An Underwriter’s Due Diligence in the Permitted Absence of an Expert’s Consent

By John J. Huber, Thomas C. Sadler, and Joel H. Trotter

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John J. Huber, Thomas C. Sadler, and Joel H. Trotter of Latham & Watkins explore an underwriter's ability to establish a due diligence defense under Section 11 of the Securities Act of 1933 for a registration statement containing financial statements audited by Arthur Andersen in which Andersen's consent has not been filed pursuant to SEC rule.

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An Underwriter’s Due Diligence in the Permitted Absence of an Expert’s Consent

With the SEC’s recent adoption of Rule 437a, underwriters and their advisers are evaluating whether financial statements audited by Arthur Andersen and included in a registration statement without Andersen’s written consent are “expertised” for purposes of an underwriter’s due diligence defense under Section 11 of the Securities Act. The authors conclude that, where the SEC dispenses with the requirement to file an expert’s written consent, the parts of the registration statement prepared or certified by that expert should remain subject to the due diligence defense under Section 11(b)(3)(C).

by John J. Huber, Thomas C. Sadler, and Joel H. Trotter

Recent events involving Arthur Andersen LLP (Andersen) have raised questions regarding the legal standard required for an underwriter to establish a due diligence defense under Section 11 of the Securities Act of 1933 (Securities Act) in a registration statement containing financial statements audited by Andersen in which Andersen’s consent has not been filed as permitted pursuant to a rule recently adopted by the Securities and Exchange Commission (SEC). Specifically, we address whether an underwriter can avail itself of the due diligence defense that applies to “expertised” parts of a registration statement in defending against a Section 11 claim based on material misstatements or omissions in financial statements certified by Andersen that were included in a registration statement without Andersen’s written consent in compliance with Rule 437a under the Securities Act.

Our analysis leads us to conclude that, where the SEC authorizes a registrant to omit an expert’s consent, the parts of the registration statement prepared or certified by that expert should nonetheless remain expertised under Section 11(b)(3)(C) for purposes of an underwriter’s due diligence defense. Despite the substantial reasons supporting our conclusion, we recommend that, depending on the facts and circumstances involved in each offering, an underwriter should consider taking additional steps to establish a due diligence defense under Section 11(b)(3)(C) with respect to such expertised material.

Overview of Section 11 Liability

Section 11 of the Securities Act provides an explicit cause of action to anyone who purchases a security issued under a materially misleading registration statement. An issuer of securities under a registration statement has absolute liability to Section 11 plaintiffs. Section 11(a) also imposes liability for the underwriters as well as the issuer’s directors, its principal executive officers, and any expert (including an accountant) who “has with his consent been named” in the registration statement. Thus, although Andersen would apparently have no Section 11 liability for securities issued under a registration statement in which Andersen did not consent to being named as the auditor of the issuer’s historical financial statements, the issue is whether the absence of Andersen’s consent pursuant to Rule 437a will affect the availability of affirmative defenses under Section 11(b)(3) to underwriters and other persons who must answer to a plaintiff who sues under Section 11(a) for a misleading statement or omission in audited financial statements contained in or incorporated by reference into a registration statement.

Due Diligence Defenses under Section 11

Section 11(b)(3) of the Securities Act provides different types of due diligence defenses to Section 11(a) liability. The level of diligence varies with the persons named in Section 11(a)(1) through Section 11(a)(5) as well as the specific parts of the registration statement and the person responsible for each part. Section 11(b)(3)(A) and Section 11(b)(3)(C) apply to underwriters and other Section 11(a) persons who are not
experts. These two provisions distinguish between those parts of the registration statement “not purporting to be made on the authority of an expert” on the one hand and those parts “purporting to be made on the authority of an expert” on the other. Thus, courts and practitioners considering questions of Section 11 liability divide the registration statement into “expertised” and “nonexpertised” parts.

For nonexpertised parts of the registration statement, Section 11(b)(3)(A) allows an underwriter or other defendant (besides the issuer) to establish a due diligence defense by proving that the defendant had, “after reasonable investigation, reasonable ground to believe and did believe” that the nonexpertised part was not materially misleading when the registration statement became effective. For expertised parts of the registration statement, however, Section 11(b)(3)(C) allows an underwriter or other defendant (besides the issuer or the particular expert whose report formed the basis of the expertised part at issue) to establish a due diligence defense by proving that the defendant had “no reasonable ground to believe and did not believe” that the expertised part was materially misleading when the registration statement became effective.

