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Liability and Due Diligence in connection with Equity Securities Offerings

An Overview of U.S., Swiss and German Law

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I. Introduction

This article outlines the principal liability provisions under U.S. federal law, Swiss law and German law in connection with an international offering of equity securities and the «due diligence» defenses available under such provisions.

The term «due diligence» as a defense to liability in connection with securities offerings broadly refers to an investigative process pursuant to which information relating to the issuer is reviewed with the aim of providing prospective investors with all material information regarding the offered securities, without a material misstatement or omission in the circumstances, prior to making an investment.

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The scope and comprehensiveness of the due diligence investigation is important not only from a legal standpoint to avoid liability but also from a reputational perspective as the reputation of offering participants may be significantly tarnished if it appears that they failed to uncover and disclose to prospective investors critical issues relating to the issuer or the offering.

While there is no single set of procedures that have to be followed in a due diligence exercise, Section V of this article describes a number of due diligence procedures that are typically considered when planning a due diligence exercise for an international offering of equity securities.

II. United States of America

The following is a discussion of (i) the principal liability provisions under U.S. federal securities laws in connection with the U.S. portion of an offering that is conducted in a manner that will make the offering exempt from the registration requirements of the Securities Act of 1933 (the «Securities Act») (the «U.S. Private Placement») and (ii) the «due diligence defenses» available to underwriters, issuers, directors and officers and controlling persons under such provisions.

Although a U.S. Private Placement is exempt from the registration requirements of the Securities Act, it is not exempt from the general antifraud provisions (the «Antifraud Provisions») of the U.S. federal securities laws. The Antifraud Provisions in general impose liability for false and misleading statements and omissions in connection with a U.S. Private Placement. Any violation of the Antifraud Provisions occurring in connection with a U.S. Private Placement may result in liability for the offering participants, in particular the issuer, directors and officers of the issuer, underwriters, and accountants.

1. Principal Bases for Liability

The principal Antifraud Provisions in connection with a U.S. Private Placement are Section 10(b) of the Securities Exchange Act of 1934 (the «Exchange Act») and Rule 10b-5 promulgated thereunder as well as Sections 12(a)(2) and 15 of the Securities Act. We also include a discussion of Section 11 of the Securities Act, which only applies in connection with public offerings of securities requiring the filing of a registration statement with the Securities and Exchange Commission (the «SEC») because of the role Section 11 of the Securities Act and decisions by U.S. courts under Section 11 have played in the development of due diligence standards in U.S. securities offerings.[1]

1.1 Section 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act – «Catch-all» Antifraud Provisions in connection with the Purchase or Sale of Securities

Section 10(b) of the Exchange Act («Section 10(b)») and Rule 10b-5 promulgated thereunder («Rule 10b-5») are regarded as «catch-all» antifraud provisions in connection with the purchase or sale of securities. Due to their very broad language and the fact that they apply to trading of securities in secondary markets as well as in initial public offerings or follow-on offerings, Section 10(b) and Rule 10b-5 are generally deemed to be the most widely applicable civil liability provisions of the U.S. federal securities laws.

Section 10(b) prohibits the use of «any manipulative or deceptive device or contrivance» in connection with the purchase or sale of any security, and Rule 10b-5 specifies three categories of conduct that qualify as violations: (i) employing any «device, scheme, or artifice to defraud,» (ii) making «any untrue statement of material fact» or «omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading», and (iii) engaging in «any act, practice, or course of business which operates as a fraud or deceit upon any person,» in each case «in connection with the purchase or sale of any security».

In a Rule 10b-5 claim, a plaintiff must prove (i) a misrepresentation or omission of a material fact; (ii) made with *scienter,* (iii) upon which the plaintiff relied, and (iv) which caused the plaintiff's economic loss. In addition, for a plaintiff to have standing to sue, he must have been a purchaser or seller of securities and must show that the fraud was «in connection with» that purchase or sale.

a. Misstatement or omission of a material fact

The first element of a claim under Rule 10b-5 is the misstatement or omission of a material fact. The fundamental test for «materiality» is whether there is a substantial likelihood that a reasonable investor would consider the information that was misstated or withheld significant[2], or that inclusion of the omitted fact would have altered

[1] This article only addresses Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder as well as Sections 11, 12(a)(2) and 15 of the Securities Act. The article does not specifically address other bases for liability, such as Section 17(a) of the Securities Act. The standard of liability under Section 17(a) of the Securities Act is identical to a violation of Rule 10b-5 under the Exchange Act. In addition, it is currently unclear whether there is a private right of action under Section 17(a) of the Securities Act and the trend in the courts in the United States is that Section 17(a) of the Securities Act, although available to the SEC to enforce the securities laws, does not provide for a private right of action of investors.

[2] *Basic, Inc.* v. *Levinson,* 485 U.S. 224, 231 (1988).

the «total mix» of information available to investors.[3] The U.S. Supreme Court in *TSC Industries* concluded that «the plaintiff is not required to demonstrate that knowledge of the omitted fact would have changed his decision to buy or sell the securities, only that it would have been relevant to his decision-making process» and that «the standard for materiality is objective in that it contemplates what a reasonable person would have considered important in making an investment decision.» The question of materiality is generally considered a mixed question of law and fact that has to be determined on a case-by-case basis.[4] According to the SEC, the determination of materiality should not be limited to a quantitative analysis but should also consider qualitative factors.[5]

Courts have modified the test for materiality with respect to forward-looking statements, such as estimates or projections, which are tentative or uncertain. Under the so-called «bespeaks caution» doctrine, a misrepresentation or omission with respect to a forward-looking statement is immaterial if accompanied by cautionary language sufficiently specific to render reliance on the false or omitted statement unreasonable.[6] The Private Securities Litigation Reform Act of 1995 clarified the boundaries of the «bespeaks caution» doctrine by creating a «safe harbor» under the Securities Act for certain forward-looking statements that are accompanied by «meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.» Although no court has specifically so decided, several courts have simultaneously considered defenses based on the safe harbor and on the «bespeaks caution» doctrine.[7]

b. Scienter

In *Ernst & Ernst v. Hochfelder,* the U.S. Supreme Court held that *scienter* is required for a violation of Rule 10b-5 and that the language of Section 10(b), which prohibits «manipulative or deceptive» conduct, precludes a claim under Rule 10b-5 for negligent conduct.[8] According to the U.S. Supreme Court, the term «manipulative» is «a term of art» when used in connection with the securities markets that «connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities».[9]

However, since *Ernst & Ernst,* all circuit courts have held that recklessness in some form does satisfy the *scienter* requirement of Rule 10b-5. Recklessness is generally defined as «highly unreasonable conduct involving not merely simple or even inexcusable negligence but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or so obvious that the actor must have been aware of it.»[10]

c. Causation and Reliance

To recover damages under Rule 10b-5, the plaintiff must also demonstrate that the defendant's misrepresentation or omission caused him to buy or sell (often referred to as «reliance» or «transaction causation») and that the misrepresentation or omission (as opposed to some other factor) caused his loss or damage (often referred to as «loss causation» or «damages»).[11] However, it is generally recognized that there is more than one way to demonstrate the causal connection.

In Rule 10b-5 cases, there is also a rebuttable presumption of reliance, which rests on the materiality of the untruth or omission complained of and, at least in connection with market transactions, is in part derived from the «fraud on the market theory», which is based on the hypothesis that, «in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business», that «misleading statements will

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

4 *See* Brodksy/Kramer, Federal Securities Litigation: commentary and forms, Brooklandville 2005, 6–7.

5 *See* SEC, *Materiality;* Staff Accounting Bulletin No. 99, Fed. Sec. L. Rep. (CCH) ¶75,563, at 64,219-4 (Aug. 12, 1999). Qualitative factors that should be considered according to the SEC include the following: whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate, and, if so, the degree of imprecision inherent in the estimate; whether the misstatement masks a change in earnings or other trends; whether the misstatement hides a failure to meet analyst's consensus expectations; whether the misstatement changes a loss into income or *vice versa;* whether the misstatement concerns a segment or other portion of the issuer's business that has been identified as playing a significant role in the issuer's operations or profitability; whether the misstatement affects the issuer's compliance with regulatory requirements; whether the misstatement affects the issuer's compliance with loan covenants or other contractual requirements; whether the misstatement has the effect of increasing management's compensation; whether the misstatement involves concealment of an unlawful transaction. The SEC has also made it clear that one should not assume that a misstatement or omission of items that fall below a certain quantitative threshold (for example, 5 %) is immaterial for disclosure purposes. While such a quantitative analysis is often a good starting point in a materiality analysis, qualitative factors also have to be considered.

6 *See* for example *Grossman v. Novell, Inc.,* 120 F.3d 1112, 1120 (10th Cir. 1997).

7 *See* for example *Secure Computing Corp. Securities Litigation,* CCH Fed. Sec. Law Rptr. ¶90,198 (D.Nev. 1998). For more information regarding the «bespeaks caution» doctrine, *see* for example Brodksy/Kramer (FN 4), 6–7.

8 *See Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 214 (1976).

9 *See Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 214 (1976).

10 *Sundstrand Corp. v. Sun Chemical Corp.,* 553 F.2d 1033, 1044–45 (7th Cir. 1977), cert. denied, 434 U.S. 875 (1977). *See* also Brodksy/Kramer (FN 4), 6–13 *et seq.* In practice, however, the SEC takes the recklessness test as being met, almost on a *res ipsa* basis, by conduct often appearing to fall well short of the «extreme departure» standard.

11 *See* Brodksy/Kramer (FN 4), 6–15.

therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements» and that «the causal connection between the defendants' fraud and the plaintiff's purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations».[12] The plaintiff must, however, show some connection between the defendant's conduct and the variation in the price of the security which gave rise to the plaintiff's loss.

d. Purchaser or Seller and «In Connection With» Requirements

To have standing to sue under Rule 10b-5, the plaintiff must be a purchaser or seller of securities. Losses from a sale or purchase not made, even if the investor's decision not to buy or sell was induced by fraud, may not be recovered in a Rule 10b-5 claim.[13]

Rule 10b-5 further requires that the alleged fraud must have been «in connection with» the purchase or sale of securities, which is generally interpreted to mean that there must be «some nexus but not necessarily a direct and close relationship» between the fraud and the purchase or sale» and that allegations that the fraud somehow affected or related to the value or characteristics of the security will be sufficient.[14]

e. Liable Persons

Rule 10b-5 imposes liability on «any person, directly or indirectly» who engages in fraudulent conduct in connection with the purchase or sale of securities. In contrast to the plaintiff, the defendant in a Rule 10b-5 claim need not have purchased or sold securities. It is enough if the conduct occurred «in connection with» purchases or sales of securities. It is generally recognized that the «in connection with» requirement is satisfied if false or misleading statements were made «in a manner reasonably calculated to influence the investing public.»[15] There is therefore no requirement of «privity» in Rule 10b-5 claims.

While the SEC may bring actions against aiders and abettors, the U.S. Supreme Court has held that private investors may not do so under Rule 10b-5.[16] The issuer's officers and directors can be liable as primary violators under Rule 10b-5 if they are directly or indirectly responsible for the material misstatements or omissions from the offering memorandum or prospectus or for any other statement or omission made in connection with the offering, for example during a roadshow.

f. Remedies

Section 10(b) and Rule 10b-5 only mention civil and administrative remedies by the SEC, and possible criminal prosecution. However, the courts have long held that buyers or sellers of securities have an implied right to recover damages based on Section 10(b) and Rule 10b-5 violations.[17]

In general, the remedies available to a plaintiff under Section 10(b) and Rule 10b-5 include actual, and not punitive, damages. The measure of damages under Rule 10b-5 is generally the out-of-pocket loss, which is the difference between the price paid or received by the plaintiff for the securities and the «true» value at the time of purchase or sale (the price at which the securities would have traded in the absence of the fraud).[18]

The SEC on the other hand may sue for injunctive relief, prohibit the relevant persons from acting as officers or directors of public companies and may also seek significant civil penalties or disgorgement of the defendant's gain from its actions, whichever is greater, for violations of Section 10(b) and Rule 10b-5. In addition, the Department of Justice may seek criminal sanctions (including substantial fines or imprisonment in the case of natural persons) for willful violations.[19]

g. Statute of Limitations

For purposes of the statute of limitations, there is a difference between private actions and actions brought by the SEC. Actions by the SEC under Section 10(b) or Rule 10b-5 for injunctive relief or disgorgement are not subject to a statute of limitations. Private actions under Section 10(b) or Rule 10b-5 on the other hand are subject to a statute of limitations and must be brought within the earlier of two years from the date of discovery or five years form the date of violation.[20] It is generally recognized by courts that a plaintiff is deemed to have discovered not just what he did discover but what a reasonable investor of ordinary intelligence would have discovered.[21]

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12 *See* for example *Peil v. Speiser,* 806 F.2d 1154, 1160–1161 (3d Cir. 1986) and *Basic Inc. v. Levinson,* 485 U.S. 224, 241–249 (1988). For more information regarding the «fraud on the market theory» *see* Brodksy/Kramer (FN 4), 6–17 and Brodksy/Hammel, The Fraud on the Market Theory and Securities Frauds Claims, New York Law Journal, Volume 230 – No. 82, October 2003.

