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Due Diligence in Private Placement Offerings

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I. Statutory and Regulatory Bases for Due Diligence

A. Public offerings

Section 11 of the Securities Act of 1933, as amended (the "1933 Act"), imposes liability on the issuer and other designated persons for any material misrepresentation or omission in a registration statement. While the issuer has few defenses to an action by a purchaser based on a misleading representation or omission (aside from actual knowledge of the misrepresentation by the purchaser), other parties[1] have an affirmative defense if they can prove that they made a reasonable investigation and had a reasonable basis to believe, and did believe at the time the registration statement became effective, that there were no material misstatements or omissions. "This is the essence of due diligence: a reasonable investigation resulting in reasonable grounds to believe and an actual state of mind in which the underwriter [or other person] does believe that the registration statement was correct."[2]

Section 12 of the Securities Act. Section 12(a)(2) provides the buyers of securities an express remedy for material misstatements or omissions made by "any seller" in connection with the offer or sale of the issuer's securities involving a prospectus or oral communications. Liability under this provision extends beyond the specific categories of persons enumerated in Section 11, attaching instead to any seller of the securities. For example, it is possible that directors or stockholders who actively participate in the offering process can be deemed "sellers" for purposes of this section.

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1 *E.g.*, persons who signed the registration statement, directors or partners, experts, underwriters, and control persons.

2 National Association of Securities Dealers, Inc., Special Report: Due Diligence Seminars (July 1981), p. 5 (hereinafter "NASD Special Report").

Section 15 of the Securities Act. Section 15 provides that any person who "controls" a person liable under Section 11 or Section 12 of the Securities Act is liable jointly and severally with and to the same extent as the controlled person. The term "controls" is broadly defined for purposes of this section and the concept of control can include directors, officers and principal stockholders, depending on the specific facts and circumstances.

Section 10(b) of the Exchange Act and SEC Rule 10b-5. Section 10(b) forbids the use of any manipulative or deceptive device in contravention of the SEC rules and regulations for the protection of investors. Rule 10b-5, adopted pursuant to section 10(b), prohibits fraudulent devices and schemes, material misstatements and omissions of any material facts, and acts and practices that operate as a fraud or deceit on any person in connection with the purchase or sale of a security. Each offering participant, including the issuer, its officers and directors, the underwriters, accountants and other experts, is potentially liable under this provision.

Section 20(a) of the Exchange Act. Section 20(a) of the Exchange Act imposes liability on any person who directly or indirectly controls any person liable under Section 10(b) or Rule 10b-5, to the same extent as the controlled person. Section 15 of the Securities Act and Section 20 of the Exchange Act have been interpreted as parallel provisions.

Offering participants can mitigate their risk of liability under these provisions by undertaking a thorough due diligence review of the issuer.

1. Standard of Reasonableness

Section 11(c) provides that "[i]n determining . . . what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property." This standard obviously requires some shared understanding of what steps a prudent person would take in the management of his or her own property. As noted in a Special Report on due diligence published by FINRA,

> "The standard of reasonableness under Section 11 is, in a sense, a 'standard of the street.' In considering whether an underwriter has conducted a reasonable investigation, therefore, one must realize that the standard of reasonableness is not an absolute standard that never changes. Rather, 'due diligence' may be construed as a standard that depends to some extent on what constitutes commonly accepted commercial practice. If you can establish that the steps taken meet the standard of the trade as it presently exists, a court should not, in applying the Section 11(c) standard, hold you liable for not being duly diligent despite the fact that you missed something and there was a material omission in the registration statement. What other underwriters are doing and the due diligence standards that are followed on the street are highly relevant in establishing one's defense.
>
> Since the prudent man standard may be construed as a 'standard of the street,' one is very reluctant to do anything that varies from street practice because that may weigh heavily in establishing liability. If every other underwriter uses a particular procedure, anyone who varies from that procedure is inviting trouble.
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> It is important, then, to be aware of what other people are doing in similar transactions. This does not mean that that is as far as one should go, but if one does not go as far as the standard of the street, he may be exposing himself to potential liability."[3]

FINRA Regulatory Notice 10-22

In April 2010, FINRA released Regulatory Notice 10-22, "Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings." In the Notice, FINRA provides guidance regarding a FINRA member's obligation to conduct a reasonable investigation of an issuer, and the securities offered, in connection with Regulation D offerings. The Notice addresses the following:

- A BD [broker-dealer] that recommends a security has a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it.

3 NASD Special Report, pp. 5-6.

- This duty emanates from the BD's "special relationship" to the customer, and from the fact that in recommending the security, the BD represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."

- "Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws and, particularly, Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder."[4]

- "Courts have found that the amount and nature of the investigation required depends, among other factors, upon the nature of the recommendation, the role of the broker in the transaction, its knowledge of and relationship to the issuer, and the size and stability of the issuer. *For example, the SEC and courts recognize that a more thorough investigation is required for 'securities issued by smaller companies of recent origin,' which could include many Regulation D issuers.* While there are no 'iron clad rules as to what a broker must do to meet his responsibility,' the presence of any 'red flags' also would alert the broker to the need for further inquiry. Each BD must make a determination of the scope of its investigation based upon the facts and circumstances." (emphasis added)

- "A BD that lacks essential information about an issuer or its securities when it makes a recommendation, including recommendations of securities in Regulation D offerings, must disclose this fact as well as the risks that arise from its lack of information."

- "The degree to which a broker-dealer that relies on information supplied by the issuer may be found to have conducted a reasonable investigation as a basis for its recommendation will depend on the facts and circumstances. With respect to reporting companies under the Securities Exchange Act, in the absence of red flags, a BD that is not an underwriter typically may rely upon the current registration statement and periodic reports of the public company. In general, however, a BD 'may not rely blindly upon the issuer for information concerning a company,' nor may it rely on the information

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[4] FINRA's position, that in recommending a security, the BD represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation" seems to directly conflict with the First Circuit's decision, issued just a month earlier, in *SEC v. Tambone*, which is discussed below, and in which the court held that a securities professional cannot be said to "make" a statement (for purposes of Rule 10b-5) in a securities offering document that was prepared by others, and cannot be said to have impliedly represented to investors that the securities professional had a reasonable basis for believing that the statements in the prospectus were truthful and complete.

provided by the issuer and its counsel in lieu of conducting its own reasonable investigation."

