rating agencies than underwriters."[231]

Consequentially, the Task Force concluded, issuers had "little incentive to cooperate with any one underwriter who raise[d] a disclosure concern or who insist[ed] on its 'standard' documentation or closing conditions."[232] These changes caused underwriters to have a "substantially reduced level of influence" on the issuer's disclosure documents, and as a result underwriters came to "function[] less as a trusted adviser and more as a trader."[233] In short, for shelf-registered investment grade offerings, the Task Force opined:

> [T]he underwriter is no longer a true "sponsor" of the issuer or its securities and . . . has a much diminished ability to obtain and verify relevant information and to influence an issuer's disclosure. . . . [In such offerings,] the underwriter's role as a "reputational intermediary" is less important to . . . investors.[234]

Prominent scholars concur.[235] In the past decade and a half, several scholars have concluded that, at least for shelf-registered debt offerings, an underwriter may no longer function as an important gatekeeper or reputational intermediary. For example, Professor John Coffee has observed that: "it is not clear that the underwriter today still performs the classic gatekeeping function" in shelf-registered offerings.[236] Further, Professor

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exception, not the norm); Nicholas Wolfson, *Investment Banking*, *in* ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS 369-70 (1980) (describing, in 1980, the then-recent phenomena of increased competition among underwriters). *But see* Hurt, *supra* note 146, at 726 & 726 n.68 (citing authors who have suggested that the market for underwriting "is not truly competitive").

[230] *Task Force Report*, *supra* note 136, at 1234.

[231] *Id.*

[232] *Id.* at 1220.

[233] *Id.*

[234] *Task Force Report*, *supra* note 136, at 1188, 1231. In such offerings, according to the Task Force, "if the investor is relying on anyone as a 'reputational intermediary' it is more likely to be the rating agency than the underwriter." *Id.* at 1231.

[235] *See, e.g.*, John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1211 (1997).

[236] *Id.*

Donald Langevoort has remarked that an underwriter's gatekeeping role in securities offerings had "diminishe[d] in significance."[237] Indeed, Professor Frank Partnoy has questioned "whether the underwriter's 'due diligence' role is justified at all."[238]

The reduced importance of the underwriter's sponsorship of an issuance, and the corresponding reduction in the underwriter's influence on the content of the registration statement, inevitably call into question the underwriter's ability to take an adversarial position to the issuer in due diligence. As one student note sagely observed, the aforementioned changes have "altered . . . the balance of power . . . between issuers and underwriters:"[239]

> A more competitive market for underwriting services has taken away much of the leverage which investment bankers traditionally held over issuers. The investment banker is not in the position to play devil's advocate for the market in shelf offerings. Nor does the underwriter have the time to exercise its leverage, if this power still exists. The ability and the necessity of getting to the market in a matter of hours combine with a lack of control over the issue to preclude the underwriter from performing any meaningful investigation.[240]

As a result, some commentators have urged that the underwriter's due diligence obligation should be eliminated for shelf-registered offerings.[241] According to these writers, the benefits stemming from due diligence in shelf-registered offerings do not outweigh the costs from an investor's

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[237] Langevoort, *supra* note 210, at 67.

[238] Partnoy, *supra* note 222, at 522; *see also id.* at 503 ("[G]atekeepers are more valuable in markets where investors perceive that issuers are of lower quality.").

[239] David M. Green, Comment, *Due Diligence Under Rule 415: Is the Insurance Worth the Premium?*, 38 EMORY L.J. 793, 825 (1989).

[240] *Id.*; *see also* Seitz, *supra* note 82, at 1639 (stating that, in theory, an underwriter "wields tremendous power" in that it can refuse to close an offering, but, in reality, an underwriter "rarely uses this arrow in its quiver . . . because of the competitive environment in which underwriters operate"); Leahy, *supra* note 41, at 2006 ("Offering-time due diligence simply cannot occur when an offering proceeds in no time at all.").

[241] *See* Langevoort, *supra* note 210, at 62-63 (questioning the need for, and cost efficacy of, Section 11 due diligence in light of integrated disclosure and shelf registration); *see generally* Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984) (explaining that underwriter due diligence in shelf-registered offerings is redundant and costly and that sufficient risk mitigating techniques exist to effectively diminish company-specific risks).

perspective.[242] However, these commentators appear to agree that due diligence remains valuable for an IPO.[243]

8. *WorldCom* Court to Underwriters: "Tough Luck"!

Despite the underwriter's declining influence over the issuer—and the end, perhaps, of underwriters' sponsorship of securities offerings—courts have refused to recognize any change to an underwriter's role in due diligence.[244] Rather, courts continue to treat underwriters as reputational intermediaries, and continue to invoke the sponsor theory as a basis for holding underwriters liable for the content of the registration statement.[245] For example, Judge Melinda Harmon recently employed the sponsor theory in the Enron securities litigation, reasoning that underwriters have a "heightened duty" to investigate the issuer because "underwriters invest the offering with their credibility, their reputation, their integrity, their independence, and their expertise, upon which the public relies."[246] A few years earlier, in *WorldCom*—the first case to discuss due diligence in the context of a shelf-registered debt offering—Judge Denise Cote also invoked the sponsor theory in the process of denying summary judgment to the underwriters.[247] Judge Cote reasoned that:

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[242]Green, *supra* note 239, at 825 ("[T]he cost of retaining the due diligence under current market conditions far outweighs the benefits associated with underwriter investigation."); *accord* Banoff, *supra* note 241, at 183 ("Due diligence, except perhaps for new issuers or novel securities, does not increase investor welfare by more than its cost.").

[243]*See* Langevoort, *supra* note 210, at 60 n.82 ("In an IPO, due diligence has a broader purpose assuring that the nature of the issuer's business and its attendant risks are effectively communicated to investors. Given that issuer's management has little experience in disclosure, outside certification plays an important role. . . ."); *see also* Banoff, *supra* note 241, at 183 (recognizing that due diligence may be worth the cost "for new issuers").

[244]Seitz, *supra* note 82, at 1658 (quoting Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 370 (2d Cir. 1973)) ("Despite [the changes that have occurred to the underwriter market,] the notion that 'no greater reliance . . . is placed on any single participant . . . than upon the underwriter' . . . has remained static . . . ."); JOHN C. COFFEE, JOEL SELIGMAN & HILLARY A. SALE, SECURITIES REGULATION: CASES & MATERIALS 154 (10th ed. 2006) ("[T]he old statutory norms requiring underwriters . . . to conduct a 'reasonable investigation' appear still to apply in court when an offering turns sour, but these rules are no longer observed in practice because, under the pressure of expedited time schedules, underwriters appear unable to perform due diligence.").

[245]*See In re* Enron Corp. Sec., Derivative & ERISA Litig., 610 F. Supp. 2d 600, 626 (S.D. Tex. 2009).

[246]*Id.*; *see also* SEC v. Tambone, 597 F.3d 436, 461 (1st Cir. 2010) (Lipez, J., dissenting in part) (quoting Dolphin and Bradbury, Inc. v. SEC, 512 F.3d 634, 640-41 (D.C. Cir. 2008)) ("These precedents reflect the unique position of underwriters as securities insiders whose role is 'that of a trail guide—not a mere hiking companion,' and who are relied upon by investors for their 'reputation, integrity, independence, and expertise.'").

[247]*See In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 661-62 (S.D.N.Y. 2004).

> Congress recognized that underwriters occupied a unique position that enabled them to discover and compel disclosure of essential facts about the offering . . . [and] imposed upon underwriters the obligation to exercise diligence of a type commensurate with the confidence, both as to integrity and competence, placed in them by those purchasing securities.[248]

The court so reasoned despite that it was explicitly cognizant of the changes described in the preceding section.[249] Judge Cote simply concluded that, regardless of changes in the economics of underwriting, Section 11 had not changed at all—and the law is the law.[250]

To the extent that courts follow *WorldCom*, they will continue to view Section 11's due diligence through the lens of *BarChris* and *Leasco*—and the sponsor theory in particular—even for shelf-registered offerings. Thus, courts will continue to require that underwriters play the same role in due diligence as they did in 1933 and 1968. This role, as we will see in Part V, is not realistic in the current environment.[251]

9. Last Theory Standing: Implications of the Shingle Theory

Although the continuing viability of the sponsor theory is in doubt, the shingle theory still supports imposing a due diligence obligation on underwriters. However, the shingle theory may support a distinctly different due diligence requirement than the sponsor theory.

As explained previously, the sponsor theory arose as a consequence of an underwriter's leverage over the issuer in due diligence.[252] This theory held that the underwriter was well positioned to ask tough questions of the issuer

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[248] *Id.* at 662 (quoting *The Regulation of Securities Offerings*, Securities Act Release No. 7606A, 63 Fed. Reg. 67174, at 67230, *available at* 1998 WL 833389 (Dec. 4, 1998); H.R. REP. NO. 73-152, at 277, *available at* 1933 WL 98 (1933)) (internal quotation marks omitted). The *WorldCom* court also invoked the shingle theory. *See id.* at 662-63 (quoting *In re* Richmond Corp., 41 S.E.C. 398, 406 (1963)) (internal quotation marks omitted) ("By associating himself with a proposed offering [an underwriter] impliedly represents that he has made such an investigation in accordance with professional standards. . . . The underwriter who does not make a reasonable investigation is derelict in his responsibilities to deal fairly with the investigating public.").

[249] *Id.* at 670-71 (noting that "academics and practitioners . . . have asserted that . . . underwriter liability under Section 11 no longer makes sense" and discussing the arguments made by academics, including Professors Coffee, Langevoort and Partnoy, and practitioners).

[250] *Id.* at 671.

[251] *See infra* Parts IV, V, VI.

[252] *See supra* Parts III.B.1, III.B.3, III.B.4.

and press the issuer to disclose material facts in the registration statement.[253] In short, the sponsor theory focused on the underwriter's ability to influence the issuer's disclosures in the registration statement. If that theory no longer holds sway, an underwriter's due diligence might be expected to focus less on disclosure.

By contrast to the sponsor theory, the shingle theory is founded on notions of fairness to an underwriter's investor customers.[254] Simply by selling the issuer's securities to the public, the underwriter is deemed to recommend those securities and to imply that it has a *basis* for that recommendation.[255] Although this theory, like the sponsor theory, demands a reasonable investigation of the issuer, the focus of that investigation under the shingle theory has nothing to do with disclosure.[256] Rather, the focus is fairness: the underwriter ought not offer securities to its customers unless the underwriter believes that the securities are a good investment.

To the extent that the sponsor theory no longer justifies imposing a due diligence obligation on underwriters,[257] courts assessing an underwriter's due diligence ought to consider what due diligence should look like under the shingle theory. Since it focuses less on an underwriter's leverage over the issuer in due diligence, and the underwriter's resulting control over the issuer's disclosure, the shingle theory provides little support for *BarChris*'s independent verification requirement.[258] Nor does the shingle theory

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[253] *See supra* Part III.B.1.

[254] *See supra* Part III.B.2; Univ. Hill Found. v. Goldman, Sachs & Co., 422 F. Supp. 879, 898 n.17 (S.D.N.Y. 1976) ("[W]hen a broker-dealer hangs out his shingle he implicitly represents that he will deal fairly with the public.").

[255] *See* Karmel, *supra* note 164, at 1275-76 (discussing the underlying bases for imposing liability under the shingle theory).

[256] *Compare id.* (stating the shingle theory is partly based on the assumption that a broker-dealer has "superior knowledge" of the market price of traded securities, and therefore there is "an implied representation that prices charged to customers will bear a reasonable relationship to current market prices"), *with* Klinges, *supra* note 149, at 1082-83 (stating that the sponsor theory is based upon the underwriter's reputation that attaches to the issue and the issuer's desire to secure a reputable underwriter to its security, which in turn gives the underwriter leverage to compel disclosure and accuracy).

[257] *See supra* Part III.B.7.

[258] At least one federal court has recognized this distinction. In *University Hill Foundation,* the court reasoned that, to the extent that cases have held Section 11's due diligence requirement "does not derive from . . . the shingle theory, but rather" from the "underwriter's relation to the issuer," then it is only logical to conclude that the due diligence inquiry must be "more substantial" because the underwriter "plays a more central role in the marketing process," so that "somewhat more is required of an underwriter than a broker-dealer to discharge its obligation to the investing public." *Univ. Hill Found.*, 422 F. Supp. at 898-99.

However, an underwriter's due diligence obligation under the shingle theory probably will nonetheless be more onerous than a typical broker's investigation obligation under the shingle theory, because of the issuer's closer relationship to the issuer and its more fundamental role in the

necessarily suggest, as the sponsor theory does, that an underwriter is or must be independent of the issuer.

Let us now dispel the two myths that have grown up around the *BarChris* opinion.

IV. DISPELLING THE MYTH OF INDEPENDENT VERIFICATION

Nearly forty-five years have passed since Judge McLean opined in *BarChris* that underwriters must *independently* verify the issuer's material statements. Undoubtedly this view was (and is) correct for *some* of the material information in *some* registration statements—and perhaps even for *most* material information in *most* registration statements.[259] But would a prudent person independently verify *all* material information in *all* registration statements? Perhaps the *perfectly* prudent person would. But a *reasonably* prudent person might not, because for such a person, the level of prudence required in any particular situation depends on the facts of that situation.[260] Surely, under *some* circumstances it would be *un*reasonable for a prudent person to verify even material information.

So, how does a prudent person act—reasonably or perfectly?

A. *Understanding the "Prudent Person"*

The "prudent person" standard, located in Section 11(c), was originally borrowed from the law of trusts.[261] It is the standard to which a trustee is held.[262] In that jurisprudence, the standard (which has evolved in ways that are not relevant to due diligence[263]) is now known as the "prudent

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marketing of securities. *See id.* at 898-99.

[259] *See infra* Part IV.C.2.ii.

[260] Others have made this observation before. *See, e.g.*, Schwartz, *supra* note 84, at 882 ("[T]he section 11 reasonableness standard . . . suggests that a reasonable investigation should vary according to the circumstances.").

[261] *Reasonable Investigation*, *supra* note 105, at 911; *see also* Bordwine, *supra* note 91, at 322; Elena Marty-Nelson, *Non-Managing Underwriters' Role In Securities Offerings: Just Eye Candy?*, 16 FORDHAM J. CORP. & FIN. L. 323, 343-47 (2011).

[262] *See* Flexner, *supra* note 146, at 241; Eustace Seligman, *Amend the Securities Act*, THE ATLANTIC MONTHLY, Mar. 1934, at 374. *See also* sources cited *supra* note 260.

[263] The change from a "prudent man" standard to a "prudent investor" standard was implemented by statute. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 (1992); *see also* Max M. Schanzenbach & Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?*, 50 J.L. & ECON. 681, 685-86 (2007) (explaining the history of the change). The reason for—and crux of—the change was to allow a trustee to manage the trust's funds as a portfolio of investments instead of being based on the prudence of each individual investment. *See* BOGERT'S TRUSTS, *supra* note 66, § 612, at 16; *accord* W. Brantley Phillips, Jr., *Chasing Down the Devil: Standards of Prudent Investment Under the*

investor" standard.[264] According to the RESTATEMENT (THIRD) OF TRUSTS, this "prudent investor" standard requires a trustee to invest and manage the funds of the trust on behalf of the beneficiary using, *inter alia*, "the exercise of reasonable care, skill, and caution."[265] To this extent, the prudent investor standard is simply a negligence standard—the duty to exercise ordinary care.[266]

Restatement (Third) of Trusts, 54 WASH. & LEE L. REV. 335, 342-46 (1997). There was no change in the trustee's duty to act with ordinary care.

[264] *See* BOGERT'S TRUSTS, *supra* note 66, § 612, at 16.

[265] *Id.* (quoting RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227(a) (1992)).

[266] Of course, a trustee must do more than simply avoid negligence in administering the trust. A trustee is a fiduciary, with all of the ramifications of that relationship. The "prudent investor" standard explicitly incorporates this fiduciary obligation by noting that the trustee owes the beneficiary a duty of loyalty. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227(c)(1) (1992)).

