
WHAT DUE DILIGENCE DILEMMA?
RE-ENVISIONING UNDERWRITERS' CONTINUOUS
DUE DILIGENCE AFTER *WORLDCOM*

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ABSTRACT

The recent WorldCom decision is widely believed to pose a “due diligence dilemma.” This dilemma supposedly forces underwriters for large, established corporations to choose between their clients’ desire to issue securities quickly in shelf-registered offering and the obligation to exercise reasonable care in due diligence. According to most commentators, the bar for due diligence set by WorldCom is simply too high to surmount during a shelf takedown. As a result, underwriters will either lose lucrative business or lose their defense to liability for misstatements or omissions in the offering document. And the stakes are high: in WorldCom, the underwriters settled for \$6.1 billion rather than test their due diligence defense at trial.

Underwriters could avoid this purported quandary if they investigated clients on a continuous basis, and thus, largely completed due diligence before each offering. Yet, scholars generally agree that underwriters perform little such “continuous due diligence.”

This article casts doubt on that scholarly consensus. This article urges that underwriters for giant corporations may perform far more continuous due diligence than most writers suppose.

This article sheds light on a source of continuous due diligence that has, to date, entirely escaped scholarly attention: investigation outside of the context of securities offerings. The global banks that

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underwrite securities for giant corporations typically are organized into “client relationship teams.” These teams serve all of the bank’s clients’ financing needs, not just securities underwriting. As such, the team has reason to investigate its clients in many contexts other than securities offerings. This investigation is continuous due diligence by another name—and it may well provide an escape from the “underwriter conundrum.”

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[W]orldCom. . . result[ed in] a dilemma that still has not worked itself out today. . . Put simply, the old statutory norms requiring underwriters . . . to conduct a “reasonable investigation” appear still to apply in court when an offering turns sour, but these rules are no longer observed in practice because, under the pressure of expedited time schedules, underwriters appear unable to perform due diligence. . . .¹

INTRODUCTION: THE “UNDERWRITER CONUNDRUM”—TO DILIGENCE OR NOT TO DILIGENCE?

In the wake of the historic² WorldCom, Inc. securities litigation,³ prominent scholars,⁴ regulators,⁵ practitioners,⁶ and journalists⁷ have all argued that underwriters of securities issued to the public by certain large, established corporations face a long-anticipated⁸ but previously

¹ JOHN C. COFFEE, JOEL SELIGMAN & HILLARY A. SALE, *SECURITIES REGULATION: CASES & MATERIALS* 154 (10th ed. 2006).

² The WorldCom litigation was historic both in size and in subject matter. The litigation was huge by any number of measures: At the close of trial in 2005, it was hailed as “the largest securities class action in history.” See *Andersen Settles as Last Defendant in WorldCom Case*, USA TODAY, Apr. 26, 2005, at 05B. Further, the aggregate dollar amount of the settlements by all defendants in the class action was slightly more than \$6 billion—the second largest in securities class action history (after Enron). See Robert J. Jossen & Neil A. Steiner, *Taking a Close Look at Personal Liability of Outside Directors: WorldCom and Enron Settlements Raise Concern but Should Not be Blown out of Proportion*, N.Y. L.J., Aug. 22, 2005, at S8. The issuances that gave rise to the WorldCom litigation, two bond offerings for a total of \$16.9 billion, included an offering for \$11.9 billion that was, at the time, said to be the largest in U.S. history. See Joseph McLaughlin, *Financial Statement Due Diligence After WorldCom*, in *SECURITIES OFFERINGS 2006: OPERATING UNDER THE NEW RULES* 539, 541 (2006). The fraud at WorldCom, Inc. that precipitated the litigation was described as “the largest accounting fraud in US history”; similarly, the company’s \$74.4 billion restatement of its financials statements was described as “the largest and most complex” ever. Paul Taylor, *MCI Profit Restatement Totals Dollars 74.4bn*, FIN. TIMES (London), Mar. 13, 2004, at 1. Additionally, WorldCom, Inc.’s 2002 bankruptcy remains the largest non-financial bankruptcy, and the third-largest bankruptcy overall (measured in terms of pre-petition assets) on record. See BankruptcyData.com, *20 Largest Public Company Non-Financial Bankruptcy Filings 1980 - Present*, https://www.bankruptcydata.com/Research/Largest_Overall_Non-Financial.pdf (last visited Jan. 19, 2009); BankruptcyData.com, *20 Largest Public Company Bankruptcy Filings 1980 - Present*, https://www.bankruptcydata.com/Research/Largest_Overall_All-Time.pdf (last visited Jan. 19, 2009). The WorldCom litigation was historic in subject matter because it resulted in the first published decision applying Section 11 to a shelf-registered offering. See *infra* notes 153-155 and accompanying text.

³ *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (S.D.N.Y. filed July 2002) (throughout this article, this consolidated securities action is referred to as the “WorldCom litigation”).

⁴ See *infra* notes 172-175 and accompanying text.

⁵ See *infra* note 176 and accompanying text.

⁶ See *infra* notes 176-177 and accompanying text.

⁷ See *infra* notes 178-179 and accompanying text.

⁸ The *potential* for a “due diligence dilemma” was first articulated in the early 1980’s when the SEC adopted Rule 415, which provided for “shelf registration” for securities offerings. See

unconfirmed conundrum: the “due diligence dilemma.”

This supposed quandary concerns “due diligence,” an underwriter’s practice of investigating the issuer’s financial health prior to an offering⁹—which, if adequate to satisfy the applicable legal standard, constitutes an affirmative defense to claims under Section 11¹⁰ and Section 12(a)(2)¹¹ of the Securities Act of 1933 (“Securities Act”) for material misstatements or omissions in the offering document (the “registration statement”).¹²

At the heart of the purported due diligence dilemma is *In re WorldCom, Inc. Securities Litigation*,¹³ in which the district court rejected the underwriter defendants’ motion for summary judgment made in reliance on their due diligence defense. In so doing, the *WorldCom* court opined that the appropriate measure of underwriter due diligence was the thorough and time-consuming investigation that was standard for secondary offerings¹⁴ in a long-bygone era, when such offerings literally took months to prepare and when underwriters oversaw drafting of the entire registration statement.¹⁵ The *WorldCom* court so ruled despite that, as a result of two regulatory changes from the early 1980s—“shelf registration”¹⁶ and “integrated disclosure”¹⁷—large, established corporations can now offer securities in weeks or even days rather than months, and underwriters have little or no role in drafting substantive portions of the registration statement.¹⁸

Thus, the crux of the “underwriter conundrum”¹⁹ is that the legal

infra Section B.1. Numerous articles at the time urged that the shelf registration regime would deny underwriters sufficient time to perform adequate due diligence. See *infra* Part I.F. The spectre of a due diligence dilemma remained present throughout the 1980s and 1990s, but underwriters and their counsel eventually were lulled into complacency because the massive liability event that everyone anticipated had not come to pass. See *infra* note 171. That event was *WorldCom*. See McLaughlin, *supra* note 2, at 545 (“WorldCom is . . . the train wreck everyone has been expecting since shelf registration” was adopted).

⁹ “Due diligence” is “an investigation or audit of a potential investment” that “serves to confirm all material facts.” Investopedia, Due Diligence, <http://www.investopedia.com/terms/d/duediligence.asp> (last visited Jan. 19th, 2009). For a specific discussion of an underwriters’ due diligence in the context of a securities offering, see *infra* Part I.A.

¹⁰ 15 U.S.C. § 77k(a)(5) (2006).

¹¹ 15 U.S.C. § 77l(a)(2) (2006).

¹² For the definition of “registration statement,” see *infra* note 42.

¹³ *In re WorldCom, Inc. Sec. Litig. (WorldCom)*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

¹⁴ A “secondary” securities offering is an offering of additional shares after a company has had an initial public offering. Investopedia, Secondary Offering, <http://www.investopedia.com/terms/s/secondaryoffering.asp> (last visited Jan. 19, 2009).

¹⁵ This time-consuming investigation is still standard for due diligence in *initial* public offerings, however. See *infra* note 112 and accompanying text.

¹⁶ Regarding shelf registration, see *infra* Part I.B.1.

¹⁷ Concerning integrated disclosure, see *infra* Part I.B.2.

¹⁸ For an explication of the *WorldCom* decision, see *infra* Part I.G.

¹⁹ The “underwriter conundrum” is a less-alliterative formulation of the “due diligence dilemma.” See generally Christopher O’Leary, *The Underwriter Conundrum*, INV. DEALERS’ DIG., Dec. 19, 2005.

standard for due diligence has remained the same while the time for due diligence has all but disappeared.²⁰ Offering-time due diligence simply cannot occur when an offering proceeds in no time at all.

The lack of time to complete adequate due diligence *during* an offering would not be a dilemma, of course, if underwriters generally performed due diligence on large, established issuers *continuously*—that is, *before* and/or *after* offerings—thereby developing a reservoir of knowledge about issuers that is *always* up to date. If underwriters performed so-called “continuous due diligence” in this manner, they would be prepared even for offerings that occur in the blink of an eye, because due diligence would be substantially complete *before* an offering.

Alas, it is widely accepted among scholars and practitioners alike that underwriters of securities offered by large, established issuers perform little, if any, continuous due diligence on such issuers.²¹ Nor are underwriters likely to adopt an adequate continuous due diligence program, according to the conventional wisdom, due to the growing commoditization of underwriting services and the much-maligned end of the era of “relationship banking.”²²

Thus, the due diligence dilemma supposedly forces underwriters for seasoned issuers to choose between two equally-unenviable alternatives: Either, hold up the offering in order to perform adequate due diligence—and possibly lose the issuer’s underwriting business as a result. Or, proceed with the offering at the usual lightning speed, perform inadequate due diligence—and possibly become subject to strict liability under Sections 11 and 12(a)(2) for any material misstatements or omissions in the registration statement.²³

Recognition of the due diligence dilemma has split commentators into two camps with regard to whether the Securities and Exchange Commission (“SEC”) should intervene on underwriters’ behalf. Prominent scholar Jack Coffee sees no need for such intervention, because underwriters are important gatekeepers to help prevent securities fraud.²⁴ Rather, Professor Coffee argues that the underwriters

²⁰ Suggestions by some commentators that *WorldCom* changed “the rules” for underwriters (see, e.g., Thomas A. Zaccaro, Jesse Z. Weiss & Michelle A. Reed, *Due Diligence Standards for Underwriters After WorldCom*, CORP. GOVERNANCE ADVISOR, Mar./Apr. 2005, at 23) are therefore misguided. Rather, *WorldCom* confirmed that, while underwriters’ practices had changed for certain offerings, the liability rules *had not* changed.

²¹ See *infra* Part I.G.2(ii).

²² Regarding “relationship banking,” see *infra* notes 185 to 188 and accompanying text.

²³ See *infra* Part I.G.2(i).

²⁴ See John C. Coffee, Jr., *A Section 11 Safe Harbor?*, N.Y. L.J., Sept. 15, 2005, at 5 [hereinafter *Safe Harbor*]. Scholars widely agree that underwriters are gatekeepers. See, e.g., Royce de R. Barondes, *NASD Regulation of IPO Conflicts of Interest—Does Gatekeeping Work?*, 79 TUL. L. REV. 859, 861 (2005) (citing Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984)). Indeed, the structure of the

should spread their risk of liability by raising fees to issuers.²⁵ By contrast, another commentator recently has argued quite forcefully that the SEC should intervene to protect underwriters by promulgating a safe harbor that “modernizes” the standard for the adequacy of due diligence.²⁶ Undoubtedly, the securities industry’s lobbying arm,²⁷ the Securities Industry and Financial Markets Association (“SIFMA”), would support the promulgation of such a safe harbor—as it did in the past, even pre-*WorldCom*.²⁸ Hence, if there is a due diligence dilemma, there soon may be a strong push for the SEC to eliminate it.

What’s more, a SIFMA-led push for a safe harbor is even more likely today than it was immediately after *WorldCom* was decided, due to recent regulatory changes that quicken the pace of offerings for many of the largest, most-well known corporations. In December 2005 the SEC adopted changes that permit certain large, established securities issuers (called “well-known, seasoned issuers” or “WKSI”) to issue securities “automatically”—that is, *without* any SEC advance review.²⁹ Hence, for WKSI issuers, the window for underwriters to conduct due diligence during an offering has in theory gone from tiny to nonexistent. If *WorldCom* presents a due diligence dilemma, then “automatic” registration exacerbates it.³⁰

Happily, however, for at least some WKSI, there may be no such dilemma (or it may not be as serious as advertised). This article casts doubt on the existence (or at least the severity) of the purported due diligence dilemma with respect to underwriters for giant companies (such as those on Fortune’s watch lists)³¹ by questioning the widely-accepted assumption that such underwriters perform scant continuous due diligence. This article suggests that continuous due diligence indeed serves as a safety valve for underwriters wishing to perform adequate due diligence despite the lightning-fast pace of today’s securities offerings. In order to understand why, we must look inside the firms that issue securities for giant corporations—and we must re-envision *who* at those firms performs, and *what* constitutes, continuous

Securities Act effectively demands it. See *infra* note 40 and accompanying text (the Act holds underwriters strictly liable for material misrepresentations, subject to an affirmative due diligence defense).

²⁵ See *Safe Harbor*, *supra* note 24.

²⁶ Christian A. Young, *Looking Back On WorldCom: Addressing Underwriters’ Due Diligence In Shelf Registration Offerings And The Need For Reform*, 40 SUFFOLK U. L. REV. 521, 547-48 (2007).

²⁷ SIFMA was formed in 2006 by the merger of the Bond Market Association (“BMA”) with the Securities Industry Association (“SIA”). See *SIA/BMA Merger Approved by Members*, *SIFMA Transition Begins*, Jul. 27, 2006, available at <http://archives1-sifma.org/story.asp?id=2536>.

²⁸ See *infra* notes 343 to 345 and accompanying text.