13 *See* Brodksy/Kramer (FN 4), 6–25.

14 *See* Brodksy/Kramer (FN 4, 6–27.

15 *See SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

16 *See* Brodksy/Kramer (FN 4, 6–27 *et seq,* and Greene/Rosen/Silverman/Braverman/Sperber, U.S. Regulation of the International Securities and Derivatives Markets, 8th edition, New York 2006, 15–47 *et seq.*

17 *See* Greene/Rosen/Silverman/Braverman/Sperber (FN 16), 15–38.

18 *See* Greene/Rosen/Silverman/Braverman/Sperber (FN 16), 15–51.

19 *See* Greene/Rosen/Silverman/Braverman/Sperber (FN 16), 15–52.

20 *See* Greene/Rosen/Silverman/Braverman/Sperber (FN 16), 15–52.

21 *See* Brodksy/Kramer (FN 4), 6–25.

h. Broad Scope

Rule 10b-5 applies not only to documents filed with the SEC (e.g. registration statement filed in connection with a public offer of securities in the United States) but also to documents used in connection with a U.S. Private Placement (e.g., an offering memorandum used in connection with a Rule 144A placement in the United States). In addition, Rule 10b-5 can be used as basis for liability regarding oral statements (e.g., during press conferences or roadshows).

1.2 Section 12(a)(2) of the Securities Act – Liability for a «Prospectus»

Under Section 12(a)(2) of the Securities Act («Section 12(a)(2)»), any person who offers or sells securities by means of a «prospectus» or oral communication containing a material misrepresentation or omission will be liable to persons who purchased from them. An oral communication must relate to the prospectus for it to be actionable under Section 12(a)(2).[22] A statement will generally be deemed material if there is a substantial likelihood that a reasonable investor would have considered it important in deciding whether or not to purchase the security. As in Section 11 of the Securities Act (described below), the plaintiff is not required to show that the defendant acted with *scienter,* or that the plaintiff relied upon the misstatements or omissions.

Unlike Section 11 of the Securities Act (described below), which establishes liability for a range of offering participants, Section 12(a)(2) creates liability for «any person who offers or sells a security» by means of a prospectus containing a false or misleading statement or omission». However, under certain circumstances, U.S. courts have extended Section 12(a)(2) liability from the immediate seller to others who have a financial interest in the sale and actively participated in its solicitation, for example directors, officers and principal shareholders of the issuer, and «controlling persons», unless they can prove that they neither knew nor had a reasonable basis to know the facts giving rise to the liability of those they control.[23]

In terms of remedies, Section 12(a)(2) provides an express measure of damages for disclosure violations. If the plaintiff still owns the security, he is entitled to rescind the sale and recover the purchase price, plus interest, less income earned. If the plaintiff no longer owns the security, he can recover damages, which are limited to the depreciation in the value of the plaintiff's securities actually caused by the misstatements or omission.

The opinion of the U.S. Supreme Court in *Gustafson v. Alloyd Co. Inc.* has cast some doubt on whether Section 12(a)(2) applies to an offering memorandum used in a U.S. Private Placement.[24] Prior to *Gustafson,* offering materials of this nature were generally accepted as being covered by Section 12(a)(2). The *Gustafson* case can be interpreted to read that an offering memorandum in connection with a U.S. Private Placement will not be a «prospectus» within the meaning of Section 12(a)(2) and therefore Section 12(a)(2) does not apply. However, as the case before the U.S. Supreme Court in that instance involved a private sale contract between a single buyer and a single seller, and until the courts speak definitely on this issue, the standards followed presume that Section 12(a)(2) liability may be imposed in connection with a U.S. Private Placement.

1.3 Section 11 of the Securities Act – Liability for Registration Statements

Section 11 of the Securities Act («Section 11»), which applies only in connection with public offerings of securities in the United States requiring the filing of a registration statement with the SEC, subjects each issuer, each person who signed the registration statement, each director of the issuer, each underwriter and each «expert» to civil liability in cases where any part of the registration statement (including the prospectus, which is part of the registration statement), when it became effective, contains «an untrue statement of a material fact» or omits to «state a material fact required to be stated therein or necessary to make the statements therein not misleading».

In addition, any person who «controls» one of the abovementioned persons may be liable under Section 11. As a consequence, a large shareholder or officer not otherwise liable under Section 11 may be liable. Plaintiffs may sue for monetary damages in an amount no greater than the public offer price. Significantly, liability under Section 11 is joint and several and buyers generally need only establish that the registration statement contained a material misstatement or omission – they need not show or even allege that the underwriters (or any other party) knew or should have known of such deficiency.

1.4 Section 15 of the Securities Act – Liability of Controlling Persons

According to Section 15 of the Securities Act, «every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under Section 11, or 12, shall be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable».

[22] *See Gustafson v. Alloyd Co. Inc.,* 513 U.S. 561 (1995).

[23] *See* Greene/Rosen/Silverman/Braverman/Sperber (FN 16), 15–25.

[24] *See Gustafson v. Alloyd Co. Inc.,* 513 U.S. 561 (1995).

This means that the issuer's officers, directors and controlling shareholders, if any, can also be potentially liable for false and misleading statements and omissions in connection with a U.S. Private Placement. Whether or not a particular individual or shareholder is a controlling person is a question of fact. Rule 405 of the Securities Act defines control as «the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise».

1.5 Summary

Rule 10b-5 claims differ from Sections 11 and 12(a)(2) claims in that the plaintiff must prove that the false or misleading statements or omissions were made with *scienter* and that the plaintiff relied on the disclosure. These requirements significantly increase a plaintiff's burden of proof as compared to a cause of action brought under Section 12(a)(2) or Section 11. Because of the *scienter* requirement, Rule 10b-5 is generally regarded as «fraud-based» remedy, unlike Sections 12(a)(2) or 11, which have a lower standard for imposing liability and are regarded as «negligence-based» remedies.[25]

Regardless, a cautious approach to avoid potential liability entails following due diligence procedures for a U.S. Private Placement which satisfy standards recognized by U.S. courts as adequate for SEC-registered offerings. Hence, the issuer and the underwriters should take steps to ensure that the offering memorandum used in connection with a U.S. Private Placement contains all information with respect to the issuer and the offering which is material in the context of the offering and does not contain a material misstatement or omission. This approach is in keeping with market expectations and will also help in the development of a due diligence defense, as considered below.

2. Due Diligence Defenses under the Antifraud Provisions

Except in the case of an issuer's liability under Section 11 (as described below), the statutory liabilities described above are not strict. As described in more detail below, Section 11 affords a «due diligence» defense in relation to SEC-registered issues of securities and Section 12(a)(2) affords a similar defense in relation to the issues of securities covered by it. The elements of Rule 10b-5 include *scienter* or recklessness, which can be rebutted by a showing of reasonable inquiry. Effectively, to avoid liability, in each case a defendant must have undertaken reasonable procedures seeking to ensure the accuracy and completeness of the offering memorandum in question. Such procedures have become known as «due diligence procedures».

In addition to the legal motive for due diligence, the reputational aspect should also be considered. Regardless of whether an underwriter can prove «reasonable investigation» or «reasonable care» in connection with an offering, an underwriter's reputation may be significantly tarnished if it appears that the underwriter failed to uncover and disclose a critical issue in connection with the issuer's business.

2.1 Underwriters' Due Diligence Defense

a. Section 11

The principal defense for underwriters under Section 11 is the so-called «due diligence defense», the form of which depends upon whether the portion of the registration statement at issue is included in «expertized» sections or «non-expertized» sections thereof.

aa. Expertized Portions

«Expertized» portions of a registration statement are those portions prepared or certified by experts, and included in a registration statement with the consent of such experts.[26]

In order to establish a due diligence defense under Section 11, experts must demonstrate reasonable investigation and reasonable grounds for belief and actual belief that statements made or certified by them did not contain material misstatements or omissions.

Conversely, non-experts (which in general includes underwriters) are not required to conduct a comparable investigation concerning expertized portions of the registration statement in order to avoid liability under Section 11. Rather, non-experts generally may establish a due diligence defense in respect of expertized portions by demonstrating that they had «no reasonable grounds to believe, and did not believe, that such portions were materially untrue or omitted material facts».[27] In practice, this reduced due diligence standard regarding expertized portions, which is often referred to as the «reliance defense», covers primarily audited financial statements, which are included with the consent of the auditors and the auditors' report thereon.

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[25] *See* Johnson/McLaughlin, Corporate Finance and the Securities Laws, 3rd edition, New York 2004, 319.

[26] Section 11(a)(4) of the Securities Act defines an «expert» as «every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him».

[27] Section 11(b)(3)(C) of the Securities Act.

As noted above, Section 11 does not expressly require underwriters to perform a «reasonable investigation» as to expertized parts of the offering document. This does, however, not mean that there shouldn't be any due diligence efforts regarding the expertized portions of the offering document.

In *In re Worldcom, Inc. Sec. Litig.,* the court concluded that underwriters may not blindly rely on an expert opinion when they are put on notice by certain «red flags» calling the auditors' opinion into question.[28] The court defined red flags as «any information that strips defendants of their confidence in the accuracy of those portions of the registration statement premised on audited financial statements». Red flags included events that would put a reasonable party in the defendant's position on notice that the company was engaged in wrongdoing or may be defrauding its investors. The court cited several examples of red flags that could potentially preclude a reliance defense, including the following: three reserve changes over a period of four years; reliance on a back-dated contract without any further investigation; an expense-to-revenue ratio that was significantly lower than the equivalent numbers of a company's two largest competitors in a competitive market; deterioration in large portion of the business with no goodwill and asset impairment charges.

The court in *Worldcom* also made it clear that an auditor's review of unaudited financial information and comfort letters regarding unaudited financial information does not qualify as an expert's opinion and cannot be the basis for an underwriter's reliance defense under Section 11. Only audited financial information that is included in the prospectus with the consent of the auditor may be used as a basis for a reliance defense. In order to succeed with a due diligence defense, the underwriter defendants will have to show that they conducted a reasonable investigation of the non-expertized portions of the registration statement and thereafter had reasonable ground to believe that the unaudited financial information included in the registration statement were true. In assessing the reasonableness of the investigation, their receipt of the comfort letters will be important evidence, but is insufficient by itself to establish the defense.

The court's decision in *Worldcom* raised several issues, including what constitutes a red flag, the scope of the reliance defense, and documentation of due diligence. The general view is that the underwriters' due diligence burden has increased after *Worldcom*. As always, prevention is the best cure. Underwriters should therefore be vigilant in conducting due diligence and evaluating red flags. Comfort letters and other assurances from auditors and management remain critical to the due diligence exercise, but, alone, they may not be sufficient. Underwriters can reduce the liability risk by completing thorough, well-documented investigations.

bb. Non-expertized Portions

With respect to non-expertized portions of a registration statement, defendants must prove that they conducted a «reasonable investigation» in order to establish a due diligence defense in respect of material misstatements or omissions contained in such portions. In addition, following such investigation the underwriters must have «reasonable grounds to believe, and must believe», at the time the registration statement became effective, that the statements therein were materially true and that there was no omission to state a material fact.