This same fiduciary-like obligation arguably applies to an underwriter if it wishes to employ the due diligence defense. *See* Greene, *supra* note 125, at 768 (quoting 15 U.S.C. § 77k(c) (1976)) ("To assist in interpretation of the adequacy of conduct, section 11(c) specified that in determining 'what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a person occupying a fiduciary relationship.'"). In due diligence, the underwriter must put the investor's interests first. In fact, as initially enacted in 1933, Section 11(c) explicitly held underwriters to the standard of "a person occupying a fiduciary relationship." 15 U.S.C. § 77k(c) (1925 & Supp. 1933). Although that language was changed in 1934, after businessmen complained that the standard was too stringent, the change did not unambiguously eliminate the requirement that an underwriter act as a fiduciary in conducting due diligence. *See generally* Greene, *supra* note 125, at 768-69. Rather, the legislative history states "that Congress did not intend any substantive change when it revised the language of Section 11(c)" and instead simply meant "to clarify that Congress wanted the standard common law fiduciary language to apply." Marty-Nelson, *supra* note 261, at 345-46. In particular, the new language "remove[d] possible uncertainties as to the standard of reasonableness by substituting for the [initially-adopted] language the accepted common law definition of the duty of a fiduciary," *id.* at 346 (internal quotation marks omitted). In short, Congress may have made the change largely "psychological" rather than for substantive reasons – i.e., to calm irate investment bankers without changing the law. *See* LOSS ET AL., *supra* note 165, at 1604. Thus, although the new Section 11(c) standard has been described by some as a "retreat[] from the vision of public trusteeship to that of private asset management," 17 J. WILLIAM HICKS, CIVIL LIABILITIES: ENFORCEMENT & LITIGATION UNDER THE 1933 ACT § 4:83, at 4-240 (2011), it still appears to require that an underwriter act as a fiduciary with regard to the quality of its investigation, *see id.* at 4-240 to -241.

Nonetheless, Section 11(c) does not render an underwriter a fiduciary of the investor in an absolute sense. An underwriter is under no obligation to perform due diligence so long as the registration statement is accurate; due diligence is simply an affirmative defense. *See* New High Risk Ventures, Exchange Act Release No. 9671, 1972 WL 125474, at *4 (July 27, 1972) (explaining that, "[a]lthough there is no express provision in the Act requiring an underwriter to conduct a due diligence investigation," an underwriter can perform a reasonable investigation "in order to establish a defense" under Section 11); STEINBERG, *supra* note 184, § 7.03, at 213 ("[D]ue diligence is a defense that may be asserted by the subject party rather than an affirmative obligation."). In theory, an underwriter could, in lieu of ever undertaking due diligence, simply purchase liability insurance against the possibility of adverse Section 11 judgments. Therefore, it probably is more correct to say that Section 11 requires that an underwriter *act like* a fiduciary in due diligence *if* it wants to be able to raise the due diligence defense, rather than to say that Section

In the eighty years since the framers of the Securities Act lifted the prudent person standard from the law of trusts, few cases have addressed Section 11(c). However, the cases that have addressed the provision are clear that it means the same thing as it does in the law of trusts: Section 11(c) is, in essence, "a negligence standard."[267] Thus, to act as a prudent person in the management of her own property simply means to avoid negligence. It means to use ordinary care—albeit the ordinary care of a person with the underwriter's financial analysis skills and access to the issuer.[268]

Thus, Section 11(c)'s "prudent" investor standard does little to affect the *level* of diligence required of an underwriter in performing its investigation; Section 11(b)(3) already requires that the underwriter's investigation and beliefs about the results be "reasonable."[269] Rather, the role of Section 11(c) is to focus the underwriter's mind on *whose shoes* it must wear when conducting due diligence: that of a prudent person in the investment of his *own* money. Therefore, the underwriter must do what is reasonable for an investor (who happens to have all the resources and skills of an underwriter) to do with *her own* money, not what is reasonable for an underwriter to do with *someone else's* money. The point, it seems, is to eliminate all agency costs between underwriter and investor.

11(c) *actually* renders the underwriter a fiduciary of the investor in due diligence.

Accordingly, any reference in this Article to an underwriter's due diligence "obligation" must be understood to be shorthand for a *contingent* obligation that, if undertaken, will permit the underwriter to later raise its affirmative due diligence defense.

[267] *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208 (1976)).

[268] Underwriters are generally understood to be more skilled and experienced in financial analysis than ordinary investors. *See, e.g.*, Sjostrom, *supra* note 94, at 608 (stating that underwriters have "specialized skill in financial matters"). An underwriter is therefore held to a higher level of care than an average investor when performing financial analysis. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 7.4, at 291-92 (6th ed. 2009) (explaining that *BarChris* imposed a Section 11 standard of care that operates as a "sliding scale" of liability, under which more is expected of defendants with greater "knowledge, expertise, [insider] status. . . and . . . participation in . . . preparing the registration materials"). As a result of its additional skill, an underwriter might also notice "red flags" that would not be apparent to an ordinary investor. HAZEN, *supra*, § 7.42, at 289 (stating, for example, that an underwriter cannot heedlessly rely on an auditor's comfort letter "when there were red flags that should have put the underwriter on notice of the alleged improprieties"); *see also WorldCom*, 346 F. Supp. 2d at 672-78. Neither scenario is relevant to the present inquiry, however. The focus of this Article is *whether* an underwriter would perform additional investigation concerning statements made by management.

However, due to an underwriter's greater financial skill (and access to the issuer), instances often may arise where an underwriter could independently verify facts with relative ease that the average investor could not independently verify without enormous effort. In such situations, the prudent person standard must be understood to require that an underwriter act as a reasonable investor would *if the investor had the underwriter's skill (and relationship with the issuer)*.

[269] Securities Act of 1933 § 11, 15 U.S.C. § 77k(b)(3)(A) (2006).

B. *How the Reasonably Prudent Person Would Invest Her Own Money*

With this in mind, let us now ask the threshold questions Judge McLean never asked: Would a reasonably prudent person (with all of the resources and skills of an underwriter) who is deciding whether to make an investment automatically investigate *everything* herself? Would she treat the registration statement like a checklist, and check *every* material fact appearing therein? Or, for each such fact, would she first consider *whether* to engage in independent verification? And if so, *what* would she consider when deciding whether or not to go ahead with such verification?

Leasco provides a clue to the answer. In *Leasco*, Judge Weinstein interpreted Judge McLean's ruling in *BarChris* to apply *only* to sources of verification that are *reasonably* available: "Judge McLean makes it plain that a completely independent and duplicative investigation is not required but, rather, that the defendants were expected to examine those documents which were *readily available*."[270] According to Judge Weinstein, *BarChris* contains no requirement that underwriters engage in *un*reasonable independent verification, such as a re-audit of the issuer's financial statements.[271] On this reasoning, the *Leasco* court held that the underwriters had conducted an adequate due diligence investigation, despite relying on management's representation that certain information (the target's "surplus surplus" data) was unavailable for inclusion in the registration statement.[272]

Leasco provided the foundation for a later case, *In re Software Toolworks, Inc. Securities Litigation*.[273] That case involved a lawsuit against the underwriters of a stock offering by a company that produced software for personal computers and video game systems.[274] The underwriters moved for summary judgment based on their due diligence defense.[275] However, they

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[270] *See* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 577 (E.D.N.Y. 1971) (emphasis added). Others writing shortly after *BarChris* was decided also held this view. *See, e.g.*, *Reasonable Investigation*, *supra* note 105, at 910 ("Possible exceptions to the court's general rule [requiring independent verification] include . . . facts about the issuer's business operations which are difficult to verify.").

[271] *See Leasco*, 332 F. Supp. at 577 (quoting Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 690 (S.D.N.Y. 1968)) ("'It is all a matter of degree. To require an audit would obviously be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable. Even honest clients can make mistakes.'").

[272] *Id.* at 582-83; *see also* Note, *Section 11 in the Exchange Offer Setting: An Analysis of* Feit v. Leasco Data Processing Equipment Corp., 1972 DUKE L.J. 1023, 1044-45 (1972) (criticizing *Leasco* for failing to require independent verification).

[273] 789 F. Supp. 1489 (N.D. Cal. 1992), *rev'd in part*, 50 F.3d 615 (9th Cir. 1994).

[274] *Software Toolworks*, 50 F.3d at 620.

[275] *Software Toolworks*, 789 F. Supp. at 1494.

allegedly did not perform an independent investigation of some aspects of the financial results for the most recent quarter (in particular, the accounting for certain sales booked that quarter).[276] The underwriters argued that independent verification was not required, and reliance on management's representations (made to the SEC in a letter regarding the current quarter's financial results) was reasonable, because there was no other way to verify the current quarterly results at that time.[277]

The district court, per Judge Fern M. Smith, agreed and granted the underwriters' motion, concluding that the underwriters could reasonably rely on management's representations.[278] In support of this holding, Judge Smith reasoned:

> That is not to say that underwriters may "tacitly rely on management assertions"; *rather, underwriters may rely on management's representations when it is reasonable to do so under the circumstances.* It would be unreasonable . . . to solely rely on management's representations when said representations could have been reasonably verified. It is not unreasonable, however, to rely on management's representations with regard to information that is solely in the possession of the issuer and cannot be reasonably verified by third parties.[279]

Judge Smith's reasoning—"a logical refinement" of *BarChris*'s independent verification requirement, according to Professor Sjostrom[280]—can be restated broadly: When sources of independent verification are not *reasonably* available to the issuer, an underwriter *need not* so verify.[281] The implication is that a prudent person, acting reasonably, would not do so.

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[276] *Id.* at 1494, 1497.

[277] *Id.* at 1497-98.

[278] *Id.* at 1494, 1497-98. Although the district court's decision to grant summary judgment was reversed in part on appeal—specifically, on the Section 11 claim regarding the SEC letter and the quarter results, *see In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 626 (9th Cir. 1994)—"[t]his reversal . . . does not appear to be a rejection of the district court's reasoning that in *some* circumstances it is reasonable for the underwriters to rely on management." Sjostrom, *supra* note 94, at 589 (emphasis added). Rather, "[t]he [appellate] court simply appears to have found that [this] . . . was not one of these circumstances." *Id.* at 589-90.

[279] *Software Toolworks*, 789 F. Supp. at 1496 (alterations omitted) (emphasis added) (citations omitted) (quoting Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 582 (E.D.N.Y.1971)).

[280] Sjostrom, *supra* note 94, at 589.

[281] *Accord* Endo v. Albertine, 863 F. Supp. 708, 732 (N.D. Ill. 1994) ("Underwriters may

Yet, *availability* of information presumably is not the *only* consideration for a reasonably prudent person when deciding upon the scope of her due diligence investigation of an issuer. Rather, many factors could conceivably affect whether, and to what extent, she will investigate. In each instance, the reasonably prudent person will weigh the costs and benefits of independent verification. Following the reasoning of *Leasco* and *Software Toolworks* to its logical conclusion leads to the realization that a reasonably prudent person probably would *not* independently verify *any* fact for which the expected *benefit* of such verification is outweighed by the expected *cost* of such verification.

Where might the costs of independent verification outweigh its benefit? To generalize, in two types of situations: (1) where the cost of independent verification is unusually high; or (2) where the gain from independent verification is particularly low.[282] *Leasco* and *Software Toolworks* addressed situations where the cost of verification was too high, i.e., when the information necessary to independently verify management's statements was not reasonably available.[283] But to date, no court or commentator has (to this author's knowledge) addressed whether there may be instances where the benefit from independent verification might be too low to warrant verification.

C. *When a Prudent Person Might Not Independently Verify*

When might the expected benefit to a prudent person from independent (or outside) verification be so low as to not be worthwhile?[284] At least two possibilities come to mind: *First*, when there is a good, objective reason for the prudent person *herself* to trust the issuer's statements,[285] and *second*, when the issuer has expressly warranted its

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rely on management's representations when it is reasonable to do so under the circumstances."); Folk, *supra* note 91, at 72 ("[T]he question is whether reliance on [the issuer's] representations is reasonable in view of all circumstances. . . . [T]he underwriter cannot guarantee the truthfulness of certain facts peculiarly within the knowledge of the issuer.").

[282]To the extent that courts decide that "independent" verification means "outside" verification, the same logic should apply. The costs of outside verification might outweigh its expected benefit—and therefore, be unreasonable—in the same two types of situations.

[283]*See supra* notes 270-81 and accompanying text.

[284]Our inquiry here differs in focus than the analysis of those who, shortly after the SEC implemented shelf registration, asked whether the due diligence was worth the cost to investors. *See generally, e.g.*, Banoff, *supra* note 241. Those writers were looking at the costs and benefits of due diligence from an external or policy perspective; by contrast, we are looking at the costs and benefits of due diligence from an internal perspective—i.e., wearing the shoes of the prudent investor. However, our ultimate conclusions may nonetheless be somewhat similar.

[285]In a similar vein, Professor Sjostrom has argued that it is reasonable for underwriters to trust reputable auditors. Sjostrom, *supra* note 94, at 608 ("Would not such a prudent man rely on

statements to the prudent person and likely will make good on that warrantee. If an investor reasonably trusts the issuer, then the investor's expected benefit from independently verifying the issuer's statements might be quite low, since the investor might reasonably believe there is little chance the statements are false. With a warranty, the investor's expected benefit from investigating the statements might be low because the investor might reasonably expect to be made whole even if the statement in question is false.

Let us investigate both of these possibilities in turn.

1. Trust as Reason Not to Independently Verify

a. *Does a Prudent Person Never Trust?*

On its face, *BarChris* explicitly rejects trust.[286] Underwriters performing due diligence must not trust the issuer's statements, the decision commands, because "a prudent [person]. . . would not" do so.[287] Here, Judge McLean's language is as explicit as it is unyielding: a prudent man simply *does not* trust. Courts and commentators have taken this as gospel, but does it make any sense?

In fact, Judge McLean's inflexible edict does not hold up to scrutiny for several reasons. *First*, the *BarChris* court cited no authority for the proposition that a prudent person never trusts. And there is no legal precedent for this proposition,[288] either in securities laws or the analogous context of the law of trusts. Nor is the author aware of any empirical data to support the assertion that trust in management is an anathema to the prudent investor.

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financial statements certified by Arthur Andersen, then one of the five so-called 'big five' accounting firms that most large publicly held corporations use as their auditors? The answer is clearly yes."). However, Professor Sjostrom made this point when discussing the *reliance* defense. *See id.* Unlike the due diligence defense, the reliance defense permits reasonable reliance *without* a reasonable investigation. *See supra* note 62. The question raised by this Article is not reasonable reliance, per se, but rather, whether reliance on the issuer's statements (when there is good reason to trust the issuer) can constitute a reasonable investigation.

[286]Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968) ("In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them.").

[287]Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

[288]This author has searched in vain, but found no authority predating *BarChris* for the proposition that a prudent person never trusts under any circumstances. *See also Barchris*, 283 F. Supp. at 696 ("There is no direct authority on this question, no judicial decision defining the degree of diligence which underwriters must exercise to establish their defense under Section 11.").

In fact, an outburst of recent scholarship suggests just the opposite: that trust plays a critical role in business relationships.[289] Further, in the analogous context of securities fraud actions—which require "reasonable reliance" on the fraudulent statement[290]—courts have long held that trust has its place: "[a]n extended relationship between the parties tends to allow persons to trust each other and make investigation seem unnecessary and reliance more reasonable."[291]

Trust as understood this way, although perhaps partly emotional in nature,[292] nonetheless has a rational and logical component: In wagering that

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[289]*See* Ronald J. Colombo, *The Role of Trust in Financial Regulation*, 55 VILL. L. REV. 577, 578-79 (2010) (citing and quoting a number of authorities that have stated that trust is essential for a properly functioning economy). Not all of the scholarship is pro-trust, but even critics appear to advocate trusting smarter, rather than simply avoiding trust. *See, e.g.*, Roderick M. Kramer, *Rethinking Trust*, HARV. BUS. REV., June 2009, at 2-3, *available at* http://hbr.org/hbr-main/resources/pdfs/comm/fmglobal/rethinking-trust.pdf?q=violation-of-trust-movie (introducing and advocating the concept of "tempered trust").

[290]The reliance defense differs from the due diligence analysis in that Section 11 always requires an affirmative, reasonable investigation of unexpertised portions of the registration statement, *see* Leahy, *supra* note 41, at 2010-11, whereas the question in the reliance defense is whether any investigation was required, *see id.* at 2011 n.50. However, if we assume that the underwriters have already engaged in some investigation of the issuer—including asking questions of management—then at that point the analysis of the two defenses is essentially the same: Is it reasonable under the circumstances for the underwriter to conclude that no further investigation is required?

Some might argue that this conflates two separate questions—the reasonableness of the underwriter's investigation and the reasonableness of its belief in the truth of the registration statement. *See* Young, *supra* note 226, at 528-29. However, that is exactly the point: the two analyses are intertwined (if not entirely overlapping). It is well established that the reasonableness of an investigation depends on the facts of the situation. *See* HAZEN, *supra* note 268, § 7.4, at 291-92. Once *some* affirmative investigation has occurred, the reasonableness of the investor's belief in the truthfulness of the registration statement ought to be one such fact.