Thus, an underwriter’s due diligence defense for expertised parts of the registration statement is less exacting than the standard for nonexpertised parts. The chief difference is that Section 11(b)(3)(C) does not require an underwriter to conduct a “reasonable investigation” as to expertised parts of the registration statement. Another difference is that Section 11(b)(3)(A) expresses an affirmative obligation for nonexpertised parts, whereas Section 11(b)(3)(C) expresses a negative obligation for expertised parts. These and other elements of Section 11(b)(3) are summarized in Figure 1.

Statutory Standard for Expertised Parts

The Section 11(b)(3)(C) defense applies to any part of a registration statement “purporting to be made on the authority of an expert.” At the most basic and fundamental level, the shorthand term “expertised” is a misnomer. Courts and practitioners use the term to refer to parts of the registration statement that are subject to the affirmative defense contained in Section 11(b)(3)(C), but that provision by its terms does not strictly require the actual involvement of an expert. The Section 11(b)(3)(C) standard applies to “any part of the registration statement purporting to be made on the authority of an expert.” By its terms, Section 11(b)(3)(C) provides a due diligence defense to underwriters and defendants other than the issuer or experts “as regards any part of the registration statement purporting to be made on the authority of an expert.” Although Section 11(b)(3)(C) makes no mention of consent, Section 11(a)(4) imposes liability on an expert only if that expert has consented to being “named as having prepared or certified any part of the registration statement.” Although Section 11(a)(4) appears to impose liability only on experts who actually consent to being named in the registration statement, there is nothing in the language of either Section 11 in general or Section 11(b)(3)(C) in particular that would condition the availability of a defendant’s Section 11(b)(3)(C) defense on the expert having consented to be named as such in the registration statement.

This view is consistent with judicial applications of Section 11(b)(3)(C) to underwriters asserting a due diligence defense. Reported cases on this point uniformly apply Section 11(b)(3)(C) to certified financial statements contained in the registration statement.
Statutory Requirements for Consent

The conclusion that the Section 11(b)(3)(C) defense does not require the relevant expert’s consent also is consistent with Section 7(a) of the Securities Act. Section 7(a), which specifies the contents of a registration statement, generally requires a registrant to obtain the consent of any expert whose report is used in the registration statement. Section 7(a) further provides, however, that a registrant need not file the consent of an expert where the SEC “dispenses with such filing as impracticable or as involving undue hardship on the person filing the registration statement.” 12 Historically, such exceptions have been exceedingly rare. 13 Without the

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**Figure 1: Due Diligence Defenses to Section 11 Liability**

<table>
<thead>
<tr>
<th>§ 11(b)(3) Subsection</th>
<th>Defendant</th>
<th>Part of Registration Statement</th>
<th>Elements of Due Diligence Defense</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A)</td>
<td>Non-expert</td>
<td>Non-expertised</td>
<td>Defendant (i) had, after reasonable investigation, (ii) reasonable ground to believe and (iii) did believe that the statements (iv) were true and (v) did not omit information necessary to make the statements not misleading.</td>
</tr>
<tr>
<td>(B)</td>
<td>Expert</td>
<td>Expertised by defendant</td>
<td>Either (i) the expert (a) had, after reasonable investigation, (b) reasonable ground to believe and (c) did believe that the statements (d) were true and (e) did not omit information necessary to make the statements not misleading or (ii) the statement at issue did not fairly represent the expert’s actual statement.</td>
</tr>
<tr>
<td>(C)</td>
<td>Non-expert*</td>
<td>Expertised (by an expert other than defendant)</td>
<td>Defendant (i) had no reasonable ground to believe and (ii) did not believe that the statements were (a) untrue or (b) omitted information necessary to make the statements not misleading or (c) that the statement at issue did not fairly represent the expert’s actual statement.</td>
</tr>
<tr>
<td>(D)</td>
<td>Non-expert</td>
<td>Statement of public official</td>
<td>Defendant (i) had no reasonable ground to believe and (ii) did not believe that the statements were (a) untrue or (b) omitted information necessary to make the statements not misleading or (c) that the statement at issue did not fairly represent the public official’s actual statement.</td>
</tr>
</tbody>
</table>

* The defense available under Section 11(b)(3)(C) also applies to experts with respect to parts of the registration statement that were purportedly made on some other expert’s authority.
SEC’s express authorization to dispense with the requirement of a consent, the registration statement would not satisfy the requirements of Section 5(b) and thus could not become effective in the first instance.