The Securities Act provides that «the standard of reasonableness shall be that required of a prudent man in the management of his own property.» Rule 176 under the Securities Act provides further guidance as to what constitutes reasonable investigation and reasonable grounds for belief, essentially endorsing a highly fact-specific, «totality-of-the-circumstances» approach. This means that the scope and comprehensiveness of the underwriters' review of the business of an issuer – the level of investigation necessary to establish the «due diligence» defense and thereby avoid liability is very much a matter of judgment and will vary from case to case.

b. Section 12(a)(2)

The principal defense for underwriters under Section 12(a)(2) is that the defendant «did not know and, in the exercise of reasonable care could not have known, of such untruth or omission,» which essentially limits liability under Section 12(a)(2) to intentional or negligent misstatements or omissions.[29]

There is no settled view of the courts on what defendants must do in order to establish a «reasonable care» defense under Section 12(a)(2). Despite the difference in the wording of the due diligence defenses to Sections 11 and 12(a)(2) claims, the two standards have been treated as «similar, if not identical» in court decisions.[30] For both Section 11 and Section 12(a)(2), the standard of reasonableness required is «that of a prudent man in the management of his own property.»[31]

c. Rule 10b-5

Unlike Sections 11 and 12(a)(2), Rule 10b-5 does not afford any statutory due diligence defense. However, the

28 *In re Worldcom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 673 (S.D.N.Y. 2004). *See* also Greene/Rosen/Silverman/Braverman/Sperber (FN 16), 15–14.

29 Section 12(a)(2).

30 *In re: Software Toolworks Inc. Securities Litigation*, 38 F.3d 1078 (9th Cir. 1994).

31 Section 11(c) of the Securities Act. *See* also *Escott v. BarChris Construction Corp.*, 283 F.Supp. 643 (S.D.N.Y. 1968).

defendant may refute the plaintiff's assertion that the untruth or omission complained of was an intentional or reckless one on the part of the defendant. A defendant's ability to show proper due diligence and reasonable inquiry in relation to the relevant statements or omissions will help effect this refutation. It is also unlikely that underwriters who meet the due diligence standards under Section 11 or 12(a)(2), would be found to have acted with *scienter.*

d. Selected Case Law on the Scope of Underwriters' Due Diligence

Among the leading cases considering the due diligence defense under Section 11 are *Escott v. BarChris Construction Corp,*[32] *Chris-Craft Industries, Inc. v. Piper Aircraft Corp,*[33] and *Weinberger v. Jackson*.[34]

In *BarChris,* the court stated that «to effectuate the statute's purpose, the phrase ‹reasonable investigation› must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of ‹data presented› to them by the company» and that «the underwriters must make some reasonable attempt to verify the data submitted them and may not rely solely on the company's officers or on the company's counsel.»

In *Chris-Craft,* the court also discussed the due diligence obligation of underwriters and the importance of independent verification of information provided by the issuer. Specifically, the court stated that the underwriter «had an obligation to reach a careful, independent judgment based on facts known to it as to the accuracy of the registration statement» and that «if it was aware of facts that strongly suggested, even though they did not conclusively show, that the registration materials were deceptive, it was duty-bound to make a reasonable further investigation.»

As to the degree of effort required in order to perform a «reasonable investigation», the court in *BarChris* refused to be specific, stating that «it is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go» and that «it is a question of degree, a matter of judgment in each case». This passage and later cases have been taken to mean that Section 11 and by implication Section 12(a)(2) impose a variable standard of due diligence for underwriters.

In *Weinberger,* the court provided a useful description of the due diligence undertaken in relation to the securities issue which was the subject of the case. The procedures were held to be sufficient to discharge the underwriters' duties both under Sections 12(2) and Section 11. The investigation described was undertaken by «experienced people, assisted by attorneys and accountants» and involved background checks,[35] meetings with management,[36] meetings with suppliers and customers,[37] documentary due diligence,[38] plant inspections and other procedures.[39]

2.2 Due Diligence Defense for Issuers

The issuer's liability under Section 11 is strict. The issuer therefore has no due diligence defense to claims under Section 11. The issuer's liability under Section 12(a)(2), however, is not strict. In practice, however, it is generally recognized that it is very difficult for the issuer to argue that in the exercise of reasonable care it could not have known about a material misstatement or omission regarding its own business, which would be required to establish the «reasonable care» defense to liability under Section 12(a)(2).

As a result, the issuer's only real defense against a lawsuit brought in connection with a securities offering is to avoid a material misstatement or omission. A material misstatement or omission, regardless of how innocent, will give rise to potential liability. Accordingly, from an issuer's perspective, the most important reason for due diligence is that it significantly decreases the likelihood that the offering document includes a material misstatement or omission.

2.3 Due Diligence Defense for Directors and Officers

The officers and directors of the issuer do have the due diligence defense. Directors and officers who can establish that they conducted a «reasonable investigation» and used «reasonable care» can therefore escape per-

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[32] *Escott v. BarChris Construction Corp.,* 283 F. Supp. 643 (S.D.N.Y. 1968).

[33] *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.,* 480 F.2d 341 (2nd Cir. 1973), cert. denied, 414 U.S. 910 (1973).

[34] *Weinberger v. Jackson,* CCH Fed. Sec. Law Rptr. ¶95,693 (N.D. Cal. 1990).

[35] «The underwriters reviewed the industry, the company, the company's management, and the company's past and projected manufacturing, sales and financial performance. They examined trade journals and other industry-related publications to ascertain industry trends, market trends and competitive information.»

[36] «The underwriters had over twenty meetings with various management personnel, covering all aspects of the company's business. Company personnel were specifically questioned about the development and scheduled availability of products, related operating systems and applications software.»

[37] «The underwriters also contacted many of the issuer's suppliers, customers, and distributors, who were asked extensive questions about the company's operations.»

[38] «The underwriters reviewed company documents including operating plans, product literature, corporate records, financial statements, contracts, and lists of distributors and customers.»

[39] «When any negative or questionable information was developed as a result of their investigation, the underwriters discussed it with the appropriate persons and arrived at informed decisions and opinions. The underwriters also obtained written representations from the selling stockholders and the company that as of the closing date of the public offering, there were no misstatements or omissions.»

sonal liability even if the offering document contains a material misstatement or omission. An important aspect for directors and officers of the issuer in establishing their due diligence defense will be the extent of their participation in the offering process. Specifically, a mechanism should be established to ensure that each director and officer reads the offering memorandum and is afforded the opportunity to ask questions and provide comments. This process should help establish that the directors and officers took «reasonable care» to ensure that the offering memorandum did not contain a material misstatement or omission.

2.4 Due Diligence Defense for Controlling Persons

As stated above, a controlling person will be liable under Section 15 of the Securities Act «unless the controlling person had no knowledge or reasonable ground to believe in the existence of the facts by reasons of which the liability of the controlled person is alleged to exist». As with the defense for directors and officers, any controlling person of the issuer should be given the opportunity to review the offering memorandum and ask questions and provide comments.

III. Switzerland

Swiss law provides for a number of independent bases of liability pursuant to which an investor may bring suit in connection with a securities offering[40].[41] However, the principal basis of liability for issuers, underwriters and advisors in connection with securities offerings is *prospectus liability.* In the following section we therefore focus on an examination of prospectus liability. In addition, we discuss whether the legal concepts of due diligence and, in particular, due diligence defense as developed in the U.S. securities market and described above (see section II.2) may also be rendered useful in Switzerland.

For clarification purposes it should be noted that Switzerland is not an EU member state and, thus, EU regulations, particularly the Prospectus Directive, the Transparency Directive and Market Abuse Directive, do not apply.[42]

1. Prospectus Liability

According to Art. 752 of the Swiss Code of Obligations («CO»)[43], any person who participates in the preparation or dissemination of a *prospectus* or *any similar instrument* containing an incorrect or misleading statement or a statement that does not otherwise comply with legal content requirements is liable to acquirors of securities to which such prospectus or instrument relates for any damage negligently or willfully caused thereby (see section III.1.2 below for further details).[44] Such prospectus liability also applies to voluntarily disseminated information such as private placement memoranda. Disclaimers that such information is not to be considered as a prospectus in accordance with Swiss law generally do not prevent the involved parties from being liable, although such disclaimers may nevertheless serve to mitigate prospectus liability.[45]

1.1 Obligation to Publish a Prospectus

Pursuant to Art. 652a and 1156 CO, offerings of newly issued equity or debt securities to the public in Switzerland trigger an obligation to publish an issue prospectus[46].[47] Offerings are deemed to be public if they are made to more than a *limited circle of persons*.[48] Despite

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40 For the purposes of section III, the term «securities offering» includes only offerings of equity securities of operating companies or holding companies. In particular, it does not include offerings of securities of investment companies or participations in open- or closed-end collective investment schemes as such term is defined or interpreted under the Swiss Collective Investment Schemes Act.

41 Investors may try to claim remedies on the grounds of Swiss contract law or tort law. Likewise, issuers, directors, managers, underwriters and advisors may be subject to criminal prosecution under the Swiss Criminal Code.

42 Except for companies admitted to trading in the «EU-compatible» segment of SWX Europe (formerly known as virt-x) *(see* Reutter/Rasmussen, Auswirkungen neuer EU-Richtlinien auf Kapitalmarkttransaktionen schweizerischer Emittenten, in: Reutter/Watter/Werlen (ed.), Kapitalmarkttransaktionen, Zurich 2006, 7 *et seq.).*

43 According to a majority of legal scholars as well as a recent decision of the Swiss Federal Supreme Court, the prospectus liability applicable to offerings of equity and debt securities by a Swiss corporation *(Aktiengesellschaft)* is governed by Art. 752 CO, which is deemed to be *lex specialis* and, therefore, supercedes Art. 1156 para 3 CO *(see* BSK OR II-Watter, Art. 1156 N 23; BGE 129 III 74).

44 Principles of conflicts of law will not be discussed in detail. In short, the following applies in Switzerland: Swiss courts will have jurisdiction in those places where the prospectus has been disseminated, in the place within Switzerland where the offering takes place (underwriters' domicile) or in the domicile of the defendant (Art. 5[3] and 2 of the Lugano Convention) or, where the Lugano Convention is not applicable, alternatively in the place within Switzerland where the offering takes place, at the seat of the issuer or the domicile of the defendant (Art. 151 of the Swiss Act on International Private Law). Claims based on prospectus liability may, at the option of the plaintiff, be governed by the law by which the issuer is governed or the law of the jurisdiction where the securities have been publicly offered (Art. 156 of the Swiss Act on International Private Law). *See* also Appenzeller/Waller – Haftungsrisiken beim IPO und ihre Minimierung aus Sicht der Gesellschaft, GesKR 3/2007, 257 *et seq.*

45 Defendants could successfully defend themselves by establishing that, given the disclaimer, the acquiror knew or should have known that the document would not necessarily comply with the minimum requirements for the preparation of prospectuses as set out by Swiss law.

46 For an overview of minimum content requirements pursuant to Art. 652a and 1156 CO *see* Schleiffer/Rehm, Zum Prospekt nach Obligationenrecht – Vorgeschriebener minimaler Inhalt, ST 2005, 1021 *et seq.*

47 There is no obligation to publish a prospectus or any other kind of offering material when raising capital by way of private placements.

48 *See* Art. 652a(2) CO.

differing views among legal scholars and in the absence of a body of precedents, market practice suggests that an offering is generally deemed to be public (and made to more than a limited circle of persons) if more than 20 investors are approached, irrespective of how sophisticated such investors are (i.e. there is no safe harbor for institutional or other qualified investors).[49] In addition, the listing of securities on a Swiss stock exchange (i.e. the SXW Swiss Exchange) obliges the issuer to publish a listing prospectus, which is subject to approval by the Admission Board of the SWX Swiss Exchange.[50] Where both are required, issue and listing prospectuses are usually combined in one document as an offering prospectus or offering circular.[51]

1.2 Prerequisites for Establishing Prospectus Liability

a. Breach of Duty

Any contribution to the drafting or dissemination of a prospectus or any other similar instrument which contains an incorrect or misleading statement, omits a statement of a fact or otherwise fails to meet the legal content requirements of Swiss law represents a breach of duty *(Pflichtverletzung)* and may give rise to prospectus liability.

It is important to note that any written communication by the issuer (or by a person attributable to or influenced by the issuer) in the context of an offering (preliminary and final prospectuses, short-form prospectuses, listing prospectuses, road show presentations, published interviews and other press releases and information available on the internet etc.) may qualify as a similar instrument according to Art. 752 CO and, therefore, give rise to prospectus liability.[52] Information provided by the issuer in the ordinary course of business and not related to the offering, such as product updates or new price lists, and information disseminated by independent third party sources published without the consent of the issuer or its advisors is not subject to prospectus liability.