- "While BDs are not expected to have the same knowledge as an issuer or its management, firms are required to exercise a 'high degree of care' in investigating and independently verifying an issuer's representations and claims."

- "Indeed, when an issuer seeks to finance a new speculative venture, BDs 'must be particularly careful in verifying the issuer's obviously self-serving statements.' The fact that a BD's customers may be sophisticated and knowledgeable does not obviate the duty to investigate. Moreover, in Regulation D offerings the SEC advises issuers to provide the same information to accredited investors as they are required to provide to non-accredited investors, in view of the antifraud provisions."

- "NASD Rule 2310 states that a BD must have reasonable grounds to believe that a recommendation to purchase, sell or exchange a security is suitable for the customer. . . . In the context of a Regulation D offering, Rule 2310 requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and nonaccredited investors that will take into account the investors' knowledge and experience. The fact that an investor meets the net worth or income test for being an accredited investor is only one factor to be considered in the course of a complete suitability analysis. The BD must make reasonable efforts to gather and analyze information about the customer's other holdings, financial situation and needs, tax status, investment objectives and such other information that would enable the firm to make its suitability determination. A BD also must be satisfied that the customer 'fully understands the risks involved and is…able…to take those risks.'"

- <u>BD that is affiliated with the issuer</u>. "A BD that is an affiliate of an issuer in a Regulation D offering must ensure that its affiliation does not compromise its independence as it performs its investigation. The BD must resolve any conflict of interest that could impair its ability to conduct a thorough and independent investigation. Indeed, its affiliation with the issuer typically would raise expectations by its customers, particularly some retail customers, that the BD has special expertise concerning the issuer."

- <u>BD that prepares the private placement memorandum</u>. "A BD that prepares the private placement memorandum or other offering document has a duty to investigate securities offered under Regulation D and representations made by the issuer in the private placement memorandum or other offering document. . . . A BD that assists in the preparation of a private placement memorandum or other offering document should expect that it will be considered a communication with the public by that BD for purposes of NASD Rule 2210, FINRA’s advertising rule. If a private placement memorandum or other offering document presents information that is not fair and balanced or that is misleading, then the BD that assisted in its preparation may be deemed to have violated NASD Rule 2210. Moreover, sales literature concerning a private placement that a BD distributes will generally be deemed to constitute a communication by that BD with the public, whether or not the BD assisted in its preparation.”

- The presence of red flags. “A BD’s reasonable investigation responsibilities would obligate it to follow up on any red flags that it encounters during its inquiry as well as to investigate any substantial adverse information about the issuer.”

- Reliance on counsel. “A BD may retain counsel or other experts to assist the firm in undertaking and fulfilling its reasonable investigation obligation . . . [but] the use of counsel or experts does not necessarily complete the BD’s investigation responsibilities, insofar as a review of the counsel’s or expert’s report may identify issues or concerns that require further investigation by the BD.”

- Documentation of reasonable investigation. “To demonstrate that it has performed a reasonable investigation, a BD should retain records documenting both the process and results of its investigation. Such records may include descriptions of the meetings that were conducted in the course of the investigation, including meetings with the issuer or other parties, the tasks performed, the documents and other information reviewed, the results of such reviews, the date such events occurred, and the individuals who attended the meetings or conducted the reviews.”

- The Notice lists the "minimum" investigation that a member should conduct with respect to a Regulation D offering – a reasonable investigation concerning, among other things, (i) the issuer and its management, (ii) past securities offerings, (iii) pending litigation or previous or potential regulatory problems; (iv) the business prospects of the issuer, and (v) the assets held by or to be acquired by the issuer.

2. **Materiality**

Section 11 liability must be predicated on the misstatement or omission of a material fact. A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in determining whether or not to purchase or sell a security.[5] Put another way, there must be a substantial likelihood that the fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available. Once again, the standard depends not only on the particular fact and the surrounding circumstances, but on a common understanding of what a reasonable investor would consider important.[6] To the extent that this common understanding exists, it tends to change with time as new issues are presented and new concerns arise. Issues related to integrity of management, financial projections, market studies, and unrealized losses all have seen increased attention during the last decade. Once again, compliance with Section 11 must be based on sufficient knowledge of SEC disclosure regulations, and of the disclosures considered material by comparable issuers, among other things, to permit evaluation of what is "material."

B. Private Offerings

Section 12 of the l933 Act imposes liability in public offerings of securities, by written or oral communications, where there has been a material misstatement or omission unless the seller can "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." While Section 12 applies only to "sellers" (a term which has been the subject of rulings and commentary far beyond the scope of this article), the standards of due diligence applied under Sections 11 and 12 have been largely identical.

Section 12(a)(2) had been interpreted by many courts and commentators to apply to private as well as public offerings of securities. In 1995, however, the Supreme Court determined in *Gustafson v. Alloyd Company, Inc.*[7] that Section 12(a)(2) does not

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4 TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

5 *See, e.g., Recupito v. Prudential Securities, Inc.*, 112 F. Supp.2d 449 (2000), for an analysis of materiality for purposes of finding liability under Section 11 and Section 12 of the 1933 Act.

6 513 U.S. 561, 569 (1995).

extend to a private sale, since an offer that is not held out to the public does not involve a "prospectus" as that term is used in the 1933 Act.[8]

Offerings made under Section 4 of the 1933 Act, particularly Section 4(a)(2) (private placements) and Section 4(6) (small business offerings) generally have been considered as "private offerings." Offerings made under Section 3 of the 1933 Act are not. As a result of *Gustafson*, a Section 12(a)(2) remedy is available for sales of securities exempt under Section 3,[9] but not offerings exempt under Section 4[10] because they are not made via a "prospectus." Thus, Regulation D offerings under rule 504 and 505 are not exempt from Section 12(a)(2) liability because these exemptions arise under Section 3(b);[11] and rule 506 offerings are exempt from Section 12(a)(2) liability only if they are exempt from registration under Section 4.[12] Within the bounds of the 1933 Act

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7 "[W]hatever else 'prospectus' may mean, the term is confined to a document that, absent an overriding exemption, must include the information contained in the registration statement." Id.