Although Section 7(a) does not use the term “expert,” the description in Section 7(a) is the same as that used for the term “expert” in Section 11(a)(4) (namely, “accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him”). In addition, Section 7(a) and Section 11(a)(4) both include the requirement of a consent, which raises a potential interpretive issue with respect to Section 11(b)(3)(C), which uses the term “expert” without further elaboration. Specifically, the issue is whether “expert,” as that term is used in each subsection of Section 11(b)(3) somehow incorporates the requirement of a consent when Section 7(a) and Section 11(a)(4) do not do so by their express terms.

To impose the requirement of a consent as part of the term “expert” in Section 11(b)(3) would ignore the express language of Section 7(a), which permits the SEC to dispense with the consent requirement and directly contemplates the possibility of a person who has not consented but is nonetheless an expert. Section 7(a) expressly refers to an expert who has not consented:

> If any such person is named as having prepared or certified a report or valuation . . . which is used in connection with the registration statement . . . the written consent of such person shall be filed . . . unless the Commission dispenses with such filing.\textsuperscript{15}

By specifically referring to instances in which a registration statement need not include the consent of “any such person” (i.e., an expert), the language and logic of Section 7(a) indicate that a consent is not a requirement for a person to be considered an expert under the Securities Act.

### Legislative History of the Consent Requirement

Presumably, Congress used the term “expert” in Section 11(b)(3) in the same way that the term generally was used at the time of the Securities Act’s adoption. Indeed, the legislative history of Section 7 and Section 11 clearly indicates how the term “expert” was used when Congress enacted the statute, and that usage demonstrates that the term “expert” is conceptually distinct from the consent requirement. During the events leading up to the Securities Act’s passage, the House had proposed a bill that added experts to the persons subject to Section 11 liability, in contrast to the Senate bill, which had not included experts as Section 11 persons. The Senate accepted the House version but modified it to require the expert’s consent as a prerequisite to Section 11 liability:

> The House bill imposed liability upon the underwriters and also upon the experts, such as accountants, appraisers, and engineers, who gave the authority of their names to statements made in the registration statement. The Senate accepted the provisions of the House bill with reference to this matter, but with the modification that, to protect an unauthorized use of the expert’s name, written consent to the use of his name, as having prepared or certified part of the registration statement or as having prepared a report to which statements in the registration statement were attributed, should be filed at the time of the filing of the registration statement.\textsuperscript{16}

Moreover, in his first-hand account of the legislative history of the Securities Act, James M. Landis, one of its principal drafters, states:

> Four drafts of the bill found their way into print before the final draft was accepted. There were numerous changes made, of which the significant ones are noted in the Statement of the House Managers contained in the Conference Report as submitted to the House. The more important were . . . the exclusion of any liability with respect to experts named in the registration statement unless they consented to the use of their names . . . . \textsuperscript{16}

Thus, in addition to the language of the statute, the legislative history indicates that the consent ordinarily required under Section 7(a) serves to provide notice to
the expert, rather than constituting an element of what an expert is.

Historical Background under the English Companies Act

The Securities Act’s historical antecedents further illuminate the issue. Congress modeled portions of the Securities Act generally, and Section 11 in particular, after provisions in the English Companies Act of 1929. The drafting team of the Securities Act, according to one of its members, “determined to take as the base of our work the English Companies Act,” and in particular, the Securities Act’s provisions imposing civil liability on the registrant were “drawn generally” from the English statute. Indeed, the drafters’ reliance on the English Companies Act is “most evident” in Section 11 of the Securities Act, as recognized both by judicial precedents and by legal commentary.

The English Companies Act not only provides the historical context in which Congress enacted the Securities Act but also contains a key provision, Section 37, on which Congress modeled Section 11 of the Securities Act. Reference to Section 37 of the English Companies Act indicates, in addition to the legislative history of the Securities Act, that the terms “expert” and “consent” are conceptually independent.

First, Section 37 did not include experts as persons subject to liability, just as earlier drafts of the Securities Act did not include experts in Section 11(a). Thus, when Congress added experts as Section 11(a) persons under the Securities Act, it added the corollary requirement that experts must consent to be named in the registration statement.

Second, although the English Companies Act did not make experts themselves liable, it did provide for affirmative defenses to officers and directors that were similar to Section 11(b)(3) with respect to liability for a “part of the registration statement purporting to be a statement by an expert.” Unlike the Securities Act, however, the English Companies Act includes a definition of an expert. That definition (“engineer, valuer, accountant, and any other person whose profession gives authority to a statement made by him”) tracks Congress’ use of the term in both the Securities Act and its legislative history. Thus, it is reasonable to conclude that when Congress enacted the Securities Act, the drafters of the statute did not understand the term “expert” to mean only a person who has with his or her consent been named as such in the registration statement.