²⁹ See *infra* Part I.H.1.

³⁰ See *infra* Part I.H.2.

³¹ See *infra* note 221 and accompanying text.

due diligence.

This article focuses on an underwriter's investigation of its colossal corporate clients *outside* the context of preparing for securities offerings, performed by investment bankers who are *not* involved with securities underwriting. To date, commentators from academia and practice alike have overlooked this type of investigation as a potential source of due diligence.

The large banking firms that typically underwrite securities for giant corporations—referred to hereinafter as “global banks”—often are organized into “client relationship teams.”³² Such teams are comprised of many “product specialist” bankers, some of whom execute securities offerings and some of whom execute *other* sorts of transactions (mergers & acquisitions, derivatives, etc.). Both types of bankers seek to meet the financing needs of their key corporate clients. In doing so, the activities of both types of bankers are coordinated by the same client-focused bankers, called “relationship managers.”

In theory, a client relationship team reflects an information gathering regime: “product specialists” of all sorts, including those who focus on underwriting and those who do not, investigate key corporate clients (and potential clients), and report back to the relationship manager, thereby adding to the underwriter's reservoir of knowledge about the issuer.

At least in theory, then, the client relationship team model is a mechanism for continuous due diligence. To the extent that practice follows theory,³³ this model permits the firms who underwrite securities for top corporations to perform far more continuous due diligence than commentators suppose. As a result, global banks with a well-functioning client relationship team presumably can avoid the unenviable underwriter conundrum.³⁴

The existence of the client relationship team therefore has both policy and practice-advisory ramifications. There are two policy implications: First, since underwriters apparently can protect themselves

³² Concerning the client relationship team, *see infra* Part II.D.

³³ An empirical study of whether, as a general matter, client relationship teams at global banks that cater to mega-WKSI clients constitute effective information-gathering regimes is beyond the scope of this article. However, in the author's personal experience, the client relationship teams at the top investment banks that serviced WorldCom did in fact constitute reasonably effective information-gathering regimes.

³⁴ This article focuses on the internal structure of “global banks,” *see infra* Part II, which underwrite securities for the largest WKSIs, *see infra* note 221. To the extent that such banks also underwrite securities for smaller, “seasoned” issuers (which also are permitted by law to employ shelf-registered offerings), this article's conclusions also may apply to such issuers. Further, to the extent that the smaller firms that underwrite securities for seasoned issuers have adopted the client relationship team model, this article's conclusions may apply there as well. However, it is not clear whether smaller banking firms have adopted the client relationship team model. *Cf.* STEVEN I. DAVIS, INVESTMENT BANKING 67-68 (2003) (noting that some mid-sized banks have not adopted a client-centered model).

from the due diligence dilemma simply by implementing a functioning client-relationship team, perhaps no safe harbor is necessary. The SEC should therefore carefully consider, when deciding whether to promulgate a safe harbor rule, the extent to which client-relationship teams may obviate the due diligence dilemma.³⁵

Second, the SEC rule that provides courts with interpretive guidance concerning the standard for diligence, Rule 176, makes no mention of how a court should evaluate an investigation of an issuer performed by bankers who do not participate in securities offerings. This failure to recognize, explicitly, the validity of continuous due diligence performed by the client relationship team could lead courts to discount or even ignore such due diligence. As a result, the SEC ought to issue guidance to clarify that courts, when assessing the adequacy of an underwriter's due diligence under Rule 176, *may* consider continuous due diligence no matter *who* performs it or in *what* context it was performed—so long as the information reached the relationship manager who led due diligence for the relevant offering.³⁶

Finally, the practice pointer: in order to better protect themselves from future *WorldCom*-sized settlements, underwriters' counsel should advise their clients to re-envision *who* performs and *what* constitutes due diligence—and to document *all* of it. Today, many investment bankers and their counsel take a narrow view of what constitutes “due diligence,” and as a result, the underwriter's “due diligence files” rarely contain documentation of continuous due diligence, whether performed by underwriting-focused bankers or other bankers. This must change. In order to mount a successful defense based on continuous due diligence, underwriters need to keep careful records of *all* continuous due diligence—including that conducted by members of the client relationship team who have nothing to do with securities offerings.³⁷

* * * *

The remainder of this article is organized into three sections and a brief conclusion. Section I provides history and background. This section describes the shelf-registration and integrated disclosure regimes that led commentators to warn of a due diligence dilemma, the *WorldCom* decision that supposedly confirmed the existence of this dilemma, and the new “automatic registration” rules that further expedite offerings by WKSIs. Section II introduces and explores the client relationship team model. In so doing, the section addresses doubts that might be raised about the efficacy of the client relationship

³⁵ See *infra* Part III.A.2.

³⁶ See *infra* Part III.B.

³⁷ See *infra* Part III.C.

team's investigation of the issuer and whether it properly constitutes due diligence. Section III addresses the policy and practice advisory implications of the client relationship team for the SEC and underwriters' counsel. Finally, the conclusion suggests that, in light of the client relationship team, the widely-heralded *WorldCom* decision may be largely irrelevant.

I. THE PURPORTED "DUE DILIGENCE DILEMMA"

A. "Traditional" Due Diligence

1. Why Perform "Due Diligence"? The Due Diligence Defense

In common parlance, a securities underwriter "buys securities . . . from the issuer and resells them to the public" or otherwise "facilitates the issuer's distribution."³⁸ However, "underwriter" also is a legal term of art, defined in Section 2(a) of the Securities Act as:

[a]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking. . . .³⁹

Any underwriter, so defined, is strictly liable⁴⁰ under Section 11 of the Securities Act⁴¹ for any material misstatements or omissions in the "registration statement."⁴² An underwriter also is liable under Section

³⁸ *In re WorldCom, Inc. Sec. Litig. (WorldCom III)*, 308 F. Supp. 2d 338, 343 (S.D.N.Y. 2004) (internal quotation marks omitted); *see also* Investopedia, Underwriter, <http://www.investopedia.com/terms/u/underwriter.asp> (last visited Jan. 19, 2009) (noting that underwriters administer the issuance and distribution of a corporation's securities).

³⁹ *See* 15 U.S.C. § 77b(a)(11) (2006).

⁴⁰ The Act holds underwriters strictly liable because, historically, they were thought to "sponsor" new securities offerings. *See* Lynn Nicholas, *The Integrated Disclosure System and Its Impact Upon Underwriters' Due Diligence: Will Investors Be Protected?*, 11 SEC. REG. L.J. 3, 11-12 (1983) (describing an underwriter's "unique role" in the process of distributing securities, and positing that underwriters traditionally were "in a position to evaluate and investigate the issuer and the issuance of the securities independently"); *see also* Andrew Seth Bogen, *The Impact of the SEC's Shelf Registration Rule on Underwriters' Due-Diligence Investigations*, 51 GEO. WASH. L. REV. 767, 777, 779-80 ("No other party has the capacity to verify the accuracy of the registration statements as effectively or efficiently as the underwriter."); COFFEE ET AL., *supra* note 1, at 67 ("[An] underwriter plays a special role as a 'reputational intermediary' or 'gatekeeper,' . . . pledg[ing] its reputational capital in order to assure investors that the issuer is reliable and honest.").

⁴¹ *See* 15 U.S.C. § 77k(a)(5) (2006).

⁴² The registration statement is the collection of documents which comprise the registration of securities under Sections 5, 6 and 10 of the Securities Act. *See id.* § 77b(a)(8). The principal document in the registration statement is the prospectus, as defined by Section 10 of the Securities Act, which contains most of the disclosure that the SEC requires be contained in the registration statement. *See* LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS §

12(a)(2) of the Act, as an “offer[or]” or “sell[er]” of securities “by means of a prospectus,” for material misstatements or omissions in the prospectus.⁴³

However, Section 11 provides underwriters with two important defenses.⁴⁴ First, an underwriter is not liable for any part of the registration statement not made “on the authority of an expert” if the underwriter establishes that it “had, *after reasonable investigation*, reasonable ground to believe and did believe” that there were no material misstatements or omissions in that part of the registration statement.⁴⁵ Second, an underwriter is not liable for any part of the registration statement made “on the authority of an expert,” if the underwriter establishes that it “had no reasonable ground to believe and did not believe” that there were material misstatements or omissions in that part of the registration statement.⁴⁶ Both defenses—the first, known colloquially⁴⁷ as the “due diligence defense,” and the second, known as the “reliance defense”—are *affirmative* defenses.⁴⁸ For either defense, the applicable standard for assessing whether the underwriter’s actions and/or beliefs were reasonable is that of a “prudent [person] in the management of [her] own property.”⁴⁹ (Hereafter, this article follows the convention⁵⁰ of referring to these defenses collectively as

3:3.1, at 3-16 (4th ed. 2005).

⁴³ See 15 U.S.C. § 771(a)(2) (2006).

⁴⁴ Other defenses exist, but they are not relevant to the due diligence dilemma. See, e.g., 15 U.S.C. § 77k(b)(1) (2006) (defense for underwriter that resigns and disavows the registration statement).

⁴⁵ 15 U.S.C. § 77k(b)(3)(A) (2006) (emphasis added); *WorldCom*, 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004).

⁴⁶ 15 U.S.C. § 77k(b)(3)(C) (2006); *WorldCom*, 346 F. Supp. 2d at 662.

⁴⁷ The term “due diligence” does not appear in Section 11. See JOSEPH AUERBACH & SAMUEL L. HAYES, III, *INVESTMENT BANKING & DILIGENCE: WHAT PRICE DEREGULATION?* 65-67 (1986).

⁴⁸ See 15 U.S.C. § 77k(b)(3) (2006) (“[N]o person . . . shall be liable . . . who shall sustain the burden of proof . . .”).

⁴⁹ 15 U.S.C. § 77k(c) (2006); *WorldCom*, 346 F. Supp. 2d at 663. This language was intended to reflect well-established fiduciary concepts. AUERBACH & HAYES, *supra* note 57, at 52-53.

⁵⁰ It is fairly common to use the term “due diligence defense” as shorthand for both defenses. See, e.g., Young, *supra* note 26, at 528; see also *WorldCom*, 346 F. Supp. 2d at 662. For the purposes of this article, lumping the defenses together seems apt. The key difference between the two defenses is that the “reliance” defense permits an underwriter to reasonably rely *without any investigation* on statements that are made on the authority of an expert, while the “due diligence” defense requires an underwriter to perform its own investigation. See *WorldCom*, 346 F. Supp. 2d at 663. Yet, although the reliance defense technically requires no investigation absent reason to do so, in practice post-*WorldCom* it almost always will require an investigation, because plaintiffs’ lawyers undoubtedly will be able to raise colorable “red flags” to overcome the presumption of reliance. See McLaughlin, *supra* note 2, at 546 (arguing that it is “relatively easy for plaintiffs to allege and for a court to identify ‘red flags’ that should have alerted underwriters to the need to make further inquiries” into expertised statements, and therefore, shift the burden of the reliance defense to the underwriters); John C. Coffee Jr., *Corporate Securities: Due Diligence After WorldCom*, N.Y. L.J., Jan. 20, 2005, at 5 [hereinafter *Due Diligence*] (“WorldCom

the “due diligence defense.”)

Section 12(a)(2) provides underwriters with an affirmative defense if they “did not know, and in the exercise of reasonable care could not have known” of the misstatements or omissions.⁵¹ Courts often treat Section 12(a)(2)’s “reasonable care” standard as “similar, if not identical to” the “reasonable investigation” standard for Section 11’s due diligence defense.⁵² (Hence this article will refer to all three defenses collectively as the “due diligence defense.”)⁵³

In light of these affirmative defenses, a key reason that underwriters perform “due diligence” *during* a securities offering is to escape liability in the event of a lawsuit.⁵⁴

2. Who Performs Due Diligence? Lead Underwriters

Generally, public securities offerings are underwritten by a syndicate of underwriters rather than a single underwriter. The lead underwriter in the syndicate—the “lead manager” or the “book-running manager”—typically performs the great bulk of the due diligence for the offering.⁵⁵ Other, “junior” members of the syndicate, with smaller

administers a judicial coup de grace to the defense bar’s fervent hope that . . . the ‘reliance on an expert’ defense provided a strong defense in Section 11 litigation . . . [A]fter this decision . . . the ‘reliance on an expert’ defense . . . can be outflanked to the extent that a plaintiff credibly alleges that a ‘red flag’ existed that required the defendants to make further inquiry.”). Thus, an underwriter defending a Section 11 claim brought by a clever plaintiff’s lawyer will be required to prove at trial or on summary judgment that it performed a reasonable investigation of the issuer in respect to both expertised and non-expertised statements. Although the scope of the investigation of red flags arguably should be narrower and perhaps deeper than the scope of “due diligence” generally, for the purpose of continuous due diligence performed by the client relationship team, the difference seems to be negligible.

⁵¹ 15 U.S.C. § 77l (2006); *WorldCom*, 346 F. Supp. 2d at 663.

⁵² *In re Software Toolworks Inc.*, 50 F.3d 615, 621 (9th Cir. 1994) (citing *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1228 (7th Cir. 1980)); *but see WorldCom*, 346 F. Supp. 2d at 663 (describing Section 12(a)(2) “reasonable care” defense as “less demanding” than Section 11’s due diligence standard) (citing the dissent in *Sanders*).

⁵³ The remainder of this article focuses on Section 11, although to the extent that the “due diligence” defense and “reasonable care” defenses are coterminous, most of its analysis also would apply to Section 12(a)(2).

⁵⁴ See ROBERT J. HAFT & MICHELE H. HUDSON, *DUE DILIGENCE: PERIODIC REPS. & SEC. OFFERINGS* § 2:4 (2007). Underwriters also perform due diligence for reasons other than avoiding liability. Such other reasons include: looking for negative information about the issuer that might require the offering to be restructured, delayed or cancelled; satisfying required third party consents; and protecting “the investment bank’s institutional reputation,” as “[n]egative surprises after an offering is completed reflect badly on” the underwriter. Valerie Ford Jacob, *The Due Diligence Process from the Underwriter’s Perspective*, in *CONDUCTING DUE DILIGENCE IN M&A AND SECURITIES OFFERINGS* 2007, at 37, 39 (2007).