8 See id (explaining that "Section 10 does not provide that some prospectuses must contain the information contained in the registration statement. Save for the explicit and well-defined exemptions for securities listed under Section 3, [citation omitted] its mandate is unqualified: ' a prospectus ... shall contain the information contained in the registration statement.'"); Securities Act of 1933 §12(a)(2), 15 U.S.C. 77l.

9 See, e.g., E.S.I. Montgomery County, Inc. v. Montenay International Co., 899 F. Supp. 1061, 1064 (S.D.N.Y. 1995) (explaining that Gustafson held that private transactions under Section 4 are not subject to Section 12 liability, but that securities offerings exempt under Section 3 may still be subject to Section 12 liability). See also, Vannest et al. v. Rutty & Co., 960 F. Supp. 651, 655 (W.D.N.Y. 1997); Whirlpool Financial Corp. v. GN Holdings, Inc., 67 F.3d 605, 609, n.2 (7th Cir. 1995). But see, Fisk v. SuperAnnuities, Inc., 927 F. Supp 718 (S.D.N.Y. 1996) (refusing to dismiss Section 12(a)(2) claims where securities were offered via private placement memorandum where the plaintiffs contended that the offering was not private).

10 It is not obvious that Rule 505 offerings must be excluded from the term "private offerings." In applying the private placement exemption that formerly existed under Regulation T, the Federal Reserve Board staff took the position that offerings that complied with either Rule 505 or Rule 506 under Regulation D were private placements, even though Rule 505 was promulgated under Section 3(b) of the 1933 Act rather than Sections 4(a)(2) or 4(6). SEC Securities Act Release No. 6389, 47 Fed. Reg. 11251, 11258 n. 33 (1982); FRB Staff Op. of January 8, 1982, SCTH d 5-606.18 (Rule 506); FRB Staff Op. of April 1, 1982, SCTH d 5-606.19 (Rule 505). While Rule 505 was not adopted pursuant to Section 4(a)(2) or 4(6), the FRB staff chose to extend the private placement exemption to Rule 505 on the ground that its provisions were substantially similar to Rule 506.

11 See, e.g., E.S.I. Montgomery County, Inc. v. Montenay International Co., supra, (dismissing Section 12(a)(2) claim because the plaintiff was exempt under Section 4(a)(2) because of "(1) the number of offerees; (2) the sophistication of the offerees, including their access to the type of information that would

and the Securities Exchange Act of 1934, as amended (the "1934 Act"), a purchaser in a private placement of securities exempt pursuant to Section 4 apparently is entitled to seek redress for material misrepresentations or misleading omissions only pursuant to the implied private right of action under Section 10(b) of the 1934 Act.[13]

As the Supreme Court also has held that Section 10(b) provides relief only for misrepresentations or misleading omissions that arise from intentional conduct (and perhaps from reckless disregard for the accuracy of the disclosures),[14] it appears that neither of the Acts provides a private right of action for negligent (as opposed to intentional) misrepresentations in a private offering exempt under Section 4.

While this may be a startling conclusion, it is important to remember, first, that private offerings exempt under Section 4 involve sales to persons able to "fend for themselves,"[15] second, that private actions for negligent misrepresentation can be based on common law,[16] state securities laws[17] or other state[18] or federal laws,[19] and, third, that

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be contained in a registration statement; and (3) the manner of the offering," citing, United States v. Arutunoff, 1 F.3d 1112, 1118 (10th Cir.), cert. den., DeVries v. United States, 510 U.S. 1017 (1993)). See also, Elliott J. Weiss, Securities Act Section 12(a)(2) After Gustafson v. Alloyd Co.: What Questions Remain?, 50 BUS. LAW. 1209, 1222 (1995) (explaining, for example, that in Rule 506 offerings the seller is only relieved of Section 12(a)(2) liability with respect to offerees able to "fend for themselves," citing SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953)).

12 Most courts have also dismissed Section 11 claims on the same basis as Section 12(a)(2) claims under Gustafson. See e.g., Stack, et al. v. Lobo, et al., 903 F. Supp. 1361 (N.D.CA. 1995); In re WRT Energy Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶ 99,560 (S.D.N.Y. 1997). But see, Saslaw v. Al Askari, Fed. Sec. L. Rep. (CCH) ¶ 99,461 (S.D.N.Y. Apr. 23, 1997). (declining to extend the Gustafson holding to Section 11 claims).

13 *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

14 See Elliott J. Weiss, supra, note 11.

15 While state law negligent misrepresentation claims are frequently asserted, a special relationship, fiduciary duty, or justified reliance is usually required if the claim is to prevail. See e.g., Vannest, et al. v. Sage, Rutty & Co., supra, note 9 (dismissing the claim because there was no fiduciary duty); In re JWP Inc. Securities Litigation, 928 F. Supp. 1239, 1261 (S.D.N.Y. 1996) (requiring the defendant know the plaintiff and have a special relationship or privity with him before liability could be imposed, but an authorized signature on the note agreement provided such privity with the audit committee); Banca Cremi v. Alex. Brown, Fed. Sec. L. Rep. (CCH) ¶ 99,460 (D.M.D. 1997), aff'd, 1997 U.S. App. LEXIS 36404 (4th Cir.

in the absence of a federal claim for negligent misrepresentation, there may be an increasing tendency to view misrepresentations as having been intentional, or at least reckless. Indeed, where Section 12(a)(2) relief is unavailable because the buyer is able to "fend for himself," the buyer-seller relationship that removes the Section 12(a)(2) remedy from the buyer may also increase his likelihood of success under other theories.[20]

The effect of *Gustafson* might therefore be to place a greater, rather than lesser burden on an issuer's ability to demonstrate that a reasonable, thorough and good faith due diligence investigation was undertaken in connection with a private placement.