[291]4 BROMBERG & LOWENFELS, *supra* note 120, § 7:445, at 7-898.14; *see also* Ronald J. Colombo, *Trust and the Reform of Securities Regulation*, 35 DEL. J. CORP. L. 829, 842 (2010) (quoting Lawrence E. Mitchell, *The Importance of Being Trusted*, 81 B.U. L. REV. 591, 600 (2001)) ("All trust . . . 'grows with use.'").

[292]Scholars of trust divide it into two main archetypes: "affective trust," which is largely emotional in nature, is based on "shared experiences, histories, or values"; by contrast, "cognitive trust" is predicated on calculation rather than emotion, i.e., a "cost-benefit analysis of a given situation." Colombo, *supra* note 289, at 580. Yet, feelings of trust in business are best described as "falling somewhere on a continuum between these two poles." *See id.* at 581. Since affective trust in institutions rather than people is probably "an exception and not the rule," *id.* at 586, presumably the sort of trust that may arise towards issuers and their management will be more cognitive and less affective.

Clearly, while "it is difficult for affective trust, which is primarily interpersonal in nature, to develop between an individual and [a corporation]," *id.* at 593, it certainly is possible. Yet there are some obvious exceptions that prove the rule. Some highly charismatic executives and their companies—the late Steve Jobs of Apple, Inc. comes immediately to mind—may inspire affective trust among vast swaths of the population who have never met the man.

the trusted person's past good behavior belies future good behavior, the trusting person reduces her own transaction costs—either research costs or monitoring costs or both.[293] Trust, therefore, can be a reasonable response for a business person or investor, despite not being *entirely* rational.

Second, Judge McLean's entire decision, although in places phrased as an absolute, must be understood in its proper procedural context: the court was engaged principally in fact-finding after a bench trial.[294] As the court recognized, whether an underwriter was duly diligent is a fact-intensive inquiry. Indeed, although most courts and commentators have long viewed *BarChris* as expounding law,[295] Judge McLean cautioned against doing just that:

> It 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. In the present case, the underwriters' counsel made almost no attempt to verify management's representations. I hold that that was insufficient.[296]

BarChris should therefore not be read to hold that an underwriter's decision to trust rather than verify management's assertions is inadequate due diligence as a matter of law.[297] Instead, the *BarChris* court's command to eschew trust is best read in context as a comment on the facts of that case: "a prudent man . . . would not rely on" management under *these* circumstances.[298]

Third, an absolute never-trust-the-issuer rule defies the underlying logic of the prudent man standard, which asks whether actions were reasonable *under the circumstances*. Indeed, since the *BarChris* court had a

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[293] *See* Colombo, *supra* note 291, at 843 (stating that trust is critical for commercial relationships because "the transaction costs of bullet-proofing every deal and relationship would simply be too high").

[294] *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 682 (S.D.N.Y. 1968).

[295] This is true even for the rare commentator who recognized that Judge McLean's holding was explicitly limited to the facts involved in the "present case." *See Expanding Liability*, *supra* note 189, at 1200 ("*BarChris* says reliance solely on management's representations is insufficient. Although Judge McLean restricts this statement to the 'present case,' his general reasoning clearly implies that such reliance alone would not be the conduct of a prudent man in the management of his own property, even in the case of the most established and trusted issuer.") (footnote omitted).

[296] *BarChris*, 283 F. Supp. at 697.

[297] At least one early commentator recognized this interpretation. *See* Bordwine, *supra* note 91, at 321 ("The standard appears to be a matter for factual determination by the court.").

[298] *BarChris*, 283 F. Supp. at 697.

reasonably prudent investor in mind, it seems likely that the court probably never intended to hem in that investor with a bright line prohibition on trusting management. Rather, it is more plausible that the *BarChris* court was mainly concerned with the agency costs inherent in a situation where an underwriter investigates on behalf of the prudent investor: an underwriter receives all of the benefit of trusting management (i.e., a reduced workload due to less extensive due diligence) with none of the detriment (because the harms of failed verification if the securities prove to be worth less than expected due to a misrepresentation will fall entirely on the investor). Plus, it is possible for an underwriter to be "too close" to management of the issuer, and to trust management to the extent that an outsider would not.

Accordingly, it is entirely plausible that Judge McLean simply meant to caution underwriters against relying on *their own* trust of management. Put another way, the better way to understand Judge McLean's admonition is not that an underwriter cannot rely on management's statements "because a prudent person . . . would not" do so—but rather, that an underwriter cannot rely on management's statements "*unless* [and to the extent that] a prudent person would" do so.[299]

Understood this way, Judge McLean's commandment to underwriters is not to "never trust management"—which defies logic—but rather, to "never trust management unless there is good, objective reason to do so." And such a good, objective reason would have to resonate with the reasonably prudent investor—not just the underwriter. In short, *BarChris* is best read to prohibit an underwriter from declining to engage in an independent investigation based on the underwriter's *own subjective* trust, but BarChris says nothing about the possibility of *objective*, reasonable trust.

b. *Implications of the Possibility of Trust*

It is not uncommon for an underwriter performing her due diligence investigation to trust the issuer not to make false statements. Underwriters, especially those for large issuers, typically have long-standing business relationships with issuers who they represent.[300] Indeed, only a foolhardy underwriter will agree to participate in an offering for an established issuer whose management the underwriter does not *already* trust—particularly

[299] As Judge Smith wrote in *Software Toolworks*, "underwriters may rely on management's representations when it is reasonable to do so under the circumstances." *In re* Software Toolworks, Inc. Sec. Litig., 789 F. Supp. 1489, 1496 (N.D. Cal. 1992).

[300] *See* Leahy, *supra* note 41, at 2033 n.186 and sources cited therein (describing the history and importance of relationships in investment banking); Greene, *supra* note 125, at 791.

if the timeframe of the offering is compressed, such as for a shelf-registered or automatic shelf offering.

However, the reasonably prudent investor standard undoubtedly would not permit an underwriter to avoid independent verification on the underwriter's own *subjective* trust of the issuer. Rather, only trust of the issuer by *investors*, i.e., the objective trust by the market as a whole, should suffice, because the underwriter is standing in the shoes and protecting the interests of the investors who are the ultimate purchasers in the offering.[301]

Accordingly, before an underwriter forgoes independent verification of any statements in the registration statement due to its trust with the issuer, the underwriter must perform an adequate investigation in order to make sure that its own trust in the issuer finds support in the investing community as a whole. Doubts by market participants about the issuer must be considered as if they were the underwriter's own.[302]

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[301] *Cf.* Laby, *supra* note 36, at 132 ("[T]he underwriter is said to play a special role as the only participant who, as to matters not certified by the auditor, has the background and knowledge to conduct a sufficient investigation to protect the investor.").

[302] Detailing the exact sort of behavior that might give rise to the investing public's trust in an issuer is beyond the scope of this Article. However, it certainly seems plausible that investors could develop even "affective trust" in an issuer by purchasing the issuer's securities and finding that their trust in the issuer is "honored and rewarded, time after time." Colombo, *supra* note 289, at 592. That is to say, as:

> [F]orecasts and predictions prove accurate, and as the issuer continues to conduct its affairs with integrity and competence, an investor can grow to develop an amount of affective trust in the issuer. Such development of trust over time between an issuer and investors is of tremendous value to each: the company will be well positioned to raise money via subsequent public offerings more easily, and less expensively, and investors will be able to view the company's subsequent offerings with less skepticism and doubt.

Id.

It may be impossible to determine whether the investing public "trusts" a company or its management (indeed, for many companies, the investing public may be no discernible, dominant public opinion). Yet, for some companies, media coverage may suggest market-wide trust or distrust of the company or its management. For example, WorldCom, Inc.'s chief financial officer, Scott Sullivan, was recognized as a "CFO of the year" by CFO magazine in 1998, a few years before his massive fraud was revealed. *See* Jayne O'Donnell, *A Couple of Bad Apples Spoiled 'CFO' Award: Magazine Scrapped Honor After Deceit*, USA TODAY, May 6, 2004, at B5, *available at* http://www.usatoday.com/money/companies/management/2004-05-05-cfomag_x.htm. Further, according to the magazine's publisher, "Sullivan's perception on Wall Street was that 'he walked on water.'" *Id.* This sort of positive public recognition for a top manager could in theory reflect market trust of the company itself.

2. Express Warranty as a Reason Not to Verify

a. *Section 11 is Akin to an Express Warranty by the Issuer*

But perhaps "trust" is too mushy for the reasonably prudent person. Perhaps it is always prudent, in business, to "trust but verify."[303] If so, an express warranty might nonetheless obviate the need of a prudent person to independently verify the truth of the issuer's statements.

As between a buyer and seller, an express warranty functions as a statement from seller to buyer that "you can trust me because I'll put my money where my mouth is." An express warranty is essentially a contractual promise that the warranted facts are true.[304] If facts expressly warranted as true in a contract prove incorrect, the buyer can sue for rescission.[305] There is no intent element.[306]

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[303]Even so, there is no inherent reason that such verification would have to look to independent sources outside of the issuer. Yet, either way, the relevant form of trust would be "cognitive" trust, which is more rational and calculating than the more emotional "affective" trust. *See* Colombo, *supra* note 291, at 836 (explaining that President Ronald Reagan's oft-used phrase, "trust but verify," is "virtually incoherent" for those wedded to a view of trust that includes only affective trust).

[304]18 RICHARD A. LORD, WILLISTON ON CONTRACTS § 52:47, at 273 (4th ed. 2001) ("It is the general rule under the Uniform Commercial Code that an affirmation of fact or promise made by the seller to the buyer, which relates to the goods and becomes part of the basis of the bargain, creates an express warranty that the goods shall conform to the affirmation or promise.").

Whether a court will recognize an express warranty often will depend on the relative knowledge of the parties. Courts are more willing to conclude that statements are express warranties when one party to a contract has information that only she would know or be in a position to know. *See, e.g.*, *id.* § 52:49, at 284-85 ("Generally, an express warranty will arise only where the seller affirms a fact of which the buyer is ignorant; a statement will be construed as mere opinion or commendation, not creating an express warranty, where the buyer and seller have equal knowledge of the facts and hence are in an equal position to express an opinion regarding the product."). This is the exact situation between the typical issuer and potential purchaser of its securities: the issuer has information about itself that reflects upon the value of the securities that it wishes issue and the potential purchaser has no access to that information.

[305]*Id.* § 68:17, at 191-93 ("Recoupment and an action or counterclaim for damages are generally admitted remedies for breach of a warranty of goods sold; but the third remedy, that of rescission, has been the cause of much discussion, particularly by the courts and commentators prior to the adoption of relevant provisions of the Uniform Commercial Code. . . . The remedy of rescission, if allowed at all, was allowed on broad principles of justice. The basis of the remedy was that the buyer had not received what it had bargained for. The desirability of such a remedy depended purely on the business customs of a community and on whether it appealed to the natural sense of justice.") (footnotes omitted).

[306]*Id.* § 52:45, at 264 ("Because an express warranty is a term of the contract, the seller's negligence or other fault in failing to comply is irrelevant to the issue whether the warranty has been breached. Indeed, a seller may be found to have breached an express warranty even though the inability to honor it was innocent or the result of a mistake.") (footnote omitted); *accord* Harry Schulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 231 (1933)

In the specific context of a securities offering, if an issuer expressly warrants to investors that all of the material facts in the registration statement are true, investors are not required to perform *any* investigation of those facts in order to obtain damages in an action for breach of warranty.[307] All an investor must show to prove her express warranty claim (in addition to reliance, which is an element in some states[308]—but is *not* a statutory element of a Section 11 claim[309]) is that (1) the statement in question was false and (2) the investor was injured by the falsehood.[310] No independent investigation by the investor is required.[311] Nor is the failure of the plaintiff's due diligence even an affirmative defense to the warrantor's liability.[312] Rather, the issuer is held *strictly* liable if the warranted statement is false (so long as the investor did not know it was false), and the investor plaintiff will be made whole for the difference between the actual value of his stock due to the inaccuracy and the value of her stock had the statement been true.[313]

This is, in essence, the regime imposed by Section 11. In all public securities offerings today, the issuer effectively warrants its statements to investors because issuers are, under the plain language of the statute,[314]

("In . . . warranty . . . the seller's wrong is sufficiently established when it is shown that he made a false representation about a material fact. It does not matter that the seller did not know of the falsity, that he did not intend to deceive, that he honestly believed in the truth of his statement, that he had very reasonable grounds for his belief.").

[307] *See* Matthew J. Duchemin, *Whether Reliance on the Warranty is Required in a Common Law Action for Breach of an Express Warranty*, 82 MARQ. L. REV 689, 692-704 (1999).

[308] Whether or not one believes that reliance on the warranty *ought* to be required, *see generally* James J. White, *Freeing the Tortious Soul of Express Warranty Law*, 72 TUL. L. REV. 2089, 2092 (1998), it nonetheless is required in some jurisdictions. *See* Duchemin, *supra* note 307, at 693-704 (discussing whether reliance is or is not required in various jurisdictions).

[309] HAZEN, *supra* note 268, § 7.3, at 278; *accord* Marc I. Steinberg & Brent A. Kirby, *The Assault on Section 11 of the Securities Act: A Study In Judicial Activism*, 63 RUTGERS L. REV. 1, 10-11 (2010). *But see id.* at 12-26 (discussing, *inter alia,* APA Excelsior III L.P. v. Premiere Techs., Inc., 476 F.3d 1261 (11th Cir. 2007), and other recent cases that have added a reliance element to the plaintiff's prima facie case under Section 11, and arguing that there is no statutory basis for this requirement).

[310] *See, e.g.*, Lindemann v. Eli Lilly & Co., 816 F.2d 199, 202 (5th Cir. 1987); Eddington v. Dick, 386 N.Y.S.2d 180, 181 (1976) (both reciting the elements for a breach of an express warranty action).

[311] *See* PETER A. ALCES ET AL., UNIFORM COMMERCIAL CODE TRANSACTION GUIDE: ANALYSIS AND FORMS § 8:11, at 23 (citing *Eddington*, 386 N.Y.2d 180 (1976)) ("A buyer is not under a duty to investigate a product before purchasing it where the seller makes an express warranty as to the condition of the product.").

[312] *See id.*

[313] 12A WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 5615, at 349 (rev'd 2009) ("[T]he measure of damages in an action for a breach of express warranty is the difference between the actual value of that which is warranted and the value as expressly warranted by the seller.").

[314] Some judges have refused to apply absolute liability to issuers concerning omissions of material facts of which the issuer was not aware. *See* Allan Horwich, *Section 11 of the Securities*

absolutely liable under Section 11 for material misrepresentations in the registration statement (unless, as with express warranty, the plaintiff knew of the inaccuracy).[315] And issuers have *no* due diligence defense![316] What's more, the measure of damages under Section 11 is similar, in many cases,[317] to the damages available for a breach of express warranty: "the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and . . . the value thereof as of the time such suit was brought."[318] Therefore, as long as the issuer can satisfy a judgment under Section 11, an investor whose securities become worthless or worth less than what she paid for them can get her money back.

Under this regime, would a reasonably prudent person nonetheless independently verify the facts in the registration statement? Perhaps, if the cost of verification was extremely low. But investigation is not costless and, at some point, the gain from added investigation might be outweighed by the cost of verification itself.

Act: The Cornerstone Needs Some Tuckpointing, 58 BUS. LAW. 1, 19-21 (2002) (discussing cases where the court has declined to apply strict liability). However, this trend appears limited largely to alternative holdings and/or dicta, and in any event, squarely contradicts the language of Section 11. *Id.* at 19.

[315]"The issuer's liability [under Section 11] is absolute with but one exception: It has the defense available to all defendants of showing that the plaintiff knew of the [inaccuracy] . . . at the time of his or her acquisition of the security." LOSS ET AL., *supra* note 165, at 1604.

[316]Horwich, *supra* note 314, at 18 & n.114; *see* Securities Act of 1933 § 11, 15 U.S.C. § 77k(b) (2006) (providing a due diligence defense for all Section 11 defendants "other than the issuer").

[317]If the material inaccuracy in the offering document results in the securities becoming worthless (or worth less than the offering price), Section 11's recessionary-type damages and express warranty's benefit-of-the-bargain damages achieve roughly the same result—assuming that the offering price reflected the price of the security if the warranted facts were true, which should be true in a well-functioning market.