Differing Approaches under Rule 436 and Rule 437

In two key respects, Rule 436 governs information in registration statements that would otherwise be information “purporting to be made on the authority of an expert” within the meaning of Section 11(b)(3)(C).

First, Rule 436(c) provides that unaudited interim financial information “shall not be considered a part of a registration statement prepared or certified by an accountant . . . within the meaning of Sections 7 or 11,” despite the fact that such information is reviewed by the registrant’s accountants, who would otherwise be considered experts under the Securities Act. The SEC adopted Rule 436(c) to provide that accountants who consent to being named in a registration statement that includes Statement of Auditing Standards (SAS) 71 unaudited financial reports are not considered experts with respect to the unaudited financial reports. In the adopting release, the SEC expressly stated its expectation that, with respect to SAS 71 reports, “directors and underwriters will continue to exercise due diligence in a vigorous manner” and that directors and underwriters “should not be able to rely” on SAS 71 reports “as statements ‘purporting to be made on the authority of an expert’” under Section 11(b)(3)(C). Instead, the SEC explained, Section 11(b)(3)(A) would apply to such parts of the registration statement. Thus, in the case of Rule 436(c), which deems certain unaudited financial reports not to be “a part of a registration statement prepared or certified by an accountant” (and therefore not expertised), the SEC clearly stated the effect of the rule in the adopting release.

Second, Rule 436(g)(1) permits a registrant to include in its registration statement the rating assigned by a nationally recognized statistical rating organization (NRSRO) without obtaining the NRSRO’s consent under Section 7. As with Rule 436(c), the rating by the NRSRO under Rule 436(g)(1) is not considered “a part of a registration statement prepared or certified by a person within the meaning of Sections 7 and 11.” In adopting Rule 436(g)(1), the SEC did not discuss Rule 436(g)(1)’s effects on an underwriter’s or other Section 11(a) person’s due diligence defense. The SEC noted that commentators had “expressed concern” that the NRSROs’ exemption from Section 11 liability might affect the liability of underwriters and other Section 11(a) persons, and, in response, the SEC point-
ed out that “disclosure of ratings is optional and, in any event, issuers may seek to obtain an NRSRO’s written consent.”

In 1947, the SEC adopted Rule 437, which governs applications to dispense with a written consent of an expert under Section 7(a) of the Securities Act. Rule 437 requires the application to be “supported by an affidavit or affidavits establishing that the obtaining of such consent is impracticable or involves undue hardship on the registrant,” and the SEC must approve the application “prior to the effective date of the registration statement.” In general, however, Rule 437 applications “will not be granted lightly” because, under Section 11(a)(4), “an expert cannot be held liable without proof of consent and such proof would be exceedingly difficult without the filing of a written consent” along with the registration statement.

**There is no implication in Rule 437 . . . that the person is not an expert or that the information is not expertised.**

Significantly, Rule 436(c) and Rule 436(g)(1) embody a different approach to Section 7 and Section 11 than the approach codified in Rule 437. Under Rule 436(c) and Rule 436(g)(1), the information, whether an accountant’s SAS 71 review or an NRSRO’s security rating, is not considered to be a part of the registration statement prepared or certified by a person under Section 7 and Section 11. Thus, in both situations, the pertinent parts of the registration statement are not considered to be statements “purporting to be made on the authority of an expert” within the meaning of Section 11(b)(3)(C). Because interim financials and NRSRO ratings are not expertised, the information, if included in the registration statement, is subject to the reasonable investigation standard of Section 11(b)(3)(A). Absent the exclusions contained in Rule 436(c) and Rule 436(g)(1), the accountant or the NRSRO, as the case may be, would be an expert whose consent would be required under Section 7. Thus, the adopting release for Rule 436(g)(1) emphasizes that non-NRSRO ratings included in a registration statement would require the consent of the non-NRSRO rating organization.

In contrast to the approach embodied in Rule 436(c) and Rule 436(g)(1), Rule 437 does not operate by defining the pertinent information as not being a part of the registration statement prepared or certified by a person under Section 7 and Section 11. Instead, Rule 437 merely dispenses with the expert’s consent if the conditions of the rule are met. There is no implication in Rule 437, as there is in Rule 436(c) and Rule 436(g)(1), that the person is not an expert or that the information is not expertised. The key distinction between the two approaches is that Rule 437, when operative, dispenses with an expert’s consent, whereas Rule 436(c) and Rule 436(g)(1), applied to interim financials and NRSRO ratings, dispense with the status of the accountant or NRSRO as an expert altogether.