C. BarChris

Escott v. BarChris Construction Corporation,[21] while decided in l968, remains the leading example of both the law and practical lessons of due diligence. BarChris involved a public offering of debentures by a builder of bowling alleys. At the time of the closing of the offering, BarChris was experiencing severe financial

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1997) (finding no negligent misrepresentation applying Maryland and Texas common law because there was no justifiable reliance).

16 For example, a state appellate court in Texas held that its state securities statute is broader than the federal law so it need not follow Gustafson's narrow reading when applying state law. See Anheuser-Busch Cos. v. Summit Coffee Co., 934 S.W.2d 705, 706 (Tex. App. 1996). See also, ARGYROPOULOS, et al. v. MEDNET, et al., 1997 U.S. Dist. LEXIS 10497 (C.D.CA. 1997) (dismissing a Section 12(a)(2) claim under Gustafson but refusing to dismiss claims based on state securities laws).

17 See e.g., Lennon v. Christoph, 1996 U.S. Dist. LEXIS 9943 (N.D.Ill. 1996) (dismissing the Section 12(a)(2) claim under Gustafson but refusing to dismiss claims based on state securities law, common law fraud, and the Illinois Consumer Fraud and Deceptive Business Practices Act).

18 See e.g., KLEIN v. BOYD, Fed. Sec. L. Rep. (CCH) ¶ 99,228 (E.D.PA. 1996) (dismissing a Section 12(a)(2) claim under Gustafson but refusing to dismiss a federal RICO claim, a state securities law claim, and a common law negligent misrepresentation claim).

19 See E.S.I. Montgomery County, Inc. v. Montenay International Co., 899 F. Supp. 1061, 1064 (S.D.N.Y. 1995), mot. den., Fed. Sec. L. Rep. (CCH) ¶ 99,345 (S.D.N.Y. 1996) (refusing to dismiss plaintiffs common law negligent misrepresentation claim on appeal because the plaintiff-defendant relationship was 'closely approaching privity' after previously dismissing liability under Section 12(a)(2) because the plaintiff was exempt under Section 4(a)(2)).

20 283 F. Supp. 643 (S.D.N.Y. 1968).

difficulties, a fact that was not disclosed in the prospectus.[22] The lead underwriter had conducted a review of the company's disclosure documents, and conducted interviews with BarChris management in which management supplied false information. The underwriter relied heavily on its law firm, which assigned the work to a junior associate who, the court concluded, performed an inadequate review.[23] In finding liability, the court reasoned as follows:

> "The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection. . . . 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."

In evaluating the standard of care of the various defendants, the court noted that the standard would vary depending on the person's responsibilities and access to information. For example, the court imposed a higher standard of care on a BarChris director who also was a partner in the company's outside law firm, stating that "[a]s the director most directly concerned with writing the registration statement and assuring its accuracy, more was required of him by way of reasonable investigation than could fairly be expected of a director who had no connection with this work."[24] The court specifically

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21 For example, the prospectus represented that a backlog of $6.9 million of orders existed, whereas all but $2.4 million had been canceled; sales figures were based on unsigned purchase contracts; the stated use of proceeds was expansion, but the proceeds were in fact used to pay down debt; and the business of the company was described as the construction of bowling alleys, whereas the principal business had become the operation of bowling alleys taken over from customers who defaulted on their obligations.

22 For example, the associate accepted assurances that missing minutes of the board of directors referred only to routine matters, failed to examine key contracts to discover that they had not been signed, failed to investigate financial difficulties between the company and a lender, and generally failed to verify information submitted by the company.

23 283 F. Supp. at 690

rejected the defense that the underwriters relied in good faith on counsel, reasoning that counsel had acted as agent of the underwriters and that the underwriters, as principals, were responsible for the actions of their agents.

D. SEC Rule 176

In 1982 the SEC adopted Rule 176 in an attempt[25], following the principles of *BarChris*, to codify some of the factors that should be considered in determining the adequacy of a due diligence investigation.[26] Rule 176 provides that "[i]n determining whether or not the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in Section 11(c), relevant circumstances include, with respect to a person other than the issuer,

(a) The type of issuer;

(b) The type of security;

(c) The type of person;

(d) The office held when the person is an officer;

(e) The presence or absence of another relationship to the issuer when the person is a director or proposed director;

(f) Reasonable reliance on officers, employees and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing);

(g) When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registration; and

(h) Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact

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24 See Langevoort, Donald, The Future of the U.S. Securities Laws, 63 Law & Contemp Prob. 45 (Summer 2000) (suggesting more equitable reform of Section 11 liability which includes a proposal to amend Rule 176 whereby those who follow the guidelines of Rule 176 would be immune from liability).

25 SEC Rel. 33-6383 (March 3, l982).

> or document at the time of the filing from which it was incorporated."

The Commission's adopting release makes it clear that the preceding is a non-exclusive list of circumstances which the Commission believes bear upon the reasonableness of the investigation and the determination of what constitutes reasonable grounds for belief.

E. <u>Attorney Liability</u>

Can counsel be liable to its client (in the absence of malpractice) or to third parties for inadequacy of a due diligence investigation?

1. <u>Historically</u>

A number of courts will permit a claim for malpractice against a lawyer only by those in privity with the lawyer.[27] The 1933 Act does not directly impose any obligation on counsel to assure the accuracy of a prospectus, and the *BarChris* court specifically rejected such a duty:

> "To say that the entire registration statement is expertised because some lawyer prepared it would be an unreasonable construction of the statute. Neither the lawyer for the company nor the lawyer for the underwriters is an expert within the meaning of Section 11."[28]

Nevertheless, some courts have held that an accountant, for example, may be liable to a specific third party who the accountant is aware will be relying on the accountant's work, even in the absence of privity,[29] and that a lawyer may be liable, on similar grounds, for a negligent misstatement "where the statement is made for the principal purpose of having it relied on by such person, and where its benefit to the party

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26 *See* Rice, *Potential Liabilities for Legal Opinions in Securities Transactions,* 31 Rev. of Sec. & Comm. Reg. 239 (December 9, 1998), at p. 241.

27 283 F. Supp. at 683.