However, IPOs are not perfect markets, and the purchaser in a "hot" (i.e., over-subscribed and much-anticipated) IPO may be able to flip her stock shortly after the offering for many times the offering price, suggesting that the offering was "underpriced." Such investors are not entitled to any damages under Section 11, due to its cap on damages at the offering price. Horwich, *supra* note 314, at 12-13. Thus, Section 11 does not protect investors in "hot" IPOs as much as an express warranty would. Perhaps for this reason (among others), underpricing is one way that underwriters protect themselves from Section 11 liability. *See* Ferris et al., *supra* note 203, at 602.

[318]15 U.S.C. § 77k(e). The damages are different if the plaintiff sells the stock prior to termination of the lawsuit:

> [T]he price at which such security shall have been disposed of in the market before suit, or . . . the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought.

Id.

b. *What a Prudent Person Would Independently Verify*

To the extent that a prudent person in the management of her own property would not investigate the registration statement, an underwriter should not be expected to do so, either. However, it would not be prudent to rely on a warranty from the issuer without being fairly sure that the issuer can make good on that warranty. As such, a prudent investor undoubtedly would engage in a thorough investigation of the issuer's general financial health—as opposed to an investigation of specific facts in the registration statement—before relying on the issuer's warranty.

Like the prudent investor relying on an express warranty, an underwriter engaging in due diligence should therefore be required to verify the issuer's ability to satisfy a judgment under Section 11. Although such verification would require an affirmative investigation, the focus of such an investigation would be different from the focus of an investigation with the target of an investigation in which "independent verification" is the goal. Rather than focus on ascertaining the truth of every material fact in the registration statement (and looking for material omissions), the underwriter would simply engage in a thorough investigation of the issuer's general financial health.

Changing the focus of an underwriter's due diligence from the specific disclosures in the registration statement to the issuer's general financial condition would re-align due diligence with its remaining theoretical justification: the shingle theory. As explained previously, the shingle theory focuses on the underwriter's fairness obligation to its customers, not the underwriter's ability to use its leverage over the issuer to control the content of the registration statement.[319]

c. *Issuer as Insurer of Truthfulness of the Registration Statement*

A walk in the prudent investor's shoes suggests that, so long as the underwriter ultimately concludes that the issuer can satisfy a judgment under Section 11, it is reasonable for an underwriter (because it would be reasonable for a prudent investor) to focus its independent verification on the issuer's solvency rather than on cross-checking every material fact in the registration statement. But does this conclusion square with the underlying purpose of the Securities Act?

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[319] *See supra* Part III.B.9.

The purpose of the Securities Act, commentators say, is neither insurance nor compensation, but deterrence and improved disclosure.[320] Thus, the Act is intended to cause underwriters to engage in a wide-ranging investigation of the issuer so that the disclosure in the registration statement is accurate[321]—not simply to pay investors back if they catch the issuer in a lie (although it does that too). Can this purpose be squared with allowing underwriters to independently verify an issuer's solvency, rather than the entire registration statement?

It can. While it is undoubtedly true that the drafters of the Securities Act *did not* intend for *underwriters* to be insurers of securities, there also can be no doubt that the Act *does* make issuers insurers of the truth of the facts in the registration statement.[322] Issuers are strictly liable for material falsehoods, with no due diligence defense.[323] Further, the Act does not actually mandate due diligence. Rather, due diligence is optional, if the underwriter wishes to avoid liability for misstatements.[324] An underwriter always theoretically has the option of performing no due diligence and taking a chance that all of the facts in the registration statement are true, or simply purchasing liability insurance against Section 11 judgments.[325]

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[320] *See, e.g.*, Scott, *supra* note 180, at 250; Horwich, *supra* note 314, at 10 n.67; Schulman, *supra* note 306, at 227; *Diligence Refined*, *supra* note 104, at 1411; Douglas & Bates, *supra* note 146, at 173; James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 34-35 (1959).

The SEC, which prohibits indemnification of officers, directors and controlling persons, does not prohibit indemnification of underwriters. *See Prospectus Liability*, *supra* note 108, at 688 (remarks of Milton P. Kroll). However, courts have struck down indemnification clauses as violating public policy "when the underwriter had actual knowledge of the false and misleading statement and when liability was predicated upon recklessness, and even mere negligence." Herb Frerichs, Jr., *Underwriter Due Diligence Within the Integrated Disclosure System—If It Isn't Broken, Don't Fix It*, 16 SEC. REG. L.J. 386, 408 (1989) (footnotes omitted). However, "[o]ccasional opinions acknowledge the possibility" of indemnification "where the underwriter is significantly less culpable than the issuer." *See* Scott, *supra* note 180, at 244 n.113.

[321] Lenz, *supra* note 108, at 410 ("Protection against liability [is] . . . consistent with the policy behind section 11 only if it makes the underwriter investigate the entire registration statement and if it subjects him to some economic sanction if he is found liable.").

[322] *See Prospectus Liability*, *supra* note 108, at 537 (describing *BarChris* as emphasizing various risks of civil liability under the Securities Act, including "the issuer itself under Section 11(a) as an insurer") (remarks of Carlos L. Israels); *accord* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 578 (E.D.N.Y. 1971) (describing inside directors as having liability that "approaches that of the issuer as guarantor of the accuracy" of the registration statement).

[323] 15 U.S.C. § 77k(b) (stating that the due diligence defense is available to everyone except the issuer).

[324] *See supra* note 266. Thus, as stated above, references to an underwriter's "due diligence obligation" (and the like) throughout this Article refer to a practical obligation, not a legal one.

[325] Such insurance presumably would be pricy, because of "moral hazard problems" and the difficulty insurers would have in assessing the general quality of the underwriter's due diligence

d. *The Anti-Indemnification Cases Do Not Counsel Otherwise*

Some courts[326] and commentators,[327] writing to urge that indemnification clauses between issuer and underwriter should be void on grounds of public policy, have reasoned that such clauses hurt the very investors that Section 11 was intended to protect. When issuers indemnify underwriters, it has been argued, the shareholders who might recover as Section 11 plaintiffs end up indemnifying the underwriter defendant.[328] This same objection could be raised to argue that Section 11 should reject an express warranty approach. Issuer as warrantor of the investor has the same result as issuer as indemnifier of the underwriter: either way, the issuer's stockholders are left holding the bag.

This objection is misguided because it fails to consider (1) how the prudent person standard functions differently in IPOs and in secondary offerings and (2) who will *in fact* be left holding the bag in these two different types of offerings.

Under the express warranty analysis, the issuer is sole insurer of the accuracy of the registration statement, i.e., the sole defendant on the hook for a Section 11 judgment, *only* if the underwriter performs a reasonable

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practices. *See* Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. FIN. 789, 799-800 (1988); *see also* James C. Freund & Henry S. Hacker, *Cutting Up the Humble Pie: A Practical Approach to Apportioning Litigation Risks among Underwriters*, 48 ST. JOHN'S L. REV. 461, 471 n.62 (1974) (describing the "limited availability and spiraling costs" of such insurance less than a decade after *BarChris* was decided). Yet, such insurance is unnecessary, because underwriters effectively can self-insure against Section 11 claims in IPOs by underpricing the offering. *Id.* at 800. With that said, empirical research suggests that liability avoidance probably is *not* the main reason for IPO underpricing. *See* Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L. J. 1397, 1446-48 & 1446 n.232 (2002); Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings are Underpriced*, 41 UCLA L. REV. 17, 19-20 (1993) (evaluating, and ultimately rejecting, the theory that IPO underpricing serves as a form of liability insurance for underwriters).

[326] *See, e.g.*, Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1289 (2d Cir. 1969).

[327] *See* Scott, *supra* note 180, at 244-46.

[328] STEINBERG, *supra* note 184, § 7.03, at 212 ("[T]he issuer's indemnification of the underwriter is suspect in that the funds ultimately come out of the shareholders' pockets, the very individuals who were damaged by the misconduct."); *see also Globus*, 418 F.2d at 1289 ("Although in form the underwriter is reimbursed by the issuer, the recovery ultimately comes out of the pockets of the issuer's stockholders. Many of these stockholders may be the very purchasers to whom the underwriter should have been initially liable. The 1933 Act prohibits agreements with purchasers which purport to exempt individuals from liability arising under the Act. The situation before us is at least reminiscent of the evil this section was designed to avoid.") (citation omitted); Scott, *supra* note 180, at 244-45 (discussing cases rejecting issuer indemnification of the underwriter for this reason). *But see* Feldman, *supra* note 142, at 34 (describing favorably the then-developing practice of issuers indemnifying underwriters as an example of loss-shifting). Yet, courts have allowed issuers to indemnify underwriters who were not negligent. *See* STEINBERG, *supra* note 184, § 7.03, at 212.

investigation of the issuer's ability to satisfy a judgment under Section 11.[329] Most IPO issuers (with the exception of rarities like Google, Inc.) are relatively young, cash-poor companies which need an infusion of cash to fund future growth.[330] Presumably such companies would be unable to pay back all of the proceeds from their IPO. As a result, an underwriter who performed a reasonable investigation of an IPO issuer's ability to pay a judgment under Section 11 would in most cases conclude that the issuer *could not* do so. Therefore, for an IPO, the underwriter will have to perform a reasonable investigation as traditionally envisioned by *BarChris* in order to successfully raise the due diligence defense and escape Section 11 liability.

This conclusion is consistent with the policy considerations counseling against allowing indemnification of the underwriter by an issuer. Purchasers of stock in an IPO are by definition the only *public* investors (excluding purchasers under Rule 144 from former private holders)[331] of that class of stock. (Any other stockholders will be sophisticated or accredited investors who obtained their securities via a private placement, such as under Regulation D.)[332] As such, the plaintiffs in an IPO are also potential Section 11 plaintiffs for that offering.

By contrast, for a secondary offering by an established corporation, it is possible (although not necessarily certain, as the *WorldCom* litigation reminds us)[333] that the issuer *could* cover a Section 11 judgment. It is therefore possible that, after a reasonable investigation, the underwriter could reasonably conclude as much. In this case, the issuer's existing stockholders would be left holding the bag for the Section 11 judgment. However, they would *not* be paying a judgment to themselves, as scholars who oppose issuer indemnification of underwriters abhor. This is because

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[329] *See supra* Part IV.C.2.a.

[330] *See* Alexander, *supra* note 325, at 22 ("Most companies making initial public offerings are young companies. . . ."); *see, e.g.*, *Why Facebook Needs More Cash*, Forbes.com *available at* http://www.forbes.com/sites/investopedia/2012/05/22/why-facebook-needs-more-cash/ (last visited Sept. 14, 2012); Ari Levy, *Groupon IPO a Must as Cash Needs Climb With Investor Tally: Tech*, Bloomberg.com, Oct. 30, 2011, *available at* http://www.bloomberg.com/news/2011-10-31/groupon-ipo-becomes-a-must-as-cash-burns-with-investor-base-at-limit-tech.html (last visited Sept. 14, 2012).

[331] 17 C.F.R. § 230.144 (2012); *see also* John W. White et al., *The Statutory Arrangement for Public and Private Securities Offerings Under the Securities Act of 1933*, *in* SECURITIES OFFERINGS 2011: GETTING YOUR DEAL DONE, at 43-45 (PLI Corp. Law & Practice Course Handbook Series, No. 28705, 2011).

[332] 17 CFR § 230.501 et seq.

[333] WorldCom, Inc., the nation's second largest telecommunications company, went bankrupt after issuing $12B in bonds in two shelf-registered offerings in 2000 and 2001. Leahy, *supra* note 41, at 2025.

the potential Section 11 plaintiffs for a secondary offering are *not* the only holders of the issuer's stock.

As a result, existing shareholders (whose corporation received an influx of capital based on a materially inaccurate registration statement) will repay new investors who bought in the offering pursuant to an inaccurate registration statement. Such a transfer from old to new shareholders does not raise the policy concerns raised by the anti-indemnification articles. This is particularly true for investment grade debt offerings, where the plaintiffs who purchased pursuant to the inaccurate registration statement will be bondholders, not equity holders.

Thus, at least for some secondary offerings, an underwriter could make out its due diligence defense under the prudent person standard as described above *and* it would be good policy that the underwriter could do so, because the Section 11 plaintiffs would not be paying themselves.

We now turn to *BarChris*'s second myth.

V. DISPELLING THE MYTH OF INDEPENDENT UNDERWRITERS

By describing an underwriter's role in due diligence as "adverse" to the issuer, *BarChris* crystalized an important (and previously implicit) idea:[334] In order to fulfill its due diligence obligation under Section 11, an underwriter must act "independently of the issuer."[335] After *BarChris*, scholars and judges all agreed that an underwriter must play "devil's advocate" in due diligence.[336] Further, despite changes to the economic landscape of underwriting, courts (and some commentators) continue to describe underwriters as well situated to play this role.[337] Accordingly, underwriters are still widely viewed (at least by the judiciary) as important "gatekeepers" who can and must push issuers to make full and fair disclosure in the registration statement.[338]

There is one critical problem with requiring that an underwriter act "adverse" to the issuer in due diligence: it squarely contradicts with the underwriter's *other* job in the securities offering. The job for which the underwriter is paid—by the issuer[339]—is to *market* the issuer's story and its securities to the public.[340] An issuer wants an offering to proceed and to

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[334] *See supra* Parts III.B.3-4.
[335] *See* Laby, *supra* note 36, at 132.
[336] *See supra* Part III.B.5.
[337] *See supra* Part III.B.8.
[338] *See supra* Part III.B.6 and *infra* Part V.B.
[339] *See* Scott, *supra* note 180, at 239 n.64 ("Underwriters are hired and paid by the issuer.").
[340] *See* Wolfson, *supra* note 229, at 366 ("Securities are sold, not bought, and this

receive a high price for its securities.[341] The issuer undoubtedly will receive a lower price if the underwriter discovers negative information in due diligence and requires the issuer to disclose that information in the registration statement. Yet, such disclosure is exactly the point of the underwriter's due diligence investigation. Due diligence and disclosure help investors avoid overpaying for securities or buying worthless ones.

This conflict is not news to those who practice or study securities law. The issuer is, without a doubt, the underwriter's client, and few would dispute that an underwriter (at least in the typical situation where the underwriter is hired by the issuer)[342] is the issuer's agent for some purposes.[343] It is therefore uncontroversial that underwriters act to further the issuer's interests.

Yet, until recently, few scholars have explored the underwriter's conflicting roles as devil's advocate to, and salesman for, the issuer. And to date, no one has asked whether the underwriter's conflicting role in due diligence should be eliminated. We will now discuss both questions in turn.

A. *Past Scholarly Analysis of Underwriter Conflicts*

Underwriters face many conflicts of interest, some of which have been discussed at length in academic journals.[344] Yet, until recently, the seemingly

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fundamental fact is at the heart of the investment banker's conflict. . . . In short, more than any other skill, investment banking requires salesmanship."); *see also* Greene, *supra* note 125, at 761-62 ("The underwriter's basic function is . . . to market securities on behalf of the issuer . . . ."); Candida P. Jose, Note, *Section 11 of the Securities Act of 1933: The Disproportionate Liability Imputed to Accountants*, 27 DEL. J. CORP. L. 565, 580 (2002) ("The underwriter's basic responsibility is to market the issuer's securities for distribution among investors.").

[341]But perhaps not the *highest* possible price. Issuers must know about, and therefore presumably accept, some underpricing of their offerings by underwriters. *See* Prentice, *supra* note 325, at 1446 ("It seems surpassingly clear that issuers going public are willing to leave large amounts of money on the table for a variety of reasons.").

[342]*But see* SEC v. Chinese Consolidated Benevolent Association, 120 F.2d 738, 740-41 (2d Cir.), *cert. denied*, 314 U.S. 618 (1941) (holding that a person who "sells for an issuer" can be an "underwriter" under the Securities Act even in the absence of privity of contract).

[343]*Compare* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

[344]*See, e.g.*, Klinges, *supra* note 149, at 1083-84 (citing Wolfson, *supra* note 229, at 365, 373-74) (describing several underwriter conflicts of interest). For example, as an agent (and perhaps fiduciary) of the issuer, the underwriter ought to raise as much capital as possible from investors in a public offering. *Id.* at 1084. However, it is widely understood that underwriters tend to "underprice" initial offerings, arguably to the issuer's detriment and to the benefit of purchasers in the offering. Steven M. Davidoff, *Why I.P.O.'s Get Underpriced*, DealBook Blog, May 27, 2011, 10:48 am, available at http://dealbook.nytimes.com/2011/05/27/why-i-p-o-s-get-underpriced/ (last visited Sept. 14, 2012); Prentice, *supra* note 325, at 1446 ("The underpricing of IPOs is a well-

obvious conflict between the underwriter's role as marketer of the issuer's securities to investors and the underwriter's role as protector of the investors via due diligence has received surprisingly little attention.[345] Prior to 2006,[346] just a few passing references to this conflict appeared in the law reviews, twenty to twenty-five years ago.[347]

The only extended treatment of the conflict underwriters face when serving two opposing masters in due diligence was written over thirty years ago. In a chapter of a 1980 book detailing "Abuses on Wall Street," Professor Nicholas Wolfson described the underwriter's role as "permeated with conflict."[348] One of these conflicts, Professor Wolfson explained, was the underwriter's dual role as agent of the issuer and protector of the public:

> On the one hand, [the underwriter] has to . . . act in the best interests of corporate issuers. On the other hand, he has a responsibility under the securities law to act in the interest of the purchasers. How does he, or indeed can he, resolve this conflict, born as it is of this dilemma?[349]

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known phenomenon that reached surprising levels in the late 1990s."); Hurt, *supra* note 146, at 724-25 ("[T]he underpricing of IPO shares is often an intentional act. . . .").