⁵⁵ See JOHN F. MARSHALL & M.E. ELLIS, *INVESTMENT BANKING & BROKERAGE: THE NEW RULES OF THE GAME* 64 (1994); Jennifer O’Hare, *Institutional Investors, Registration Rights, and the Specter Of Liability Under Section 11 of the Securities Act of 1933*, 1996 WIS. L. REV. 217, 261, & nn.196-97 (1996).

participations in the offering, tend to rely on the due diligence performed by the lead(s).⁵⁶

3. What Does Due Diligence Involve? An Extensive Investigation

As traditionally envisioned, an underwriter's due diligence is an extensive investigation of the issuer.⁵⁷ This investigation includes a thorough and time-consuming review of the issuer's industry,⁵⁸ its reputation and the reputation of its principal officers,⁵⁹ the issuer's business,⁶⁰ and its financial position (and the financial statements in

⁵⁶ See HAZEL J. JOHNSON, *THE BANKER'S GUIDE TO INVESTMENT BANKING* 35 (2006); *THE INVESTMENT BANKING HANDBOOK* 107 (J. Peter Williamson ed., 1988) [*hereinafter* BANKING HANDBOOK].

⁵⁷ See generally HAFT & HUDSON, *supra* note 54, ch. 2; accord AUERBACH & HAYES, *supra* note 47, at 65-67; Bogen, *supra* note 40, at 778 (noting that, in due diligence, an underwriter traditionally examines the issuer's "industry; its charter and bylaws; its various lines of business; the capabilities of its management; its financial statements; any pending litigation . . . its relationship with banks, customers, and suppliers; the condition of its physical properties; proposed uses of its revenues; and any marketing, engineering or similar studies"); Samuel F. Pryor & Richard B. Smith, *Significant Changes in Primary Stock Distributions over the Last 25 Years*, NAT'L L.J., Aug. 9, 1982, at 21, 39-41.

⁵⁸ See HAFT & HUDSON, *supra* note 54, § 2:6. This investigation would put the issuer "into perspective vis-à-vis its competition and the overall industry structure . . . over a . . . period of . . . five years or more, so that trends can be detected"; the investigation requires "understanding . . . the industry's potential and the key problems facing [it]" as well as "general economic factors" and "financial results for companies in the industry" to ascertain "how well the industry is doing compared to how well the issuer is doing within a relevant universe." *Id.*

⁵⁹ See *id.* § 2:8. This investigation would include "credit checks on the company and checks on the reputation and experience of its officers"; "contact[ing] the issuer's principal banks and review[ing] Dun & Bradstreet reports"; reviewing the experience and ages of management; meetings with management—and not just senior management; "reviewing annual reports, proxy statements . . . the issuer's charter and bylaws and corporate minutes"; if the client is new, interviewing the company to obtain a full understanding of the company's history and how it has changed over the years; reviewing "organizational documents" such as "minutes of stockholder meetings, directors' meetings, and executive committee meetings for . . . the preceding five years"; and scrutinizing insider transactions. *Id.*

⁶⁰ See *id.* § 2:9. This investigation involves "consideration of the issuer's competitive position"; involves inquiry into "pricing, advertising, and customer financing"; understanding the "size of the market for the issuer's products and services"; seeking information on "the distribution system used by the issuer for its products or its services"; investigating "production facilities"—including a "visit [to] the principal plants," "source of raw materials," potential problems in the "labor force," "research and development" expenditures, "new products that the company is working on," and "patents and patent licenses"; determining "whether there are any pending mergers, plant closings, plant openings, acquisitions, new product lines, discontinuance of services, or other matters that could have a material effect on the business"; studying "management compensation policy, the existence of loans to or from officers and directors, stock option programs, retirement plans, and miscellaneous perquisites" as well as "employment contracts," "securities holdings and transactions which may have required reporting to the SEC; verifying the specific "intended use of proceeds" for the offering; obtaining "cash requirements and cash flow projections"; identifying the company's cost structure; understanding the "pricing of products, pricing trends, and the cost of products," the "company's production cycles," "the composition and the age of inventory and the rate at which new orders are received"; reviewing

particular).⁶¹ Further, since precedent demands that underwriters independently verify information about the issuer,⁶² the investigation involves consulting information sources both inside⁶³ and outside of the issuer.⁶⁴

B. *Big Changes: The SEC Deregulates Securities Offerings*

1. Rapid Access to Capital: “Shelf Registration”

From the passage of the Securities Act up until the late 1970’s, securities offerings generally proceeded deliberately, taking several months to complete.⁶⁵ Public offerings all followed the same general

the “status of pending and threatened litigation,” “all debt instruments, major leases, all bank credit agreements, and principal contracts,” and the “overall regulatory climate affecting the issuer’s operations, particularly relating to environmental considerations.”

⁶¹ See *id.* § 2:10. This investigation involves an “analysis of the issuer’s financial statements . . . and other financial data to determine . . . profit margins and trends . . . working capital requirements, cash flow, and sales and earnings projections”; an understanding of “accounting principles utilized by the company” and “methods of accounting for [any recent] past acquisitions”; consideration of “the level of inventories . . . inventory turnover and possible obsolescence”; analysis of “the company’s budget . . . and future plans to raise capital” including any “cash projections”; and importantly, “review[ing] the audited financials with the company’s auditors.”

⁶² See *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 581-82 (E.D.N.Y. 1971); *Escott v. BarChris Construction Corp. (BarChris)*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

⁶³ See HAFT & HUDSON, *supra* note 54, § 2:12. Sources inside the issuer include “basic corporate documents . . . includ[ing] articles of incorporation, bylaws, major contracts, loans to or from officers and directors, and similar documents . . . lists of products or services, principal competitors, principal suppliers, principal customers, and copies of catalogs and other customer marketing literature, business plan documents . . . annual and quarterly reports to stockholders, reports to the SEC on Form 10-K, proxy statements, previous registration statements, company histories, relevant engineering reports, reports to any regulatory agencies, speeches to securities analysts by officers, material prepared for rating agencies, answers to antifraud questionnaires, and any documents or SEC filings relating to insider transactions or other problems caused by sales of securities”; “interviews with management and key personnel . . . on a one-on-one basis”; “participation of the company’s auditors at meetings to review the prospectus”; and importantly, making sure that “the auditors are satisfied with their relationship with management and with the cooperation which they receive from management . . . [and any] questions concerning the adequacy of internal accounting controls.”

⁶⁴ See *id.* § 2:13. Sources outside issuer include “research reports from the underwriter’s firm and other broker-dealers, Dun & Bradstreet reports, Moody’s and other services, reports of investment advisory services, material from rating agencies such as Standard & Poor’s and Moody’s, trade journals, and general business publications”; “interviews with third parties . . . to verify . . . information” including “interviews with the suppliers, customers, and competitors, if possible” as well as interviews with “[c]ommercial banks . . . if there are existing lending relationships”; plus “utilizing experts to verify specialized information.”

⁶⁵ See William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 560 (2006) (an IPO took “four to six months”); Merritt B. Fox, *Shelf Registration, Integrated Disclosure and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1026 (1984) (the traditional registration process “once inevitably took a few weeks to a few months”); Bogen, *supra* note 40, at 778 (“[t]he average

offering process, whether it was the initial public offering (“IPO”) for a start-up company or the umpteenth investment grade debt offering by a well-established behemoth like General Electric (“GE”).⁶⁶ The time for follow-on offerings⁶⁷ by large, established issuers was “somewhat shorter,” because the existing “periodic reports facilitated quicker preparation of the registration statement, and oftentimes the SEC chose not to review” the registration statement for such an offering.⁶⁸ However, offerings nonetheless came to the market slowly—in weeks or more.⁶⁹ As such, even follow-on offerings generally provided considerable time for underwriters to perform extensive due diligence.⁷⁰

By the early 1980’s, however, the SEC recognized that large issuers desired rapid access to the capital markets “to capitalize on advantageous market situations while minimizing the costs of registration.”⁷¹ Nearly instantaneous access already was available in European capital markets, leading to concerns that issuers would move their offerings outside of the U.S.⁷²

The SEC therefore created a system commonly known as “shelf registration” under Securities Act Rule 415.⁷³ Shelf registration is so known because it permits issuers to register an amount of securities to be offered or sold “on a continuous or delayed basis in the future”⁷⁴—

time” to prepare and file a traditional registration statement was “six to eight weeks”—and then “another four to eight weeks” until the registration statement became effective).

⁶⁶ See HAFT & HUDSON, *supra* note 54, § 1:1.

⁶⁷ A “follow-on” offering is the same as a “secondary offering.” See Investopedia, *Follow-On Offering*, <http://www.investopedia.com/terms/f/followonoffering.asp> (last visited Jan. 19, 2009); *cf. supra* note 14.

⁶⁸ Sjoström, *supra* note 65, at 560; accord AUERBACH & HAYES, *supra* note 57, at 64.

⁶⁹ See Nicholas, *supra* note 40, at 15. Traditional offerings provided underwriters with “a comfortable amount of time” for “a relatively thorough” due diligence—*e.g.*, “more than a month might pass” between the underwriter and issuer’s initial discussions and the issuance of the securities. *Id.* And if the SEC *did* decide to review the registration statement for such an offering, there would be *additional* time. See *id.* at 16. Underwriters had the time “between the filing and effective date [of the registration statement] to complete its ‘due diligence’”—a period that was extended if the SEC issued a “detailed letter of comment” to, or held meetings with, the issuer. *Id.*

⁷⁰ See *id.* at 42 (describing the typical due diligence for follow-on offerings).

⁷¹ Young, *supra* note 26, at 533; see also Roberta S. Karmel, *Assessment of Shelf Registration: How Much Diligence is Due Investors?*, 3 YALE J. ON REG. 401, 405 (1986) (explaining that the SEC’s adoption of shelf registration reflected a “pragmatic recognition” of “the changed character of the securities markets”); Nicholas, *supra* note 40, at 17-18 & n.34 (citing SIA letter of comment pointing to “market windows” as a reason for issuers “to bring securities to market in haste”—particularly with regard to debt securities); see generally Edward F. Greene, *Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System*, 56 NOTRE DAME L. REV. 755 (1981).

⁷² See Bogen, *supra* note 40, at 770 n.23 (discussing the Eurobond markets); Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45, 46 (2000) (same).

⁷³ 17 C.F.R. § 230.415 (2008).

⁷⁴ *Id.*

placing them “on a shelf” so to speak⁷⁵—for up to two years, by filing the basic offering documents in advance.⁷⁶ After the shelf registration is filed, the issuer can sell some or all of the securities listed in the shelf registration—to “take down” the securities⁷⁷ off the shelf—at any time.⁷⁸

Like all registration statements, the shelf registration itself must be declared effective by the SEC, and is subject to SEC review.⁷⁹ However, after the shelf registration statement is approved and the issuer is ready to issue the securities, the issuer is merely required to update the registration with the specific details of the offering by filing a “prospectus supplement,”⁸⁰ which the SEC generally does *not* review.⁸¹ There being no delay due to SEC review, an issuer can take down a shelf-registered offering *fast*—in as little as “a few hours.”⁸²

2. Short-Form Registration: “Integrated Disclosure”

One restriction on shelf registration is that corporations may not use it to issue run-of-the-mill debt or equity securities *unless* the issuer is permitted to register using “Form S-3.”⁸³ Form S-3 was part of the SEC’s existing “integrated disclosure” initiative (a.k.a. “short-form registration”) which was expanded in tandem with the creation of shelf registration.⁸⁴ The idea behind integrated disclosure is that market participants already have a great deal of information about large, established corporations due to their history of issuing public reports

⁷⁵ The rule does not use the term “shelf registration.” It is market slang. See Joseph F. Morrissey, *Rhetoric & Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 CATH. U. L. REV. 561, 591-92 (2007); accord BANKING HANDBOOK, *supra* note 55, at 87. The SEC also used the term in its releases.

⁷⁶ See 17 C.F.R. § 230.415.

⁷⁷ See Morrissey, *supra* note 75, at 592.

⁷⁸ See 17 C.F.R. § 230.415.

⁷⁹ See Morrissey, *supra* note 75, at 591.

⁸⁰ See *id.* at 592-593.

⁸¹ See Michael McDonough, *Death in One Act: The Case for Company Registration*, 24 PEPP. L. REV. 563, 591 n.230 (1997); HAFT & HUDSON, *supra* note 54 § 1:1; Nicholas, *supra* note 40, at 20, 21.

⁸² Nicholas, *supra* note 40, at 6; accord MARSHALL & ELLIS, *supra* note 55, at 77 (noting shelf offerings can occur with as little as 24 hours notice to the SEC).

⁸³ See MARSHALL & ELLIS, *supra* note 55, at 77.

⁸⁴ See Adoption of Integrated Disclosure System, Sec. Act Release No. 6,383, 47 Fed. Reg. 11,380 (Mar. 3, 1982) (codified at 17 C.F.R. pt. 230); see also Stephen Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 633-34 (1997) (describing adoption of integrated disclosure). For various accounts of the SEC’s halting steps towards integrated disclosure over the years, see AUERBACH & HAYES, *supra* note 57, at 111-18, 125; COFFEE ET AL., *supra* note 1, at 136-39; David M. Green, *Due Diligence Under Rule 415: Is the Insurance Worth the Premium?*, 38 EMORY L.J. 793, 794-801 (1989); Nicholas, *supra* note 40, at 4-5 & n.2.