Information is *incorrect* in the context of Art. 752 CO if the respective statement in the offering document is not true at the time of publication. Statements may be deemed to be *misleading* if the facts described in the offering document, even if technically correct, do not properly reflect the facts or circumstances due to an omission[53] or due to a presentation of facts in the offering document which prevents an investor from reaching an informed assessment of the assets and liabilities, financial position, profits and losses or prospects of the issuer. Offering documents do not meet the *legal content requirements* if they do not meet the standards as set out in particular in Art. 652a and 1156 CO and, more importantly, Art. 32 SWX Listing Rules and Scheme A (in relation to equity securities) and Scheme B (in relation to debt securities) of the SWX Listing Rules.[54]

Some legal scholars argue, by reference to German and U.S. law, that any incorrect, misleading or omitted information must be of a *material* nature in the context of the offering in order to be considered a breach of duty.[55] Others have offered an alternative view that considers *materiality* according to whether the incorrect, misleading or omitted information has caused the plaintiff's loss (see section III.1.2c below).[56]

b. Damages

For a prospectus liability claim to be successful, an investor needs to prove that it suffered a damage due to an incorrect or misleading statement or an omission of a statement in the prospectus or any other similar instrument. Damage is deemed to be the difference between the purchase price of the acquired securities and the market value of the securities after the correct statements have been communicated to the market. A lack of precedents on this issue has led to scholarly debate on whether the market prices before and after the communication that a statement has been incorrect, misleading or omitted are the appropriate figures to consider in the calculation of such loss.[57] For example, a deterioration in the price of the respective securities may also have been caused by other circumstances, such as general

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49 Although, under certain circumstances, a group comprising more than 20 investors could still qualify as a limited circle of persons and, therefore, the offering would not deemed to be public.

50 Pursuant to Art. 32 of the Listing Rules of the SWX Swiss Exchange (the «SWX Listing Rules»).

51 Apart from these obligations, a public offering of securities in Switzerland does not require any additional governmental authorization, filing or registration. However, it should be noted that the Swiss Bankers Association issued Guidelines on Notes of Foreign Borrowers in connection with Swiss law governed Swiss Franc notes issues of non-Swiss companies (denominations of CHF 10,000 or more; *see Richtlinie zu Notes ausländischer Schuldner (2001)* available at <www.swissbanking.ch>).

52 Whether *oral* statements, such as statements made in the course of road show presentations, are also subject to prospectus liability is uncertain.

53 *See* also the Swiss Federal Supreme Court's decision 4P.96/2006 E.2.1.

54 *See* BSK OR II-Watter, Art. 752 N 18; Noth/Grob, Rechtsnatur und Voraussetzungen der obligationenrechtlichen Prospekthaftung – ein Überblick, AJP 2002, 1435 *et seq.,* 1452.

55 *See* Böckli, Schweizer Aktienrecht, 3rd ed., Zurich 2004, § 18 N 32; Daeniker/Waller, *Due Diligence Defense* der Banken bei Prospekthaftungsansprüchen, in: Reutter/Watter/Werlen (ed.), Kapitalmarkttransaktionen, Zurich 2006, 55 *et seq.,* 63; Noth/Grob (FN 54), 1450.

56 *See* for instance Roberto, Prospekthaftung in der Schweiz, SZW 2001, 161 *et seq.,* 165.

57 *See* BSK OR II-Watter, Art. 752 N 23; Noth/Grob (FN 54), 1460; *critical* Daeniker/Waller (FN 55), 61 *et seq,;* Appenzeller/Waller (FN 44), 263; *dissenting* Böckli (FN 55), § 18 N 34.

market movements, changes in the economic outlook or changes in interest rates. As such, a price drop following the communication of a mistake in the prospectus may only serve as a starting point for the calculation of damages. Additional factors relating to the general market environment will also have to be weighed against the deterioration of the price of the particular securities.[58]

In principle, a plaintiff is entitled to damages in the amount of the loss he suffered. Under certain circumstances, a plaintiff may alternatively be entitled to rescind the securities purchase agreement.

c. Causation

The defendant's breach of duty, i.e. typically the insufficient disclosure in the prospectus or other means of communication in connection with an offering must have caused a loss suffered by the plaintiff in order for a prospectus liability claim to succeed.[59] In a recent landmark decision, the Swiss Federal Supreme Court held that, based on the assumption of capital market efficiency, an investor need not necessarily have read the prospectus.[60] The court's rationale is that in efficient markets the information provided in the prospectus leads to the pricing of the securities by financial intermediaries and other professional market participants on which an investor may rely.[61]

Thus, a plaintiff needs to show that he has based his investment decision either on the incorrect information of the issuer provided in the prospectus (so-called *«direct causation»)* or, where the plaintiff did not read the prospectus, on the *investment atmosphere* created by the inadequate disclosure in the prospectus through the efficient markets pricing mechanism described above (so-called *«indirect causation»)*[62], and that he either would not have acquired the securities or would have done so only at a lower price had the correct information been set forth in the prospectus and, thus, provided to the market. This suggests that the incorrect, misleading or omitted statement must be of a *material* or *price-sensitive* nature in order to establish causation.[63]

d. Fault

Finally, the establishment of prospectus liability requires negligent or willful misconduct on the part of the defendant. In contrast to other jurisdictions, such as Germany[64], negligence (as opposed to gross negligence) is sufficient to meet the fault requirement of prospectus liability.[65]

In the context of prospectus liability, negligence requires the violation of the duty of care required in business dealings. As the required duty of care is an objective standard *(objektiviertes Verschulden),* behavior is deemed to be negligent if a diligent and experienced person in the same situation as the defendant would have acted differently. Personal abilities or circumstances are irrelevant in this context. In other words, a court would consider the behavior of each of the defendants individually in a particular case by analyzing what a third party, acting reasonably, would have done in a similar situation.[66] Consequently, the observance of recognized market standards in connection with the preparation and dissemination of a prospectus is of great importance in ensuring that the duty of care is satisfied.

As discussed in more detail in section III.2 below, there is considerable agreement among legal scholars in Switzerland that in the absence of suspicious facts the involved parties are generally entitled to rely on experts' statements.[67] A defendant may therefore typically only be liable for the part of the prospectus for which it was responsible as an expert. The lead manager, however, bears the duty to carry out ordinary but – in the absence of alarming issues – not disproportionate investigations to verify the accuracy and completeness of information provided by the issuer.[68]

1.3 Burden of Proof

The burden of proof for the existence of a breach of duty, damage, and fault lies with the plaintiff.[69] In a recent

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58 *See* also BSK OR II-Watter, Art. 752 N 28.

59 *See* the substantially similar concept of «loss causation» under US law (see section II.1.1c).

60 Decision of the Swiss Federal Supreme Court 4P.96/2006 E. 2.2 and 2.4; *see* also BGE 132 III 721; Chammartin/von der Crone, Kausalität in der Prospekthaftung – Entscheide des Schweizerischen Bundesgerichts 4C.136/2006 und 4P.96/2006, SZW 2006, 452 *et seq.,* 456.

61 *See* also BSK OR II-Watter, 752 N 23; Lenoir, Prospekthaftung im Zusammenhang mit Going Publics, Diss. St. Gallen 2004, 143 *et seq.*

62 *See* 4P.96/2006 E.2.2. This concept is known as «fraud on the market» under US law which basically entitles plaintiffs to a rebuttable presumption of the existence of transaction causation (e.g., that they relied upon allegedly fraudulent information) even where they were unaware of the fraudulent conduct at the time of their purchase or sale (see section II.1.1c). According to Swiss law, however, no rebuttable presumption in favour of the existence of transaction causation exists (under Swiss law the burden of proof lies with the plaintiff, *see* section III.1.3).

63 If the wrong or omitted statement was not price-sensitive it would not have an effect on the pricing of the securities and, thus, no damage would be caused. *See* also BSK OR II-Watter, 752 N 28. As already indicated some legal scholars discuss the materiality in connection with the question whether a breach of duty occurred *(see* section III.1.2a above).

64 In relation to transactions within the scope of §§ 44 BörsG *(see* section IV.2 below).

65 BSK OR II-Watter, 752 N 29.

66 *See* BSK OR II-Watter, 752 N 29; Daeniker/Waller (FN 55), 64.

67 *See* BSK OR II-Watter, 752 N 31, including further references; Daeniker/Waller (FN 55), 73.69 *et seq.*

68 *See* also BGE 129 III 71, 75 *et seq.; see* section III.2 for further details on the concept of due diligence defense under Swiss law.

69 *See* BGE 129 III 75. However, some legal scholars argue that the existence of fault would be presumed *(see* in par-

case[70], the Swiss Federal Supreme Court reiterated that the plaintiff also bears the burden of proof for causation, but that the required standard of proof only amounts to the level of a preponderance of the evidence *(überwiegende Wahrscheinlichkeit)* and not to «strict» evidence.[71]

1.4 Potential Plaintiffs

Potential plaintiffs include primarily investors who purchased issued securities in an offering (i.e. the primary market). Plaintiffs do not necessarily still have to hold the acquired securities. Further, a claim may also be brought by any secondary market purchasers, in addition to the original investors.[72] However, the longer the period of time between the closing of the offering and the secondary market purchase, the lower is the probability that a plaintiff will be able to successfully establish causation.

1.5 Potential Defendants

Prospectus liability claims may be brought against persons who were involved in the *preparation* or the *dissemination* of the prospectus or a similar document[73], including, but not limited to, the issuer, the members of its board of directors and the management, the lead managers and other syndicate banks, auditors, lawyers and other external advisors and experts. It should be noted that persons not mentioned in the responsibility statement, which is required to be included in a listing prospectus according to the SWX Listing Rules, are nevertheless subject to prospectus liability and hence also potential defendants.[74] The scope of prospectus liability under Swiss law proves to be broader than the German liability regime, where experts are not subject to prospectus liability.

It should be noted, however, that according to the prevailing opinion of legal scholars, claims may only be brought against persons who made a *significant* contribution to the preparation or the dissemination of the untrue, misleading or incomplete document in question.[75]

1.6 Joint and Several Liability

If several persons have been involved in the preparation or dissemination of the prospectus, each defendant will be jointly and severally liable to the extent the damage is attributable to him or her based on his or her own degree of fault and the circumstances (so-called *«differenzierte Solidarität»*).[76] The court must therefore differentiate between defendants according to their degree of fault and other circumstances, including their role in the preparation and/or dissemination of the prospectus.[77]

Usually, the parties involved in the listing or offering of the securities internally agree on a different allocation of liability. For instance, the agreement among underwriters usually provides for pro-rata sharing of liability in proportion to the underwriting commitments of each underwriter. Also, the underwriting agreement typically provides for an indemnification for the underwriters by the issuer. However, these limitations to liability do not limit the liability to third parties but only govern the internal allocation of liability among the underwriters and the issuer.

1.7 Statute of Limitation

Prospectus liability claims must be brought within five years of the date when the plaintiff knew or became aware of the incorrect or incomplete prospectus and the responsible person, or, in any event, within ten years of the breach of duty.[78]

2. Due Diligence Defense to Liability

2.1 Avoidance of Liability

Unsurprisingly, the most important measure one can take in order to avoid liability in the context of a securities offering in Switzerland is to ensure that the prospectus and other communications, such as press releases and roadshow presentations, do not contain any material untrue or misleading statements and do not omit to state a material fact.

However, even if a prospectus does not comply with the legal requirements set out above the involved parties may successfully defend themselves against liability claims by acting diligently in the context of the offering, particularly in connection with the preparation and dissemination of the prospectus and any other communication to the public.[79] Provided that the participants do not act negligently or with willful misconduct, no liability would be imposed on them. As outlined above,

ticular BSK OR II-Watter, 752 N 30, including further references).

70 BGE 132 III 715 ff., E. 3.2 and 3.2.2.

71 In this respect the Swiss concept deviates from the US *«fraud on the market»* theory which entitles the plaintiff to a (rebuttable) presumption of the existence of transaction causation *(see* FN 62).

72 BGE 131 III 306 *et seq.*, E 2.1.; *see* also Dobler/von der Crone, Aktivlegitimation zur Geltendmachung von Verantwortlichkeitsansprüchen – Entscheid des Schweizerischen Bundesgerichts 4C.111/2004, 211 *et seq.*

73 Art. 752 CO.

74 *See* also Appenzeller/Waller (FN 44), 262.