**Approach of Rule 437a**

In March 2002, the SEC adopted Rule 437a as part of its release addressing issues faced by clients of Andersen. By its terms, Rule 437a allows any registrant filing a registration statement with financial statements in which Andersen had been the independent public accountant to dispense automatically with the requirement to file Andersen’s written consent pursuant to Section 7(a) where the registrant:

- Has not already obtained the consent;
- Is not able to obtain the consent after reasonable efforts; and
- Discloses clearly any limitations on recovery by investors posed by the lack of consent (which presumably refers to the notion that “an expert cannot be held liable without proof of consent” under Section 11(a)(4) of the Securities Act).

Rule 437a follows the approach of Rule 437 by dispensing with the consent. The only difference between the two rules is that Rule 437a is self-executing. For issuers that meet the conditions of Rule 437a, the dispensation is automatic and requires neither application by the issuer nor further SEC action.

Rule 437a does not change the status of the financial statements as having been certified nor does it exclude Andersen’s audit report from being considered a part of the registration statement prepared or certified by a person under Section 7 and Section 11, as Rule 436(c) and Rule 436(g)(1) do with respect to an accountant’s SAS 71 review and an NRSRO’s security rating. Thus, Rule 437a, similar to Rule 437, does not by its terms change the expertised nature of the information included in the registration statement or the status of the person who prepared or certified such information as Rule 436(c) and Rule 436(g)(1) do.
Good Faith Reliance

Presumably, Rule 437a does not change the due diligence defense available to any person named in Section 11(a) with respect to an issuer that uses Rule 437a to file a registration statement without a consent because the person subject to Section 11(a) may “rely in good faith upon the rules and regulations of the Commission.” Here, an underwriter would be relying on Rule 437a to conclude that the financial statements are still expertised and that, with respect to the financial statements, which remain audited despite the lack of a consent, the underwriter remains subject to Section 11(b)(3)(C), rather than Section 11(b)(3)(A). Section 19(a) provides:

No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

Unlike Rule 437, in which the SEC has dispensed with the consent requirement on a case-by-case basis and only rarely after a specific application has been made, Rule 437a dispenses with the requirement automatically for over two thousand companies if specified conditions are met. Given Rule 437a’s automatic operation and specific conditions, if the SEC had intended to depart from Section 11’s existing liability matrix, Rule 437a presumably would have contained guidance to that effect beyond the general statement in paragraph (b)(3), which apparently refers to the operation of Section 11(a)(4) rather than Section 11(b)(3).

Applying Section 19(a) would appear to support the position that an underwriter can rely on Rule 437a without subjecting the underwriter to additional liability that it would not have faced in the absence of such reliance.

Additional Steps to Consider for the Prudent Man Standard

Notwithstanding the availability of Section 11(b)(3)(C), under some circumstances an underwriter may have to take additional steps with respect to the expert’s report so that the underwriter will have “no reasonable ground to believe” that the registration statement is misleading or omits a material fact under that subsection. Specifically, Section 11(c) provides that, in determining what constitutes a “reasonable ground for belief” (as well as “reasonable investigation”) under Section 11(b)(3), “the standard of reasonableness shall be that required of a prudent man in the management of his own property.”

Section 11(c) thus involves a fact-intensive inquiry. In general, the extent of an underwriter’s due diligence under Section 11(c) as it applies to Section 11(b)(3)(C) will vary according to the particular circumstances, including the nature of the available information. In the absence of any reason to doubt the accuracy of an expert’s report, a “prudent man in the management of his own property” might well rely solely on the expert without doing anything more. If information comes to an underwriter’s attention that raises potential red flags, however, Section 11(c) may require the underwriter to conduct additional diligence even under Section 11(b)(3)(C).

In re Software Toolworks, Inc. Securities Litigation provides a useful model for an underwriter to establish, on summary judgment, that the underwriter satisfied Section 11(c)’s requirement that the underwriter had a “reasonable ground for belief” that the registration statement was not misleading with respect to audited financial statements that had been

Consistent with this reasoning, cases applying Section 19(a) to a defendant who has relied in good faith on a rule or regulation of the SEC uniformly apply that section to prevent the imposition of liability.

Thus, Section 19(a) seems to provide additional support for the conclusion that an underwriter can rely on Rule 437a without subjected the underwriter to additional liability that it would not have faced in the absence of such reliance.
called into question in advance of the offering. Specifically, the plaintiffs alleged that the underwriter could not establish a due diligence defense because it had “blindly relied” on the issuer’s auditor “in spite of numerous ‘red flags’” regarding the issuer’s financial condition.33 In response, the court pointed out that underwriters “need not conduct due diligence into the ‘expertised’ parts of a prospectus, such as certified financial statements.”34 Instead, the court explained, the issue is whether the underwriters’ reliance on the expertised financial statements is “reasonable.”

