

### ***Liability for Outside Directors in Public Offerings***

The securities laws require you, as an outside director, to ensure that the registration statement filed in connection with a public offering is correct and complete. If it is not, you may be liable even though you were unaware of any faulty disclosure.

Fortunately, the law provides you with defenses to this liability, a reliance defense for the audited financials and a due-diligence defense for the remainder of the registration statement. To set up these defenses, you must take active steps during the registration process.

#### **Using “First-Class Professionals” is No Defense**

Many directors feel that they will meet their obligations if they involve reputable professionals to handle the public offering. Unfortunately, even if management, inside counsel, outside counsel, underwriters and underwriters’ counsel are first-class, you are not entitled to rely on them as a defense against Section 11 liability. Instead, to establish a defense, the law requires you to do your own diligence on the registration statement and to look out for “red flags” in the audited financials.

In the WorldCom litigation, director Bert Roberts argued in his defense that he shouldn’t be liable because he relied on other directors, experts and professionals. The court rejected his argument. Roberts paid \$4.5 million out of his own pocket in the resulting settlement.

#### **There is no “Sergeant Schultz” Defense**

Can you be liable even if you didn’t know about any faulty disclosure? Absolutely.

The law does not require plaintiffs to prove you knew anything was wrong or omitted. They only have to show that the registration statement contained a material misstatement or omitted material information that should have been included.

#### **The “Due-Diligence Defense” Requires Real Effort**

You can defend yourself against liability under Section 11 by proving you conducted a reasonable investigation, i.e., due diligence. Unfortunately, the law does not give a checklist of the steps you need to take in due diligence. What is clear is that you have to put in the effort to make a reasonable investigation. In particular, you are not allowed to rely on the company’s attorneys or management to do the work for you. Some specific steps you can take are discussed below.

#### **The “Reliance Defense” May Be an Illusion**

The reliance defense allows you to rely on the audited financials if you reasonably believe them to be correct. This means you are not required to diligence the audited financials.

However, you cannot rely unless you had “reasonable” grounds to believe the audited financials were correct and complete. If there were “red flags” in the financials (information that would cause one to question the audited financials), the reliance defense is not available. As a result, we believe that you should not plan to rely on the audited financials except after conducting enough diligence of the audited financials to satisfy yourself that there are no red flags.

## What Can You Do to Protect Yourself?

We believe directors should review their corporate indemnities and D&O policies to ensure that they have up-to-date provisions, and, in the case of the D&O policies, are in sufficient amounts. Directors should also review the registration statement carefully and put in the effort to properly diligence the information it contains. In addition, directors should review the company's audited and unaudited financial statements carefully, with an eye toward spotting possible red flags.

Outside directors may consider hiring experienced independent counsel (which may be done at the company's expense) to assist the directors with these tasks.

Independent counsel can advise the outside directors as to the registration process and can prepare a record that documents the diligence efforts undertaken by the outside directors. This record may be very valuable to the directors if they ever need evidence of their due-diligence efforts.

We have prepared a list of 20 specific steps to take in registration statement diligence that may help directors to establish their defenses. If you would like a copy of this list or if you have any questions regarding director diligence, please contact Michael Whalen ([mwhalen@wllpweb.com](mailto:mwhalen@wllpweb.com)), Phyllis Schneider ([pschneider@wllpweb.com](mailto:pschneider@wllpweb.com)), Karen Goodin ([kgoodin@wllpweb.com](mailto:kgoodin@wllpweb.com)) or Kirsten Foos ([kfoos@wllpweb.com](mailto:kfoos@wllpweb.com)) of Whalen LLP at (714) 384-4340.