75 *See* BSK OR II-Watter, Art. 752 N 10.

76 Art. 759 CO.

77 *See,* for a comprehensive overview of this concept, Roberto, Probleme der differenzierten Solidarität, GesKR 1/2006, 29 ff.

78 Art. 760 CO.

79 The Swiss Federal Supreme Court explicitly stated: «Qu'un prospectus soit objectivement inexact ne suffit pas encore pour constater l'existence d'une violation du devoir de diligence incombant à son auteur» (BGE 129 III 75).

negligence in this context means a violation of the duty of care required in business dealings. The determination of such a violation of the duty of care is based on an objective test.[80]

In other words, if the defendants are able to show that they acted diligently according to the required standard of care they can successfully defend themselves and will not be subject to prospectus liability.[81] Moreover, as the required standard of care is determined based on an objective test, it is of paramount importance to observe recognized market practices in order to mitigate prospectus liability risks. Therefore, in connection with international transactions practices developed in more sophisticated markets such as the U.S. securities market have been adopted in Switzerland as well.[82]

As outlined above[83], *due diligence procedures*[84] in relation to the issuer of the securities are typically carried out by underwriters and their legal, financial and tax advisors in connection with international offerings of such securities. These due diligence procedures[85] are generally undertaken to confirm the completeness and accuracy of the information contained in the prospectus and other offering documents.[86] The due diligence procedures may also serve as a defense for the involved parties, including the issuer, against potential liability claims as they support the argument that the defendants had acted with the required care in such circumstances – namely that they carried out a due diligence process according to recognized market practices.[87]

2.2 Concept of Due Diligence Defense of U.S. Provenance

As described above[88], the form of due diligence defense under U.S. law depends, in part, on whether the relevant portion of the prospectus is included in expertized or non-expertized sections thereof. Under U.S. law, the due diligence defense enables non-experts to rely on the accuracy and completeness of expertized portions of the prospectus. Thus, non-experts would not be subject to liability for untrue or misleading statements in expertized portions of the prospectus as long as such non-experts had no reasonable grounds to believe and did not, in fact, believe that the statements in the expertized portion were materially untrue or omitted material facts.[89] For non-expertized portions of a prospectus, defendants must prove under U.S. law that they conducted a «reasonable investigation» in order to establish a due diligence defense.

This concept of due diligence defense under U.S. law is not incongruous with Swiss law and the above outlined liability in tort requiring an element of fault *(Verschuldenshaftung),* a fundamental principle of civil law.[90] In other words, to determine the required standard of care under Swiss law, the courts will also distinguish between expertized and non-expertized sections of the prospectus. It is widely agreed among legal scholars in Switzerland that in the absence of suspicious facts, the participants in the preparation of a prospectus may rely on the other participating experts' statements (i.e. the underwriters may rely on their legal, financial and tax advisors and vice versa).[91] Also, underwriters are considered to bear the duty of limited investigations into the accuracy and completeness of information and statements provided by the issuer.[92] The Swiss Federal Supreme Court has essentially confirmed such opinions in a case where an underwriter stated that it had carried out the *«vérification usuelles»* (usual verifications) and relied on confirmations of the issuer's legal advisors and the auditors.[93] First, the court held that the underwriters in principle have to verify the information provided by the issuer, but that in the absence of *«indices alarmantes»* (alarming indications), no *«investigations disproportionnées»* (disproportionate investigations) are required to be carried out by the underwriters. Further, the court indicated that the underwriters generally may rely on the statements of other experts such as lawyers or auditors.[94] It should be emphasized, however, that the term «expertized portion» under Swiss law may not necessarily be identical with the meaning of such term under U.S. law. And while the Swiss Federal Supreme Court did not clearly define what it understands an «expertized portion» to include, it is considered that the term under Swiss law is interpreted more broadly than it is under U.S. law.[95]

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80 *See* section III.1.2d above.
81 *See* also Daeniker/Waller (FN 55), 70.
82 Further, international offerings require the observance of US securities law standards since the US liability regime is deemed to be the most stringent *(see* for example Harsch, Publicity und Research Guidelines, in: Reutter/Watter/Werlen (ed.), Kapitalmarkttransaktionen, Zurich 2006, 235 *et seq.,* 236.
83 *See* section II.2.
84 The English term *due diligence* is also used in German which indicates its Anglo-Saxon provenance.
85 *See* section V.2 for a description of such due diligence procedures.
86 In a broader sense the due diligence process also includes the appointment of seasoned experts, in particular underwriters and their advisors, and the determination of the scope of the legal, financial and any other investigations.
87 *See* for due diligence procedures and the resulting legal opinions and comfort letters section V.2 below.
88 *See* section II.2.1a above.
89 *See* section II.2.1a above.
90 *See* also Daeniker/Waller (FN 55), 69 *et seq.,* 75 *et seq.*
91 *See* section III.1.2d above.
92 *See* BSK OR II-Watter, Art. 752 N 31, including further references.
93 *See* BGE 129 III 71, 75 *et seq.*
94 *See* BGE 129 III 76.
95 *See* Daeniker/Waller (FN 55), 73 *et seq.,* including further references, who represent the view that the banks may rely – in the absence of suspicious facts – on any confirmations and other statements of experts.

Summing up, in connection with *expertized portions* (in particular, financial information provided in the MD&A section and the financial statements included in the prospectus as well as other experts' reports or further information derived from or examined by experts included elsewhere in the prospectus), under Swiss law the participants (in particular the underwriters) may – in the absence of indications to the contrary – rely on the accuracy of information provided by or examined by experts included in those sections of the prospectus. As to *non-expertized portions,* where the issuer typically delivers information to the working group and the underwriters in order to prepare the prospectus, the underwriters must carry out ordinary (but not disproportionate) investigations in order to verify those statements. Following such limited investigations and in the absence of suspicious facts, however, the underwriters are generally entitled to rely on the statements made by the issuer.

IV. Germany

The following section of this article provides an overview of prospectus liability for public offerings of securities in Germany or listings of securities on a German stock exchange under German law, in particular, Sections 44 *et seq.* of the German Stock Exchange Act (the «SEA») *(Börsengesetz).* The German prospectus liability regime differentiates between a listing of securities on the regulated market and a public offering of securities. In a listing of securities on the regulated market in Germany, a cause of action may be directly based on Sections 44 *et seq.* of the SEA. In a public offering of securities without a listing on the regulated market in Germany, a cause of action may be based on Section 13 of the Sales Prospectus Act *(Wertpapierverkaufsprospektgesetz)*[96], which cross-references Sections 44 *et seq.* of the SEA.

According to the majority view of legal scholars[97] in Germany, Sections 44 *et seq.* of the SEA take precedence over the general provisions concerning prospectus liability and also particularly Sections 71 *et seq. (Erwerb eigener Aktien)* and Section 57 of the German Stock Corporations Act (the «SCA») *(Einlagenrückgewähr).* This is important since the implementation of prospectus liability would otherwise be in violation of the limited permissibility of repurchases of shares only in certain situations as set forth in Section 71 of the SCA and the return of contribution as set forth in Section 57 of the SCA. Therefore, a potential plaintiff can base its cause of action in a prospectus liability law suit on Sections 44 *et seq.* of the SEA and no remedy under civil law prospectus liability is available if the requirements of Section 44 *et seq.* of the SEA are met.[98]

In a public offering outside of Germany where the prospectus is not «passported» into Germany and there is no listing on a German stock exchange, but an institutional private placement takes place in Germany, a potential plaintiff may generally only rely on civil law prospectus liability principles, such as a quasi-contractual cause of action *(culpa in contrahendo)* or tort. Accordingly, an investor must have acquired securities based on a false or misleading prospectus that the issuer, syndicate members[99] or other persons responsible for the content of the prospectus, used to sell the securities. There are certain differences between Sections 44 *et seq.*[100] of the SEA and civil law prospectus liability. The most significant difference is the applicable standard of care. Civil law prospectus liability only requires negligence, whereas Sections 44 *et seq.* of the SEA require gross negligence or willful misconduct by the responsible persons[101]. In addition, as outlined below, the term «prospectus» may also have a broader definition under the civil law prospectus liability regime. Therefore, if Sections 44 *et seq.* of the SEA are applicable, these could be understood as a «liability privilege» since liability will only be triggered by gross negligence or willful misconduct by the responsible persons in respect of a false or misleading prospectus.

The Sales Prospectus Act, the German statute implementing the EU Prospectus Directive[102] (EU *Prospektrichtlinie)* and governing the publication of

96 The German Sales Prospectus Act *(Wertpapierverkaufsprospektgesetz)* was largely replaced by the German Prospectus Act *(Wertpapierprospektgesetz)* (the «Prospectus Act»), but certain provisions remain applicable.

97 *See* Gross, Kapitalmarktrecht, 3rd ed., Munich 2006, §§ 44, 45 BörsG Rz. 14 *et seq.* (hereinafter Gross); Harrer in Beck'sches Handbuch der AG, Munich 2004, § 23 Rz. 241; Krämer/Baudisch, Neues zur Börsenprospekthaftung und zu den Sorgfaltsanforderungen beim Unternehmenskauf, Wertpapier-Mitteilungen 1998, 1161, 1164; Gross, Die börsenrechtliche Prospekthaftung, AG 1999, 199, 208; Landgericht Frankfurt am Main, (3/11 O 44/96 of 7 October 1997); Wertpapier-Mitteilungen 1998, 1181, 1185; Government Reasoning *(Regierungsbegründung)* concerning 3rd Financial Market Improvement Act *(Finanzmarktförderungsgesetz)* Official Gazette, BT-Drs. (hereinafter BT-Drs.) 13/8933, 54, 78.

98 Other claims against a person responsible for a prospectus under Section 44 *et seq.* of the SEA may be brought (e.g. Section 47 para 2 of the SEA). This includes in particular contractual claims or claims under tort.

99 Syndicate members are hereinafter referred to as «underwriters», lead syndicate members are hereinafter referred to as «lead underwriters» and junior syndicate members are hereinafter referred to as «junior underwriters».

100 German Federal High Court of Justice *(Bundesgerichtshof)* judgment (24 April 1978-II ZR 172/76) BGHZ 71, 284, 286 *et seq.;* Keul/Erttmann, Inhalt und Reichweite zivilrechtlicher Prospekthaftung, Der Betrieb 2006, 1664 *et seq.*

101 Typically those will be the issuer and the underwriters.

102 Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (hereinafter «Prospectus Directive»).

prospectuses for public securities offerings and listings of on a regulated market in Germany, has been in force since 1 July 2005. The aim of the EU Prospectus Directive is to ensure uniform investor protection across the European Community by harmonizing the information contained in prospectuses. As part of this process, the European Community created a single European «passport» regime and, in doing so, rendered obsolete the need for additional scrutiny by authorities outside the issuer's home member state.