[345]Perhaps the conflict is so obvious that it goes without saying. If so, why did it warrant mention, albeit infrequently, more than two decades ago—and then not again until recently? The inherent conflict in the underwriter's role has not disappeared. If anything, it has intensified.

[346]*See generally* Laby, *supra* note 36 (discussing the conflict inherent in the role of underwriter; Professor Laby's article was published in 2006).

[347]*See, e.g.*, Ferris et al., *supra* note 203, at 583-84 ("The underwriter performs several functions, some of which are conflicting. The first function . . . is in an agency capacity to the issuing company, the principal . . . Th[e] second function is . . . as a certifier of veracity under [the Securities Act] . . . . Th[is] . . . due diligence [function] provides a 'check on the accuracy of disclosures,' which is . . . in tension with, the agency function . . . .") (footnotes omitted); Folk, *supra* note 91, at 54-56; Klinges, *supra* note 149, at 1083-85 ("[A]n underwriter may have motives that are not . . . beneficial to investors. . . . [A]n underwriter has . . . interests which . . . often conflict . . . [including] success for its client (the issuer) and protection of investors. The structure of the underwriting process itself . . . work[s] against total disclosure. . . . [An] underwriter's] profits depend on the price of the securities as well as the number of sales. A more optimistic—if not entirely accurate—prospectus may increase both the market price and sales; this puts a strain on an investment banker's integrity and investigative efforts. . . . The issuer and underwriter may have a longstanding and amicable affiliation . . . or the issuer may be a new client, [so] . . . their relationship may be . . . fragile. . . . [I]n each of these cases the interests of an investment banking firm in itself and its client are likely to overwhelm its desire to protect investors.") (footnotes omitted); Scott, *supra* note 180, at 235 (noting the "dual function of . . . underwriters, as both evaluators and marketers, in . . . securities distribution"); *see id.* at 239 ("This stress on the underwriter as an adversary to the issuer is . . . [necessary to stop the underwriter from focusing] solely on pleasing its client-issuer.").

[348]Wolfson, *supra* note 229, at 365.

[349]*Id.* (footnote omitted); *see also id.* at 373 ("The law . . . [of] due diligence means he is to protect and inform investors. The economic facts of life, however, place him in a . . . conflict[]

This dilemma rears its ugly head during due diligence. Section 11 requires that an underwriter "probe into the financial and operational details" of the issuer and to "identify its weaknesses publicly," thereby serving as the "people's tribune" by protecting investors "from the tendency of . . . management to exaggerate prospects."[350] Yet, this role as people's tribune is at cross purposes with the underwriter's incentive to sell the issuer's securities to "anyone who can be convinced to buy" them—a goal that is best served by painting a rosy picture of the issuer.[351]

This conflict is not just theoretical. Issuers know that negative disclosures can reduce the offering price for their securities, and may not take kindly to being told to make such disclosures. As a result, Professor Wolfson observed, underwriters must worry that playing a staunch advocate for investors in due diligence will lead the issuer to "never retain [its] services again."[352] Moreover, if an investment bank repeatedly turns down offerings in an attempt to avoid selling poor-quality securities to the public, it "will soon be looking for a new line of work."[353]

Professor Wolfson proposed solutions to eliminate or ameliorate many of the conflicts that he identified in his book chapter.[354] However, he offered no proposal to obviate the conflict between the underwriter's dueling due diligence and marketing roles. Instead, Professor Wolfson urged that, so long as the due diligence defense is "strict, precise, and adequately enforced," Section 11 would provide the underwriter with a "legal shield" against pressure from issuers and provide investors with "considerable assurance" that they would be protected.[355] In addition, Professor Wolfson advocated increased disclosure about an underwriter's conflicts. He urged

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[between] his duty to the buying public, [and] his obligations to corporate issuers.").

[350] *Id.* at 373.

[351] *Id.*

[352] Wolfson, *supra* note 229, at 374; *accord* Royce de R. Barondes, *NASD Regulation of IPO Conflicts Of Interest--Does Gatekeeping Work?*, 79 Tulane L. Rev. 859, 861 (2005) ("An investment bank that is too aggressive in requiring adverse disclosure about an issuer may lose future underwriting business."). Professor Wolfson does not cite examples, but they can be found in the case law. For example, in the WorldCom securities litigation, the plaintiffs alleged that one of the team leaders for one of the lead underwriters "admonished his team not to push WorldCom's management on certain due diligence issues, undoubtedly for fear of losing one of [the investment bank's] most profitable clients." Lead Plaintiff's Memorandum of Law in Opposition to the Underwriter-Related Defendants' Motion for Summary Judgment, *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004) (No. 02 Civ. 3288), 2004 WL 2386818 (emphasis omitted). Something similar may have occurred in *BarChris*. *See supra* Part II.B.

[353] Wolfson, *supra* note 229, at 374.

[354] *See id.* at 372-73, 389, 396-403, 412-13.

[355] *Id.* at 374.

that a section be added to the prospectus in which an underwriter would "fully disclose [its] conflicts."[356]

In sum, Professor Wolfson's prescription for reform of the underwriter's conflict in due diligence was two-fold: (1) courts should set a high bar for an underwriter's investigation of the issuer, to counterbalance the underwriter's incentive to be less rigorous to please its issuer client; and (2) the SEC should require that underwriters disclose more information about their conflicts of interest to investors, so that investors can take those conflicts into account when deciding how much weight to place on the underwriter's due diligence investigation.

The first prescription implicitly assumes that an underwriter's incentive to serve its main master, the issuer, can be overcome by legal obligations to serve its secondary master, the investing public. This argument devalues Professor Wolfson's keen observations about the conflicts that an underwriter faces in due diligence. What's more, the argument proves too much. If "enforcing the laws on the books" is enough for underwriters, then why not for auditors? If strict enforcement of Section 11 is a sufficient threat, then there is no need for the limits on non-audit business that the Sarbanes-Oxley Act imposed on independent auditors a decade ago. Clearly, Congress felt otherwise after the WorldCom and Enron scandals, and this legislative instinct was sound.

Professor Wolfson's second proposal also has serious limitations. First, it is unclear what additional information would be disclosed under this proposal. Issuers are already required to disclose any material relationships with their underwriters.[357] Further, failing to disclose an underwriter conflict can be a material omission even if the applicable regulations do not

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[356] *See id.* at 381. Professor Wolfson also suggested that the underwriters be required to provide their own "subjective evaluation of the future prospects of the [issuer] and the prospective plans of corporate management." *See id.* This suggestion seems quaint in light of what we learned a decade ago about the objectivity of securities analysts employed by underwriters. *See generally* James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625, 651-58 (2007) (discussing events leading up to the global research analyst settlement). Investors presumably would be better served by requiring inclusion in the registration statement of a report issued by an unaffiliated, randomly-chosen "buy side" analyst.

[357] The requirement to disclose any "underwriter having a material relationship with the [issuer]" and state "the nature of that relationship" is found in Item 508(a) of Regulation S-K. 17 C.F.R. § 229.508(a) (2011); *see also In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 689 (S.D.N.Y. 2004) (quoting Degulis v. LXR Biotech., Inc., 928 F. Supp. 1301, 1314 (S.D.N.Y.1996)) ("Regulation S-K . . . 'requires an issuer to identify each underwriter with a material relationship with the issuer and the nature of the relationship . . ., the underwriter's compensation, the existence of any underwriter's representatives on the issuer's board of directors, and any indemnity provided to the underwriter.'").

specifically call for the disclosure.[358] Thus, if the additional disclosures that Professor Wolfson proposed are material, in theory they already ought to appear in the registration statement.[359]

The second proposal also does not go far enough. As Professor Wolfson's own co-authors argued, disclosure is a halfway measure.[360] It makes sense only if the underlying conflicts cannot be eliminated or if structural changes have "side effects of great complexity or undesirable impact."[361] By contrast, "if a structural change can eliminate the temptation to abuse, there is no reason to settle for the mere inhibition of abuse through disclosure."[362] Thus, before accepting Professor Wolfson's proposal for more disclosure, we should ask whether changes could be made to eliminate an underwriter's conflict of interest in due diligence. If so, disclosure is not sufficient.

There is yet another problem with the idea of redressing an underwriter's conflict of interest in due diligence solely with more or better

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[358] *WorldCom*, 346 F. Supp. 2d at 689 ("Information regarding relationships that undermine the independence of an underwriter's judgment about the quality of the investment can be material to an investor. As a consequence, non-disclosure of an underwriter or issuer's conflicts of interest can constitute material omissions, even where no regulation expressly compels the disclosure of such conflicts."). This requirement is found in Rule 408, which provides that, "in addition to the information expressly required to be included in a registration statement" issuers must disclose "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." 17 C.F.R. § 230.408 (2011).

[359] In reality, such disclosures tend to be boilerplate. For example, WorldCom, Inc.'s registration statement for its 2000 bond offering contained the following disclosure concerning material relationships with its underwriters:

> The underwriters and their affiliates have performed certain investment banking and advisory and general financing and banking services for us from time to time for which they have received customary fees and expenses. The underwriters and their affiliates may, from time to time, be customers of, engage in transactions with and perform services for us in the ordinary course of their business. Salomon Smith Barney Inc. has acted as financial advisor to WorldCom in connection with the Sprint merger, for which it has received certain fees and for which it expects to receive additional fees upon the closing of the Sprint merger. In addition, Salomon Smith Barney Inc. will receive a financial advisory fee in connection with this offering.

Lead Plaintiff's Memorandum of Law in Opposition to the Underwriter-Related Defendants' Motion for Summary Judgment, *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004) (No. 02 Civ. 3288), 2004 WL 2386818 (emphasis omitted). These disclosures probably will continue to be boilerplate unless the SEC mandates more detail.

[360] Roy A. Schotland, *Conclusions and Recommendations*, *in* ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS, at 589 (stating that disclosure has its own limitations and that without structural changes, disclosure alone will not alleviate inherent conflicts of interest).

[361] *Id.*

[362] *Id.*

disclosure. Presumably the purpose of greater disclosure about an underwriter's conflict of interest is to give investors pause about the underwriter's due diligence, and to cause them to rely less on the underwriter's sterling reputation when purchasing the securities. If this is true, then why impose the due diligence requirement in the first place? Increasing investor distrust of underwriters seems to be squarely at odds with Section 11's due diligence regime. It makes little sense to require that underwriters protect investors by performing due diligence and at the same time encourage investors to doubt that due diligence.[363] A better solution would be to implement reforms to justify investors' confidence in the underwriter.

In sum, while Professor Wolfson's observations are valuable, his proposal to require more disclosure about an underwriter's conflicts is not a substitute for eliminating those conflicts.

B. *Do Underwriters Lack the Independence to Perform Due Diligence?*

Since Professor Wolfson wrote in 1980, few authors have discussed an underwriter's conflicts of interest in due diligence.[364] However, Professor Arthur Laby recently brought this long-neglected issue back to the fore with his seminal article on independent and dependent gatekeepers.[365]

1. Independent and Dependent Gatekeepers

As previously explained, Section 11 envisions that underwriters, like auditors, function as "gatekeepers" to protect public investors from

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[363] In addition, research by social psychologists suggests that disclosure of conflicts of interest may have a "perverse effect" rather than a positive one. *See* COFFEE, PROFESSIONS AND CORPORATE GOVERNANCE, *supra* note 208, at 334-35. Disclosure "may cause the party to whom the disclosure is made to let down its guard and assume that those making full disclosure of their conflicts will . . . deal with them fairly." *Id.* at 335. This may also lead the party with the conflict to feel that, "having disclosed, it can now pursue its own interests aggressively. In short, the recipients of biased advice will not adequately discount it, but those making the disclosure may thereby feel 'morally licensed' to act in their own self-interest." *Id.* (citing Daylian M. Cain et al, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1 (2005)).

[364] *See supra* notes 345-48 and accompanying text. However, some authors have looked at this conflict from the issuer's perspective. *See, e.g.*, Hurt, *supra* note 146, at 724 ("Although the investment banker's role is to advise the issuer on raising capital with the least cost, the investment banker may be using the issuer to extract wealth for its regular customers and future clients. The underwriter has a conflict of interest . . . [by] simply representing both the buyer and the seller in the same transaction.") (footnote omitted).

[365] *See generally* Laby, *supra* note 36.

inaccuracies in the registration statement.[366] However, not all gatekeepers are created equal, particularly with regard to their independence from the issuer. In his article, Professor Laby was the first to take a detailed look at the question of gatekeeper independence. He divided gatekeepers into two categories: (1) those that are largely independent of the issuer and (2) those that are largely dependent on the issuer.[367] In Laby's taxonomy, "independent" gatekeepers are those who "are supposed to be independent of their clients in order to critically evaluate a set of facts and render an unbiased opinion for an unknown audience."[368] Auditors are, according to Laby, "the archetypical independent gatekeeper."[369] They serve the public as a "public watchdog" and "cannot be the client's advocate" in any way.[370] By contrast, Professor Laby explains, "dependent" gatekeepers are those that "depend on the client to determine the nature, purpose, and scope of their agency" and who "provide advice and recommendations to assist a client in meeting its goals."[371] Unlike independent gatekeepers,[372] dependent gatekeepers often are fiduciaries for their clients, and as such "must act for the client's benefit, furthering its ends."[373] The relationship between a

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[366] *See supra* Part III.B.6.

[367] Laby, *supra* note 36, at 123-34.

[368] *Id.* at 124.

[369] *Id.*

[370] *Id.* *Accord* Coffee, *An Agenda for the SEC*, *supra* note 209, at 1311 ("Auditors, of course, must be independent from their client, and SEC rules have long defined tests for auditor independence."). This view of auditor independence is of course a normative statement, not a positive statement. In fact, even auditors are not *entirely* independent from their issuer clients. Issuers, after all, hire auditors. An auditor's independence is therefore potentially compromised because they "rely on repeat business" from their issuer clients and "may well consider the prospects of being retained for next year's audit even as they perform this year's audit." Sean M. O'Connor, *The Inevitability of Enron and the Impossibility of "Auditor Independence" Under the Current Audit System* 3 (March 1, 2002) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303181. Further, despite the existence of a "bramble bush" of "auditor independence" rules, updated by the supposedly "sweeping reforms" of the Sarbanes-Oxley Act of 2002, some scholars have expressed doubt that such attempts to mandate auditor independence have been truly effective. *See, e.g.*, Sean M. O'Connor, *Strengthening Auditor Independence: Reestablishing Audits As Control and Premium Signaling Mechanisms*, 81 WASH. L. REV. 525, 559-71 (2006).

Yet, although an auditor lacks perfect independence, it surely is *far* more independent than a lawyer—and more independent, as we will see, than an underwriter. Accordingly, while it might be more accurate to label auditors "largely" or "mostly" independent gatekeepers, the distinction between gatekeepers who should be largely independent and gatekeepers who should be largely dependent is nonetheless a valuable one. If underwriters are largely dependent gatekeepers today, *should* they be? Or should reforms be enacted to make them largely independent gatekeepers?

[371] Laby, *supra* note 36, at 120, 127.

[372] *Id.* at 127 (stating that "an auditor is not . . . a fiduciary to the client when performing an audit function").