(and coverage by securities analysts, who dissect those reports for the investing public).⁸⁵ This information is current as of the most recent quarterly report on 10-Q (or current report on 8-K) filed with the SEC under the Securities Exchange Act of 1934 (“Exchange Act”). As such, there is little need for large, seasoned corporations to make the same disclosures in a lengthy registration statement that are already contained in the issuer’s public filings. Investors ought to have access to these public filings—and, many would argue, the largely-efficient market for the issuers’ securities has already digested the information and built it into the security’s price.

Short-form registration therefore permits certain public companies “to incorporate by reference” the information contained in their most recent quarterly, annual, or current reports.⁸⁶ As such, that information “is not actually set forth in the registration statement, but instead the registration statement contains a cross reference to the company’s Exchange Act reports.”⁸⁷ Indeed, the only information about the issuer that must appear on Form S-3 is a discussion of any material changes in the issuer’s business since the filing of the last public report under the Exchange Act.⁸⁸ All other information about the issuer is incorporated by reference.⁸⁹ As a result, Form S-3 prospectuses typically are quite short, “containing only very abbreviated financial and business disclosure about the issuer.”⁹⁰

As with shelf registration, only large, established filers of public reports may use Form S-3.⁹¹ And, due to the ease of incorporation by reference, shelf registrations are generally done on Form S-3.⁹² Hence, the offering document for a shelf offering—which, unlike the issuer’s public filings under the Exchange Act, the underwriter helps the issuer prepare⁹³—merely “consists of the barebones^[94] prospectus filed with

⁸⁵ See Shelf Registration, Sec. Act. Release No. 6,499, 48 Fed. Reg. 52,889, 52,890 (Nov. 23, 1983) (codified at 17 C.F.R. pt. 230) (noting that the basis for integrated disclosure was that, for the largest companies, there was “a steady stream of high quality corporate information continually furnished to the market and broadly digested, synthesized and disseminated”); see also COFFEE ET AL., *supra* note 1, at 136-39; Greene, *supra* note 71; see generally Milton H. Cohen, “*Truth in Securities*” Revisited, 79 HARV. L. REV. 1340 (1966).

⁸⁶ Sjostrom, *supra* note 65, at 560.

⁸⁷ *Id.* at 561.

⁸⁸ See Herb Frerichs, Jr., *Underwriter Due Diligence Within the Integrated Disclosure System—If It Isn’t Broken, Don’t Fix It*, 16 SEC. REG. L.J. 386, 390 (1989).

⁸⁹ See McDonough, *supra* note 81, at 590; Sjostrom, *supra* note 65, at 561.

⁹⁰ See Sjostrom, *supra* note 65, at 561.

⁹¹ Specifically, in order to file on Form S-3, a corporation must (1) have continuously and timely filed reports under the Exchange Act for at least one year and (2) have “at least a \$75 million public float (owned by non-affiliates) if engaging in a primary offering for cash.” McDonough, *supra* note 81, at 590.

⁹² See Sjostrom, *supra* note 65, at 562.

⁹³ See *id.*

⁹⁴ See Nicholas, *supra* note 40, at 19 (joking that the prospectus requires little beyond the issuer’s “name, address, phone number”).

the S-3 shelf registration plus a prospectus supplement containing little more than a description of the securities being offered by the issuer.”⁹⁵ The bulk of the important information about the company already appears in the company’s most recent public reports⁹⁶—over which the underwriters have no editorial control.⁹⁷

C. *Too Much, Too Fast: Underwriter Opposition to Shelf Registration*

The advent of shelf registration slashed the time it took for follow-on public offerings by large, seasoned public issuers. The time frame for an offering by such an issuer went from “months” before Rule 415 to “weeks or even days” afterwards.⁹⁸

Issuers were ecstatic at this development, as shelf registration offered them many benefits.⁹⁹ The combination of shelf registration and integrated disclosure not only permitted them to take advantage of favorable “market windows,”¹⁰⁰ it also permitted them to reduce underwriter fees¹⁰¹ by forcing underwriters to bid for shelf takedown services.¹⁰² Since there was less company-specific disclosure for the underwriter to help prepare, an issuer could pick a low-priced underwriter that knew less about the company instead of the issuer’s traditional underwriter.¹⁰³ Empirical studies appear to confirm that issuers have benefited from Rule 415.¹⁰⁴

However, for underwriters, shelf registration—and especially integrated disclosure—were unhappy changes (which the underwriters opposed vehemently, but to no avail)¹⁰⁵. An issuer’s traditional

⁹⁵ Sjostrom, *supra* note 65, at 562.

⁹⁶ *See id.*

⁹⁷ *See id.*

⁹⁸ *Id.*

⁹⁹ *See* Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 145-54 (1984) (discussing benefits of shelf registration to issuers).

¹⁰⁰ Market windows are “brief, advantageous fluctuations in the capital markets.” Bogen, *supra* note 40, at 770 n.23 (citation omitted).

¹⁰¹ *See* SAMUEL L. HAYES III & PHILIP M. HUBBARD, *INVESTMENT BANKING: A TALE OF THREE CITIES* 116 (1989).

¹⁰² *See* AUERBACH & HAYES, *supra* note 57, at 129-30.

¹⁰³ COFFEE ET AL., *supra* note 1, at 153 (“[U]nder shelf registration the issuer gained the leverage to choose among underwriters in terms of both price and the underwriters’ ability to meet the issuer’s schedule.”).

¹⁰⁴ *See* Ann E. Sherman, *Underwriter Certification & the Effect of Shelf Registration on Due Diligence*, 28 FIN. MGMT. 5, 5, 14 (1999) (surveying prior literature and concluding that issuers were better off after shelf registration even if underwriters increased their fees to compensate for greater risk).

¹⁰⁵ *See* Nicholas, *supra* note 40, at 26-29 (describing the investment banks’ impassioned, but ultimately unsuccessful, protest against integrated disclosure).

underwriter now faced a bidding war when it previously had faced little or no competition.¹⁰⁶ Less secure in their client relationships, underwriters also felt less able to push the issuers with hard questions in due diligence.¹⁰⁷

Worse yet, the underwriters' time for due diligence was "sharply reduced."¹⁰⁸ By contrast to traditional registration statements, for which underwriters had "a few weeks" or longer to perform due diligence,¹⁰⁹ for short-form shelf-takedown registrations, underwriters had days or less.¹¹⁰ Thus, while due diligence did not "act as a brake" on offerings under the previous regime, "performing the traditional amount of due diligence would now cause a significant delay."¹¹¹

Due to this new time pressure, underwriters began to differentiate the level of due diligence they would perform based on the whether the offering was a traditional offering, like an IPO, or a shelf-registered, follow-on offering by a seasoned issuer.¹¹² An IPO still provided plenty

¹⁰⁶ See, e.g., AUERBACH & HAYES, *supra* note 57, at 143; BANKING HANDBOOK, *supra* note 55, at 33 (explaining that shelf offerings led to greater competition among underwriters); *id.* at 409 (shelf registration led to "increase[d] fee competition"); HAFT & HUDSON, *supra* note 54, § 5:1 ("[U]nderwriters today are confronted by . . . lower compensation for their services, tremendous competition from other possible underwriters on a global basis."); MARSHALL & ELLIS, *supra* note 55, at 17 (shelf registration "increased competition in underwriting"); Bogen, *supra* note 40, at 780-82 (shelf registration "substantially altered the traditional underwriter-issuer relationship by creating a highly competitive atmosphere in which underwriters bid, on short notice, for . . . an offering").

¹⁰⁷ See COFFEE ET AL., *supra* note 1, at 153-54 (noting that issuers' leverage increased and positing that, due to underwriters' reduced leverage "few underwriters dared to object to expedited schedules that precluded meaningful due diligence"); HAFT & HUDSON, *supra* note 54, § 5:1 ("Underwriters today [have] . . . little leverage with the issuer to effect disclosure changes in the documents incorporated by reference . . ."); Bogen, *supra* note 40, at 780-82 (under shelf registration, "an issuer does not depend on any particular underwriter to prepare the offering for the market; consequently, the issuer has no incentive to retain an underwriter that objects to an aspect of its disclosure documents;" "[e]ven if an underwriter had sufficient bargaining power to compel the issuer to make changes in a registration statement, it may not have the amount of time needed to conduct a proper due-diligence investigation"); Young, *supra* note 26, at 536 ("[R]elationships . . . between underwriters and issuers are now strained, and underwriters must work within the time restraints of a shelf registration or risk losing the issuer's business. Such competition has impacted the underwriters' ability to conduct due diligence.") (citing, *inter alia*, JAMES D. COX, ROBERT W. HILLMAN & DONALD LANGEVOORT, SECURITIES REGULATION, CASES & MATERIALS 198, 201 (4th ed. 2004)); accord Frerichs, *supra* note 88, at 398-99; Green, *supra* note 84, at 814.

¹⁰⁸ Joel Seligman, THE TRANSFORMATION OF WALL STREET 608 (rev. ed. 1995); see also HAFT & HUDSON, *supra* note 54 § 5:1 (noting that underwriters today face "severe time compression for conducting due diligence"); *Report of the New York City Bar Association Task Force on the Lawyer's Role in Corporate Governance* (excerpted for publication) [hereinafter *NY City Bar Report*], 62 BUS. LAW. 427, 504 (2007) (noting that underwriters time for due diligence was "severely truncated").

¹⁰⁹ HAFT & HUDSON, *supra* note 54, § 1:1; see also COFFEE ET AL., *supra* note 1, at 153.

¹¹⁰ See Sjostrom, *supra* note 65, at 562.

¹¹¹ Fox, *supra* note 65, at 1029.

¹¹² See HAFT & HUDSON, *supra* note 54, § 5:1 ("Except for [IPOs], underwriters today are rarely able to perform 'traditional' due diligence as it was practiced in the leisurely, localized, and mildly competitive first few decades following the passage of the [Securities] Act . . ."); *id.* §

of time for due diligence; as a result, underwriters commonly conducted a great deal of due diligence for an IPO, including visits to the client's plants or factories, calls to customers and competitors, etc. On the other hand, a follow-on, shelf takedown offering by a seasoned issuer moved so fast that underwriters did little if any due diligence for such offerings.¹¹³ Often as not, there was time only for a brief "updating" phone call with the issuer.¹¹⁴ Further, even if underwriters took issue with statements in the public reports incorporated by reference, issuers were reluctant to admit in a registration statement that their prior reports were flawed due to liability concerns.¹¹⁵ For these reasons, the quality of due diligence suffered.¹¹⁶

In light of the reduced level of due diligence that underwriters performed for short-form shelf takedowns, commentators criticized the shelf registration and integrated disclosure regimes for lowering the

1:1 (Post-shelf registration, "[t]here [wa]s a great difference between the time devoted to, and the extent of, a due diligence investigation of a company going public for the first time and of GE's . . . one hundredth . . . public debt offering."); *compare id.* ch. 2 (discussing extensive due diligence practices for IPOs), *with id.* ch. 5 (discussing limited due diligence practices for shelf registrations).

¹¹³ See HAFT & HUDSON, *supra* note 54, § 1:1 ("Due diligence for an [IPO] of common stock . . . [wa]s conducted over an extended period of time (a few weeks to a month or more) At the other extreme is the GE 'shelf takedown' of debt, offered and purchased in the wink of an eye, without any waiting or review time at the SEC . . . quickly distributed by underwriters . . . with little time and incentive for extensive due diligence."); *see also id.* § 2:4 (same); Committee on Federal Regulation of Securities, *Report of the Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, 48 BUS. LAW. 1185, 1185 (1992) [hereinafter *Due Diligence Task Force*]; *id.* at 565 ("[I]t is obvious that a due diligence investigation for a shelf takedown is not as extensive as a due diligence investigation for [an IPO]."); Sjostrom, *supra* note 65, at 563; *accord* Samuel L. Hayes III, *The Impact of Recombining Commercial and Investment Banking*, 70 BROOK. L. REV. 39, 45-46 (2004) [hereinafter *Recombining Banking*] (noting that, for shelf registered offerings, "[u]nderwriters might not undertake due diligence, instead relying completely on the issuers' periodic SEC filings").

¹¹⁴ See Sjostrom, *supra* note 65, at 563 (noting that, for a shelf takedown, typically an issuer "holds a due diligence conference call with the underwriters" that will "simply update them as to the . . . latest developments").

¹¹⁵ See Nicholas, *supra* note 40, at 19.

¹¹⁶ See Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 689 (1995); *accord Due Diligence Task Force, supra* note 113, at 1185 ("[U]nderwriters' ability to engage in due diligence investigations prior to an offering was weakened by the introduction of the 'integrated disclosure system' . . . and the availability of 'shelf' registration."); *id.* (noting that, under shelf registration, the "traditional underwritten public offering by a reporting company"—formerly the "high ceremony of capitalism"—"degenerated . . . into a series of bargain-basement brawls, characterized by abbreviated and sporadic opportunities for investigation and successive sales by different underwriters of large amounts of securities on the basis of identical disclosure documents"); Sherman, *supra* note 104, at 14 (concluding, based on application of model to pricing data, that shelf registration leads to "an increase in underwriter competition and a reduction in due-diligence investigation"); *see, e.g.,* Bogen, *supra* note 40, at 786 n.117 (in light of shelf registration and integrated disclosure, "less due diligence investigation is being done now than at any time during my 35 years in the business." (quoting John L. Whitehead, then-Senior Partner, Goldman Sachs)).

quality of corporate disclosure.¹¹⁷ Indeed, in the SEC release adopting Rule 415, then-SEC Commissioner Thomas dissented for this reason.¹¹⁸

D. *First, Be Prepared: The SEC Promotes Continuous Due Diligence*

However, the official SEC view was different. The SEC did not view shelf registration and integrated disclosure as an excuse for underwriters to do *less* due diligence on large, established issuers; rather, the SEC saw the shelf registration and integrated disclosure regime as forcing underwriters to do due diligence *earlier*.¹¹⁹ The SEC admonished underwriters to “arrange [their] due diligence procedures over time” by finding “somewhat different, but equally thorough, investigatory practices and procedures to integrated registration statements” in order to “develop in advance a reservoir of knowledge about the companies that may select the underwriter to distribute their securities on short form registration statements.”¹²⁰ Thus was born the concept of “continuous due diligence.”