1. Prospectus Liability

1.1 Objective Requirements *(objektive Tatbestandsvoraussetzungen)* for a Claim based on Section 44 *et seq.* of the SEA

A prospectus liability claim based on Sections 44 et seq. of the SEA requires that the plaintiff has acquired securities which have either been admitted to trading on a regulated market or publicly offered without a listing on a regulated market in Germany (due to the cross-reference in Section 13 of the Sales Prospectus Act) on the basis of a prospectus that contained incorrect or incomplete statements which are material for the assessment of the value of such securities.

a. Person Responsible for the Content of the Prospectus *(Prospektveranlasser)* and Persons «Issuing» the Prospectus *(Prospekterlasser)*

Under the SEA, a person responsible for the content of the prospectus is either (i) a person accepting responsibility for the content of the prospectus, typically by signing the prospectus and/or the listing application *(Prospekterlasser),* assuming responsibility for its content in accordance with Section 5 para. 4 of the Prospectus Act or (ii) a person that has a certain level of economic interest therein *(Prospektveranlasser).* Issuers and financial institutions applying for the admission to trading *(Zulassungsantragsteller)* are required[103] to sign the prospectus and thereby to assume responsibility for its content.[104] If several banks form a syndicate, each bank will be deemed to be a person assisting in the offering and assumes prospectus responsibility, regardless of the level of its involvement in the IPO process.[105] In addition, individuals who have an independent economic interest in the issuance of the securities described in the prospectus may also be responsible for its content. Such individuals might, depending on the specific circumstances, include, for example, selling shareholders or members of the issuer's management board selling securities in the offering. However, the mere fact of being a selling shareholder or a member of the issuer's management board does not trigger prospectus liability.[106]

According to the majority view [107] of the legal scholars, the persons responsible for the content of the prospectus under civil law prospectus liability are the same as those who would be responsible under the SEA. According to both liability regimes, neither the auditors[108] nor other experts or anyone else who assists in the drafting of the prospectus is liable for its content of the prospectus. Moreover, the approval of the prospectus by the Federal Agency for Financial Services Supervision *(Bundesanstalt für Finanzdienstleistungsaufsicht – the «BaFin») does* not impose on it any prospectus liability pursuant to Sections 44 *et seq.* SEA. However, a cause of action based on public law liability *(Amtshaftung)* against the BaFin is possible.

b. Definition of the Term «Prospectus»

Section 44 para. 1 sentence 1 of the SEA refers to admission to a German stock exchange based on a prospectus, but, interestingly, the SEA does not contain a definition of the term «prospectus». Therefore, «prospectus» should be understood to refer only to the «listing prospectus» *(Börsenzulassungsprospekt)* set forth in Section 32 para. 3 No. 2 of the SEA in conjunction with the Prospectus Act[109] and, consequently, is narrowly defined to mean a prospectus prepared for the application for a listing on a German stock exchange or due to the cross reference of Section 13 of the Sales Prospectus Act in the event of a public offering without a listing on the regulated market in Germany. However, for a document (or set of documents) to be deemed a prospectus, it is not necessary that there was a legal obligation to prepare a prospectus. This is important in the context of a private placement of a capital increase excluding preemptive rights (typically pursuant to Section 186 para 3 sent. 4 of the German Stock Company Act *[Aktiengesetz – AktG])* of less than 10 % of the shares of the same class where no obligation to prepare a prospectus exists for the listing of the new shares if certain additional requirements set forth in Section 4 para 2 No. 1 of the Prospectus Act are met. If a prospectus is prepared and approved by the BaFin in this context and the shares are applied for trading on a German stock exchange, pro-

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103 Section 32 para. 2 sentence 1 SEA in connection with Section 5 para. 3 sentence 2 Prospectus Act.

104 Section 32 para. 2 sentence 1 SEA in connection with Section 5 para. 4 sentence 2 Prospectus Act.

105 *See* Schäfer/Hamann, Kapitalmarktgesetze, 2nd edition, Stuttgart 2007, note 91–93 (hereinafter Schäfer/Hamann); Bergdolt in Heidel (ed.) Aktienrecht und Kapitalmarktrecht, 2nd ed., Baden-Baden 2007 (hereinafter Heidel), § 44 BörsG Rz. 54–56.

106 *See* Schäfer/Hamann (FN 105), note 91–93; Heidel (FN 105), § 44 note 58.

107 *See* Schäfer/Hamann (FN 105), note 96.

108 A minority view suggests that auditors might fall within the realm of responsible persons *(see* Gross [FN 97], note 36, 37).

109 *See* Gross (FN 97), note 23; Steup in Habersack/Mülbert/Schlitt (eds.), Unternehmensfinanzierung am Kapitalmarkt, Cologne 2005, § 26 note 8; Heidel (FN 105), note 6.

spectus liability under Sections 44 *et seq.* SEA will be triggered. This definition of a prospectus however excludes research reports or other marketing materials. In addition, information memoranda that do not replace a prospectus and, therefore, are not used for the application for a listing on a German stock exchange are also not considered a «prospectus» within the meaning of Section 44 of the SEA.[110] According to Section 44 para. 4 of the SEA, written material that replaces the legal requirement to prepare a prospectus used for the listing application on the regulated market in Germany is also deemed a prospectus, thus triggering prospectus liability[111] *(prospektbefreiende Darstellung).*

The term «prospectus» is also not defined in the context of civil law prospectus liability. Unlike the SEA, which defines the term prospectus by reference to the Prospectus Act, legal scholars[112] have developed various definitions of «prospectus» for the purposes of civil law prospectus liability. The majority takes the view that a prospectus is a written document (including documents available via the Internet or sent by email) that contains substantially all the information necessary for an investment decision or that purports to contain the information necessary to form the basis for the investment decision.[113]

Due to this potential discrepancy between the definition of the term prospectus in the context of civil law prospectus liability and in a cause of action based on Sections 44 *et seq.* of the SEA, the scope of potential liability for written material is therefore broader if the privilege of Sections 44 *et seq.* of the SEA is not available.

c. Incorrect or Incomplete Statements Contained in the Prospectus

Prospectus liability is premised on an incorrect or incomplete prospectus. A prospectus is incorrect if it contains misstatements about material facts and is incomplete if facts were omitted which are material to the investor's assessment of the securities. Whether a fact is «material» depends on the circumstances of the specific case and will be determined from the viewpoint of the investor. The German Federal High Court of Justice *(BGH)*[114] has held, in the context of a listing prospectus, that the standard of sophistication to be expected of an investor is that of an average person who is able to comprehend the information contained in the prospectus if it has carefully read the prospectus and is able to understand the information contained in a balance sheet, but who has no further special knowledge or education. Legal scholars[115] disagree on the level of investor sophistication required, but a discussion of these arguments is beyond the scope of this article. Thus, a prospectus must present information in such a manner that not only sophisticated investors can understand its contents; on the other hand, an investor cannot argue that the prospectus did not provide sufficient explanations for each and every person to understand its meaning.

Incorrect statements are statements that are not true at the time of publication of the prospectus, and can include value judgments as well as forecasts. Value judgments are considered incorrect if they are not based on facts or are commercially unreasonable.[116] The same is true for forward-looking information.[117] Common ways in which a prospectus may be incorrect include false balance sheets or violation of accounting rules. Issuers are often permitted to exercise discretion with respect to their accounting policies and principles. However, even if an issuer exercises such discretion within the permissible limits or each of the individual decisions concerning accounting principles is in and of itself correct, the financial statements in the prospectus may nevertheless, as a whole, fail to present a fair and complete description of the issuer, its financial condition or results of operations (fair view requirement).[118] Therefore, in addition to fully disclosing such individual policies or decisions, the issuer must ensure that the disclosure meets the fair view requirements.

If material new facts and circumstances arise during the offer period or prior to admission to trading, the persons responsible for the prospectus have a duty under Section 16 para. 1 sent. 1 of the Prospectus Act to update the prospectus by way of publication of a supplement *(Nachtrag).* If a supplement is not prepared and such new information is material, the previously approved prospectus becomes incorrect.[119]

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110 *See* Gross (FN 97), note 23; Steup (FN 109), § 26 note 8; Heidel (FN 105), note 6.

111 *See* Gross (FN 97), note 24, 29.

112 *See* Schäfer/Hamann (FN 105), note 46; Meyer, Aspekte einer Reform der Prospekthaftung, Wertpapier-Mitteilungen 2003, 1301, 1302 *et seq.*

113 *See* Keul/Erttmann, Inhalt und Reichweite zivilrechtlicher Prospekthaftung, Der Betrieb 2006, 1664, 1665; Schäfer/Hamann (FN 105), note 46.

114 BGH (12 July 1982 II ZR 175/81), Wertpapier-Mitteilungen 1982, 862, 865.

115 For a discussion of the different requirements concerning the sophistication of an investor, *see* Gross (FN 97), note 41, 42, Harrer (FN 97), note 252 *et seq.*

116 *See* Gross (FN 97), note 44; Schäfer/Hamann (FN 105), note 142.

117 *See* Commission Regulation (EC) No. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements (hereinafter Prospectus Regulation), Annex I No 5.2.2 and 5.2.3 or 12.2.

118 BGH (12 July 1982 II ZR 175/81), Wertpapier-Mitteilungen 1982, 862, 865.

119 *See* Gross (FN 97), note 56; Schäfer/Hamann (FN 105), note 197 *et seq.*

A prospectus is incomplete if it does not contain facts that are material to the investor's investment decision.[120] A prospectus is formally complete if it fulfills the content requirements set forth in Section 7 of the Prospectus Act in conjunction with the Prospectus Regulation. Even if all these requirements are met, however, a prospectus may be incomplete as to its content based on the specific facts and circumstances, because the Prospectus Act, together with the Prospectus Regulation, establishes only minimum disclosure requirements. On the other hand, a prospectus that does not contain all information required by Section 7 of the Prospectus Act in conjunction with the Prospectus Regulation may nevertheless be complete if, for example, disclosure relating to certain items set forth in an Annex to the Prospectus Regulation is not relevant in a particular case. It is noteworthy that the BaFin does not review a prospectus with regard to the material correctness of the content, instead the BaFin only formally examines that the information contained in the prospectus fulfills the requirements of Section 7 of the Prospectus Act in conjunction with the Prospectus Regulation and that it is consistent and not contradictory *(vollständig, verständlich und kohärent)*.[121] For this purpose, the BaFin requires that a cross reference check list is submitted setting forth the required information to be included in the prospectus and the page number of the draft prospectus where such information is contained.

d. Materiality to the Assessment of the Value of such Securities

Prospectus liability requires that the incorrect or omitted information be material for the assessment of the value of the securities. The legislative reasoning *(Gesetzesbegründung)* of the Lower House of the German Parliament (Bundestag) included in the reasoning for the enactment of the Prospectus Act and accompanying changes to the SEA some examples to that extent. Accordingly, inaccurate figures on line items that are negligible in the assessment of the balance sheet as a whole are not material.[122] In addition, line items in the balance sheet that are of little significance for the assessment of future earnings of the issuer are also not material. In contrast, information relating to future operations, the business, results of operations or new product lines is deemed to be material.[123]

In summary, there is no clear-cut rule to determine when a prospectus is incomplete or contains material incorrect information. It requires analysis on a case-by-case basis in accordance with the guidance set forth above.

1.2 Burden of Proof and Exclusion of Liability *(Haftungsausschluss)*, Section 45 para. 2 of the SEA

The plaintiff must prove the incorrectness or incompleteness of the prospectus and the purchase price of the securities (or the difference between the purchase price and the price at which it sold the securities in the event the plaintiff is no longer in possession of the securities).

In order to avoid prospectus liability, the defendant must prove that either (i) the securities were not acquired on the basis of the prospectus, (ii) the facts contained in the prospectus were not incorrect or incomplete and those did not contribute to a reduction in the stock price, (iii) the plaintiff was aware of the incorrectness or incompleteness of the statements in the prospectus at the time of the purchase of the securities, (iv) prior to the execution of the plaintiff's purchase transaction, a clear correction of the incorrect or incomplete statements was made public in Germany either in the annual financial or the interim report of the issuer, in a publication pursuant to Section 15 of the Securities Trading Act *(Wertpapierhandelsgesetz)* or in a comparable announcement or (v) if the claim is only based on information contained in the summary of the prospectus or a translation thereof, that the summary is not misleading or incorrect when read in conjunction with the rest of the prospectus.

The burden of proof with respect to these exclusions of liability *(Haftungsausschluss)* lies with the defendant, i.e., the person(s) responsible for the prospectus. In particular with regard to the requirement of causation, this allocation of the burden of proof is similar to the rebuttable presumption of reliance under U.S. law, i.e., the defendant must prove that the plaintiff did not acquire the securities based on the prospectus.

Finally, the false prospectus must have caused the damages which the investor claims. Section 45 para. 2 No. 2 of the SEA states that the omitted or false statements contained in the prospectus must have caused the decrease in value of the share price. However, also with regard to this requirement of „loss causation«, the investor benefits from a rebuttable presumption and the defendant is required to show that the false or omitted statement did not cause the decrease of the share price.[124]

In order to determine if a prospectus was complete and not misleading, one needs to determine with the knowledge at the time of the publication of the prospectus if

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[120] *See* Heidel (FN 105), § 44 note 25; Gross (FN 97), note 45.

[121] Section 13 para. 1 sentence 2 Prospectus Act, Schäfer/Hamann (FN 105), note 108a; Gross (FN 97), WpPG note 8; Government Reasoning concerning Prospectus Directive Implementation Act *(Prospektrichtlinie-Umsetzungsgesetz)* BT-Drs 15/4999, 20, 35.

[122] BT-Drs (FN 121), 76.

[123] BT-Drs (FN 121), 76; *see also* Gross (FN 97), note 68; Steup (FN 109), note 33, 34.

