Sedgwick LLP

# D&O Claims – Overview of US Securities Law

The Securities Act of 1933 **("the 1933 Act") regulates the process by which securities are first offered and sold to the public, and has two primary objectives: (1) to ensure that investors receive full and accurate information in relation to securities offered for public sale; and (2) to prohibit misrepresentations and other fraud in relation to the sale of securities.**

## Registration Requirements

Subject to limited exceptions (e.g., private or limited offerings), the 1933 Act requires that all securities offered for sale in the US first be registered with the Securities and Exchange Commission ("SEC"). The 1933 Act and supporting rules govern the registration process and require (among other things) that a Registration Statement be filed with the SEC. The Registration Statement is an SEC-proscribed form that contains certain information about the business of the issuer company, the security being sold, and additional information about the management of the company and its financial condition. It is different than the sales document for investor use, which is called the Prospectus (or offering document). The Prospectus is the sales/marketing presentation, while the Registration Statement seeks SEC approval of the sale.

## Enforcement

The SEC has the power to bring civil enforcement actions for violations of the 1933 Act. Although it can seek to impose monetary fines or penalties, disgorgement of funds or injunctions limiting future violations (including prohibitions of further securities sales, or holding official positions in SEC-regulated companies), only the US Department of Justice can bring an action seeking incarceration.

Private investors may also bring civil lawsuits seeking redress for violations of the 1933 Act, but not under all provisions. Any action must be brought within 1 year of the plaintiffs becoming aware of the cause of action, but in no event beyond 3 years of the Registration Statement date. The causes of action that investors may seek redress under are discussed below.

## Section 11

Section 11 creates civil liability in the event a Registration Statement, which includes the Prospectus attached thereto, contains untrue statements of material fact or which omits to state a material fact. To ensure that full and complete disclosure occurs, Section 11 imposes strict liability on the issuer and any person or expert (e.g., accountants and attorneys) who signs the Registration Statement. In addition, the directors of the issuer will be held strictly liable as well, even if they did not sign the documents. Generally, only those who purchased in the affected offering may sue, although subsequent purchasers of the securities may bring suit if they can track their securities to the original offering (called "tracing").

As a strict liability statute, purchasers do not need to prove causation or reliance. If a materially inaccurate misstatement or omission occurred, liability is assumed and damages are calculated by determining the difference between the offering price in the IPO and the value of the shares at the time of the purchaser's suit (or at the time the purchaser disposed of the securities if they were sold prior to commencement of the suit). All defendants are jointly and severally liable for all damages.

Defenses to Section 11 include: (a) no material misrepresentation or omission occurred; (b) the presumed damages were actually caused by other, unrelated causes (the "negative causation" defense); (c) as for individual defendants only, they conducted a reasonable investigation and had a reasonable basis to believe that the documents were accurate (the "due diligence" defense); and (d) as for those portions of Registration Statement that contained expert opinions, the non-experts had no basis to believe that the "expertised" portions were inaccurate.

## Section 12

Section 12 addresses misrepresentations or omissions outside the Registration Statement, including the Prospectus (although Section 11 liability usually exists for Prospectus inaccuracies as they are normally attached to a Registration Statement).

Section 12(a)(1) creates liability for persons who sell unregistered securities to the public, whether through a written document (e.g., Prospectus) or through oral communications. Like Section 11, the seller is absolutely liable and the purchaser can either seek to rescind the purchase of the securities or claim damages if the securities have been sold for an amount less than the original purchase price.

Section 12(a)(2) creates liability for any person who offers or sells securities through either a Prospectus or oral communication that contains a material misstatement or omission. The presumptions and defenses applicable to Section 11 liabilities, generally apply to Section 12(a)(2) violations.

*continued*

### Section 15

Section 15 imposes "secondary" liability on certain persons who "control" persons found to have violated Sections 11 or 12 of the 1933 Act. There can be no "controlling person" liability in the absence of a primary violation, and generally the issue of "control" is one based upon the facts and circumstances. If a primary violation occurred, and a person or entity is considered to be a "controlling person," the latter will have the same degree of liability as the "controlled" primary violator. Generally, then, secondary violators are jointly and severally liable as well.

A defense to Section 15, other than having a lack of sufficient control over the primary violator, is proof that the secondary actor had no knowledge, or reasonable basis to believe in the truth of the facts giving rise to the controlled person's liability (the "good faith" defense).

### Jurisdiction

Claims seeking class action status and arising out of violations of the 1933 Act most often must be brought in federal court. Under the Securities Litigation Uniform Standards Act ("SLUSA"), plaintiffs are generally precluded from bringing class action lawsuits arising from misrepresentations made in connection with the purchase or sale of a covered security in state court. However, some courts have found that state courts can have concurrent jurisdiction with federal courts for certain claims involving securities not covered by SLUSA that are brought under the 1933 Act.