28 *See, e.g., Credit Alliance v. Arthur Andersen & Co.*, 483 N.E.2d 110 (NY 1985).

authorizing the statement stems precisely from such reliance by the third party."[30] New Jersey law was taken beyond the "specific third party" standard in *Petrillo v. Bachenberg*,[31] in which the court concluded that a lawyer may be liable to a third party for professional negligence where it was "reasonably foreseeable" that the attorney's advice would be relied on by third parties. In dicta, the court indicated that "a lawyer reasonably should foresee that third parties will rely on an opinion letter issued in connection with a securities offering."[32]

As the Supreme Court has held that there is no civil liability for aiding and abetting a violation of Rule 10b-5,[33] an attorney can be liable under Rule 10b-5 solely as a primary violator. At least one court has held that attorneys who draft a prospectus that contains misrepresentations can be primary violators of Rule 10b-5,[34] and the Third Circuit has concluded that lawyers may be primarily liable for material misrepresentations and omissions in legal opinions they provide that they know will be relied on by third parties.[35]

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29 *Vereins-Und Westbank v. Carter*, 691 F. Supp. 704, 709 (S.D.N.Y. 1988) (applying New York law). *See also, Prudential Ins. Co. v. Dewey Ballantine, Bushby, Palmer & Wood*, 605 N.E.2d 318 (NY 1992), *recons. denied*, 613 N.E.2d 972 (NY 1993) (reaching the same conclusion as to duty of counsel, but limiting the scope of its liability because the opinion letter in question had stated that counsel relied on its client as to factual matters, among other qualifications).

30 655 A.2d 1354 (NJ 1995).

31 655 A.2d at 1359.

32 *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994), *superseded in part by statute*, 15 U.S.C. §78t(e) (permitting public prosecution of aiding and abetting violations).

33 *Employers Ins. of Wausau v. Musick, Peeler & Garrett*, 871 F.Supp. 381 (S.D.Cal. 1994), *amended in part*, 948 F.Supp. 942 (1995).

34 *Kline v. First Western Govt. Secs., Inc.*, 24 F.3d 480 (3rd Cir. 1994), *rehearing denied*, 1994 U.S. App. LEXIS 13306 , *cert. denied*, 513 U.S. 1032 (1994).

Other courts have relied on the “fraud on the market” theory[36] to find that lawyers and other professionals can be liable as primary violators of Rule 10b-5 for misleading opinions given in securities transactions.[37]

Some courts have referred to a "duty" of securities counsel to make a thorough investigation to correct any misleading statements or omissions.[38] In 1995, the Ninth Circuit concluded that this implied duty of securities counsel extended to both the client and to third parties. In *Federal Deposit Insurance Corp. v. O'Melveny & Meyers*,[39] the FDIC sued the law firm that had prepared certain private placement memoranda for a bank for which the FDIC later became conservator. The FDIC had settled with the disappointed investors and had obtained assignments of any claims they had arising from the private placements. The FDIC then sued the law firm, charging the firm with professional negligence, negligent misrepresentation, and breach of fiduciary duty. The law firm argued that it owed no duty to the bank to discover the bank's own fraud. The Court of Appeals, however, concluded that the law firm owed a duty of care to the issuer to conduct a thorough investigation:

> "Part and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow from promulgating a false or misleading offering to investors. An important duty of securities counsel is to make a 'reasonable, independent investigation to detect and correct false or misleading materials.' [Citing <u>Felts</u>] This is what is meant by a due diligence investigation . . . . The [law firm]. . . had a duty to guide the [client]. . . as to its obligations and to protect it against liability. In its high specialty field, [the law firm]. . .

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35 *Basic Inc. v. Levenson*, 485 U.S. 224 (1988).

36 *Rose v. Arkansas Valley Env. & Util. Auth.*, 562 F. Supp. 1180 (W.D. Mo. 1983), *T. J. Raney & Sons, Inc. v. Ft. Cobb, Okla. Irr. Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984).

37 *See Felts v. National Account Systems Ass'n, Inc.*, 469 F. Supp. 54, 67 (N.D. Miss. 1978).

38 *Federal Deposit Insurance Corp. v. O'Melveny & Meyers*, 969 F.2d 744 (9th Cir. l992*), rev'd on other grounds*, 512 U.S. 79 (1994), *remanded*, 61 F.3d 17 (9th Cir. 1995) (rejecting the notion that there is federal common law in this area, the Supreme Court reversed and remanded for a decision based on state law. On remand, the Ninth Circuit reaffirmed its previous decision reversing the District Court based on state law).

> owed a duty of due care not only to the investors, but also to its client. . . ."[40]

More recently, in *In re Enron Corporation Securities, Derivative & ERISA Litigation*,[41] the Southern District of Texas found that secondary actors (lawyers, accountants and underwriters) could be liable as primary violators under Rule 10b-5 for participating in the preparation of documents that contained material misstatements and omissions. In the *Enron* litigation, the plaintiff alleged that Enron's lawyers, accountants and underwriters participated with the company's management in a large-scale Ponzi scheme to artificially inflate the corporation's earnings and to conceal corporate debt. The court concluded that "professionals, including lawyers and accountants, when they take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client's financial condition, do have a duty to third parties not in privity not to knowingly or with severe recklessness issue materially misleading statements on which they intend or have reason to expect that those third parties will rely."[42]

This trend continued through 2005 and 2006. The Florida Supreme Court in 2005, in *Cowan Liebowitz & Latman v. Kaplan*[43], in the course of permitting the assignment of a legal malpractice case involving the preparation of a private placement memorandum, argued that the role of counsel in a private placement was similar to that of the auditors, because counsel prepared an offering memorandum and other documents that were intended to disclose information about the client to third parties. "Like the independent auditors in [*KPMG Peat Marwick v. Nat'l Union Fire Ins. Co.*, 765 So.2d 36 (Fla. 2000)], the attorneys intended that third parties would rely on the representations

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39 969 F.2d at 749.

41 2002 U.S. Dist. LEXIS 25211.

42 2002 U.S. Dist. LEXIS 25211, at 141.