[124] *See* Steup (FN 109), note 64, 65; Heidel (FN 105), § 45 note 23.

as at its date it was correct, complete and not misleading *(ex ante)*.[125]

1.3 Potential Plaintiffs

Anyone who acquired the securities within six months from the date of listing may base a cause of action on Sections 44 *et seq.* of the SEA if that investor acquired the securities for value.[126] With the exception of a pledgee or mere holder of a profit interest in the securities, who is not entitled to claim damages, it is irrelevant how the plaintiff acquired the securities or how they were offered. Thus, incorrect or incomplete prospectuses may, for example, trigger liability even if the securities were acquired in a purchase after the primary distribution in a normal market transaction or even outside the organized markets.

1.4 Acquisition within Six Months

Sections 44 *et seq.* of the SEA require the issuance of securities that relate to the prospectus. In addition, the securities must have been acquired for value within six months of the publication of the prospectus and the start of trading *(Einführung)(Section 38 of the SEA)*, without extension for any supplement *(Nachtrag)* that may be published.[127] Any investor who acquires the securities within this six-month period may base its cause of action on Sections 44 *et seq.* of the SEA, regardless of whether the securities were acquired during the issuance process or thereafter.

1.5 Calculation of Damages

In the calculation of damages, the SEA differentiates between an investor in possession of the securities and one who no longer is in possession. Damages also include «typical» costs associated with the purchase of securities, such as, for example, broker fees.

a. Investors in Possession of the Securities

An investor in possession of the securities may, pursuant to Section 44 para. 1 of the SEA, put them to the person responsible for the contents of the prospectus against payment of the price paid by the plaintiff to the extent such price does not exceed the initial offer price («Ausgabepreis»). This permits the investor to be put in the position in which it would have been had it been properly informed. However, the investor will not be put in a position in which he would have been had the misstated information in the prospectus been correct and complete.

As with any other claim for damages, an investor has a duty to mitigate the damage. In respect of the duty to mitigate where the investor is still in possession of the securities, a court will evaluate the plaintiff's conduct on a case-by-case basis.

b. Investors no longer in Possession of the Securities

A plaintiff who no longer is in possession of the securities may, pursuant to Section 44 para. 2 of the SEA, only claim the difference between the price at which it sold the securities and the initial offer price *(Ausgabepreis)*. As set out above, the duty to mitigate also applies in this circumstance. If the plaintiff sells the securities below market value at the time of the sale, it can only claim the difference between that market value and the initial price of the securities.

1.6 Joint and Several Liability

If more than one person is liable, pursuant to Section 44 para. 1 of the SEA, all such persons are jointly and severally liable. In general, contribution among the liable parties is imposed in proportion to the relative fault of the various defendants. Among the issuer and underwriters, contribution depends on whose breach of duty caused the incorrectness or incompleteness of the prospectus, i.e. on how these duties were internally allocated among them.

Despite the statutory joint and several liability of the responsible persons, the parties involved in the listing or offering of the securities will typically agree internally to a different allocation of liability which prevails over statutory rules of attribution. For instance, the agreement among underwriters typically states that each underwriter will be liable in the amount of the quota it subscribed securities. In addition, the underwriting agreements usually provides for an indemnification of the underwriters by the issuer. These provisions of the underwriting agreement and agreement among underwriters do not limit the scope of liability to third parties, instead they determine a «reimbursement» obligation of the issuer in the event that a prospectus liability law suit is lost and the underwriters, together with the issuer, are charged to pay damages. This internal allocation of liability does not, however, limit the liability to third parties, but only governs the internal allocation of liability among the underwriters and the issuer.

1.7 Statute of Limitation

Under Section 46 of the SEA, prospectus liability according to Section 44 of the SEA will be time-barred within one year after the plaintiff's knowledge of the incorrect or incomplete prospectus, but in any event after three years after publication of the prospectus. The civil

[125] *See* Heidel (FN 105), § 44 note 43.
[126] *See* Heidel (FN 105), § 44 note 48.
[127] *See* Steup (FN 109), note 64, 65.

law prospectus liability regime has the same three-year statute of limitation.

1.8 No Limitation or Exclusion of Liability

Any agreement which provides for the reduction or exclusion of a prospectus liability claims pursuant to Section 44 of the SEA which is entered into in advance is invalid pursuant to Section 47 para. 1 of the SEA. However, agreements such as a settlement after the existence of a prospectus liability claim are valid and enforceable.

2. Due Diligence to avoid Prospectus Liability

Pursuant to Section 45 para. 1 of the SEA, the person responsible for the content of the prospectus is only liable for an incorrect prospectus if it acted intentionally or with gross negligence. The burden of proof is on the defendant who must prove that it was unaware of the misstatements or omissions in the prospectus without gross negligence or willful misconduct on its part.

A person will be found to have acted with gross negligence if the standard of care required in the ordinary course was breached in a particularly severe manner, which means that such person did not consider obvious issues. In addition to this objective standard, the responsible person must have subjectively breached its duty of care, i.e., with gross negligence breached that duty of care.[128] It should be noted that in contrast to the rules of the SEA; under German civil law prospectus liability, negligence *(einfache Fahrlässigkeit)* is sufficient.[129]

In order to determine the standard of care for gross negligence, one needs to determine the different standards of care for each person responsible for the content of the prospectus.

2.1 Issuer

The standard of care required of the issuer is the highest due to the fact that all information used in the preparation of the prospectus are within its sphere. Prospectus liability is triggered if the issuer has omitted a material fact which it thought could possibly be material, or if the issuer knows that the means used to examine the information were insufficient to warrant the completeness of the prospectus and, despite this knowledge, the issuer failed to either initiate or conduct further investigations. Furthermore, it is liable for the incompleteness of a prospectus if it knowingly concealed or omitted material facts. This means that the issuer both positively knew the specific possible consequences of its conduct and accepted such consequences, or that the issuer, while it had no positive knowledge of the specific possible consequences of its conduct, did not care whether such possible consequences occurred.

2.2 Lead Underwriters

As stated above, the standard of care required of the lead underwriters is lower than for the issuer. Typically, all necessary information is within the issuer's sphere, while the lead underwriters can only review documents and conduct management interviews or other due diligence measures (see Section V.2). The principal question in relation to the lead underwriters' duty of care is to which extent they are generally required to conduct certain investigations (due diligence). Due to the lack of uniform court decisions in Germany concerning the scope of the standard of care, legal scholars[130] expressed different views as to the necessity and scope of due diligence required.

The lead underwriters are required to examine the information submitted to them and to investigate such information to the extent possible and reasonable.[131] They are, however, not required to examine the issuer's bookkeeping, unless they have reasons to believe that the information provided therein is incorrect. In this case, the lead underwriters are required to conduct further investigations concerning the issuers' bookkeeping.[132] In addition to documentary due diligence, the due diligence process typically involves management interviews, site visits and obtaining disclosure letters from legal counsel and comfort letters from the issuer's auditors as is typical in a U.S. Private Placement and further discussed above under II. 2. In addition, the lead underwriters are required to examine whether any recent developments may have changed the evaluations on which the audit was based, if a certain period of time has elapsed since the latest audited financial statements. The lead underwriters must also examine whether the conclusions and projections that were made in the prospectus based on the figures contained therein are plausible and thus give a fair view of the issuer from an investor's point of view.

The lead underwriters generally have fulfilled their duty of care if they can demonstrate that they conducted the required diligence in the preparation of the prospectus. As set forth above, if further investigations were required, the lead underwriters would need to show that they conducted further due diligence.

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128 *See* HEIDEL (FN 105), § 45 note 5 *et seq.;* GROSS (FN 97), note 75; SCHÄFER/HAMANN (FN 105), note 213.

129 *See* SCHÄFER/HAMANN (FN 105), note 216.

130 *See* SCHÄFER/HAMANN (FN 105), note 220 *et seq.;* GROSS (FN 97), note 80 *et seq.;* HARRER (FN 97), note 264 *et seq.;* HEIDEL (FN 105), § 45 note 7 *et seq.*

131 *See* GROSS (FN 97), note 80–84; SCHÄFER/HAMANN (FN 105), note 224; Setup note 74.

132 *See* GROSS (FN 97), note 81; SCHÄFER/HAMANN (FN 105, note 223 *et seq.*

2.3 Junior Underwriters

If the prospectus is signed by all members of a syndicate of banks, all such banks accept responsibility for the content of the prospectus, i.e., they are responsible persons within the meaning of Section 44 of the SEA. The lead underwriter is charged with the preparation of the prospectus and the overall management of the transaction, the junior underwriters will only be involved in a much later stage of the offering or listing. Therefore, according to the majority view of legal scholars[133] the duty of care required of such junior members of the syndicate cannot be the same as for the listing sponsor and lead underwriters. This is particularly true given the limited level of involvement of the junior banks; typically, they have much less time to review the prospectus and to sign the necessary agreements to participate in the offering. Therefore, junior underwriters need only conduct plausibility examination. In essence, they need to verify that the lead underwriters conducted due diligence as required for an issuance of securities.[134] Only if there are circumstances that lead the junior underwriters to question whether the lead underwriter(s) adequately conducted its/their due diligence in line with German market standards, are they required to conduct further own investigation.

V. Conclusion and Due Diligence Procedures

1. Conclusion

While the specific requirements for liability in connection with offerings of equity securities are different under U.S., Swiss and German liability provisions, such provisions generally impose liability if the offering memorandum or prospectus contains a materially incorrect or misleading statement or omits a material fact. The violation of any applicable liability provisions may result in liability for offering participants, in particular the issuer and the underwriters. These liability provisions emphasize the need for careful preparation of all materials to be used in international securities offerings, in particular the offering memorandum or prospectus.

Each of U.S., Swiss and German law affords the «due diligence» defense to liability. While the specific due diligence standards are different under U.S., Swiss and German law, a defendant who has undertaken reasonable procedures seeking to ensure the accuracy and completeness of the offering memorandum or prospectus has good arguments to avoid prospectus liability. In an international offering of equity securities including a U.S. Private Placement, the offering participants should follow due diligence procedures which reflect best practice in international offerings and satisfy standards which U.S. courts have recognized as adequate for offerings in the United States. In addition to the legal risk, the scope and comprehensiveness of the due diligence investigation is also important from a reputational standpoint as the reputation of offering participants may be significantly tarnished if it appears that they have failed to uncover and disclose to prospective investors critical issues relating to the issuer or the offering. The due diligence process also forms the basis for so-called disclosure letters delivered by legal counsel to the underwriters (but not to the public) regarding the disclosure in the offering memorandum or prospectus.

It is further fair to say that the U.S. capital market is considered to be the most developed capital market and, thus, the standard of care developed by U.S. case law and market participants has significantly influenced prospectus disclosure and due diligence processes in Europe, including Germany and Switzerland, resulting in an increasing convergence of internationally recognized due diligence standards.

In addition to the importance of the U.S. capital market as such, globalization, resulting in, among others, converging international capital markets, is accelerating the creation of a level playing field for the capital markets participants (e.g., issuers and investors). In the United States the introduction of the Securities Act and the Exchange Act ushered in a new era more than half a century ago. A development that was adapted and fostered in Europe with the implementation of the Prospectus Directive into local national law mostly in Europe by mid 2005. However, in contrast to the Securities Act and the Exchange Act, the Prospectus Directive does not include a prospectus liability regime but leaves it to the member states to implement adequate basis of prospectus liability which is not yet uniform but deviates from country to country. Although uniform investor protection at the European Union level will therefore only become a reality if prospectus liability, the key issue underlying investor protection, is harmonized throughout the European Union, the international nature of securities offerings results in a high convergence of the applied standards of care. In other words, in the absence of a uniform disclosure and liability regime throughout the United States, Switzerland and Germany, internationally developed standards and best practices of disclosure requirements and due diligence have created a comparable level playing field for issuers and investors in Switzerland and Germany.

The U.S. liability regime is generally considered to be the most stringent. Unlike in Europe, the litigious U.S. environment with far reaching discovery rules and the

133 *See* Gross (FN 97), note 79 *et seq.;* Schäfer/Hamann (FN 105), note 223 *et seq.;* Harrer (FN 97), note 264.