The purpose of SLUSA is to prevent plaintiffs from circumventing the reforms contained in the Private Securities Litigation Reform Act ("PSLRA"). The PSLRA is a federal statute that was enacted to limit the number of frivolous securities lawsuits that were being asserted against companies and their directors and officers. If brought in state court under state securities laws, plaintiffs' 1933 Act claims are otherwise not subject to the PLSRA reforms.

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## The Securities Exchange Act of 1934

**("1934 Act") regulates securities brokers, dealers and the post-offering trading of securities in the public markets. Unlike the 1933 Act, the 1934 Act regulates the corporate statements and disclosures made after a security has been issued. Issuers are required to file periodic disclosure reports to the SEC (quarterly reports, called Form 10-Q; and annual reports, called Form 10-K), which are made available to the public on the SEC's website. Interim developments are also to be reported, usually on a Form 8.**

Because the 1934 Act applies to public disclosures made in the post-offering period, a company's press releases or communications, whether written or oral, may also give rise to liability, apart from the periodic SEC filings.

### Enforcement

The SEC has the power to bring civil enforcement actions for violations of the 1934 Act and can seek the imposition of monetary fines or penalties, disgorgement of funds or injunctions limiting future violations (including prohibitions of further securities sales, or holding official positions in SEC-regulated companies), but cannot seek incarceration. It is the role of the US Department of Justice to criminally prosecute violations of the US laws, including under the 1934 Act.

Private investors may also bring civil lawsuits seeking redress for some (but not all) violations of the 1934 Act. Under the 1934 Act, the statute of limitations requires suit to be brought within 2 years of the plaintiffs becoming aware of the misconduct, and in no event after 5 years of the statement or omission.

### Section 10(b) and Rule 10b-5

Section 10(b) of the 1934 Act prohibits the use of any "manipulative device or contrivance" that violates rules and regulations of the SEC. The SEC has adopted its Rule 10b-5, which broadly makes it unlawful to make any untrue statements of material fact, or fail to state a material fact that is necessary in order to make other statements made not misleading. Rule 10b-5 has a "catch-all" provision that prohibits any act, practice or course of business that "operates as a fraud or deceit."

In order for a Section 10(b) claim to succeed: (a) securities must have been purchased by the plaintiff in transactions in securities listed on domestic exchanges or through domestic transactions in other securities; (b) a material misrepresentation or omission must have been intentionally made by the defendant while knowing (or recklessly disregarding) the truth; (c) the plaintiff must have relied upon that misrepresentation or omission; (d) there is a causal link between defendant's misrepresentation or omission and the loss; and (e) provable damages resulted.

As it is the burden of the plaintiff to establish each of these elements, it is possible to defeat a Section 10(b) claim on several grounds. For example, a complaint may be dismissed if the plaintiff fails to demonstrate that an actual misstatement or omission of a material fact occurred. Similarly, because the liability is based on fraud, the plaintiff is required to state with particularity facts giving rise to a strong inference that each named defendant acted with the requisite culpable state of mind ("*scienter,*" which is an intentional or recklessness standard). So, too, must the plaintiff establish that the damages resulted from the alleged misstatement or omission, causing the losses suffered. Competent damage computations, reflecting the difference between the actual trading value of the securities, and the "true" value the securities would have traded at absent the fraud, is required. The failure of any of these *prima facie* elements renders the case dismissible. In addition to challenging the *prima facie* elements, a defendant can also assert that either (a) the statements or omissions were already publicly known; (b) the statements arose as to future predictions or events, and not current facts; or (c) sufficient warnings were given at the time of the disclosure (the "bespeaks caution" or "safe harbor" defenses).

Because of the difficulty in proving individual reliance for each class member that purchased a security for every alleged misrepresentation or omission, US courts have adopted a presumption of reliance that applies to all purchasers. The assumption is made that publicly traded securities exist in an "efficient market", meaning that the price of the security reflects all publicly available information about the security. Based on that economic presumption, if a false or misleading statement or omission was made, it is assumed that it acted as a "fraud on the market" and reliance can be presumed class-wide. The presumption is not conclusive, but can be rebutted by defendants at or prior to the class certification stage through evidence that the misrepresentation or omission did not, in fact, have an impact on the price of the security. Thus, if there is no "price impact" as a result of the misrepresentation or omission, the plaintiff cannot establish reliance based on price.

Unless the defendant intentionally (and not recklessly) violated Section 10(b), the defendant is responsible only for that portion of the liability or damages ascribed to the misconduct at issue. There is no joint and several liability for those who recklessly violate Section 10(b).

Section 10(b) and Rule 10b-5 have been interpreted to prohibit the trading of securities on material non-public information (i.e., insider trading or tipping others) if it was obtained and used in violation of a relationship of trust and confidence or misappropriated. The test under Rule 10b-5 is whether the information is the kind that might affect the judgement of reasonable investors (both conservative and speculative).