43 902 So.2d 755 (Fla. 2005).

made in the memoranda. The legal services at issue, therefore, were not personal but involved publication of corporate information."[44]

A 2008 Supreme Court case suggests that courts may be moving in the direction of imposing greater limits on third-party liability in securities cases. The Supreme Court decided in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, that investors may not bring private lawsuits against third parties -- investment bankers, lawyers, accountants and vendors -- in corporate-fraud cases unless the investors relied on the actions of those third parties when making their investment decisions or those third parties had an independent duty to speak.[45]

The *Stoneridge* investor plaintiffs accused two suppliers of Charter Communications of colluding with the company to deceive its stockholders and manipulate the price of its stock. The Court held that §10b's "implied private right of action does not extend to aiders and abettors" and that "[t]he conduct of a secondary actor must satisfy each of the elements or preconditions for liability" under §10(b).[46] The Court's majority opinion turned, in large part, on whether the investors had relied on the third parties' statements in making their investment decisions. The Court indicated that, even if a plaintiff can establish some type of deceptive conduct, the plaintiff also must prove that he relied on that conduct, because reliance is "an essential element of the private §10(b) cause of action,"[47] and concluded that, in this case, "the private right of action does not reach the customer/supplier companies because the investor did not rely upon their statements or representations."[48]

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44 *Id.* at 759.

45 Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., et al., Supreme Court Docket No. 06-43 (January 15, 2008).

46 *Id*. at 7.

47 *Id*. at 8.

48 *Id*. at 1.

The distinction between primary and secondary liability was further explored in *SEC v. Tambone*, U.S.App. LEXIS 5031 (1st Cir., March 10, 2010). In that case, James Tambone and Robert Hussey were senior executives of a registered broker dealer, Columbia Funds Distributor, Inc. The SEC's complaint against the executives alleged that the two men engaged in fraud in connection with the sale of mutual fund shares. The prospectuses for the funds told investors that market timing was not permitted. A number of customers were, however, permitted to market time. According to the SEC, the two defendants were responsible for the false statements in the prospectuses, having commented on the market timing passages prior to their inclusion in the documents.

The prospectuses were not prepared by, or the responsibility of, the broker dealer which employed the two defendants. The defendants were not alleged to have uttered or written direct misstatements, but the SEC brought suit based on an "implied representation" theory. Under this theory, Rule 10b-5 liability could attach to one who was not the actual speaker of an alleged misstatement but used the alleged misstatement to sell securities. In *Tambone*, the SEC argued that the individuals "made" misrepresentations in two ways: (1) by using prospectuses drafted by others to sell mutual funds that allegedly contained misrepresentations, and (2) by acting on behalf of the underwriter, thus implying they must have had a reasonable basis to believe the statements in the prospectuses were accurate and complete.

The district court granted a motion to dismiss the complaint on the basis that mere participation in the drafting of an offering document is insufficient to establish primary liability. On appeal by the SEC, an en banc panel of the First Circuit affirmed the district court's dismissal. Specifically, the court held that a securities professional cannot be said to "make" a statement in a securities offering document that was prepared by others, and cannot be said to have impliedly represented to investors that the securities professional had a reasonable basis for believing that the statements in the prospectus were truthful and complete. The court concluded that the duty of an underwriter to investigate in Sections 11 and 12 of the Securities Act does not mean that an implied representation is made about the accuracy of the issuer's statements. The court also concluded that the SEC's attempt to broaden the meaning of Rule 10b-5 would undermine the Supreme Court's decision in *Central Bank*, which had held that aiding and abetting liability does not fall within the text of Section 10(b).

The *Tambone* decision refused to extend primary liability under Rule 10b-5(b) to securities professionals whenever they use a prospectus drafted by others that fails to disclose material information. Most significantly, it rejects the concept that use of an offering document means the underwriter impliedly vouches for the accuracy and completeness of such document.

II. General Principles of Due Diligence Investigations

A. Preparing for due diligence

The due diligence team will involve a range of people with different knowledge and skills, including company counsel, underwriters' counsel, accountants and the underwriter(s). Depending on the issuer's industry and business, independent experts such as independent engineers and environmental surveyors may also need to be involved. If appropriate, securities counsel should be supplemented by tax, environmental and other specialists.

Prior to the first due diligence meeting and prior to preparing the due diligence request list, counsel should read all relevant and available materials on the issuer. Counsel should then meet with the client to ask any questions they have or likely issues the client may have.

Before commencing due diligence, counsel should agree with the issuer on the due diligence budget, the scope of review, the deadline for completion, and whether any outside consultants will be engaged. Counsel should also raise any threshold issues that could affect the ability to complete the offering.

B. <u>Custom tailor each investigation</u>

Each due diligence investigation, if evaluated with the benefit of hindsight, will stand or fall on the thoroughness of the investigation in light of the particular facts and circumstances. Thus, while sample checklists may be useful in crafting a list of questions and issues for a particular offering, no checklist can substitute for thoughtful molding of the due diligence inquiry to the specific offering. Just as there is no checklist that will satisfy the duty of due diligence in all cases, there is no checklist that must rigidly be followed to prove adequacy of due diligence.[49] As the SEC staff has stated,

> "The important point is that each subject person should evaluate the surrounding facts, including the extent of his prior relationship with the registrant, and utilize techniques of investigation appropriate to the circumstances of the offering. . . . Judicial interpretations of Section 11 have confirmed the principle that what constitutes reasonable investigation and reasonable ground for belief depends upon the circumstances of each registration. The prospect of continued flexible application of that standard by the courts should provide assurance to subject persons that they will not incur unreasonable investigative burdens."[50]

The NASD's (now FINRA's) Special Report on due diligence observed that in tailoring the scope and content of a due diligence investigation, "consideration should be given to the nature of the offering, the SEC form with which the securities are being registered, the size of the issuer, the availability of public information about the company, the issuer's operating and business history, the nature of the legal structure of the issuer . . ., the nature of the offering . . ., and the type of security being offered. . .. The underwriter. . . must analyze potential problems relating to the particular issuer and its industry. The underwriter should determine the competence of the company's inside

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40 Except perhaps Regulation S-K, the l933 Act registration forms and regulations, and the Securities Act Industry Guides.