To determine the reasonableness of the underwriters’ reliance on the expertised financial statements, the court examined the underwriters’ conduct with respect to the particular red flag at issue, which involved revenue recognition relating to a backdated contract. The plaintiffs alleged that, on discovering the backdated contract, the underwriters could no longer rely on the auditor as an expert.35 The court disagreed:

If the Underwriters had done nothing more, the plaintiffs’ contention might be correct. The plaintiffs, however, ignore the significant steps taken by the Underwriters after discovery of the memorandum [about the backdated contract] to ensure the accuracy of Deloitte’s revenue recognition. The Underwriters first confronted Deloitte, which explained that it was proper for Toolworks to book revenue in fiscal 1990 . . . . The Underwriters then insisted that Deloitte reconfirm, in writing, the [backdated] agreement and Toolworks’ other OEM contracts. Finally, the Underwriters contacted other accounting firms to verify Deloitte’s OEM revenue accounting methods.36

The court found that the underwriters had discharged the Section 11(c) standard of reasonableness because, when a red flag appeared, the underwriters:

- Confronted the auditor for an explanation;
- Required the auditor to reconfirm the matter in writing; and
- Contacted other accounting firms to verify that the matter had been resolved properly.

Thus, the court determined that the underwriters had not blindly relied on the auditors and that the underwriters’ investigation in response to the red flag was reasonable as a matter of law. Accordingly, the court upheld the trial court’s grant of summary judgment in favor of the underwriters on this Section 11 claim.37

### Additional Steps to Consider for Risk Mitigation Generally

Ultimately, despite substantial reasons supporting the conclusion that an underwriter should have a due diligence defense under Section 11(b)(3)(C) available to it where the registrant omits Andersen’s consent in compliance with Rule 437a, any underwriter facing this situation must satisfy itself in advance that the risk of litigation can be sufficiently mitigated to proceed with the proposed public offering. One particular cause for concern, in addition to the lack of binding precedent on the specific issue under consideration, is that a court could reach a result completely at odds with what anyone who is conversant with the Securities Act’s provisions would expect.38 At least on occasion, a judicial interpretation of the Securities Act can draw criticism for having “surprised almost everyone,”39 for employing “an exceedingly flawed understanding” of the statute and for having “failed miserably” to reach the correct result.40

In particular, rather than looking to the statute’s text, logical structure, and legislative history, a court could instead focus on the possible effects on the plaintiff. If Andersen is not liable under Section 11(a)(4) because it has not consented, and if the underwriter establishes a due diligence defense under Section 11(b)(3)(C), then Section 11 liability would attach only to the issuer and its officers and directors. If those persons are bankrupt and insurance coverage is unavailable, a plaintiff could be unable to recover any damages under Section 11. Notwithstanding the substantive merits of the legal analysis, a court in these circumstances may be tempted to apply Section 11(b)(3)(A), rather than Section 11(b)(3)(C), to an underwriter with respect to financial statements audited by Andersen that were included in a registration statement without a written consent pursuant to Rule 437a.

Alternatively, and perhaps more likely, a court would focus on the actions taken by the underwriter in light of the absence of a consent and on the disclosure made in compliance with the requirements of Rule 437a and otherwise. Thus, the risks of litigation generally and of unorthodox judicial determinations in particular can be mitigated in two respects. First, the approach outlined previously with respect to the prudent man standard will allow an underwriter to discharge its obligations under Section 11(c) by following additional steps, such as those in Software Toolworks, to address issues that may arise in connection with the financial statements. Second, the underwriter can work
with the registrant to ensure that the registration statement includes adequate disclosure of the circumstances surrounding the lack of consent, the reliance on Rule 437a, and possible limitations on recovery as required by Rule 437a(b)(3).