## Section 14

When regulating the exchange of publicly-available information concerning securities, the SEC has also regulated the dissemination of inter-corporate information upon which securities-holders may exercise a voting right. This occurs most frequently in the context of an offer to purchase the shares of a public company. Regulating the manner in which the voting rights of securities holders are solicited (through a "proxy" request made to the securities holders), Section 14 can be the basis of private actions.

Section 14(a) generally regulates the solicitation of shareholder votes in Proxy statements, setting forth minimal disclosure standards. Like SEC Rule 10b-5, SEC Rule 14a-9 broadly prohibits any solicitations that contain a materially misleading fact or statement, or omits to state any material fact that would be necessary to ensure that the facts and statements disclosed are not misleading. Aggrieved shareholders may bring suit for damages or other appropriate relief. Like an action under Section 10(b), the plaintiff bears the burden of proving that a misstatement or omission occurred, the materiality of that statement or omission, causation and damages.

Section 14(e) regulates those proxy statements that arise in the context of takeovers or tender offers: corporate "changes in control." Again, like other sections of the 1934 Act, the plaintiff has the burden of proving the materiality of a suggested misstatement or omission.

## Section 16(b)

Recognizing that it may be difficult to establish that certain corporate officials who purchase or sell company securities are acting on non-public, confidential information, the SEC has adopted the view that any purchase/sale (or sale/purchase) reciprocal transactions that occur within any one six-month period are considered *per se* illegal. This six-month prohibition is known as the "short swing profit" window, and is prohibited.

Whether the corporate insider harbored non-public, material data (or not) is irrelevant. Proof that an insider bought and then sold (or *vice versa*) corporate shares within the six-month period allows a shareholder to bring suit seeking disgorgement of the profits realized. Disgorgement is made to the company itself.

## Section 20(a)

Section 20(a) of the 1934 Act imposes secondary liability on those persons who "control" primary violators of the 1934 Act. Although it is applicable to any primary violations of the 1934 Act, it is most frequently asserted in connection with Section 10(b) claims.

In a Section 20(a) claim, the plaintiff must establish that someone else is a primary violator of the 1934 Act, and that the secondary actor has sufficient "control" over the primary violator so as to be accountable as well.

A Section 20(a) claim can be defeated if it can be established that: (a) no primary violation occurred; (b) that the control-

ling person did not have the power to direct or cause the other defendant to commit the primary violation; and/or (c) the controlling person did not directly or indirectly induce the other defendant to commit the primary violation, but instead acted in good faith.

## Section 20A

Section 20A was enacted due to the inability of certain securities counterparties to have sufficient "standing" to bring a claim alleging "insider trading" or "tipping" violations of Section 10(b). Section 10(b) liability can only be asserted by those who had some relationship with the securities purchaser or seller (e.g., the direct counterparty).

Section 20A allows any person who purchased or sold securities at the same time some prohibited trade occurred, as well as counterparties to the prohibited trade, to sue. Any person who purchased or sold securities while in the possession of material, non-public information is liable. Liability attaches not only to the speakers, but those who obtained the inside information.

## Jurisdiction

Claims seeking class action status and arising out of violations of the 1934 Act are also subject to SLUSA, and as a result, most often must be brought in federal court.

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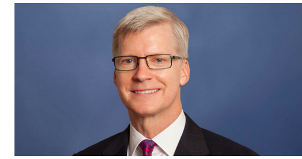

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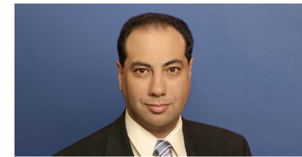

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## About Sedgwick

Sedgwick's D&O team has experience representing primary and excess insurers in connection with D&O and other policies issued to large-, mid-, and small-cap publicly-traded companies, private companies, not-for-profits, professional services firms, LLCs, financial institutions, investment trusts, and limited and general partnerships domiciled in both US and international markets. Our experience also extends to advising insurers on a variety of professional and fiduciary risks. We routinely assess coverage, prepare coverage opinions, and investigate these claims. We regularly participate in resolution of underlying claims on behalf of our insurer clients, participating in mandatory settlement conferences and private mediations. Our experienced trial lawyers prosecute and defend coverage actions in federal and state trial courts and on appeal. Our goal is to assist our insurer clients in resolving claims as quickly and as economically as possible; we pride ourselves in obtaining the best possible results for our clients, often resolving matters for significantly less than the estimated exposure. The cases we handle are frequently complex, international and highly sensitive. This requires a specialized knowledge of the types of claims that arise and a strong international team covering the US, Europe and offshore jurisdictions.

Sedgwick's D&O team is part of the firm's Insurance Division, one of the largest international teams of lawyers dedicated to the institutional concerns and success of the global insurance industry. Sedgwick is the only law firm with full service offices in the three leading international insurance centers: the United States, London and Bermuda. For more information, visit **sedgwicklaw.com.**

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