The SEC suggested several specific practices that underwriters might employ in performing continuous due diligence. In particular, the SEC urged underwriters to “participate in the drafting and review of periodic [Exchange Act] disclosure documents before they are filed” and hold “periodic due diligence sessions” with issuers, either upon the issuance of quarterly earnings reports and/or in “annual meetings with management to review financial trends and business developments.”¹²¹

¹¹⁷ See, e.g., AUERBACH & HAYES, *supra* note 57, ch. 10; Nicholas, *supra* note 40, at 26 (noting that, under shelf registration, underwriters perform “the minimum essential due diligence and as much more as the issuer and time will allow and take a calculated business risk as to the balance” (quoting SIA comment letter)); *id.* at 5 (“While the theory underlying integrated disclosure may be beguiling, in practice integration may have serious and detrimental effects on the quality of corporate disclosure, thus undermining the . . . protection of investors.”); *id.* at 19 (“[T]he SEC has speeded up the process of registration by, in effect, virtually eliminating the process of drafting a registration statement which central to the ‘due diligence’ investigation.”); accord Fox, *supra* note 65, at 1029.

¹¹⁸ See Nicholas, *supra* note 40, at 26.

¹¹⁹ See Green, *supra* note 84, at 813.

¹²⁰ *Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act*, Sec. Act Release No. 33-6335, 46 Fed. Reg. 42,015, 42,020 (Aug. 6, 1981) [hereinafter *Reasonable Investigation*].

¹²¹ *Shelf Registration*, *supra* note 85, at 52,892-93. The SEC also suggested that issuers appoint “designated underwriters’ counsel” for each shelf registration, so that there would be continuity even if different underwriters participated in different shelf takedowns. *Id.* at 52,892. This practice is “common” but of “questionable” effectiveness, according to some commentators. Sjostrom, *supra* note 65, at 564; but see HAFT & HUDSON, *supra* note 54, § 5.4 (summarizing the views of two experienced underwriters counsel, including Joseph McLaughlin). In any event, counsel’s due diligence generally is narrow, relating to formal legal documents such as board minutes and corporate charters, as opposed to the issuer’s business and financial statements. As a result, it is no substitute for an investment banker’s due diligence. Cf. *Escott v. BarChris*

Most commentators are skeptical that underwriters heeded the SEC.¹²² Others reject continuous due diligence altogether as less rigorous than traditional due diligence.¹²³

E. *The SEC Steps in, “Wimpish[ly]”*¹²⁴: Rule 176

Despite informing underwriters that their burden for due diligence was no less for shelf registration than before, the SEC threw underwriters a bone:¹²⁵ Securities Act Rule 176.¹²⁶

Rule 176 is not a safe harbor.¹²⁷ Rather, it provides a list of “relevant circumstances” that a court should¹²⁸ consider when assessing “whether or not the [underwriter performed] a reasonable investigation” under Section 11 (and by analogy, but not explicitly, to whether the underwriters exercised “reasonable care” under Section 12(a)(2)). The relevant circumstances include: the “type of issuer”; the “availability of information with respect to the [issuer]”; and whether the underwriter “had any responsibility” for the document incorporated by reference that is alleged to be false.¹²⁹

Rule 176 was not intended to give underwriters an iron-clad defense to Section 11 liability; far from it. Indeed, the rule was widely viewed by the securities bar with skepticism even prior to *WorldCom*.¹³⁰

Construction Corp. (*BarChris*), 283 F. Supp. 643, 697 (S.D.N.Y. 1968) (holding that underwriters may not delegate due diligence to counsel and wash their hands of it; they remain liable if counsel performs an inadequate investigation).

¹²² See *infra* note 181 and accompanying text, and notes 183 to 190 and accompanying text.

¹²³ See Bogen, *supra* note 40, at 786 n.117 (“There is simply no substitute for the traditional give and take of discussions that focus on the preparation of an informative offering document. Perfunctory meetings at which underwriters listen to a speech and are then permitted to ask a question will not do the job.”) (quoting testimony of John L. Whitehead, then-Senior Partner, Goldman Sachs); Nicholas, *supra* note 40, at 33-34 (arguing the continuous due diligence “only deals with the underwriters’ need to obtain information and does not address the problem of verification of the information”); see also *id.* at 31-32 (noting that public investor relations meetings are not adequate for due diligence as they are no substitute “for the discipline of drafting sessions and the intimate confidences between the issuer and its underwriter”); *id.* at 30 (commenting that the “‘reservoir of knowledge’ approach has never been . . . a substitute for ‘due diligence;’” “it is merely a tool . . . [for] expediting ‘due diligence’”).

¹²⁴ See *Safe Harbor*, *supra* note 24 (describing Rule 176’s intent as “wimpish”).

¹²⁵ See Sjostrom, *supra* note 66, at 570-71 (noting that Rule 176 was adopted in response to underwriters’ concerns about their ability to perform adequate due diligence under shelf registration and integrated disclosure); COFFEE ET AL., *supra* note 1, at 152.

¹²⁶ 17 C.F.R. § 230.176 (2005).

¹²⁷ See AUERBACH & HAYES, *supra* note 57, at 118; Langevoort, *supra* note 72, at 63; Sjostrom, *supra* note 65, at 571.

¹²⁸ Courts are not required to adopt the SEC’s interpretation, but they generally give it considerable weight. See Fox, *supra* note 65, at 1031 n.84 (noting that courts give deference to an agency’s interpretation of the statute it is charged with enforcing).

¹²⁹ 17 C.F.R. § 230.176.

¹³⁰ John S. D’Alimonte & Ian M. Ogilvie, *The Bought Deal: The Edge Of The Shelf?*, in 30TH

Yet, by providing a list of factors that affect the reasonableness of an underwriter's due diligence, the SEC created some ambiguity about whether due diligence under shelf registration would be held to a lower standard than traditional due diligence.¹³¹

F. *Critiques of "Shelf Registration": Prelude to WorldCom*

1. The Predicted Due Diligence Dilemma

Almost immediately after the advent of shelf registration and integrated disclosure, commentators began to predict a coming "due diligence dilemma." For example, in 1985, shortly after the SEC adopted Rule 415, Milton H. Cohen, the often-prescient dean of the securities bar (and a former securities regulator himself),¹³² wrote:

[W]hat poses the due diligence dilemma in its severest form is . . . [R]ule 415 . . . Many underwriting firms . . . feel quite uncomfortable with . . . wishing to compete for business but being unable to fulfill their . . . due diligence obligation in accustomed ways.¹³³

Another author put it even more starkly:

[S]helf registration has forced a choice between the lesser of two evils: failing to verify the veracity and completeness of registration statements, including the incorporated documents, or losing business to another underwriter who is not so particular.¹³⁴

At the time, other commentators—including former SEC Commissioner Roberta Karmel¹³⁵—echoed these concerns, in varying

ANNUAL INSTITUTE ON SECURITIES REGULATION 587-88 (1998) (explaining, prior to the *WorldCom* decision, that Rule 176 "has yet to be tested and is largely viewed by the bar as ineffective").

¹³¹ See, e.g., AUERBACH & HAYES, *supra* note 57, at 179 (observing that the "SEC appears to be of two minds" on the issue of due diligence under shelf registration, as it enacted Rule 176 but also stated that Rule 415 did not abrogate the existing due diligence standard); D'Alimonte & Ogilvie, *supra* note 130, at 587 (urging, prior to the *WorldCom* decision that, for "bought deals," "Rule 176 might appear to set a somewhat relaxed standard of due diligence" due to the "speed" and "the lack of underwriter involvement in [documents] incorporated by reference").

¹³² See U.S. Sec. & Exch. Comm'n, Statement Regarding Milton Cohen (Nov. 2, 2004), available at <http://www.sec.gov/news/speech/spch110204com.htm> (SEC statement honoring Cohen upon his passing).

¹³³ Milton H. Cohen, *The Integrated Disclosure System—Unfinished Business*, 40 BUS. LAW. 987, 993 (1985); see also Nicholas, *supra* note 40, at 26 (arguing that the SEC's position, that underwriters can always refuse to go through with an offering if they do not have adequate time for due diligence, "flies in the face of . . . business realities"; and concluding that underwriters are "not in a position to delay an offering in order to accomplish a complete 'due diligence' investigation").

¹³⁴ Green, *supra* note 84, at 801.

¹³⁵ See Karmel, *supra* note 71, at 405-06 (noting that integrated disclosure has led to a "dilemma": "underwriters due diligence procedures have changed over the past

degrees.¹³⁶ And, in more than two decades since shelf registration and integrated disclosure were adopted, many other commentators have concurred.¹³⁷

2. Continuous Due Diligence: Underwriters Ignore the SEC

Yet, underwriters did little to protect themselves. According to most commentators at the time, underwriters did not heed—and had no incentive to heed—the SEC’s admonition to perform continuous due diligence.¹³⁸ Instead, most underwriters apparently hoped that, when the time came, their reduced due diligence in shelf-registered offerings would be protected by Rule 176.¹³⁹ But they had their doubts.¹⁴⁰

The underwriters’ reckoning came with *WorldCom*.

decade . . . however . . . the SEC’s shelf registration and integrated disclosure rules have not altered the liability provisions of Section 11”); *but cf. id.* (positing that a month might no longer be enough time to perform adequate due diligence on the largest issuers).

¹³⁶ See, e.g., AUERBACH & HAYES, *supra* note 57, at 131-32 (discussing the pressure on underwriters to bid on shelf registration even if there is inadequate time to investigate); Bogen, *supra* note 40, at 780-82 (noting that, under shelf registration, underwriters “will often be forced to choose between either foregoing participation in an offering or risking liability under section 11”); Ralph Ferrara & J. Sweeney, *Shelf Registration Under SEC Temporary Rule 415*, 5 CORP. L. REV. 308 (1982); see Banoff, *supra* note 99, at 155-60 (summarizing arguments against Rule 415); Greene, *supra* note 71, at 797-98 (noting the existence of a “perceived dilemma imposed on underwriters by [shelf registration]” which may place them “in the unfortunate position of having to either truncate their investigation or withdraw from participating in the offering”).

¹³⁷ See, e.g., John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1168 (1995) (“In a compressed time period, the underwriter cannot conduct the same ‘due diligence’ investigation that the ‘33 Act intended.”); Marianne M. Jennings, *Let’s Have Liability, More Liability and No Case Law: Due Diligence, 10Qs, 10Ks, and \$10Ms (as in Average Verdict)*, 22 SW. U. L. REV. 373, 380 (1992-93) (noting lack of time for due diligence under Rule 415); U.S. SEC. AND EXCH. COMM’N, ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATION PROCESS 13 (1996), available at <http://www.sec.gov/news/studies/capform/capffull.txt> [hereinafter *Wallman Committee Report*] (observing that shelf registration and other SEC rules changes “to facilitate issuer access to the markets . . . may be impairing the ability of . . . underwriters . . . to perform their traditional Securities Act ‘due diligence’”); Langevoort, *supra* note 72, at 62-63 (“There may be no time for serious due diligence between the decision to proceed, at which point the underwriters are selected and notified, and the sales. That puts . . . the underwriters, in an uncomfortable position given the size of the liability exposure.”).

¹³⁸ See, e.g., Green, *supra* note 134, at 814-17; Bogen, *supra* note 40, at 782 (recognizing that they have “only a small chance of being selected to actually underwrite [any particular] offering,” underwriters “have little incentive to expend the considerable resources necessary to conduct [continuous] due-diligence”).

¹³⁹ See COFFEE ET AL., *supra* note 1, at 154 (“[U]nderwriters relied . . . on Rule 176, hoping that courts would tolerate reduced due diligence efforts in view of the new integrated disclosure system.”); Langevoort, *supra* note 72, at 46 (noting that Rule 176 and the SEC’s admonitions regarding continuous due diligence “seemed to describe a more permissive standard of due diligence” in the context of shelf registration); see also *infra* note 171 and accompanying text.

¹⁴⁰ Indeed, shortly after the adoption of shelf registration, one commentator summed up underwriters’ experience with “due diligence” under integrated disclosure pithily—and perhaps only half jokingly—as, “[p]rayer.” Nicholas, *supra* note 40, at 35; see also *supra* note 130.

G. WorldCom: *Confirming the “Underwriter Conundrum”?*

1. The *WorldCom* Decision

Countless articles in trade journals,¹⁴¹ practice guides,¹⁴² law reviews,¹⁴³ and legal treatises¹⁴⁴ have spilled ink summarizing the facts and holding of the momentous *WorldCom* case. A full explication of the case here is therefore unnecessary.

For purposes of this article it is sufficient to say that, in July 2002, after a massive fraud at WorldCom, Inc.¹⁴⁵ and the company’s similarly massive bankruptcy,¹⁴⁶ a class of WorldCom, Inc. security holders—including the purchasers of bonds in two, multi-billion dollar public bond offerings in May 2000 and May 2001—sued the underwriters of those bonds under Section 11 (and Section 12(a)(2), which the court did not address in its opinion).¹⁴⁷ After more than two years of litigation, the underwriters moved for summary judgment with respect to the due diligence that they conducted *during* the two bond offerings.¹⁴⁸ Arguably the Rule 176 factors pointed against liability for the underwriters because, *inter alia*, the offerings were shelf-registered and

¹⁴¹ See, e.g., *Safe Harbor*, *supra* note 24; *Due Diligence*, *supra* note 50.

