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Underwriters' Due Diligence; What Is It And How Much Is Enough?

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One often hears of underwriters "doing due diligence". But what in fact is "due diligence", why do underwriters have to do it and when is enough, enough? These are questions that have plagued underwriters and investment bankers for years with little, if any, guidance. Hopefully, this will help.

The story begins in 1929. In the wake of the stock market crash of that year and the Great Depression that followed it, it is not going too far out on a limb to suggest that by the early 1930s the American people had begun to loose confidence in our financial institutions. Chief among these financial institutions were the capital markets. Since capital is the engine that drives expansion, that confidence had to be restored.

Congress addressed this issue in a series of new laws that were adopted at the start of the New Deal, known today as the federal securities laws. The first such law that was passed was the Securities Act of 1933. While this Act has been amended and updated many times over the years, it remains the bedrock law governing the issuance and sale of securities both privately and publicly.

At its core the Securities Act of 1933 is a consumer protection statute. Recognizing that the whole point of the legislation was to restore and maintain investor confidence in the capital markets in general, and in new sales of securities in particular, the Act is designed to ensure two things. First, that the purchaser of a newly issued security (the Act has nothing to do with secondary trading) be given proper, adequate and meaningful disclosure. That is, that the investor be given enough honest information to understand what he or she is buying and the risks associated with such an investment. Second, that if the investor is defrauded, that is, if the information that was provided turns out to have been false, or something was omitted that ought to have been included to give the investor the whole story or a more accurate picture of the company issuing the securities, then the aggrieved investor can bring an action to recover damages.

It is the second element that concerns underwriters. In any underwritten public offering, whether best efforts, firm commitment, minimum/maximum, or otherwise, the basic structure is the same. The underwriter, who must be registered with the Securities and Exchange Commission as a broker/dealer and be a member of the National Association of Securities Dealers, purchases the securities from the company that is selling the security (the ?issuer?) and resells those securities to the public. The difference in price between what is paid to the issuer and what received from the public purchasers of the securities is the underwriter's commission, or profit.

So what has all this to do with "due diligence"? Everything. Remember that at its core the Securities Act of 1933 is a consumer protection statute designed to restore and maintain confidence in the capital markets. Prior to 1933, if a company committed fraud when issuing securities, naturally that company could be sued for what is known as common law fraud. If the company were found to have had committed fraud it would have to pay damages. But what if the fraud occurred during an underwritten public offering? Should the underwriters be at all liable? Well, the investment banking industry answered no, of course not. They

argued that they were not ?guarantors? of the veracity of the company's disclosures, but were merely conduits that bought securities from the company and resold them to the public. Why should they be liable to anybody if the company lied? That was their position.

In the face of that, Congress answered with Section 11 of the Securities Act of 1933. Congress felt that many people purchased securities issued through an underwritten public offering at least in some measure on the reputation and standing of the underwriter. Therefore, Congress felt that underwriters should accept some responsibility for the securities they were reselling to the public. Part of that responsibility ought to include making sure that the securities they were underwriting, or passing on to the public, were not bogus. If things turned out not to be as advertised, then the underwriter ought to have some liability. Thus was born the concept of underwriter's liability.

Section 11 is simple in principle, yet complicated in practice. It states that in any underwritten public offering of securities, if the disclosure given the investor proves faulty in any material respect, the company is liable to the purchaser for the loss. That seems straight forward enough. But it goes further. It also says that if the securities were sold as part of an underwritten public offering, not only is the company liable, but the underwriter is also equally liable.

Section 11 also defines the relative defenses available to both the issuer of the securities and the underwriter. In the case of the former, the answer is simple. The issuer has no defense. If the public offering disclosure document (the prospectus) is faulty in any material respect, the issuer is liable. Period. Even if the faulty disclosure was the result of a mistake or made in good faith, it does not matter. The issuer is strictly liable for any material disclosure that proves to be faulty. That however is not the case for the underwriter. The underwriter has a defense and that defense is to so-called ?due diligence defense?.

Recall that prior to the Securities Act of 1933, underwriters argued that they ought not to be the guarantors of the veracity of the company's disclosures. If the company lied to them, they argued, why should they be liable to the ultimate investors, when in fact they were as much a victim as anyone else? To some extent Congress understood that logic. On the other hand Congress did not want underwriters to stick their heads in the sand so to speak and be willing to re-sell securities to the public willy-nilly with no reality check. To address this tension Congress fashioned the due diligence defense.