[373] *Id.*

dependent gatekeeper and its clients—by contrast to the relationship of an independent gatekeeper and its clients[374]—is "characterized by values such as longevity and mutual trust."[375] Such gatekeepers "perform their responsibilities under the yoke of unconscious bias that affects the[ir] rigor . . . and the accuracy of their judgments."[376]

The securities lawyer—whose job is to zealously represent its client—is an obvious example of a dependent gatekeeper.[377] Perhaps the *most* dependent gatekeeper, the lawyer represents its client first and foremost; nobody expects a lawyer to be impartial.[378] Thus, as Professor Laby observes, even when counsel is asked to provide a legal opinion for its clients—a situation when its objectivity and impartiality, if any, should be paramount—the lawyer is "not completely objective" because of its "dual role as opinion-giver and engineer of the transaction on which he is opining."[379] The lawyer is, as Professor Laby astutely observes, "passing on [its] own work," which no auditor is allowed to do.[380]

2. Underwriters Are Dependent Gatekeepers

According to Professor Laby, underwriters are "dependent gatekeeper[s] in many respects."[381] First and foremost, underwriters are dependent on issuers because "[t]he issuer engages the underwriter to promote the distribution of its securities."[382] Also, underwriters function as a

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[374] *Id.* at 125 & n.28 (discussing restrictions in the recent Sarbanes-Oxley Act that prohibit an auditor from being the lead partner for any particular client for more than seven years, due to the concern that such a long-standing relationship threatens the auditor's objectivity).

[375] *See* Laby, *supra* note 36, at 127.

[376] *Id.* at 121.

[377] *Id.* at 128 (stating that a lawyer is "[a] prime example of a dependent gatekeeper").

[378] *Id.* (contrasting the role of a lawyer, whose ethical norm is loyalty and who "seeks to achieve success for his or her client," with the role of the judge, whose "ethical norm is impartiality").

[379] *See* Laby, *supra* note 36, at 131.

[380] *Id.* Professor Laby is not alone in his opinion that a securities lawyer giving its legal opinion to its client is not objective in the same sense as an auditor. Professor Coffee, who literally wrote the book on gatekeepers, appears to concur. *See id.* at 132 n.82 (citing John C. Coffee, Jr., *Can Lawyers Wear Blinders? Gatekeepers and Third Party Opinions*, 84 TEX. L. REV. 59 (2005)).

[381] *See* Laby, *supra* note 36, at 131. Elsewhere Professor Laby states that underwriters "share characteristics of both" independent and dependent gatekeepers. *Id.* at 121. However, he does not elaborate on any characteristics that underwriters share with independent gatekeepers like auditors. Rather, his entire argument is that underwriters are dependent gatekeepers. *See id.* at 132-34. As such, perhaps Professor Laby means to make the exact point of this Article: that underwriters are viewed by the law as independent, despite actually being dependent.

[382] Laby, *supra* note 36, at 132-33.

trusted "adviser to the issuer" prior to the offering.[383] Further, "an underwriter often has a direct or indirect financial interest in an offering" and "[s]ome underwriters invest directly in their clients."[384] Additionally, in stark contrast to independent auditors who are "restricted in the performance of non-audit services,"[385] "underwriters perform multiple services for their clients,"[386] and therefore "continue to have an interest in cultivating the client relationship to obtain additional consulting and other work."[387] As a result, some courts even "recognize a fiduciary relationship between an underwriter and an issuer" with respect to the underwriter's role as a financial advisor to the issuer.[388] Also unlike auditors, for some offerings (known as "best efforts" offerings), an underwriter does "not [even] receive a fee unless some or all of the securities are sold."[389] Thus, underwriters regularly find themselves in the untenable position of working for two different masters whose interests may be largely at cross purposes: the underwriter must perform due diligence on the issuer as a quasi-fiduciary for investors while also selling the securities of the issuer (and further, perhaps advising as a fiduciary).

Professor Laby's insights are, without a doubt, correct for underwriters of all stripes. However, underwriters for the world's largest corporations (call them "mega-WKSIs")[390] are dependent on their issuer clients for a number of additional reasons.

For starters, many massive companies issue securities frequently, particularly debt securities.[391] As a result, an underwriter who walks away from an offering due to a dispute about due diligence with its mega-WKSI client probably gives up the possibility of doing substantial future underwriting business with that particular issuer. Further, massive companies traditionally (but perhaps less so today)[392] have long-term relationships with their underwriters.[393] Thus, an issuer's current lead

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[383] *Id.* at 133.

[384] *Id.*

[385] *Id.* at 134; *see* Sarbanes-Oxley Act of 2002 § 201(a), 15 U.S.C. § 78j-1(g).

[386] Laby, *supra* note 36, at 133.

[387] *Id.* at 134.

[388] *Id.* at 133.

[389] *Id.*; *see also* Andrew F. Tuch, *Securities Underwriters in Public Capital Markets: The Existence, Parameters and Consequences of the Fiduciary Obligation to Avoid Conflicts*, 7 J. CORP. L. STUD. 51, 72 (2007) (arguing that underwriters may be fiduciaries of the issuer in an IPO, depending on the facts of the situation).

[390] Leahy, *supra* note 41, at 2040 & n.221.

[391] *See* Scott, *supra* note 180, at 265.

[392] *See* Leahy, *supra* note 41, at 2033 n.185.

[393] *Id.* at 2033 n.186; *see also* Greene, *supra* note 125, at 791.

underwriter is probably first in line to underwrite future offerings. As a result, an underwriter who falls out with its issuer client over due diligence risks not just a possibility, but a substantial probability, of losing future underwriting business with that client.

In addition, as Professor Laby recognizes, it's not just about underwriting business.[394] Lead underwriters often are full-service investment banks that provide other financial services besides underwriting to their clients.[395] For example, such banks commonly provide loans to their issuer clients at the same time that they provide underwriting services.[396] Yet, this is really just the tip of the iceberg if the issuer is a mega-WKSI.[397] The lead underwriters for such corporations are "global banks"[398]—massive "financial supermarkets" that provide "one-stop shopping" to meet *all* of their clients' financing needs.[399] Such banks may provide, *inter alia*, advice on mergers and acquisitions ("M&A") to their issuer clients.[400] Underwriting is just a small part of what these global banks do.[401] Thus, the global bank underwriter does a *lot* more business with its massive issuer clients than simply selling their securities in occasional investment grade debt offerings. The global bank may provide a wide-ranging and steady stream of financial products to the issuer throughout the year. Walking away from an offering due to a disagreement in due diligence would likely fracture the entire relationship between global bank and client, thereby jeopardizing not just future underwriting business but *all* future banking business.

Not only is underwriting just one of the *many* services that global banks offer to their clients, it is by no means the most appealing from the bank's perspective. Some other financial services, such as advising on M&A, provide for a higher profit margin than commoditized services like investment grade debt underwriting.[402] Further, the 1990s and 2000s also

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[394] *See* Laby, *supra* note 36, at 133.

[395] *See* Leahy, *supra* note 41, at 2046.

[396] *See generally* Steven Drucker & Manju Puri, *On the Benefits of Concurrent Lending and Underwriting*, 60 J. FIN. 2763 (2005) (exploring the possible benefits of an underwriter concurrently lending to an issuer while also underwriting its securities offerings).

[397] *See* Leahy, *supra* note 41, at 2046.

[398] *Id.* at 2045-46.

[399] *Id.* at 2046.

[400] *See id.* at 2050 & n.273.

[401] *See* Erik Sirri, *Investment Banks, Scope, and Unavoidable Conflicts of Interest*, 89 FED. RESERVE BANK OF ATLANTA, ECON. REV. 23, 25 tbl. 1 (2004) (for three investment banks – Morgan Stanley, Merrill Lynch and UBS – underwriting consisted of 8-10% of overall bank revenue in 1999, 2001 and 2003), *available at* http://www.frbatlanta.org/filelegacydocs/erq404_sirri.pdf.

[402] *See* Leahy, *supra* note 41, at 2048 & n.265. *See also Task Force Report*, *supra* note 136, at 1210 (stating that underwriting investment grade offerings and seasoned offerings generally has declined in profitability).

saw the rise of new and highly profitable derivative financial products that banks may attempt to sell to their issuer clients.[403] Thus, when a global bank underwrites a securities offering for an issuer client, it may be more interested in providing financial services *other than underwriting* to their issuer clients.

As a result, when a global bank underwrites an offering for a mega-WKSI client, the bank may be doing so with an eye to doing *more lucrative* business with the bank in the future.[404] Bank-client relationships are not static, and it is common for bankers who are underwriting securities for an issuer to "pitch" their issuer clients and attempt to "cross-sell" "a whole range of additional or alternative financial services" to assist the client with its financing needs.[405] Thus, even if the global bank underwriter for a massive corporation does not *already* have an existing relationship with its issuer/client, the bankers are undoubtedly attempting to *develop* one. Underwriting a highly successful public offering for the issuer is certainly one way to build such a relationship; walking away from an offering due to a dispute about due diligence is certainly one way to destroy such a relationship.[406]

For all of these reasons, underwriters for mega-WKSIs may be *even more* dependent on their issuer clients than the average underwriter.

3. Dependent Gatekeepers Arguably Cannot Play "Devil's Advocate"

Members of the investing public presumably would prefer that their interests be watched over by an independent gatekeeper.[407] According to Professor Laby, the reason is "intuitive":

> The dependent gatekeeper faces a dilemma. He can act as a weak monitor, enhancing his potential liability, but preserving his client relationship and positioning himself for future business. Alternatively, he can act as a robust monitor,

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[403] *See generally* FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS (rev. 2009).

[404] *See* Leahy, *supra* note 41, at 2059 n.320 (citations omitted) ("[B]anks may use [securities issuances] . . . to build the relationship necessary for other—more lucrative—types of business.").

[405] *Id.* at 2050.

[406] *Cf.* COFFEE, PROFESSIONS AND CORPORATE GOVERNANCE, *supra* note 208, at 167 (discussing the same cross-selling problem for auditors, which was ameliorated but perhaps not eliminated by the Sarbanes-Oxley Act); Cunningham, *supra* note 207, at 344-45.

[407] *See* Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO J. LEGAL ETHICS 411, 415-16 (2008) (noting that there exists a preference for gatekeepers that are independent).

> shielding himself from potential liability, but possibly damaging his client relationship and acting inconsistently with his fiduciary duty.[408]

Behavioral economics provides more guidance, as Professor Laby explains: an underwriter is likely to fail to be an effective gatekeeper due to a range of factors including cognitive bias in favor of its client,[409] alignment with the directional goals of the client (i.e., favoring the particular result desired by its client rather than the accurate result desired by the public who the underwriter is supposed to protect),[410] and commitment bias (the tendency to escalate one's enthusiasm for an endeavor once one commits to a course of action).[411] Like a lawyer, an underwriter "is accountable to" his issuer client rather than to the nameless, faceless retail investors who supposedly depend on the underwriter's due diligence.[412] For these reasons, urges Professor Laby, "independent gatekeepers will be better monitors than dependent gatekeepers, and perform a more robust gatekeeper role."[413]

Although the *BarChris* and *Leasco* courts obviously did not have the benefit of Professor Laby's analysis, their conflicting holdings actually lend credence to his point. In *BarChris*, the underwriter was anything but independent from the issuer.[414] The "partner in the underwriting firm who had primary responsibility for investigating the issuer was also a director of the issuer."[415] This was a serious conflict of interest, because unlike with an underwriter (where it is an open question),[416] there can be no doubt that a director owes a duty of loyalty to the corporation.[417] It is therefore not surprising that the underwriter's due diligence in *BarChris* was shoddy and incomplete. Although the *BarChris* court did not explicitly reject the

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[408]Laby, *supra* note 36, at 134-35 (footnote omitted).
[409]*Id.* at 138.
[410]*Id.* at 139-40.
[411]*Id.* at 143-45.
[412]Laby, *supra* note 36, at 142-43.
[413]*Id.* at 162.
[414]*See* HAZEN, *supra* note 268, § 7.4, at 289.
[415]*Id.*
[416]*See* Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 433 n.297 (2010) (citing recent opinions holding that an underwriter *may* owe a fiduciary duty to its issuer client).
[417]*See, e.g.*, William Meade Fletcher, 3 FLETCHER CYC. CORP. § 837.60 (2012) ("In discharging their function of managing the business and affairs of the corporation, directors and officers owe fiduciary duties of care and loyalty to the corporation.") (footnote omitted).

underwriter's due diligence defense due to its lack of independence,[418] that certainly may have played a role in the court's decision.[419]

In *Leasco*, by contrast, "there was no interlocking directorate or relationship between the issuer and the underwriter," so the underwriters "were truly outsiders who were dealing at arm's length with the issuer."[420] Although this was not an explicit basis for the *Leasco* court's holding, the court did determine that the underwriters had "just barely" satisfied their due diligence obligation.[421] It is certainly possible that the greater independence of the underwriters in *Leasco* convinced the court that a marginal due diligence effort was nonetheless sufficient to pass muster.

Anecdotal evidence also suggests that, at least for shelf-registered offerings, investment bankers today do not play an adversarial role in due diligence as required by *BarChris*. This author's impression, as former counsel to the underwriters in the WorldCom, Inc. securities litigation,[422] is that the investment bankers who underwrote that company's bond offerings did not *feel* adverse to their client or its management when performing due diligence. These investment bankers worked hard to understand their issuer client and took pride in thoroughly understanding its business and financial data. However, these bankers seemed to perform their investigation of WorldCom, Inc. primarily to serve their *own* business purposes, rather than primarily for the purpose of verifying the facts in the company's registration statement. They worked hard to learn about WorldCom, Inc.'s business because doing so allowed them to better serve the client and to earn more business from that client. They did not investigate WorldCom, Inc. for the

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[418] *See* HAZEN, *supra* note 268, §7.4, at 289.

[419] *See id.*, § 7.4, at 290 (cautioning readers to bear in mind when analyzing the significance of *BarChris* that "the underwriter's investigation was not a truly independent one").

[420] *See id.*, § 7.4, at 291.

[421] *See* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 582 (E.D.N.Y. 1971).

[422] In the WorldCom litigation, the author represented the syndicate of banks that underwrote WorldCom, Inc.'s two massive investment grade bond offerings in 2000 and 2001 that were the basis for plaintiffs' Section 11 claims. In that litigation, the author was a principal architect of the underwriting syndicate's due diligence defense, the lead associate on the team that prepared the lead underwriter's due diligence witnesses (i.e., various investment bankers) for trial, and the point of contact between the trial team and its due diligence expert witness. In those roles, the author spent hundreds of hours in interviews and deposition preparation with a handful of investment bankers who lead the team for one of the lead underwriters. The author also spent literally thousands of hours reviewing and analyzing documents created or reviewed by other investment bankers who worked on the two massive offerings, including documents created or reviewed by the team for the other lead underwriter. The author's impressions of these bankers' attitudes and purposes are based *entirely* on his own general observations and (so far as the author recalls) his review of unprivileged documents. The author's impressions are *not* based on any specific confidential communications with his former clients.

purpose of catching its officers in a lie or to root out fraud. They did not approach WorldCom, Inc. or its management with inherent suspicion—and certainly not with a suspicion of fraud. They viewed their role as empowering WorldCom, Inc. to obtain financing, not sleuthing whether management has falsified the company's financial statements. Their purpose was to help WorldCom, Inc. with its business objectives, not to act as its adversary. Indeed, they never would have taken on WorldCom, Inc. as a client if they did not trust its management in the first place. In short, they did not seem to view themselves as "devil's advocates."[423]

For all of these reasons, Professor Laby's insight that underwriters are dependent gatekeepers—and the fact that underwriters for mega-WKSIs are particularly dependent gatekeepers—suggests that reforms are needed if the underwriter is to serve as an effective gatekeeper.

4. Other Proposals for Gatekeeper Reform

As explained above, an underwriter's role as dependent gatekeeper has not garnered much scholarly attention. Other scholars who write about underwriters' gatekeeping role undoubtedly know that underwriters face a conflict due to their dual – and dueling – roles as both seller of the issuer's securities and devil's advocate in due diligence.[424] Perhaps based on this understanding, prominent scholars writing about gatekeepers in the post-Enron era have repudiated the traditional view that, above all else, a gatekeeper will diligently investigate the issuer to protect its reputation.[425]

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[423] Professor Wolfson voiced a similar theme. *See* Wolfson, *supra* note 229, at 373 (quoting the 1972 testimony of a banker before Congress: "In view of the good reputation [of the issuers] . . . we were . . . flattered to be selected as the underwriter. It would have been regarded as poor taste if we . . . made any further investigations of the company . . . .").

[424] *See, e.g.*, Coffee, *Challenge of Fashioning Reforms*, *supra* note 208, at 309 ("Unavoidably, the gatekeeper as a watchdog is compromised . . . [because] it is typically paid by the party that it is to monitor."); Cunningham, *supra* note 207, at 346 (stating that how gatekeepers are paid is a "pervasive" limitation on their ability to remain neutral because of the "inherent inclination for solicitude simply to retain business"); Partnoy, *supra* note 222, at 492 ("[I]nvestment banks face demonstrated conflicts of interest [and] frequently do not uncover issuer . . . fraud.").