¹⁴² See, e.g., John Baner & Patrick Kenadjian, *The WorldCom Decision—Underwriters’ Due Diligence*, in *PLI’S FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION IN EUROPE: A CONTRAST IN EU & US PROVISIONS* 489 (2005) (describing the *WorldCom* decision in detail); Jeremy W. Dickens, Paul Dutka & Joshua S. Amsel, *Underwriter Due Diligence: WorldCom and Beyond*, in *THIRD ANNUAL DIRECTORS’ INSTITUTE ON CORPORATE GOVERNANCE* 59 (2005) (same); Leslie N. Silverman, *Due Diligence in Securities Offerings After WorldCom*, in *37TH ANNUAL INSTITUTE ON SECURITIES REGULATION* 1185 (2005) (same).

¹⁴³ See, e.g., Sjoström, *supra* note 65, at 589-92, 598-605 (describing the *WorldCom* decision in detail); Young, *supra* note 26, at 536-41 (same).

¹⁴⁴ See, e.g., HAFT & HUDSON, *supra* note 54, § 7:9 (section devoted to *WorldCom*); ROBERT A. FIPPIER, *SEC. L. PUB. FIN.* § 7:7.2 (2007) (section devoted largely to *WorldCom*).

¹⁴⁵ The details of this fraud are well-chronicled and do not bear repeating here. See generally LYNNE W. JETER, *DISCONNECTED: DECEIT AND BETRAYAL AT WORLD.COM* (2003); WALTER PAVLO JR., *STOLEN WITHOUT A GUN: CONFESSIONS FROM INSIDE HISTORY’S BIGGEST ACCOUNTING FRAUD—THE COLLAPSE OF MCI WORLD.COM* (2007); see also JOHN C. COFFEE JR., *GATEKEEPERS: THE PROFESSIONS & CORPORATE GOVERNANCE* 36-47 (2006); CHARLES GASPARINO, *BLOOD ON THE STREET* (2005); FRANK PARTNOY, *INFECTIOUS GREED* (2003).

¹⁴⁶ See sources cited *supra* note 2.

¹⁴⁷ See *WorldCom*, 346 F. Supp. 2d at 663-64 (“Because Section 11 imposes a more exacting standard, this Opinion principally addresses the law that applies to Section 11.”).

¹⁴⁸ See *WorldCom*, 346 F. Supp. 2d at 683. Although the offering-specific due diligence in the case was “not particularly extensive,” see Sjoström, *supra* note 65, at 591, it “was probably no worse, and arguably even better, than that in the standard public debt offering of recent years.” *Due Diligence*, *supra* note 50; accord Scott Budlong, *WorldCom Puts Due Diligence in the Spotlight: A Recent Judgment in the WorldCom Class Action Has Thrown into Question the Liabilities Underwriters Face for Their Due Diligence Work*, *INT’L FIN. L. REV.*, May 5, 2005, at 25 (“The due diligence investigation made by WorldCom’s underwriters was probably consistent with normal practice in the shelf market, but it now seems clear that business as usual is no longer safe.”).

WorldCom, Inc.'s public reports were incorporated by reference.¹⁴⁹

In December 2004, the *WorldCom* court denied the underwriters' motion, holding that there were material issues of fact in dispute with respect to whether the underwriters conducted a reasonable investigation of the issuer during the offerings.¹⁵⁰

a. *WorldCom* on Due Diligence During an Offering

In arguing for judgment as a matter of law with respect to their offering-time due diligence, the underwriters sought the cover of Rule 176. They urged that under Rule 176, in assessing whether the underwriters' offering-time due diligence comported with the applicable "prudent man" standard, the court should consider the expedited time for shelf-registration offerings, as well as the underwriters' lack of involvement in preparing the substantive portions of the registration due to the integrated disclosure regime.¹⁵¹ In sum and substance, the underwriters urged that less time for due diligence and less control over the offering documents meant that they should be held to a lower standard for what due diligence was "reasonable."¹⁵²

This argument reflected the view of Rule 176 that underwriters had taken since the rule was promulgated some 20-odd years earlier.¹⁵³ However, the rule had not previously been tested in court,¹⁵⁴ so its interpretation presented a question of first impression in *WorldCom*.¹⁵⁵

The *WorldCom* court rejected the underwriters' characterization of Rule 176, holding that the rule did not "dilute[]" the "prudent man standard."¹⁵⁶ Rather, the court concluded that "the processes through which and the timing in which due diligence is performed have changed, but the ultimate test of reasonable conduct in the specific circumstances of an offering remains unchanged."¹⁵⁷ While recognizing

¹⁴⁹ See Zaccaro et al., *supra* note 20, at 23.

The underwriters argued that all the Rule 176 factors favored them because WorldCom was a well-established issuer; the bonds were investment-grade securities; they conducted interviews of the CFO and auditors; they assigned experienced personnel to the due diligence teams; the offering was a shelf-registration; analysts and credit reporting agencies followed WorldCom; and they were not responsible for preparing or reviewing the interim financial statements.

Id.

¹⁵⁰ See *id.*

¹⁵¹ See *WorldCom*, 346 F. Supp. 2d 628, 669-70 (S.D.N.Y. 2004).

¹⁵² See Zaccaro et al., *supra* note 20, at 23.

¹⁵³ See *supra* note 139 and accompanying text.

¹⁵⁴ See Langevoort, *supra* note 72, at 65.

¹⁵⁵ See *WorldCom*, 346 F. Supp. 2d at 671.

¹⁵⁶ See *id.* at 684.

¹⁵⁷ *Id.*

that underwriters' practices had changed,¹⁵⁸ the *WorldCom* court reasoned that, while Rule 176 recognized that the manner and timing of due diligence would have to change "in view of the compressed preparation time" for shelf-registered offerings, the rule "did not alter the fundamental nature of underwriters' due diligence obligations."¹⁵⁹ Hence, the *WorldCom* court held that, despite this compressed timeframe, the underwriters' investigation was nonetheless required to be "equally thorough" as the due diligence for a traditional (*i.e.*, non-shelf registered) offering.¹⁶⁰

In support of its interpretation of Rule 176, the *WorldCom* court relied primarily upon guidance from the SEC releases surrounding the Rule's adoption. According to the court:

the SEC . . . explain[ed] that integrated disclosure was intended to "simplify disclosure and reduce unnecessary . . . redelivery of information," not to "modify the responsibility of underwriters . . . to make a reasonable investigation." . . . And the SEC warned underwriters that the verification "required by the case law . . ." would still be required in appropriate circumstances.¹⁶¹

Further, the *WorldCom* court posited that the SEC had "expressly rejected the consideration of competitive . . . pressures" when evaluating the reasonableness of underwriter's due diligence.¹⁶²

To further bolster its interpretation of Rule 176, the *WorldCom* court pointed to commentators' critiques of the due diligence regime for shelf-registration (including some critiques discussed above). The court summarized these authors' views as contending that "the current regime for underwriter liability under Section 11 no longer makes sense" and that "[t]he benefits of [shelf registration] . . . are undermined by continuing to impose on [underwriters] the responsibility to take the time necessary to do a sufficient due diligence investigation to assure quality disclosure without . . . making allowances for their . . . inability to do so."¹⁶³ These authors' criticism and calls for reform, the *WorldCom* court reasoned, implicitly recognized that Rule 176 had not altered the standard for an underwriter's due diligence in a shelf-

¹⁵⁸ *See id.* at 684.

¹⁵⁹ *Id.* at 669 (internal citations omitted).

¹⁶⁰ *Id.* at 670 (internal citations omitted).

¹⁶¹ *Id.* at 669-70 (quoting *Reasonable Investigation*, *supra* note 120, at 42,020).

¹⁶² *Id.* at 670 (quoting *The Regulation of Securities Offerings*, Sec. Act. Release No. 33-7606A, 63 Fed. Reg. 67,174, 67,231 (Dec. 4, 1998) (the "aircraft carrier" release, proposing a never-adopted change to Rule 176 that would have added a checklist of six practices that courts should consider when assessing the adequacy of an underwriter's due diligence for certain offerings (but not including investment grade debt offerings)); *see* HAFT & HUDSON, *supra* note 54 § 7:13 (discussing SEC's proposed amendments to Rule 176 in the aircraft carrier release).

¹⁶³ *WorldCom*, 346 F. Supp. 2d at 670-71 (quoting Letter from ABA Comm. on Fed. Regulation on Sec., Bus. Law Section, to David B.A. Martin, Dir., Div. of Corp. Fin., SEC (Aug. 22, 2001)).

registered offering.¹⁶⁴

b. *WorldCom* on Continuous Due Diligence

In *WorldCom* the underwriters did not move for summary judgment based on their continuous due diligence, and as such, the court did not assess the adequacy of that due diligence.¹⁶⁵ Instead, the underwriters announced plans to prove their continuous due diligence at trial.¹⁶⁶ That never happened, because the underwriters all settled on the eve of trial.¹⁶⁷

However, the *WorldCom* court did recognize the important—indeed, dominant—role of continuous due diligence in assessing the reasonableness of the underwriters’ investigation with respect to a shelf-registered offering. According to the *WorldCom* court, in enacting Rule 415, the SEC fully anticipated that due diligence *would* change under the shelf registration and integrated disclosure regime—and had explained exactly how it *ought* to change:

[The SEC] recognized that “the techniques of conducting due diligence investigations of registrants qualified to use short form registration . . . would differ from due diligence investigations under other circumstances.” Nonetheless, it stressed the use of “anticipatory and continuous due diligence programs” to augment underwriters’ fulfillment of their due diligence obligations.¹⁶⁸

In particular, the *WorldCom* court pointed to the aforementioned strategies that the SEC had suggested for developing a “reservoir of knowledge” via continuous due diligence.¹⁶⁹ The *WorldCom* court therefore concluded that, while the SEC had taken away time for due diligence *during* an offering, the SEC had explicitly provided that

¹⁶⁴ See *id.* at 670-71 (“[A]cademics and practitioners have called for a reexamination of underwriters’ liability under Section[] 11 . . . on the grounds that ‘Congress’s assumptions in 1933 and 1934 about registrants working with individual underwriters in a relatively leisurely atmosphere are at odds with today’s competition by multiple underwriters for high-speed transactions.’ Implicit in these calls for a legislative change is the recognition that current law continues to place a burden upon an underwriter to conduct a reasonable investigation . . .” (internal citations omitted)).

¹⁶⁵ See *id.* at 684 (“The [underwriters] contend that they will . . . show at trial that [their] continuous due diligence . . . amounted to a reasonable investigation This Opinion does not address the likelihood of that showing because the [underwriters] have not moved for summary judgement [sic] on that ground.”).

¹⁶⁶ See *id.*

¹⁶⁷ See Thor Valdmanis, *J.P. Morgan Settles WorldCom Claims for \$2 Billion*, USA TODAY, Mar. 17, 2005, at 1B (JP Morgan was last major bank to settle); Susan Harrigan, *\$2B Deal in WorldCom Suit*, NEWSDAY, Mar. 16, 2005, at A48 (announcing co-lead underwriter J.P. Morgan’s settlement on the eve of trial).

¹⁶⁸ *WorldCom*, 346 F. Supp. 2d at 670 (internal citations omitted).

¹⁶⁹ *Id.* at 669-70 (internal citations omitted); see *supra* Part I.D.

underwriters could still perform equally “adequate due diligence,” if they “arrange[d their] due diligence procedures *over time*.”¹⁷⁰

* * * *

In sum, the *WorldCom* court: (1) held that Rule 176 required the *same* degree of investigation for shelf-registered offerings as for traditional offerings, despite the compressed time frame and lack of involvement in drafting documents incorporated by reference; and (2) admonished underwriters that they had an adequate opportunity, via continuous due diligence, to satisfy that mandate. However, the *WorldCom* court was silent on whether underwriters *actually* perform—or have any incentive to perform—continuous due diligence.

2. The Long-Feared “Dilemma” Finally Comes to Head?

a. Commentators Recognize the “Underwriter Conundrum”

Commentators’ reactions to the *WorldCom* decision were swift and decisive. In an outpouring of articles and practice commentaries after the decision, scholars and practitioners alike confirmed the existence of a quandary—characterized as the “due diligence dilemma” or the “underwriter conundrum”—that underwriters had long feared, but essentially ignored.¹⁷¹

Among those writing the most forcefully about the underwriters’ conundrum were the authors of a leading securities regulation textbook, including Professor Coffee, who described *WorldCom* (in the quote at the outset of this article) as posing “a dilemma” under which “old statutory norms requiring underwriters . . . to conduct a ‘reasonable investigation’” apply in court but not “in practice” because underwriters cannot comply with those rules “under the pressure of expedited time schedules.”¹⁷² This view was echoed in a recent student note, which

¹⁷⁰ *WorldCom*, 346 F. Supp. 2d at 669 (internal citations omitted) (emphasis added).

¹⁷¹ Some commentators contend that underwriters had essentially played “ostrich” since the advent of shelf-registration, by hoping unrealistically that Rule 176 would protect them against liability. See Langevoort, *supra* note 72, at 62-63 (the due diligence dilemma led to “finger-crossing during a public offering”); see also *Safe Harbor*, *supra* note 24; Marc Rossell & Andrew Stemmer, *Underwriters’ Due Diligence Obligations in the Wake of In re WorldCom*, WALLSTREETLAWYER.COM, June 2005, available at <http://www.realcorporatelawyer.com/wsl/wsl0605.html> (arguing that the *WorldCom* decision “challeng[ed] many of the industry’s long held—though possibly ill-founded—assumptions regarding underwriters’ due diligence obligations”).