41 SEC Rel. 33-6383 (March 11, l982), Fed. Secs. L. Rep. (CCH) para. 72,328.

counsel and the extent to which one can rely on the company's previous filings at the SEC."[51]

C. Don't adopt a formal checklist

This principle should follow from the need to custom tailor each due diligence investigation, but there are additional reasons why it is inadvisable for a person or organization to adopt a standardized checklist for due diligence investigation. To the extent that the checklist proves to have been inadequate in a particular case, it will be difficult to establish that it was reasonable to have relied on the checklist; on the other hand, if the checklist is not strictly followed (which is likely to occur in a large number of cases), the failure to obey the checklist is persuasive evidence that the entire investigation was inadequate.

D. Counsel must be competent

The *BarChris* case emphasized, if the point needed to be made, that reliance on counsel is only as valuable as the quality of the counsel's services. Since the counsel acts as agent for his client, the client is responsible for the counsel's failures; if the lawyer conducting the due diligence investigation is inexperienced, his inexperience may be evidence of the lack of care of the due diligence inquiry.

E. Work closely with the outside accountants

A company's outside auditors often have rare access to and understanding of a company's inner workings, and are typically candid and forthcoming if asked for information. It is a common mistake to treat the role of accountants as being simply to provide certain specified tables to insert into a document or to assume that their concerns are different from those of counsel. In fact, their concerns will substantially overlap with those of counsel, and their insights will have the benefit of more rigorous examination of the company's finances.

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42 NASD Special Report at 10-11.

F. <u>Be cautious of the integrity of management</u>

A lawyer's instinct of loyalty to his or her client must always be accompanied by the knowledge that some clients will distort or manufacture information they give their lawyers in the mistaken belief that they will benefit from "improved" facts. Clients involved in offerings of securities are no different from other clients, and may believe that they can improve the chances of success of their offerings by concealing damaging information or manufacturing favorable information. Every lawyer (and every underwriter) must find his or her own best method for ferreting out untruths or evasions, stepping up the level of inquiry when faced with either, and convincing the client that misstatements and omissions benefit no one.

G. <u>Where are the hidden risks</u>?

The most obvious risks of a particular venture are usually apparent; an office building may burn down or be condemned, an oil well may be dry or may explode, causing environmental damage. The more subtle risks are harder to discern. What combination of market forces and economic conditions favor a particular enterprise, and what combination would threaten it? When real estate development was booming in the mid-l980's, it was fueled by generous tax incentives and growing demand for both office and residential properties. Soon, however, the tax incentives were cut back and the building boom that had been driven by tax considerations had produced a vast oversupply of office and residential space throughout the country. These forces are apparent in hindsight; however, while an offering is being undertaken, it is more difficult to analyze what economic conditions or market forces need to exist or remain in place to support the business to be conducted.

H. <u>Verify, verify</u>

Independent verification and investigation is the entire purpose of due diligence. The underwriters and their counsel must review the underlying documents and records that are important to the issuer's operations, prepare questions that challenge management, and follow up on unanswered questions.

I. Look out for red flags

One of the greatest risks in any due diligence process is the possibility that the persons involved will ignore "red flags" which may indicate problems underlying the financial statements or other information. In the *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628 (S.D.N.Y.) 2004)), the court described a red flag as "any information which strips, or should strip, underwriters of their confidence in the accuracy of an offering memorandum premised on audited financial statements."

The *WorldCom* court indicated that "...what constitutes a red flag is an issue of fact. These are exquisitely fact intensive inquiries that depend on the circumstances surrounding a particular issuer and the alleged misstatement". . . . There is no category of information which can always be ignored by an underwriter on the ground that it constitutes an ordinary business event. What is ordinary in one context may be sufficiently unusual in another to create a duty of investigation."

The due diligence process should be sensitive to red flags, as failure to follow up on reg flags can compromise the entire due diligence defense. Examples of red flags include a lack of minutes of the company's board, or lack of records of financial transactions, or representations by management that information about certain material transactions cannot be found.

J. Update

If a due diligence investigation was completed six weeks before the offering document is completed, it is unreasonable to expect that there has been no change in any of the items covered by the inquiry. If the closing of the offering takes place six months after the offering begins, it also is unreasonable to assume that no events have occurred that would make the statements made in the offering documents misleading as of the closing. In every case, there must be some effort to update the due diligence investigation to the dates on which final decisions are made and investments are accepted.

K. <u>Kick the tires</u>

Is the apartment building (or company headquarters) really there? One lawyer was barred from practice before the SEC after giving tax opinions on tax shelter offerings for the acquisition of over fifty greenhouses to grow ornamental plants, when it developed that there was never more than one greenhouse. Appropriate due diligence cannot take place without a careful review of the issuer's business, its management, its financial statements, its material contracts and its physical property.

L. <u>Should you keep your records</u>?

There are at least three common answers to the question whether you should retain detailed documentation and notes of the due diligence investigation and development of the offering materials.

1. <u>Keep them</u>

One answer is that you should retain this information to be in the best position to provide affirmative evidence of the due diligence investigation. After all, memories fade, and people quit their jobs, move away or die. The notes and other written materials that were produced in connection with the due diligence investigation provide the best mechanism of refreshing recollections and establishing what was done.

2. <u>Don't keep them</u>

The other answer is that, after an offering is completed, any materials that you keep other than the offering materials (and, many would say, a memorandum summarizing the due diligence investigation) are likely to be misused and misunderstood in any subsequent litigation. Perhaps your old notes will permit you to refresh your recollections, but the adequacy of a due diligence investigation is not established by introducing folders full of marked drafts. On the other hand, your notes, marks and questions are a rich lode of material for a plaintiff's lawyer, who will be able to exploit apparent failures to have responded to questions marked on interim drafts, or failures to follow up on questions for which there are only partial answers in the materials.

3. Compromise

Some lawyers believe that although most work papers should be discarded, careful records should be kept of the time spent on the due diligence inquiry, the dates of meetings and who was present, and the different versions (unmarked) of the draft offering materials.