Factors that an underwriter may consider in these circumstances include, but are not limited to, the following:

- Whether the issuer received Andersen’s consent on the most recently audited year’s financial statements with respect to any prior filing with the SEC;
- The underwriter’s relationship with the issuer prior to the time at which Andersen became unable to provide its consent (i.e., whether the underwriter has conducted multiple offerings for the issuer in recent years, on the one hand, versus whether this is the underwriter’s first offering involving the issuer, on the other);
- Whether the underwriter has research analyst coverage of the issuer and/or the issuer’s particular industry, and the extent of the research analyst’s prior access to the issuer and its accounting team;41
- Whether the Andersen engagement partner for the issuer went to the issuer’s new auditor and is available to be interviewed by the underwriter;
- Whether the underwriter has obtained additional representations from the issuer’s chief financial officer, comptroller, treasurer, or other members of the issuer’s financial management team;
- Whether the issuer is a foreign private issuer (because, in the case of foreign private issuers, the entire audit firm that was previously a foreign affiliate of Andersen typically has become a foreign affiliate of a different US audit firm);
- The availability of a SAS 71 review of the most recent interim financial statements by the issuer’s new auditors;
- The ability to negotiate agreed-upon procedures between the underwriters and the issuer’s new auditors, which may depend on the new auditor’s ability to issue a comfort letter under SAS 72;
- The underwriter’s use of a different accountant (either another accounting firm or a forensic accountant retained directly by underwriter’s counsel in a context subject to the attorney-client privilege) to conduct a review of one or more critical accounting policies or otherwise examine portions of the financial statements;
- Whether the underwriter has conferred with other accounting firms with respect to specified accounting issues; and
- Whether any changes in accounting policies or subsequent events would require changes to the Andersen financial statements in order to comply with generally accepted accounting principles.42

In addition to these factors, an underwriter should consider including in the registration statement additional disclosure that augments the disclosure made pursuant to Rule 437a(b)(3) concerning the absence of Andersen’s liability. For example, disclosure could be made to the effect that a plaintiff may have no recourse under Section 11 against an underwriter that satisfies a due diligence defense under Section 11(b)(3)(C). If disclosure is made, it could serve the dual role of putting investors on notice and thereby ameliorate the risk that a court would reach a different result than that described in this article, as well as protect investors by informing them of the operation of Section 11’s liability matrix under circumstances in which Andersen has not consented.43

Finally, if the factors previously described do not enable an underwriter to resolve the issues raised by any red flags with respect to the financial statements, it should consider requesting that the registrant’s new auditor reaudit the most recent fiscal year. In these circumstances, a reaudit of the most recent fiscal year could allow the underwriter to resolve the issues raised by any red flags and thus to determine, consistent with Section 11(c) as applied to Section 11(b)(3)(C), that the additional steps it has taken with respect to the Andersen financial statements would establish that the underwriter has “no reasonable ground to believe” and does not believe that the registration statement is misleading or omits a material fact under Section 11(b)(3)(C).

Conclusion

Although our research has identified no reported decision on the issue, and the SEC has not taken a position on the matter, the preceding analysis demonstrates that, where the SEC authorizes a registrant to omit an expert’s consent, the parts of the registration statement prepared or certified by that expert should nonetheless remain expertised under Section 11(b)(3)(C) of the
Securities Act for purposes of an underwriter’s due diligence defense. Even though the underwriter should not be subjected to the reasonable investigation standard of Section 11(b)(3)(A), the underwriter may have to take additional steps, depending on the relevant facts and circumstances, to be able to establish a due diligence defense under Section 11(b)(3)(C) that will be sufficient to support a summary judgment motion. Although the specific steps required to satisfy Section 11(c)’s prudent man standard for establishing that the underwriter had “no reasonable ground to believe and did not believe” will vary according to the particular facts and circumstances involved in a given offering, the factors outlined previously should provide useful guidance to an underwriter seeking to perform the level of investigation necessary to establish a due diligence defense under Section 11(b)(3)(C).

NOTES

1. Andersen is a current client of Latham & Watkins. The views expressed in this article do not reflect those of Andersen. Following Andersen’s recent conviction on obstruction of justice charges arising from the federal government’s investigation of Enron Corp., the SEC stated that it will continue, on an interim basis, to accept financial statements audited by Andersen if Andersen is able to make certain representations to its clients concerning audit quality controls. See SEC Press Release 2002-89 (June 15, 2002); see also Regulation S-X, Article 3, Temporary Note 3T. This article is based on a more comprehensive memorandum prepared by the authors and available at www.lw.com/pubs/articles/pdf/lw0628.pdf (Latham Memorandum).

2. Although neither Section 11 nor Section 12(a)(2) apply to initial purchasers in Rule 144A transactions, the analysis in this article may provide useful guidance to initial purchasers in Rule 144A transactions because initial purchasers in Rule 144A transactions have established a market practice (considered more than adequate to defeat a claim of scienter under Rule 10b-5) of engaging in a due diligence process substantially similar to that carried out by underwriters in public offerings.

3. See Section 11(b) (making affirmative defenses to Section 11(a) available to all of the parties named in Section 11(a) “other than the issuer”).