¹⁷² COFFEE ET AL., *supra* note 1, at 154; see also *Safe Harbor*, *supra* note 24 (arguing that an “unaddressed dilemma” faces underwriters because the court’s summary judgment opinion in the *WorldCom* litigation “largely renders existing due diligence practices meaningless”); *Due*

contends that the *WorldCom* opinion “failed to address the near impossibility of meeting . . . traditional due diligence requirements under a shelf registration.”¹⁷³ According to this author:

Underwriters are . . . left with a difficult choice between meeting the demanding requirements of traditional due diligence, or succumbing to the demands of a competitive and time-sensitive industry. Caught between the proverbial rock and a hard place, underwriters must confront increasing legal liability while regulators and issuers are encouraging them to close deals at lightning speed. Lurking behind this dilemma is the underwriters awareness that if they pass on a deal because of due diligence, another less demanding firm will acquire and complete the deal.¹⁷⁴

Other scholars have also recognized the existence of this dilemma, post-*WorldCom*.¹⁷⁵

Regulators, too, noted an underwriter’s dilemma in the aftermath of *WorldCom*. As then-chairman of the SEC, William Donaldson, put it in a speech in 2005:

A transaction twenty years ago might have taken six months, and five years ago it might have taken two weeks. Today it can be done overnight, and next year it might take even less time But the standard for legal liability remains that which is enshrined in the Securities Act. You can move as fast as you like, but your customers will be protected by that standard.

The principles of underwriter liability and the due-diligence defense were, of course, created in a much slower-paced era. The advent of shelf registration over twenty years ago, with time pressure issues akin to those facing market participants today, raised similar concerns In the end [an underwriter] must decide whether, in a compressed timeframe, [it has] the ability to bring to bear [its] business, legal and financial knowledge of the issues . . . in order to

Diligence, *supra* note 50 (describing *WorldCom* as “expos[ing] a basic mismatch between the legal responsibilities imposed . . . by Section 11” of the Securities Act on directors—and by implication, underwriters—and “their ability to satisfy these obligations within the compressed time frames of shelf registration”).

¹⁷³ Young, *supra* note 26, at 524 (citing, *inter alia*, *Safe Harbor*, *supra* note 24, at 5).

¹⁷⁴ *Id.* at 544-45 (footnotes omitted); *see also id.* at 545 (“Underwriters face constant pressure to effectuate shelf offerings quickly In the competitive underwriting industry, investment banks will not have the weeks or months necessary to satisfy due diligence requirements because impatient and demanding issuers will look elsewhere. . . . [Thus,] underwriters will face a choice between potential liability and cumbersome, lengthy due diligence.”); *id.* at 522 (“The increase in technology and rapid access to the capital markets . . . places underwriters in a predicament, as there is no guide establishing the requisite due diligence for preparing for such offerings.” (citing, *inter alia*, *Safe Harbor*, *supra* note 24 at 5)); *id.* at 524 (“As time is of the essence . . . underwriters are in an unenviable position between complete liability and unachievable due diligence requirements.”).

¹⁷⁵ *See* FIPPINGER, *supra* note 144, § 7:7.2 (“Integrated disclosure and shelf registration combined to enable more rapid access to the capital markets. Together, they also restricted the ability of underwriters to engage in . . . due diligence in the course of” an offering.)

conduct the inquiry into the issuer's business . . . that the due-diligence defense demands¹⁷⁶

These views of the SEC Chairman have since been echoed by numerous practitioners.¹⁷⁷

The legal press also joined the chorus of complaints, post-*WorldCom*, of the due diligence conundrum. As one lawyer-journalist explained (quoting several other lawyers):

Underwriters face pressure to finalize shelf-registrations quickly. If they tell clients they need weeks and months to conduct more due diligence, the client may look elsewhere.

Yet, as that same journalist explained:

There is a disconnect between the way the offering process has developed and the law," The law remained fixed on decades-old standards in which underwriters conducted months of due diligence while shelf-registrations could go from start to finish in a week's time. "There's not much an underwriter can do within a week," The inconsistency between stringent legal standards and fast-paced shelf-registrations led underwriters years ago to implore the SEC for a safe-harbor that would provide clear guidelines to absolve them from liability

¹⁷⁶ William H. Donaldson, Remarks Before the Bond Market Ass'n, New York, New York (Apr. 20, 2005), available at <http://www.sec.gov/news/speech/spch042005whd.htm>.

¹⁷⁷ See, e.g., Patrick J. Schultheis, *A Practical Guide to the New Securities Offering Reforms* 27 (June 21, 2006), available at http://www.realcorporatelawyer.com/programs/HT-Seattle_06-21-06/Panel-II.pps (slideshow presentation for "Sec Hot Topics Institute" presented by Wilson Sonsini Goodrich & Rosati attorney) (noting "Due Diligence Dilemma" in that, post-*WorldCom* "[u]nderwriters [are] still required to comply with traditional standards of due diligence"); Zaccaro et al., *supra* note 20, at 21 (*WorldCom* "exposes a stark asymmetry between the legal duties of underwriters and realities of practice"); Christopher C. Paci, *Recent Developments in the Securities Laws: Securities Offering Reform*, in UNDERSTANDING THE SECURITIES LAWS 2006, at 723, 737 (PLI Corp. Law and Practice Course Handbook Series No. 8902, 2006), WL 1556 PLI/Corp 723 (explaining that, post-*WorldCom*, "[c]ourts will hold underwriters to the same high standard in asserting due diligence defense regardless of whether transaction is a "drive-by" take-down off a WKSI's automatic shelf or a fully marketed IPO"); Catherine T. Dixon, Securities Offering Reform from a WKSI Perspective, in PRIVATE PLACEMENTS 2006, at 38 (2006) ("underwriters . . . have had less and less time to perform pre-takedown diligence functions as rapid short-form shelf deal techniques have evolved over the years") (citing *Wallman Committee Report* §§ II.B.5-.6 & app. A, § III); Dixie L. Johnson, *Assessing the Strict Liability Implications for Outside Directors of a Newly Streamlined Shelf Registration System*, SEC. REP., Fall 2005, at 25-26 ("[U]nderwriters . . . have had less and less time to perform pre-takedown diligence . . . as rapid short-form shelf deal techniques have evolved Even as the timing pressures attendant to shelf offerings have escalated in the past 20-plus years, there has been no meaningful modification of the draconian Section 11 standard of liability. . . . [C]ritics charge that the . . . *WorldCom* [decision] seem[s] to have applied judicial precedent fashioned in a non-shelf environment without regard to the exigencies of modern debt takedowns."); Gideon A. Schor, The Due Diligence and Reliance Defenses in *WorldCom*: Retrospect and Prospect 8 (Jan 16., 2006) (unpublished manuscript, on file with the CARDOZO LAW REVIEW), available at http://www.wsgr.com/PDFSearch/Due_Diligence_after_WorldCom.pdf (arguing that *WorldCom* "heightens the tension between the underwriter, who must still perform the same diligence, and the issuer, who wants to get to market at ever greater speeds").

But instead, the commission[’s rules] largely applied the same strict due diligence requirements to shelf registrations as it had for run-of-the mill offerings One day . . . people knew it would hit the fan and the name of that day is WorldCom.¹⁷⁸

Others in the media have since recognized the existence of the underwriter conundrum.¹⁷⁹

It is clear, then, that commentators from many perches view *WorldCom* as posing a “due diligence dilemma” for underwriters—and see Rule 176 as offering little, if any, cover.¹⁸⁰ To date, there has been no published dissent from this view.

b. Continuous Due Diligence: Unrealistic for Underwriters?

Critical to the aforementioned commentators’ argument that underwriters face a due diligence dilemma is the assumption that the SEC’s suggested (and *WorldCom*-approved) safety valve—continuous due diligence—*simply does not occur in practice*.¹⁸¹ Commentators seem to be almost universally united in holding this view.¹⁸²

One reason for this, according to most authors, is that underwriters

¹⁷⁸ Michael Bobelian, *Post-WorldCom Liability: Underwriters Look for Guidance from Courts, SEC*, N.Y. L.J., Mar. 17, 2005, at 5.

¹⁷⁹ O’Leary, *supra* note 19 (describing a “dilemma” for underwriters: “[o]n the one hand, they face increasing legal danger when a deal goes south, but . . . they are being encouraged by issuers . . . to bring deals to market at lightning speed—and if they turn down the business, they know another, less rigorous firm will simply step in and execute it anyway. The current situation has been brewing for years. It reached critical mass a year ago with the decision . . . that WorldCom’s underwriters had not done a reasonable degree of due diligence”); see also Budlong, *supra* note 148 (“The [*WorldCom*] message is that, while modern shelf financings place underwriters under great practical pressures . . . the explicit requirements of Section 11 remain firmly—if awkwardly—in place.); *id.* (“One must assume that the plaintiffs’ bar will be emboldened by *WorldCom*, as the decision severely dents the apparent utility of Rule 176 Given the Court’s unwillingness to accept that . . . shelf offerings should add flexibility to traditional due diligence standards, it is difficult to see what real defensive value Rule 176 now has.”); Rossell & Stemmer, *supra* note 171 (“The *WorldCom* decision . . . highlights the discrepancy between the standards of liability for underwriters . . . which have not evolved since the enactment of the Securities Act, and the timing demands of the modern marketplace. Although there have been several attempts by the private bar . . . to remedy these discrepancies, the law . . . has never changed, and underwriters have not obtained any relief from their diligence obligations”).

¹⁸⁰ Budlong, *supra* note 148 (arguing that “*WorldCom* . . . severely dents the apparent utility of Rule 176”; and that “[g]iven the Court’s unwillingness to accept that the realities of shelf offerings should add flexibility to traditional due diligence standards, it is difficult to see what real defensive value Rule 176 now has”).

¹⁸¹ See, e.g., COFFEE ET AL., *supra* note 1, at 153 (“despite the Commission’s encouragement. . . [c]ompanies did not conduct year-round due diligence”); Frank Partnoy, Symposium, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 522 (2001) (“for shelf registrations, disinterested advance due diligence is the exception, not the rule”).

¹⁸² To date, only one commentator has bucked the trend in print, urging that underwriters do in fact perform continuous due diligence. See *infra* note 200.

have found the SEC's suggested continuous due diligence practices to be "impractical."¹⁸³ Yet, not all the blame lies at the underwriters' feet. Issuers, and the demands of the marketplace, also play a role.¹⁸⁴

In particular, the purported demise¹⁸⁵ of "relationship banking,"¹⁸⁶ under which issuers partnered with the same investment bank for most or all of their securities underwriting and other financial transactions; and the rise of "transactional banking,"¹⁸⁷ under which banks bid for an

¹⁸³ Young, *supra* note 26, at 534-35 (citing, *inter alia*, Smeeta S. Rishi, *The Impact of the SEC's Rule 415 on Individual Investors*, 46 OHIO ST. L.J. 223, 233-35 (1985)).

¹⁸⁴ See Sjostrom, *supra* note 65, at 563 (citing *Due Diligence Task Force*, *supra* note 113) ("some issuers may invite potential underwriters to comment on drafts [periodic disclosure] documents prior to filing[, but many] are loath to discuss unfiled draft . . . reports with potential underwriters fearing such discussion will lead to leaks"); *id.* at 572 ("[I]t is often not possible for underwriters to engage in some of [the SEC's suggested] techniques given market realities.").

¹⁸⁵ Over the past two decades, many commentators have proclaimed the "death" of relationship banking. See BANKING HANDBOOK, *supra* note 56, at 56 (detailing the supposed demise of relationship banking); HAYES & HUBBARD, *supra* note 101, at 130 ("It has become fashionable in recent years to maintain that relationship banking is dead and that U.S. corporate business is up for grabs."); accord ROBERT G. ECCLES & DWIGHT B. CRANE, DOING DEALS: INVESTMENT BANKS AT WORK 53 (1988) (describing how many corporations now use multiple investment banks, which was not previously the norm); ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 20-21 (2007) ("[T]he exclusivity of client-bank relationships has diminished in recent years. The trend became pronounced during the 1990s when commercial banks started to enter the lucrative securities underwriting business."); see, e.g., ECCLES & CRANE, *supra*, at 53 ("[A]t one time the relationship between General Motors and Morgan Stanley was so strong that other investment bankers did not call on the company. . . . [But] times have changed."); MORRISON & WILHELM, *supra*, at 20 (from 1956, "Goldman Sachs . . . had a nearly fifty year exclusive banking relationship with Ford Motor Company"); ROBERT C. PEREZ, INSIDE INVESTMENT BANKING 41 (1984) ("Gone are the days when an upstart firm had to ask permission of a Morgan . . . to approach one of their clients!").

¹⁸⁶ The preliminary issuance of securities has traditionally been "a very 'relationship-oriented' business" in which "[c]orporations establish a relationship with an investment bank and . . . tend to use the same investment bank each time they have a new securities issue . . ." MARSHALL & ELLIS, *supra* note 55, at 61; see also MORRISON & WILHELM, *supra* note 185, at 20 ("Investment banks have traditionally maintained relatively exclusive client relationships."). As a result of these relationships, all aspects of an underwriting were performed by the same investment bank. See MORRISON & WILHELM, *supra* note 185; see also MANAGING BANKING RELATIONSHIPS 8-9 (Gerald Leahy ed., 1997) [hereinafter BANKING RELATIONSHIPS] (under "extreme" relationship banking, "a company has a very small number of banks—if not one alone—with which it has dealt for many decades," and which has "a detailed knowledge of the company's business, kept up to date by regular briefings"; in such a model, business is awarded to the relationship banks "whatever the price").

However, since the 1980's, due in part to the advent of shelf registration, the importance of these relationships in securities issuance supposedly has declined. See *supra* note 185. As a result, preparation of the securities to be offered—and accompanying due diligence—might be performed by one underwriter, and other aspects of the offering (e.g., distribution of the securities), might be competitively bid out to other underwriters or another syndicate of underwriters. See MARSHALL & ELLIS, *supra* note 55, at 61.