Without quoting the technical language of Section 11, the way it works is this: an underwriter is equally liable along with the issuer of securities if there is a material misstatement of omission in the publicly offered disclosure document unless?.and this is very important?unless the underwriter can show that "after reasonable investigation" (and that is the key language) it had reasonable grounds to believe that the disclosure document was accurate. That is the due diligence defense. Note that the words "due diligence" do not appear anywhere in the Securities Act of 1933. It is a phrase that has come to be used colloquially to refer to the process of fulfilling the statutorily created standard that if an underwriter believes the disclosure to be accurate and complete, then the underwriter has no liability, so long as that belief is arrived at "after reasonable investigation.." The "reasonable investigation" is the due diligence process. It is designed to make sure the underwriter has not stuck its head in the sand and merely accepted as gospel all that the issuer has written, but rather that has conducted a "reasonable investigation" before accepting the disclosure document as complete. If, after a "reasonable investigation" there exists nonetheless a material misstatement or omission , the issuer is liable (recall the issuer has no defense) but the underwriter escapes liability. That is why the "reasonable investigation" process is known as the "due diligence" defense.

But this raises another question. What is a "reasonable" investigation? Put another way, how much due diligence is enough, how much investigation need be done to be found "reasonable" enough to invoke the "due diligence" defense?

We start with the standard of what constitutes "reasonable" investigation that is contained in Section 11 itself. It says that "the standard of reasonableness shall be that required of a prudent man in the management of his own property." Congress gets no bonus points for guidance on this one.

Where Congress started, the courts and industry practice have filled in the landscape to some extent. Typically an underwriter engages a law firm to assist in the due diligence process. The law firm is assigned the task of conducting the "legal" due diligence. At a minimum, this is a review of all material and business documents contracts and agreements. Starting with the basic incorporation documents, the law firm will review loan documents, bank and other financing documents, contracts, leases and agreements material to the business, pension plans, compensation plans and benefits, insurance coverage, profit sharing arrangements, shareholder lists, union contracts, and internal corporate governance documents. In appropriate situations, title reports and environmental surveys may be requested for significant real property owned by the company. In today's environment, Patriot Act and money laundering regulations may have a bearing on a company's operations or ownership. The "legal" review is a key element of the due diligence process and an underwriter should have the greatest confidence in the law firm selected for this task.

A second level of analysis is the financial analysis. This is a thorough review and dissection of the issuer's financial statements, book and records, including its tax returns. The outside accounting firm engaged by the company is debriefed, questioned and challenged, not in an adversarial manner, but to get an insight into the level of review or audit conducted by the outside accountant and an explanation of the various accounting principles relied upon to generate the financial presentation. Where alternate presentations are permissible, typically the underwriter will try to understand why the method chosen was found to be the better presentation. Included in this financial review should be a complete understanding of internal controls and accounting and bookkeeping practices. The underwriter should not hesitate to interview all levels of accounting personnel.

The third key element of a due diligence review is an understanding of the business of the company and the industry in which it operates. This is perhaps the most significant area of due diligence. For an underwriter to have fulfilled its due diligence obligations, it should be thoroughly familiar with the business of the company and its industry. There are three major components to this, a company's products and services, its supply chain and its administration. As to the company products or services, the underwriter should be familiar with the manner the goods or services are produced, including manufacturing issues, as well as the marketing strategy, pricing and gross margins. This would include market share, a grasp of the total market and the strategy to capture part of that market. On the supply side, the underwriter should understand the strategy for sourcing raw materials, pricing and vulnerabilities. On the administration side, the underwriter ought to have a firm grasp on how the company is organized, in addition to understanding the organizational chart and lines of responsibility.

All of this is well and good, but how much is enough. The answer is - enough to be assured that the underwriter has a firm grasp on the business and affairs of the company that enables it to offer and sell securities with confidence that its customers have been fully

apprised of the company's legal, financial and business position The underwriter ought to take the Securities Act at face value and think,? *"if this were my money, if my entire retirement and my family's future, were invested in this company, what would I like to know?"* If the underwriter can honestly say that it had done all it would have if that were the case, then . . .it will have done enough.

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