[425] *See* COFFEE, PROFESSIONS AND CORPORATE GOVERNANCE, *supra* note 208, at 333 ("[G]atekeepers will not always seek to protect their reputational capital. Circumstances can arise in which it is rational to risk that capital. Particularly in concentrated markets, the rational gatekeeper may recognize that it does not need an unblemished record, but only one not significantly worse than its rivals.") (summarizing chapter 9); Coffee, *About the Gatekeepers*, *supra* note 208, at 1419; Partnoy, *supra* note 222, at 494-505, 510-28; *see also* Frank Partnoy, *Strict Liability For Gatekeepers: A Reply To Professor Coffee*, 84 B.U. L. REV. 365, 366, 367 (2004) (summarizing common ground with Professor Coffee in stating that "reputational pressures alone do not create adequate incentives for issuers to disclose material facts, or for gatekeepers to certify that issuers have done so" and noting the growing support for the view that "gatekeepers might rationally decide

However, most scholars' approach to gatekeepers, post-Enron, has been to propose stricter regulation.[426] For example, Professors Coffee and Partnoy have both advocated that underwriters be subject to strict liability without a due diligence defense.[427] More recently, Professor Merritt Fox has proposed to replace underwriter liability for misstatements in the registration statement with a requirement that "an investment bank or other well-capitalized entity with substantial financial expertise" certify reporting companies' periodic reports.[428] By contrast, others such as Professor Lawrence Cunningham have proposed creating incentives to improve gatekeeper effectiveness.[429]

None of these scholars squarely address (or anticipate[430]) the concerns raised by Professor Laby.[431] Since underwriters are structurally dependent

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to deplete their reputational capital . . . in an attempt to maximize expected profits").

[426] *See* Cunningham, *supra* note 207, at 325 ("[R]eforms concentrate on reconfiguring the type and combination of sticks in use."). However, at least two scholars have bucked this trend. *See, e.g.*, Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 102-06, 114 (2003) (arguing against strict liability and for a negligence regime for gatekeepers); Noam Sher, *Negligence Versus Strict Liability: The Case of Underwriter Liability in IPO's*, 4 DEPAUL BUS. & COM. L.J. 451, 465 (2006) ("[A] negligence-based liability arrangement can better serve the existing primary market issuing mechanism and reduce its existing costs better than a strict liability arrangement."). Others advocate that, since an underwriter no longer plays an important role as sponsor of an offering, underwriters should only be liable if their conduct is sufficiently reckless to constitute scienter. *See* Langevoort, *supra* note 210, at 67-68. Still others advocate that underwriters for shelf-registered offerings should face no liability at all. *See* JOSEPH AUERBACH & SAMUEL L. HAYES, INVESTMENT BANKING & DILIGENCE: WHAT PRICE DEREGULATION? 189-98 (1989).

[427] *See* Coffee, *Challenge of Fashioning Reforms*, *supra* note 208, at 349-50; Partnoy, *supra* note 222, at 540 ("The proposal is simple: impose strict liability on gatekeepers for material misstatements and omissions in offering documents and remove any due diligence-based defenses from securities regulation"); Coffee, *Challenge of Fashioning Reforms*, *supra* note 208, at 349-50 (proposing a modified strict liability regime). However, Professor Coffee also has advocated involving other gatekeepers (albeit not independent ones) in the process. *See infra* note 444. Under a strict liability regime with no due diligence defense, underwriters would candidly become simple re-insurers. *See* Partnoy, *supra* note 222, at 544-45. Some have argued that underwriters are essentially insurers now, especially for shelf registered offerings where they have no time to perform due diligence and are usually indemnified by issuers. *See id.* at 520, 543, 544-45; Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 245 (2009) [hereinafter Fox, *Civil Liability*].

[428] Fox, *Civil Liability*, *supra* note 427, at 240.

[429] *See generally* Cunningham, *supra* note 207 (arguing that sanctioning gatekeepers is not an effective means to regulate the capital market and that a new regime focusing on positive incentives should be adopted).

[430] "Anticipate" is perhaps the better word choice, since the articles in which Professors Partnoy and Coffee propose stricter liability for gatekeepers predate Professor Laby's article on independent and dependent gatekeepers.

[431] Professor Cunningham, writing after Professor Laby's commentary in the area, recognized that "[g]atekeepers must be independent," *see* Cunningham, *supra* note 207, at 334, and noted that gatekeepers could be subject to the constraints of behavioral psychology identified by Professor Laby (e.g., commitment bias), *see id.* at 350-51. However, Professor Cunningham did not explicitly address how to eliminate an underwriter's dependence on the issuer's client.

gatekeepers, their economic and psychological role in a securities offering places them in a position where they are far more likely to cater to the interests of the issuer than to the interests of the investing public. Simply creating a better carrot to properly incentivize gatekeepers, as Professor Cunningham suggests, or using a bigger stick to punish them, as Professors Coffee and Partnoy both advocate, does not necessarily solve the independence problem.[432] Professor Fox's idea to change the locus of an investment bank's certification from the registration statement to the issuer's public reports, while intriguing,[433] also does not wholly eliminate independence concerns.[434] If, as the behavioral psychology martialed by Professor Laby indicates, some gatekeepers are structurally unsuited to protect the public, then perhaps reforms other than carrots and sticks must be considered. Improvements to free underwriters from their dependence on the issuer—i.e., to make underwriters more independent—might be a better approach. At a minimum, increasing underwriter independence could complement these other proposed reforms.

C. *A Potential Solution: Expand the Use of Independent Underwriters*

As we have seen, *BarChris* and its progeny read Section 11 to require that the underwriter's investigation be "adverse," i.e., independent.[435] In *BarChris*, the underwriter was not independent,[436] but courts have deemed those facts anomalous and have heralded underwriters as perfectly suited to play devil's advocate.[437] This is no longer true (if it ever was), in light of the economic changes to the underwriting business, and particularly for

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[432]In fact, these writers bring much of their analysis to bear on auditors rather than underwriters. This may reflect an implicit understanding by these authors that an independent gatekeeper is a better gatekeeper in the first place.

[433] Professor Fox's approach would eliminate the "due diligence dilemma" that underwriters purportedly face in shelf-registered and "automatic" offerings, *see* Leahy, *supra* note 41, at 2004-06; Fox, *Civil Liability*, *supra* note 427, at 277 n.99, 299. The largest underwriters, however, may have already solved this dilemma. *See* Leahy, *supra* note 41, at 2064-65.

[434]Professor Fox's proposal, if implemented, would eliminate the immediate conflict between an underwriter's marketing and due diligence roles, because the due diligence Professor Fox envisions does not occur in the context of a securities offering. Yet, Professor Fox does not propose any independence rules for the certifying entity. Indeed, he suggests elsewhere that the entity could compete for the company's issuing business in its next offering. *See* Merritt B. Fox, *Gatekeeper Failures: Why Important, What to Do*?, 70 MICH. L. REV. 1089, 1108-09 (2008) [hereinafter Fox, *Gatekeeper Failures*].

[435]*See supra* Parts III.B.4-5.

[436]*See supra* notes 414-19 and accompanying text.

[437]*See supra* Part III.B.1.

underwriters of massive, mega-WKSIs.[438] Underwriters are dependent gatekeepers, structurally unsuited to play "devil's advocate."[439] As a result, the due diligence can work today only if the threat of liability under Section 11 *forces* a dependent gatekeeper to *function* as an independent gatekeeper.[440] Scandal after scandal would seem to suggest otherwise.[441] Underwriters, like other gatekeepers, cannot easily escape their structural bias towards their clients.[442]

Yet, nothing in Section 11 requires that the underwriter who markets the issuer's securities perform the due diligence investigation on its own. An underwriter certainly can hire an agent to perform that investigation.[443] Why not hire an independent underwriter with no ties whatsoever to the issuer?[444] Section 11 contains no requirement that the underwriter who performs due diligence on behalf of investors be the *same* underwriter who markets the issuer's securities.[445] A different underwriter with no prior (or potential future business relationship with the issuer) *could* potentially function as an independent gatekeeper.

Indeed, to the extent that the underwriter who markets the issuer's securities is inherently conflicted,[446] such underwriters could be *prohibited* from performing the due diligence investigation on their own. Rather, in order to successfully assert the defense, such an underwriter could be

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[438] *See supra* Parts III.B.7, V.B.3.

[439] *See supra* Parts V.B.2-3.

[440] *Cf.* Klinges, *supra* note 149, at 1085 ("[A]n underwriter's . . . legitimate business goals interfer[ing] with full disclosure—is exactly what Congress intended the Act to remedy.").

[441] *See generally* Simon Romero & Alex Berenson, *WorldCom Says It Hid Expenses, Inflating Cash Flow $3.8 Billion*, N.Y. TIMES, June 26, 2002, at A.1 (discussing the financial scandals involving WorldCom, Adelphia Communications, Dynergy, and Tyco).

[442] *See supra* Parts V.B.1-2.

[443] *See, e.g.*, Folk, *supra* note 91, at 72 (noting that the underwriters in *BarChris* designated the majority of the investigation of the issuer to their counsel, and such a practice occurs in the "industry generally"); Wolfson, *supra* note 229, at 375 ("As in many underwritings, the bulk of the investigation [is] . . . conducted by the underwriter's law firm.").

[444] This approach differs starkly from Professor Coffee's proposal that issuers be required to hire certifying disclosure counsel to review their periodic reports, *see* COFFEE, PROFESSIONS AND CORPORATE GOVERNANCE, *supra* note 208, at 347-52, because nowhere does his proposal require that counsel be *independent* of the issuer, s*ee id.* at 348. What's more, Professor Fox's critique of Professor Coffee's proposal rings true: bankers, not counsel, ought to perform financial due diligence. *See* Fox, *Gatekeeper Failures*, *supra* note 434, at 1108. That said, the independent underwriter also could certify the issuer's periodic filings under the Exchange Act if the SEC ever adopts Professor Fox's proposal to require such certification. *See id.* at 1108-10; Fox, *Shelf Registration*, *supra* note 75, at 1034. However, to retain its independence, this underwriter could not turn around and later be the lead underwriter in a subsequent public offering for the issuer as Professor Fox suggests. *See* Fox, *Gatekeeper Failures*, *supra* note 434, at 1108-10.

[445] *See generally* Securities Act of 1933 § 11, 15 U.S.C. § 77k (2006).

[446] *See supra* Part V.B.3.

required to hire an unconflicted underwriter to perform due diligence in its stead. Such a requirement would reduce the structural bias in due diligence, as an independent investment bank would be better situated to play "devil's advocate" with an issuer.

In a recent article, Professor Laby mentions the possibility of involving an independent underwriter model in certain offerings, apparently in a supervisory or complimentary role.[447] Professor Laby does not develop the idea in detail, but it is a great starting point.[448]

First, as Professor Laby notes, a framework for independent underwriters already exists in regulations governing underwriters by their self-regulatory organization, FINRA.[449] Today, an underwriter must hire a "qualified independent underwriter" ("QIU") when the underwriter has a conflict of interest in representing the issuer.[450] FINRA defines conflict of interest quite narrowly, to include only situations where the underwriter actually owns a controlling equity stake in the issuer or where the underwriter will obtain a large chunk of the proceeds from the offering.[451] Yet, the rule easily could be broadened (either by FINRA or by the SEC)[452] to implement stronger conflict of interest rules for underwriters—analogous, perhaps, to the rules for auditors. The new rule should not function exactly like the QIU rule, however, since a QIU typically is part of the syndicate of underwriters and does not receive separate compensation for its role.[453]

Hiring an independent underwriter also should not absolve the marketing underwriter from its due diligence responsibility.[454] Rather, like

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[447] *See* Laby, *supra* note 416, at 433 ("[A] . . . possible reform to help ensure that an underwriter acts in a fiduciary capacity with respect to customers is to require an issuer conducting a public offering to engage an independent outsider to superintend the offering, with a skeptical eye to ensuring the interests of investors.").

[448] *See id.* at 433-34 .

[449] FINRA was formerly the National Association of Securities Dealers ("NASD"). *See About the Financial Industry Regulation Authority*, FINANCIAL INDUSTRY REGULATORY AUTHORITY, http://finra.org/AboutFINRA/index.htm (last visited Feb. 10, 2012).

[450] FINRA Rule 5121 is the former NASD Rule 2720, which has been renumbered as Rule 5121 in the FINRA rulebook consolidation process. NASD Rule 2720 was substantially amended in 2009 to modernize and simplify the rule. *See* Order Approving Proposed Rule Change to Modernize and Simplify NASD Rule 2720, Exchange Act Release No. 60113, 96 SEC Docket 326, 2009 WL 1662201 (June 15, 2009), *available at* http://www.sec.gov/rules/sro/finra/2009/34-60113.pdf.

[451] *See* FINRA Rule 5121(f)(5) (defining "conflict of interest").

[452] Indeed, no new SEC or FINRA rule is necessary to implement an "independent" underwriter requirement. Rather, a court could easily conclude, in a particular case, that an underwriter's due diligence was not sufficient because *BarChris* demands an "adverse" investigation. Yet, a regulatory solution is preferable to a judicial solution, as it would promote certainty and avoid litigation about an underwriter's conflicts after the due diligence already was performed.

[453] *See* Laby, *supra* note 416, at 434.

[454] In this important way, the proposal set forth herein differs from a prior proposal to have

the FINRA QIU rule, hiring an independent underwriter would simply subject an *additional* underwriter to liability for material inaccuracies in the prospectus.[455] Unlike the primary underwriter, that second underwriter would not be involved in pricing decisions or advising the client (differing here from the current QIU rule). Indeed, the whole point of the reform proposed here is to separate the pricing and due diligence decisions, so that the due diligence investigation drives price, not vice versa.

The independent underwriter proposed herein also should not purchase the issuer's securities or make a commission on the sale. Rather, the independent underwriter would be required to charge a flat fee or an hourly rate that would be paid in full regardless of whether or not the offering is completed.[456] Further, the independent underwriter would be subject to protection from wrongful termination due to bad faith disagreements in due diligence, just as an independent auditor is protected in the context of an audit.[457] The independent underwriter's name also ought to appear on the front of the registration statement, set off from the other underwriters to indicate that it is the independent due diligence underwriter. Also, to prevent a revolving door, the independent underwriter should be prohibited from marketing the issuer's securities for five years.[458]

Strictly liable for material inaccuracies in the registration statement and paid whether or not the offering succeeds, the independent underwriter would be aligned less with the issuer than underwriters are currently. An independent underwriter obviously might feel *some* pressure to satisfy its marketing underwriter client (for many of the same reasons that marketing underwriters identify with their issuer clients)[459]—particularly if the

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"experts" take over due diligence for underwriters. *See* AUERBACH & HAYES, *supra* note 426, at 193-95 (proposing that due diligence for some types of underwriters be handled by "professional diligence agencies"). As envisioned herein, independent underwriters would be an *additional* gatekeeper, not an *alternative* gatekeeper – and underwriters would *not* be permitted to assert the defense of "reliance" on an expert if the independent underwriter's due diligence was shoddy. What's more, as proposed herein, the hiring of an independent underwriter either would be mandated, not discretionary. *Cf. id.* at 193 (proposing that issuers would have the "discretion" whether to employ a "professional diligence agency").

[455] *See* FINRA Rule 5121(f)(12).

[456] *Cf.* Laby, *supra* note 416, at 434 (proposing that an independent underwriter supervising an offering should be required to refrain from participating in the underwriting and "limit its fees to those earned by serving as a QIU").

[457] It is unlawful for an issuer to "take any action to fraudulently influence, coerce, manipulate, or mislead" any independent auditor "for the purpose of rendering such financial statements materially misleading." *See* Sarbanes-Oxley Act of 2002 § 303, 15 U.S.C. § 7242(a) (2002).

[458] Indeed, regulators would be wise to prohibit the underwriter from doing any substantial business whatsoever with the issuer for five years, lest banks use "independent" underwriting as a loss leader to generate *non*-underwriting business from their issuer clients.