Which answer is right? Unfortunately, none is. It is probably true that keeping everything more often helps the plaintiff's counsel than the defense. It might be appealing to destroy all of one's records in response to this concern, but (l) you will never destroy all of the copies of those records that were routinely circulated to the working group or stored in your computer system's backup disk drives, and (2) you will never obtain uniformity of document destruction even within your own organization, so that the destruction of records from one offering will contrast unfavorably with the retention of records in others.

Perhaps the only realistic answer is to be careful what you say in documents that are circulated, and to exercise control if you think that other members of the working group are circulating material that would suffer from being read in hindsight. When an offering has been completed, before the files are put away, review them one last time to make sure you are not mindlessly keeping documents that are unnecessary and subject to misinterpretation. Encourage everyone in the working group to do the same, and follow up with memos to all parties asking them to confirm that they have conducted such a file review.

III. Special Issues in Partnership Offerings

A. Structural Issues

Offerings of interests in limited partnerships raise a large number of questions not present in corporate offerings. These include:

(a) the status of the partnership as a partnership for federal tax purposes;

(b) the availability of any claimed tax benefits;

(c) the validity of allocations of tax items;

(d) democracy rights of the limited partners and potential for liability;

(e) financial and other risks relating to the general partner;

(f) restrictions on transfer and lack of a secondary market for partnership interests;

(g) restrictions on fees charged by and transactions with the general partner and affiliates; and

(h) prior performance of the general partner.

B. Regulation of Partnership Due Diligence

Partnership offerings often are subject to additional levels of regulation which impose additional due diligence responsibilities.

1. FINRA Rules

The FINRA adopted Appendix F to Article III, Section 34 of the FINRA Rules of Fair Practice in 1982 (now combined with the FINRA Manual--Conduct Rules) for the purpose of regulating public offerings of direct participation programs.[52] FINRA rules require that a broker-dealer involved in a public offering of interests in a direct participation program "have reasonable grounds to believe, based on information made available to him by the sponsor through a prospectus or other materials, that all material facts are adequately and accurately disclosed and provide a basis for evaluating the

43 FINRA is authorized to regulate the activity of FINRA members in registered public offerings of interests in direct participation programs. FINRA Manual—Conduct Rules, ¶2710(b)(9)(A).

program."[53] A broker-dealer may rely on the due diligence investigation of another FINRA member if:

(a) the member or person associated with a member has reasonable grounds to believe that such inquiry was conducted with due care;

(b) the results of the inquiry were provided to the member or person associated with a member with the consent of the member or members conducting or directing the inquiry; and

(c) no member that participated in the inquiry is a sponsor of the program or an affiliate of such sponsor."[54]

2. ABA Opinion 346

In any public or private offering of interests in a "tax shelter investment," where a legal opinion is to be given on tax consequences, ABA Formal Opinion 346, issued by the ABA Committee on Ethics and Professional Responsibility on January 29, l982, and the related Treasury Department Circular 230, 31 C.F.R. Part 10, impose a heightened standard of due diligence. Opinion 346, which prohibits false or misleading legal opinions, states that a "lawyer who accepts as true the facts which the promoter tells him, when the lawyer should know that a further inquiry would disclose that these facts are untrue, . . . gives a false opinion." While stating that a lawyer "does not have the responsibility to 'audit' the affairs of his client or to assume, without reasonable cause, that a client's statement of the facts cannot be relied upon," Opinion 346 also attempts to define the extent of factual inquiry required as an ethical matter if an opinion is to be given:

> "[T]he lawyer should, in the first instance, make inquiry of his clients as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect; or are suspect; or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry.

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44 FINRA Manual--Conduct Rules, ¶ 2810(b)(3)(A).

45 FINRA Manual--Conduct Rules, ¶ 2810(b)(3)(C).

> The extent of this inquiry will depend in each case upon the circumstances; for example, it would be less where the lawyer's past relationship with the client is sufficient to give him a basis for trusting the client's probity than where the client has recently engaged the lawyer, and less where the lawyer's inquiries are answered fully than when there appears a reluctance to disclose information."

The Treasury Department sought to impose a similar ethical standard on lawyers giving tax shelter opinions through Circular 230, stating as follows:

> "A practitioner may not accept as true asserted facts pertaining to the tax shelter which he/she should not, based on his/her background and knowledge, reasonably believe to be true. However, a practitioner need not conduct an audit or independent verification of the asserted facts, or assume that a client's statement of the facts cannot be relied upon, unless he/she has reason to believe that any relevant facts asserted to him/her are untrue."[55]

IV. Private Placement Compliance Systems

Issuers and broker-dealers that have failed to defend the availability of a private placement exemption generally have lost because of a lack of adequate documentation of efforts to comply with the exemption. Counsel involved in a private placement should establish with the issuer and managing broker-dealer adequate procedures to ensure that the offering is conducted in accordance with the applicable private placement exemption and that the compliance is documented. The subjects of such a compliance program should include the following:

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46 31 C.F.R. § 10.33(a)(1)(ii).

(a) Timetables for state and federal filings (including post-closing filings).

(b) Monitoring of offers for purposes of additional state filing requirements and compliance with numerical limits.

(c) Procedures for determination of which investors may be solicited without engaging in general solicitation, including dating of investor information sheets and establishment of a "record date" for each offering.

(d) Monitoring of subscriptions for completeness and for suitability of investors.

(e) Recordation of all offerees and of distribution of all private placement memoranda.

(f) Offeree representative documents.

V. Conclusion

While the Supreme Court's decision in Gustafson might appear to provide issuers and their counsel with greater protection from liability for innocent failures in disclosure that appear subsequent to a private placement, its protection is limited to private placements exempt under Section 4. In addition, it is likely that in such offerings the plaintiffs will be more successful in prevailing on alternative theories of liability such as negligent misrepresentation, because of a special relationship with the issuer that may be the basis for the exemption under Section 4. Alternatively, such plaintiffs may focus increasingly on characterizing the problem disclosures as having been made intentionally or recklessly. Because of the serious consequences of any such finding of intentional wrongdoing, proper representation of an issuer must include attention to the issuer's ability to prove that the due diligence investigation that was conducted was reasonable, thorough and made in good faith.