4. Section 11(a)(4). Even if Andersen is not liable under Section 11 due to its lack of consent under Section 7, it could still face liability under the antifraud provisions of the federal securities laws, see, e.g., Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as under principles of common law fraud, see, e.g., Ultramares Corp. v. Touche, 255 N.Y. 170, 173, 174 N.E. 441, 442 (1931).

5. Rule 437a was adopted pursuant to Section 7(a), which imposes a wai
able requirement of expert consent if the registration statement names the expert as having prepared or certified material “which is used” in the registration statement (but not as having prepared such material “for use in connection with” the registration statement), provided that the registration statement contains “such other information” as the SEC may require.

6. Section 11(b)(3)(C) also applies to experts with respect to portions of the registration statement purportedly made on some other expert’s authority, whereas Section 11(b)(3)(B) applies to each expert as to that portion of the registration statement regarding that expert’s report and is similar to the standard in Section 11(b)(3)(A) applicable to nonexperts with respect to nonexpertised portions of the registration statement.

7. See, e.g., Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 683 (S.D.N.Y. 1968) (defining the “expertised portion” as “the part of the registration statement purporting to be made on the authority of an expert” as described in Section 11(b)(3)(C)).

8. Section 11(b)(3)(A) (requiring an underwriter actually to possess both “reasonable ground to believe” and the actual belief that the statements at issue “were true and that there was no omission to state a material fact . . . necessary to make the statements therein not misleading”).

9. Section 11(b)(3)(C) (requiring an underwriter simply to have “no reasonable ground to believe” and no actual belief that the statements at issue “were untrue or that there was an omission to state a material fact . . . necessary to make the statements therein not misleading”).

10. Section 11(b)(3)(C) (emphasis added).


12. See also Rule 437 (adopted 1947) (governing applications to dispense with the Section 7(a) consent requirement).


14. Section 7(a) (emphasis added).


17. 19–20 Geo. 5, ch. 23.

18. Landis, supra n.16 at 34–35.


21. See English Companies Act Sections 37(1)(a)–37(1)(d).

22. Compare English Companies Act Section 37(4) (defining “expert” to include “engineer, valuer, accountant, and any other person whose profession gives authority to a statement made by him”) with Securities Act Section 7(a) (referring to “any accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him”) and Securities Act Section 11(a)(4) (referring to “every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him”).


24. Release No. 33-6173, supra n.23 at 4; id. at 3 n.8 (citing Codification of Statements on Accounting Standards, AU Section 630.02).


28. Adoption of Integrated Disclosure, supra n.25 at 24 ns.54 and 58.


32. 50 F.3d 615 (9th Cir. 1995).

33. Id. at 623.

34. Id.

35. Id. at 624.

36. Id.

37. The court reversed the trial court’s grant of summary judgment and remanded the case for trial on the merits of certain other Section 11 claims, finding that a genuine issue existed for trial on whether the underwriters responded adequately to new developments that arose after circulation of the preliminary prospectus but before effectiveness of the registration statement. Id. at 623.

38. E.g., Gustafson v. Allodd Company, Inc., 513 U.S. 561 (1995) (construing the Securities Act’s broad definition of “prospectus” to be coterminous with the type of prospectus described in Section 10).


41. Cf. Rule 176(g) (including, among other factors for determining whether a person has a “reasonable ground for belief” under Section 11(c), “the type of underwriting arrangement, the role of the particular person as an underwriter, and the availability of information with respect to the registration”); see also Adoption of Integrated Disclosure, supra n.25 at 35; James M. Landis, “Liability Sections of Securities Act Authoritatively Discussed,” 18 Am. Acct. 330, 332 (1933); Loss and Seligman, supra n.13 at 4258.

42. Audited financial statements may have to be reclassified, restated, and supplemented as a result of a number of matters that can occur after the auditor has rendered its audit report. These matters include: (1) reclassifications; (2) stock splits; (3) compliance with Regulation S-X for private companies making an initial public offering; (4) certain transitional disclosures; (5) new accounting standards and interpretations requiring retroactive reclassification or pro forma disclosure; (6) changes to segment data; (7) discontinued operations; (8) certain retroactive accounting changes; (9) changes from the cost method of accounting to the equity method; (10) reorganization of entities under common control; (11) changes in reporting entity; and (12) correction of an error. See Latham Memorandum, supra n.1 at 21 n.55. As this article goes to press, we understand that the Staff of the SEC is considering (based on ongoing discussions with representatives of the accounting profession, including the Auditing Standards Board) whether changes to one or more prior years’ financial statements as a result of one or more of these matters would require a reaudit of each of the financial statements for each affected year.