[459] *See supra* Part V.B.3.

independent underwriter hopes to be engaged by the marketing underwriter in future offerings. Yet, the fact than an independent underwriter is one step removed from the issuer surely would allow it to exercise *some degree* of independent judgment in due diligence. Such an underwriter would likely take its due diligence *more* seriously, and be *more* willing to stop the offering if it was not satisfied with issuer's disclosures, than would an underwriter who is only paid if the offering proceeds to its conclusion.[460]

D. *Changing How Courts Deal With Underwriter Conflicts*

In the absence of a new SEC or FINRA rule, judicial implementation of the aforementioned proposal would improve courts' approach to underwriter independence. The current approach seems to be limited to assessing whether the failure to disclose an underwriter's conflict(s) of interest constituted a material omission. For example, in *WorldCom*, the lead plaintiff alleged that the failure to disclose many business ties between the lead underwriters, Citibank and JP Morgan, and the issuer, WorldCom, Inc., were material omissions.[461] The *WorldCom* court agreed, reasoning that "[i]nformation regarding relationships that undermine the independence of an underwriter's judgment about the quality of the investment can be material to an investor."[462] The *WorldCom* court then held that the plaintiff had raised a material question of fact concerning the adequacy of the disclosures in the registration statements between the issuer and one of the lead underwriters.[463]

This approach makes little sense. First, as the *WorldCom* court recognized, the purpose of the registration statement is to describe the issuer, not the underwriter.[464] Any conflicts of interest caused by the underwriter's prior due diligence are material only to the extent that they affect the value of the issuer's securities.[465] And how would the underwriter's conflict affect the value of the issuer's securities? Only if the underwriter overpriced the securities, either because it performed inadequate due diligence or because it

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[460] *Accord* Seitz, *supra* note 82, at 1658 (citing Cunningham, *supra* note 207, at 354 (discussing a quote by Warren Buffet about investment bankers advising on a merger)) ("A major flaw . . . lies in the manner in which underwriters are rewarded . . . . Since most underwriters are paid based on a percentage of the per-share offering price, it follows that they get paid nothing if there is no offering. Like issuers, underwriters have a strong incentive to 'close the deal.'").

[461] WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 689 (S.D.N.Y. 2004).

[462] *Id.*

[463] *Id.*

[464] *Id.* at 688.

[465] *WorldCom*, 346 F. Supp. 2d at 688.

did not disclose all material information it learned about the issuer in due diligence. Hence, the material omission is simply a reflection on the quality of an underwriter's due diligence. Further, as explained above, the only purpose for such disclosure would be to cause investors to doubt the underwriter's ability to perform due diligence in the first place.

This approach seems to be exactly the opposite of what is required. Rather than treat the issue as a question of disclosure, a court should explicitly consider an underwriter's lack of independence in deciding whether the underwriter's investigation of the issuer was reasonable. In order to be reasonable, an investigation must at least be somewhat objective – somewhat "adverse."

This new approach would be consistent with the prudent person standard, which tells the underwriter *in whose shoes* to stand when performing due diligence.[466] A prudent person managing her own money would demand an *unbiased* investigation of the issuer. A prudent person would not accept a less-searching investigation of the issuer simply because its agent performing the investigation had other relationships with the issuer (unless, perhaps, the cost of a truly independent investigation outweighed the benefit of the investigation in the first place).

VI. TWO MYTHS DISPELLED: RAMIFICATIONS & PROPOSALS

As explained in Part IV, an underwriter need not always independently verify every material fact in the registration statement, even if it is reasonably able to do so.[467] This means that the focus of an underwriter's due diligence as understood by courts should change dramatically – at least in some offerings. These changes would bring courts' understanding of due diligence more in line with the due diligence that underwriters actually perform in practice.

Further, as explained in Part V, some underwriters may not be sufficiently independent to perform due diligence.[468] This means that courts may have to evaluate an underwriter's independence as part of their analysis of whether the underwriter's investigation was reasonable.

This Part briefly explains how courts' approach to an underwriter's due diligence should change now that the Myth of Independent Verification has been dispelled. Further, now that the Myth of Independent Underwriters has been exposed, this Part offers some suggestions about when an underwriter

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[466] *See supra* Part IV.A.
[467] *See supra* Part IV.B.
[468] *See supra* Parts V.B.2-3.

should be deemed sufficiently independent to raise the due diligence defense.

A. *Changes to How Courts Evaluate Underwriters' Due Diligence*

BarChris, as traditionally understood, is a goldmine to plaintiffs' lawyers.[469] If underwriters are required to independently verify all material facts in the registration statement (to the extent that they can reasonably do so), then that document is essentially a checklist. In its ideal form, *BarChris*-inspired, independent verification-centric due diligence requires an underwriter to read through the registration statement line-by-line and independently verify every single fact—either by reference to the issuer's own internal documentation or (preferably) by looking to outside sources.[470]

This is not how underwriters actually perform due diligence in the real world, however. Underwriters use checklists in due diligence, but these checklists typically list aspects of the underwriter and its business to investigate (e.g., management, clients, product lines, etc.); the registration statement itself does not serve as the checklist.[471] Although someone working for the investment bank (probably a lawyer)[472] does, at least for an IPO, perform a line-by-line review of the registration statement, this review is part of the drafting process, not the basis for bankers' investigation of the issuer. Indeed, by the time this review occurs, much of the due diligence may be complete.

This is particularly true for shelf-registered offerings. Due to their compressed time frame, most of the due diligence for such offerings (to the extent that due diligence is performed at all) is "continuous due diligence," performed *before* the offering.[473] Although investment banks perform

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[469] *See, e.g.*, Folk, *supra* note 91, at 79.

[470] *Id.* (stating that *BarChris* requires that "the underwriter's investigation . . . embrace all material facts in the registration statement"); Lake, *supra* note 189, at 665 (stating that the *BarChris* holds that "the underwriter should demand substantiation, if reasonably possible, for all facts appearing in the registration statement, especially [material] facts"). Practicing lawyers appear to agree that this is the safest approach to due diligence. *See, e.g.*, Larry W. Sonsini et al., *Who Does What in a Securities Registration (With Checklist)*, 39 PRAC. LAW. 43, 66 (December 1993) ("To minimize the likelihood of a material misstatement or omission occurring in the registration statement, underwriters' counsel . . . should review the registration statement line by line to verify that every assertion made in the registration statement has been substantiated to the satisfaction of the underwriters and underwriters' counsel.").

[471] *See, e.g.*, HAFT & HUDSON, *supra* note 83, §§ 2:15 to 2:25 (providing examples of checklists for due diligence).

[472] *See* Sonsini et al., *supra* note 470.

[473] Leahy, *supra* note 41, at 2021.

continuous due diligence in a variety of ways, using a variety of bankers (i.e., not just the debt capital markets bankers who participate in underwriting),[474] the unifying thread for all such due diligence is that it does not focus on the registration statement—*because there is no registration statement yet*.[475] There is simply no time for the sort of due diligence that *BarChris* envisioned—devil's advocacy and review of primary source material like key contracts to make sure that management is telling the truth—during a shelf-registered offering.[476]

The integrated disclosure regime adds further complications to the devil's advocate-with-a-checklist approach envisioned by *BarChris*. When the bulk of the issuer's material disclosure about itself is incorporated by reference from prior public filings, the underwriter cannot play devil's advocate lightly. Any change to the issuer's prior disclosures has the potentially serious consequence of inviting a securities fraud lawsuit on the theory that the issuer's prior public disclosures were inaccurate. Knowing this, the issuer is likely to resist any changes to material that is incorporated by reference. Thus, even if an underwriter engages in a line-by-line review of the prior public reports that will be incorporated by reference into the registration statement, the underwriter undoubtedly will suggest changes to the registration statement only with some trepidation.

Using the registration as a checklist would not be required, however, to the extent that the underwriter can just investigate the issuer's objective trustworthiness and/or whether the issuer can satisfy a judgment under Section 11. Rather, an underwriter could simply investigate as it always has, focusing on developing a complete understanding of the issuer's business for its business purposes[477]—albeit with the specific focus on the issuer's equity cushion.

As explained previously, this change to due diligence probably would only benefit underwriters for seasoned issuers and mega-WKSIs.

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[474] *See id.* at 2047-49.

[475] *See id.* at 2062-63.

[476] *See* Langevoort, *supra* note 210, at 66; Fox, *Civil Liability*, *supra* note 427, at 245.

[477] Even prior to the Securities Act, it was "customary" for an investment bank to engage in a "thorough investigation" before taking on a new issuer or an established issuer as a client. Gourrich, *supra* note 148, at 46. This investigation helped the bank decide whether to take on the issuer as a client in the first place, aided the bank "in appraising the quality of the risk [it] was about to undertake," and helped the bank advise the client on what securities to offer and at what price. *Id.* This tradition of investigating the issuer for business purposes apparently continues to this day. *See* Valerie Ford Jacob & Stephanie J. Goldstein, *Conducting Due Diligence in a Securities Offering*, PRACTICING LAW INSTITUTE § 6:2 (2011). However, for seasoned or WKSI issuers, about which much information is publicly available, this investigation presumably depends heavily upon public information.

Underwriters for IPOs by new companies (and for many unseasoned issuers) will have little reason to expect that the issuer can pay a judgment under Section 11 without falling into bankruptcy. Further, it will be the rare exception where the public has sufficient information and regard for a non-public or unseasoned company that it would be reasonable for an underwriter to conclude the public objectively trusts that company's disclosures. As a result, in such cases, the underwriter would be wise to engage in independent verification as *BarChris* and its progeny envision.

Thus, this Article's proposed redefinition of what constitutes "reasonable investigation" would not water down Section 11's protection to investors. To the contrary, the proposed changes make sense in light of the decline of the sponsor theory. While underwriters once sponsored offerings and were undoubtedly responsible for the content of the prospectus, other than for an IPO or unseasoned issuer that time has passed. For shelf-registered offerings employing integrated disclosure, the sponsor theory probably no longer squares with reality. Investors do not buy the securities sold in such offerings simply because of the underwriter's reputation, and the underwriter no longer exercises dominion over the registration statement.[478]

As such, the scope of the underwriter's due diligence ought to be commensurate with the remaining justification for due diligence—the shingle theory.[479] That theory only requires a reasonable basis for the recommendation of the security being offered, not thorough control over the issuer's disclosure.[480] A less unyielding independent verification requirement actually makes *more* sense if the shingle theory provides the sole remaining rationale for the due diligence defense.[481] The underwriter's obligation under the shingle theory is to carefully review the issuer's creditworthiness, not to verify every material fact in the issuer's registration statement.[482]

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[478] *See supra* Part III.B.7.

[479] *See supra* Part III.B.9.

[480] *See supra* Part III.B.2.

[481] *Cf.* Langevoort, *supra* note 210, at 66-67 (suggesting that changing Section 11 to a pure negligence theory likely would result in underwriters continuing to perform their typical level of due diligence for shelf-registered offerings, due to, *inter alia*, their "'shingle theory' obligation").

However, to the extent an underwriter's due diligence serves purposes *other* than simply investor protection, *see generally, e.g.*, Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711 (2005-06) (arguing that the essential role of securities regulation is to promote an efficient market for sophisticated professional investors and analysts), those other purposes might not be served by the changes proposed by this Article.

[482] *See* Univ. Hill Found. v. Goldman, Sachs & Co., 422 F. Supp. 879, 898 (S.D.N.Y. 1976) (explaining that a broker's "shingle theory" investigation obligation usually "does not impose a duty of first hand verification"); *see also id.* at 899 (explaining that "there are significant distinctions between the task of . . . verifying specific factual representations in a particular registration statement . . . , which [is] the focus . . . [in Section] 11 cases, and pursuing an on-going, judgmental

B. *Courts May Have to Wrestle With Underwriter Independence*

This Article's proposed approach to underwriter independence undoubtedly would lead to additional costs for underwriters. Hiring an independent underwriter to investigate the issuer from scratch would be no small expense. Presumably an independent underwriter would require substantial compensation for time and effort spent on a dead-end "client" (i.e., one from whom it could not seek other business for five years); an independent underwriter undoubtedly also would demand some risk premium to compensate it for the potential of liability under Section 11. These costs likely would be passed on to issuers, and ultimately, to investors.[483] Regulators should consider these costs when deciding under what circumstances to require that the marketing underwriter hire an independent underwriter for due diligence. Further, until the SEC or FINRA implements rules to expand the definition of an underwriter "conflict of interest," courts evaluating an underwriter's due diligence under Section 11 will have to decide whether and to what extent *unconflicted* due diligence is worth the price to investors.

So, under what circumstances would a prudent investor want *unconflicted* due diligence? When is hiring an *independent* underwriter worth the cost to investors? One possible answer is that – just as with the question of independent verification—it will depend largely on the type of offering: Independent *underwriters* may be warranted only when there must be independent *verification* of material facts in the registration statement. Or to put it another way, an independent underwriter is necessary only when the underwriter's sponsorship of the offering *actually* matters to investors.[484]

On this view, for new or small companies about which markets have little information—e.g., companies engaged in an IPO—*unconflicted* due diligence (and *independent* verification) by underwriters of an issuer's material statements (to the extent that such verification is reasonably

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determination such as 'creditworthiness'").

[483] *See* STEINBERG, *supra* note 184, § 7.03, at 212.

[484] As one student urged long ago:

> [I]f the issuer is well established, courts should regard the underwriter's implied endorsement as being of doubtful value to the investor. . . . The underwriter's importance . . . would seem to be inversely related to the experience of the issuer. Thus, the investor might more justifiably rely on the underwriter's implied endorsement and assurance of due care where uncertainty surrounds the issuer. Similarly, the corporation expanding production of a proven market winner would presumably require a less extensive investigation by the underwriter than an issuer entering a high risk market with an untried product.

Expanding Liability, *supra* note 189, at 1203.

practicable) may in fact be worth the additional cost to investors.[485] But for large, well-established corporations, *unconflicted* due diligence (and *independent* verification) of all an issuer's material statements probably is *not* worth the cost to investors.[486]

Ironically (or perhaps not), this is exactly how underwriters viewed their due diligence obligation before the recent *WorldCom* decision: Underwriters performed far more stringent due diligence for IPOs than they performed for secondary offerings by established issuers.[487]

As a result, perhaps only minor changes ought to result from the debunking of the two irrepressible myths of *BarChris*. For IPOs, in the unusual case that an underwriter has a long-standing relationship with (and does significant business with) the issuer, the underwriter ought to be required to hire an independent underwriter to perform due diligence. Further, unless the newly-public company was an established private company with a huge stash of cash, the underwriter (independent or marketing) will *not* be able to rely on public trust of the issuer or simply investigate the issuer's ability to satisfy a Section 11 judgment. Rather, the *independent* underwriter will have to make a reasonable attempt to *independently* verify all material statements in the registration statement.

By contrast, for the great bulk of securities offerings—secondary offerings of debt by established issuers—underwriters should perhaps be allowed to satisfy the due diligence defense *without* hiring independent underwriters and *without* having to independently verify most material statements in the offering documents.[488]

VII. CONCLUSION

Dispelling *BarChris*'s two irrepressible myths could lead to some significant changes for underwriters, issuers and investors.

If courts accept that underwriters need not independently verify every material fact in every registration statement, then due diligence in some

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[485] *Cf.* Ferris et al., *supra* note 203, at 599 ("The arguments for relaxing due diligence requirements and allowing for flexibility in issuance of seasoned equities, however, are negated by the uniqueness of the initial public offering.").

[486] *See supra* Part II.A.2; *see also* notes 240-41 and accompanying text.

[487] *See supra* notes 87-88 and accompanying text.

[488] If the SEC or FINRA adopted this dichotomy, its new rules would contain an exception similar to the QIU rule. No QIU is required despite the existence of a conflict of interest as defined by the rule if, *inter alia*, there is a "bona fide public market" for the security being issued, *see* FINRA Rule 5121(f)(3), or if the securities are rated "investment grade" by a nationally-recognized statistical rating organization, *see* FINRA Rule 5121(f)(8).

offerings (i.e., those where public investors trust the issuer or where a reasonable investigation suggests that the issuer can satisfy a Section 11 judgment) may become less expensive. Issuers, and probably investors, will benefit from the elimination of costly due diligence that even a prudent person would not perform to protect her own interests. Further, underwriters could ignore the *WorldCom* case's holding that due diligence for a Fortune 200 company requires the same independent verification as the due diligence in an initial public offering.

This Article's proposed changes regarding underwriter independence cut the other way, possibly imposing additional costs on underwriters, issuers and investors. Hiring an independent underwriter, even in the limited instances proposed herein (i.e., for an initial public offering where the underwriter has an established relationship with the issuer that casts serious doubt on the underwriter's independence), will undoubtedly increase the cost of such offerings. Yet, addressing underwriter independence might lead to improved due diligence in such offerings, making it perhaps worth the candle.[489] Ultimately, this policy decision is better left to the SEC than to the courts. The SEC should therefore act promptly to consider and address this issue.

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[489]Or perhaps not, if the increased costs keeps smaller, high-risk/high-reward firms from coming to market. *Cf.* Henry G. Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws*, *in* WALL STREET IN TRANSITION, at 21 (Henry G. Manne & Ezra Solomon eds., 1974) (arguing that the burden of securities regulation falls more heavily on smaller issuers than on larger issuers). In any event, regulators should at least carefully consider the issue.