134 *See* Gross (FN 97), note 83; Schäfer/Hamann (FN 105), note 220; Heidel (FN 105), § 45 Rz. 16.

possibility of class actions with unforeseen damages and large settlements cause additional risks in the United States. There is also a significant cultural difference between U.S. and European societies which results in an increased likelihood of prospectus liability claims brought in the United States – a perception that is also reflected and further underscored by the concept of class actions in the United States. In Germany, a similar concept was adopted based on the recently introduced Act on the Initiation of Model Case Proceedings in respect of Investors in the Capital Markets *(Gesetz zur Einführung von Kapitalanleger-Musterverfahren)*[135] as a reaction to handle the more than 16,000 individual law suits filed against Deutsche Telekom AG following the placement of shares in 2000. Unlike the United States and Germany, Switzerland does not provide for the possibility of «class actions», although under certain circumstances prospectus procedures may be combined. However, in all jurisdictions it is correct to state that a bad investment in securities does not *per se* result in a successful prospectus liability claim as a material incorrectness or omission in the prospectus is required to establish a successful cause of action.

2. Due Diligence Procedures

As discussed above, the ultimate goal of the due diligence procedures is to help ensure that the offering memorandum or prospectus does not contain any material misstatements or omissions and to establish, where available, a due diligence defense. In addition, the due diligence process also forms the basis for so-called disclosure letters delivered by law firms to the underwriters (but not to the public) regarding the disclosure in the offering memorandum or prospectus.

There are no official due diligence guidelines creating a single set of procedures that should be followed in a due diligence exercise. Rather, most of the due diligence processes described below are based on transactional experience or market practice applied in international equities securities offerings. The scope of the due diligence procedures varies from transaction to transaction and depends on a number of factors and circumstances, including the nature of the offering (IPO or follow-on offering), jurisdictional coverage (domestic or international), familiarity of the underwriter with the issuer (new client of the underwriter or established client), the issuer's industry, and stock exchange requirements.

As a rule of thumb, the following procedures are typically considered when planning the due diligence process for a securities offering.[136]

2.1 Issuer's Website and Publicly Available Information

The issuer's website and other publicly available sources are often helpful to identify information relevant to the disclosure. Checking these sources at an early stage of the transaction will certainly help structure and organize the due diligence exercise.

2.2 Review of Documents

The review of documents (often referred to as documentary due diligence) plays an important role in the due diligence effort. Law firms with extensive experience in securities offerings have developed a practice of preparing a comprehensive list of documents to be requested from the issuer (and/or the selling shareholders) in connection with an offering, including corporate documents, documents regarding outstanding debt instruments, documents regarding government regulations and filings, financial and accounting information and information regarding contingent liabilities, information relating to management and employees, material agreements, intellectual property and taxes. It is important that this so called documentary due diligence request list is tailored to the specific issuer and the issuer's industry. It should be avoided to send issuers a lengthy request list that includes document requests that are clearly not applicable to the issuer or the issuer's industry.

2.3 Meetings with Management

In addition to the review of documents, an integral part of the due diligence process are interviews with the issuer's management (often referred to as management due diligence).

This process is typically kicked-off with presentations by members of the issuer's management who are responsible for key areas of the issuer's business, followed by Q&A sessions. These presentations are typically scheduled at an early stage of a transaction because they provide a good overview of the issuer's business and are helpful for the group that will be conducting due diligence and drafting the offering document. Advance preparation for meetings with management, including drafting a questionnaire, is very important because it will provide structure and organization to the process. Follow-up meetings are often requested by the deal team at a later date to discuss specific topics or problem areas identified during the course of a transaction.

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135 *See* Act on the Initiation of Model Case Proceedings in respect of Investors in the Capital Markets *(Gesetz zur Einführung von Kapitalanleger-Musterverfahren)* of 16 August 2005 (Official Gazette BGBl. I p. 2437); *see* also Gängel/Gansel in Heidel, KapMuG, § 1 *et seq.;* Maier-Reimer/Wilsing, Zeitschrift für Unternehmens- und Gesellschaftsrecht 2006, 79 *et seq.;* Möllers/Weichert, Neue Juristische Wochenschrift 2005, 2737 *et seq.;* Reuschle, Wertpapier-Mitteilungen 2004, 966 *et seq.*

136 *See* Johnson/McLaughlin (FN 25), 331.

The thrust of these interviews should be to obtain a deeper understanding of the issuer's business and prospects, particularly any problems and challenges that it may face in the future.

2.4 Underwriting Agreements

Underwriting agreements contain extensive representations and warranties from the issuer and any selling shareholders, which not only provide a basis for a warranty claim against the issuer (or selling shareholder) should the underwriter incur damages as a result of a material misstatement or omission in the offering document, but also help focus the attention of all parties on due diligence matters generally and, in particular, on issues which should be disclosed in the offering document. This will both reduce the likelihood of material misstatements or omissions in the offering document as well as facilitate the establishment of a due diligence defense by the underwriter.

2.5 Legal Opinions, Disclosure Letters, Officers' Certificates

Underwriters typically condition their purchase obligations on the receipt from legal counsels of legal opinions[137] as to various legal matters and disclosure letters[138]. While the precise matters to be addressed by counsels depend on a number of factors, legal opinions and disclosure letters are typically an integral part of an underwriter's due diligence defense as they may support a claim of reasonable belief regarding certain matters that are not typically within an underwriter's professional competence.

Further, legal opinions and disclosure letters also facilitate thorough legal due diligence by focusing the attention of the issuer's and the underwriter's counsel on legal matters which bear on disclosures made (or required to be made) in the offering memorandum or prospectus. In addition, written representations from the issuer's directors and officers regarding the accuracy of the offering memorandum or prospectus and other matters should be obtained.

2.6 Comfort Letters

An additional important feature of the underwriters' review process is the obtaining of comfort from the issuer's auditors on various matters relating to the issuer's financial position and results of operations.

The principal purpose of the so-called comfort letter[139] is to assist the underwriters in establishing the due diligence defense by providing assurance that the financial information contained in the offering memorandum or prospectus is accurate and has been independently verified and that there are no significant changes in specified financial statement items in the period for which there are no financial statements in the offering memorandum or prospectus. Standard forms for such comfort letters have developed in the U.S.[140] («SAS 72 comfort letters») and Germany[141]. SAS 72 permits accountants to issue a traditional «negative assurance» comfort letter to underwriters only if the underwriters represent in writing that they have conducted a review process that is substantially consistent with the due diligence process that would be performed if the offering were registered under the Securities Act and that they are knowledgeable with respect to the diligence review process that would be performed if the offering were registered under the Securities Act.[142]

2.7 Review of Financial Statements and Meetings with Accounting Personnel and Auditors

As part of the accounting due diligence exercise, the issuer's financial statements, including the notes thereto, should be reviewed. This review is often followed by a meeting with the issuer's accounting personnel and the outside auditors. In advance of such accounting due diligence meetings with the auditors, the underwriters typically present the auditors with a specific list of questions.

2.8 Drafting Sessions

The offering memorandum or prospectus is prepared, discussed and revised in numerous drafting sessions, in which typically the issuer, the underwriters and the

[137] *See* Gruson/Hutter/Kutschera, Legal Opinions in International Transactions, 4th ed., The Hague 2004; *See* for example Seiler in Habersack/Mülbert/Schlitt (eds.), Unternehmensfinanzierung am Kapitalmarkt, Cologne 2005, § 22 note 1 *et seq.;* Harrer (FN 97), note 129 *et seq.*

[138] *See* for example Harrer (FN 97), note 136 *et seq.*

[139] *See* for example Kunold in Habersack/Mülbert/Schlitt (eds.), Unternehmensfinanzierung am Kapitalmarkt, Cologne 2005, § 21 note 1 ff.; Ebke/Siegel, Comfort Letters, Börsengänge und Haftung: Überlegungen aus Sicht des deutschen und US-amerikanischen Rechts, WM Sonderbeilage No. 2/2001; Harrer (FN 97), note 148 *et seq.*

[140] *See* SAS 72, Statement on Auditing Standards, AICPA, Professional Standards, Letters for Underwriters and Certain Other Requesting Parties (AU § 634). *See,* for an overview of practices regarding comfort letters in Switzerland, Amrein, Comfort Letters der Wirtschaftsprüfer, in: Reutter/Watter/Werlen (ed.), Kapitalmarkttransaktionen, Zurich 2006, 81 *et seq.*

[141] Institute for Public Accountants *(Institut für Wirtschaftsprüfer)* (ed.) IDW Examination Standards: Principles for the Issuance of Comfort Letters) *(IDW Prüfungsstandard: Grundsätze für die Erteilung eines Comfort Letters)* IDW AuS 910, 2004, WP 2004, 342 *et seq.*

[142] SAS 72 purports to recognize that what is «substantially consistent» may vary from situation to situation and may not be the same as that done in a registered offering of the same securities of the same issuer. Whether the procedures being, or to be, followed will be «substantially consistent» will be determined by the requesting party on a case-by-case basis.

lawyers participate. Drafts of the offering memorandum or prospectus should be carefully reviewed by all parties involved. Any substantive comments or questions should be discussed during drafting sessions with the issuer's relevant officers. As regards the underwriters, legal due diligence, representations and warranties in the underwriting agreement and legal opinions should not be taken to suggest that there is any substitute for ongoing, «hands-on» involvement by the underwriters in all phases of transaction execution. In this regard, regular attendance by representatives of the underwriters at drafting sessions and other meetings during which the contents of the prospectus are discussed is particularly important.

In addition, while the Securities Act does not require underwriters to conduct an investigation of statements made or information given in expertized portions of the offering memorandum or prospectus, prudence suggests that relevant experts be interviewed to confirm the basis of statements made and disclosures prepared or certified by them.

While it is general practice to ask the issuer's auditors to attend drafting sessions during which the financial statements of the company are discussed, auditors are often very reluctant to attend drafting sessions due to a perceived liability risk which is not justified.

The focus should be on problem areas and the related disclosure in the offering memorandum or prospectus should be discussed with the relevant officers in order to ensure accurate and complete disclosure. The time spent in discussing and perfecting disclosure of certain issues in the offering memorandum or prospectus can be the most important time spent in the entire process. As regards style, an offering memorandum or prospectus should be written in «plain English» to ensure that it is comprehensible to the average investor.

2.9 Directors & Officers Questionnaires

Offering documents must include certain information regarding the issuer's directors and officers, their compensation, holdings of securities and material transactions, if any, with the issuer. It is therefore standard procedure to ask the directors and principal officers of the issuer to complete directors and officers questionnaires (often referred to as D&O questionnaires) in order to meet the applicable disclosure requirements.

2.10 Interviews with Third Parties

Depending on the circumstances, it may be appropriate to further investigate the issuer's relationships with third parties, including creditors, customers, suppliers, and major shareholders on a selected basis. In addition, if the issuer is involved in material litigation, discussions with the issuer's external legal advisors regarding such litigation matters should be considered.

2.11 Site Visits

Depending on the business of the issuer, visits to the issuer's plants, factories, stores or other principal facilities should be considered.

2.12 Bring-Down Due Diligence

Due diligence should not stop when the preliminary offering memorandum or prospectus is printed but should continue until the pricing date and the closing date. While the comfort letter can be useful in this connection because it covers increases or decreases in specific balance sheet or income statement line items until the «cut-off date», which is usually a few days before the date of the comfort letter, it is equally important to ask management before publication of the offering memorandum or prospectus, the pricing and again at closing to verify that nothing has occurred that would materially change the premises on which the transaction is based.

2.13 Documentation of Due Diligence Procedures

Under U.S. and German law the burden of proof that the required due diligence standards were met is with the defendants. Underwriter defendants may have conducted a «reasonable investigation» or acted with «reasonable care» in connection with an offering but in the absence of any records that prove the specific due diligence performed may be unable to prevail. It is therefore important to properly document the due diligence procedures performed.

Policies with respect to documenting due diligence vary. While the prospectus, legal opinions, disclosure letters, comfort letters, and the other documents obtained by the underwriters in connection with the closing of the offering, will be kept on file and be very helpful for the due diligence defense, it may, depending on the individual circumstances of a specific transaction, be decided to maintain more detailed records of the various procedures performed, in particular minutes of bring down due diligence calls or meetings with the auditors or other experts. If it is determined to document a more detailed record, it is crucial that such record not only list the issues but also the manner in which issues were resolved. It goes without saying that such a detailed record is a double-edged sword in the event of litigation, in particular due to the U.S. discovery procedures which apply also to prospectus liability law suits.