¹⁸⁷ By contrast to the long-term relationships of traditional "relationship banking," so-called "transactional" investment banking is "highly-competitive." See Nicholas, *supra* note 40, at 23 ("Traditionally, major corporations . . . selected one investment banking firm and then relied on that firm decade after decade as the managing underwriter in every new issuance of securities."). Under transactional investment banking, even the "announcement of a deal is often viewed as an

issuer's services and an issuer may partner with a different bank for each different financial transaction, supposedly have played a major role. This competition reduced an underwriters' leverage in due diligence, thereby hampering their ability to ask "tough questions" and greatly reducing their incentive to conduct a painstaking investigation.¹⁸⁸ Due to issuers' increased leverage, "few, if any" have adopted continuous due diligence programs, and underwriters have not insisted that they do so due to the "fear that any such insistence would place them at a competitive disadvantage in an increasingly competitive market."¹⁸⁹ If "[i]ssuers . . . are largely unwilling to subject themselves to continuous due diligence," then certainly "underwriters cannot be expected to conduct such due diligence."¹⁹⁰

Accordingly, most commentators¹⁹¹ have urged that, in the current competitive environment for underwriting services—particularly for low-margin investment grade debt—underwriters are unlikely to develop continuous due diligence techniques anytime soon.¹⁹²

opportunity for competitors to jump in with a more appealing idea"—and a long-standing relationship between underwriter and issuer is "more the exception than the rule." See *id.* at 24 & n.64 & 68 (citing, *inter alia*, Hayes, *The Transformation of Investment Banking*, HARV. BUS. REV., Jan.-Feb. 1979, at 153, 154, and quoting Feinberg, *Poaching is the New Name of the Game*, INSTITUTIONAL INVESTOR, Nov. 1980, at 37); accord BANKING HANDBOOK, *supra* note 56, at 3-5 (explaining how "technology-driven, transaction-based banking has elbowed out much of" relationship banking in the 1970's and 1980's); BANKING RELATIONSHIPS, *supra* note 186, at 8 (explaining that in "transactional" relationships, a "company keeps banks at a distance, gives them limited information and seeks quotations . . . from many banks"); *id.* at 69 (describing "transactional banking as 'hit and run' banking").

¹⁸⁸ See Nicholas, *supra* note 40, at 33 (criticizing the SEC's suggested continuous due diligence techniques because they all "assume a traditional, ongoing relationship between the issuer and the underwriter"—which, according to that author, no longer exists).

¹⁸⁹ *Safe Harbor*, *supra* note 24.

¹⁹⁰ Young, *supra* note 26, at 546-47; accord Morrissey, *supra* note 75, at 592 ("frequent[ly]" underwriters have no opportunity to perform any extensive due diligence on the issuer before the updating call).

¹⁹¹ See, e.g., Young, *supra* note 26, at 546-47; accord MARSHALL & ELLIS, *supra* note 55, at 17. However, one treatise disagrees that underwriters have no incentive to perform continuous due diligence. Robert Haft—the underwriters' due diligence expert in the WorldCom litigation, who has participated in due diligence for more than 200 offerings—and his co-author posit that due diligence is not only a liability defense, but also "good business practice." HAFT & HUDSON, *supra* note 54, § 2:4. According to Professor Haft and Ms. Hudson, due diligence may place the underwriters in "a much better position to decide whether to proceed with an underwriting from a business point of view" and it may enable an underwriter to "do a better job of marketing the securities, since [e]ffective marketing is the product of a thorough understanding of the company[]." *Id.*

¹⁹² One commentator has suggested that perhaps, in light of *WorldCom*, this question ought to be revisited. See Schor, *supra* note 177, at 8-9 (noting that, although "issuers may recoil" at the idea, "one solution [to the due diligence dilemma] may be continuous diligence by underwriters . . . [and] there may be no alternative").

c. The Importance of *WorldCom*?

Of course, all of the foregoing noise about the due diligence dilemma assumes that the *WorldCom* opinion is an important one. Yet, as a district court decision, *WorldCom* is not binding precedent on any federal court. In theory, other courts could simply ignore it.

Nonetheless, *WorldCom* has all the indicia of an important case. For one thing, *WorldCom* has little competition from other precedents. Decisions regarding the due diligence defense are “sparse”¹⁹³—undoubtedly because most cases under Section 11 and 12(a)(2) settle early.¹⁹⁴ In the seventy-five plus years since Congress enacted the Securities Act, only a handful of decisions have addressed the due diligence defense.¹⁹⁵ What’s more, the most commonly-cited of these decisions are all New York district court decisions from over 30 years ago.¹⁹⁶ Most important, *WorldCom* is the *only* decision that addresses the due diligence defense in the context of a shelf-registered offering—and, for that matter, is the first to interpret Rule 176.¹⁹⁷ Since *WorldCom* occupies the field with respect to the standard for due diligence (in shelf-registered offerings), it seems “unrealistic” to expect that other courts will simply ignore it.¹⁹⁸

Yet, although it is doubtful that courts will ignore *WorldCom*, underwriters might—if they do, indeed, perform adequate due diligence. To date, although lawyers have clamored to advise their underwriter clients how to change their due diligence practices in light of *WorldCom*,¹⁹⁹ it is not clear that underwriters have followed that advice.²⁰⁰

Further, there is little evidence after *WorldCom* that underwriters, faced with the proverbial choice between a rock and a hard place, have either angered issuers by stalling offerings to perform more due

¹⁹³ *WorldCom*, 346 F. Supp. 2d 628, 671 (S.D.N.Y. 2004).

¹⁹⁴ See Nicholas, *supra* note 40, at 9 (assertion, by former S.E.C. staff member, that “most Section 11 litigation is settled long before trial”). One explanation for this phenomena is the *in terrorem* effect of Section 11 lawsuits. See *id.* at 8 (quoting, *inter alia*, William O. Douglas & Milton H. Cohen).

¹⁹⁵ See Rossell & Stemmer, *supra* note 171.

¹⁹⁶ *Escott v. BarChris Construction Corp. (BarChris)*, 283 F. Supp. 643 (S.D.N.Y. 1968); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 554, 550 (E.D.N.Y. 1971).

¹⁹⁷ See *WorldCom*, 346 F. Supp. 2d at 671.

¹⁹⁸ See *Safe Harbor*, *supra* note 24.

¹⁹⁹ See, e.g., *supra* note 177 (listing just a few of the scores of practitioner articles on the topic).

²⁰⁰ See generally Alix Nyberg Stuart, *False Alarm? For Better or Worse, WorldCom Hasn't Done Much to Raise the Bar for Underwriters' Due Diligence*, CFO MAG., Oct. 1, 2005, at 56, available at http://www.cfo.com/article.cfm/5010009/c_5038012?f=insidecfo.

diligence or have lost business by backing out of deals.²⁰¹ Nor have there been any published reports (to this author's knowledge) of underwriters raising fees across the board, after *WorldCom* (as some have suggested that they could or would)²⁰² to compensate for their supposed increased risk of Section 11 liability.²⁰³ While it may be that underwriters have simply accepted that the additional risk of liability posed by *WorldCom* will mean lower profits from underwriting fees,²⁰⁴ or that underwriters already raised their fees sufficiently when shelf registration was first adopted,²⁰⁵ both explanations seem lacking.

Part II describes one hypothesis about why underwriters may not be so concerned about *WorldCom*—and why they may not be approaching due diligence any differently—despite their lawyers' near-universal²⁰⁶ alarm.²⁰⁷ But first, sub-section H offers a brief discussion of important regulatory changes, post-dating *WorldCom*, that seemingly make the due diligence dilemma even more dire.

H. "Automatic" Shelf Registration: Deepening the Dilemma

Underwriters barely had time to react to the December 2004 *WorldCom* decision before the SEC revised Rule 415 to ratchet up the speed of securities offerings for the largest issuers. Effective December 1, 2005, reforms permitted a new category of large issuer—the "well-known, seasoned issuer" ("WKSI")—to file "automatic" shelf registration statements. Pursuant to "automatic" shelf registration, a

²⁰¹ See Young, *supra* note 26, at 545.

²⁰² See Banoff, *supra* note 99, at 181; *Safe Harbor*, *supra* note 24.

²⁰³ Cf. MORRISON & WILHELM, *supra* note 185, at 24-25 (describing the "collapse[]" of "underwriting spreads" corresponding with the "entry of commercial banks into the underwriting business," with debt spreads "respond[ing] more rapidly and in a more extreme fashion to competition" than equity spreads). Underwriting spreads—the difference between what an underwriter pays for securities and what the underwriter receives for them—are an underwriter's compensation for securities issuance.

²⁰⁴ See K. THOMAS LIAW, *THE BUSINESS OF INVESTMENT BANKING* 15 (2d ed. 2006) (explaining that the shorter time for new issues under shelf registration has led to "increased due diligence risks" for underwriters).

²⁰⁵ Some empirical studies concluded that underwriters initially raised their fees after shelf registration was implemented in the early 1980's—presumably as an "insurance premium" for higher due diligence risks. See David W. Blackwell et al., *Shelf Registration and the Reduced Due Diligence Argument: Implications of the Underwriter Certification and the Implicit Insurance Hypothesis*, 25 J. FIN. & QUALITATIVE ANAL. 245, 246 (1990) ("Our findings suggest that underwriters require an 'insurance' premium for shelf issues and that the premium is higher for firms with higher due diligence liabilities. We conclude that underwriters perceive that due diligence is eroded by shelf registration and subsequently price the due diligence erosion . . .").

²⁰⁶ See Stuart, *supra* note 200 (quoting Marjorie Gross, regulatory counsel for the BMA) ("Many of our members are already doing a good job in performing continuous due diligence on frequent issuers.").

²⁰⁷ See *supra* note 177.

WKSI may issue any amount of the listed securities into the market at any time, *without* prior SEC review. Thus, “automatic” registration for WKSIs means *instantaneous* offerings by WKSIs—without the shelf filing as warning.²⁰⁸

This sub-section briefly describes the WKSI reforms and commentators’ assessment of the effect of these reforms on the supposed due diligence conundrum.

1. The 2005 Reforms: WKSIs vs. “Seasoned Issuers”

- a. This Massive WKSI Went to Market—*Instantly*

WKSIs are the cream of the crop of “seasoned issuers”—the largest 30% of all listed issuers. In order to be a WKSI, a corporation generally must have a market capitalization \$700 million or more.²⁰⁹ WKSIs “account[] for about 95% of U.S. equity market capitalization and more than 96% of the total debt raised in registered offerings since 1998.”²¹⁰ The SEC presumes that WKSIs are the “most widely followed” by securities and industry analysis.²¹¹

When WKSI issuers file an “automatic” registration statement, the company’s registration becomes effective immediately.²¹² Hence, there is no waiting, and the WKSI can start offering the classes of securities listed in the “automatic” registration immediately—and sell an unlimited number of those classes of securities, at any time in the next three years.²¹³ Thus, at least in theory, automatic registration shortens the time for secondary offerings by WKSIs.

²⁰⁸ See Morrissey, *supra* note 75, at 591-93 (explaining automatic registration “provides WKSIs with an incredible amount of freedom to sell securities whenever they wish”).

²⁰⁹ Specifically, under the 2005 reforms, a corporation qualifies as a WKSI if it: (1) files annual, quarterly and current public reports pursuant to section 13(a) or section 15(d) of the Exchange Act of 1934; is (2) eligible to offer securities in a shelf-registered offering using Form S-3; and (3) either has a “public float” (*i.e.*, outstanding share value) of common equity held by non-affiliates of at least \$700 million or has issued least \$1 billion in non-convertible securities other than common equity (*e.g.*, debt) in primary, registered offerings in the past three years. See Securities Offering Reform, Securities Act Release No. 8,591, 70 Fed. Reg. 44,722, 44,727 (Aug. 3, 2005) [hereinafter Offering Reform]. WKSIs also may not otherwise be “ineligible” issuers. *See id.*

²¹⁰ David B. Gail, Comment, *Uncertain Future: Liability Concerns Surrounding the Application of Section 12(A)(2) of the Securities Act of 1933 to Free Writing Prospectuses After the Enactment of the SEC’s Recently Reformed Offering Rules*, 60 SMU L. REV. 609, 621 nn.83-84 (2007).

²¹¹ See Offering Reform, *supra* note 209, at 44,728 (such companies were followed by, on average, twelve analysts).

²¹² See 17 C.F.R. § 230.415 (2008).

²¹³ See 17 C.F.R. § 230.415(a)(5) (2008). By contrast, a regular shelf registration statement permits the issuer to put a *specific* amount of securities “on the shelf” for up to two years. See 17 C.F.R. § 230.415 (2008).

However, for many WKSIs, the effect of “automatic” registration on offering speed may have been negligible. Even prior to the automatic offering reforms in 2005, many blue-chip companies kept “universal” shelves²¹⁴ on file with the SEC as a matter of course, so that the company could offer securities of any type at any time. Nonetheless, before 2005 at least *some* top companies—including WorldCom²¹⁵—did not keep a shelf on file. For such WKSIs, the filing of a shelf provided underwriters with advance warning of a potential secondary offering.

b. “Seasoned” Issuers: Same Old Shelf

Established issuers that are eligible to offer securities on Form S-3, but which do not qualify as WKSIs (*i.e.*, qualified issuers with market floats above the \$75 million threshold necessary for shelf registration and below the \$700 million threshold necessary to be a WKSI)—now known as “seasoned” issuers—generally cannot use “automatic” shelf registration. However, they may still use regular shelf-registration.²¹⁶

2. Dilemma Redux

As might be expected, commentators who are concerned that underwriters face a due diligence dilemma view “automatic” shelf registration as deepening that dilemma.

For example, one author claims that underwriters “face considerable pressure to do this heightened due diligence in even less time” because of the confluence of the *WorldCom* decision and the “automatic” shelf reforms:

[The automatic shelf reforms] removed obstacles that hindered regular issuers from whisking their issues into securities markets whenever they wished. . . [and] basically speed up the process and push[ed] the capital markets closer to where drive-by deals-offerings announced at 7 a.m., for example, and priced by noon-could become even more of the norm. . . .

[T]he \$64,000 question [is:] what can underwriters do? Creating new speed bumps to securities offerings is very unpopular with

²¹⁴ Universal shelves “register debt, equity and other securities on a single shelf registration statement, without having to specify in the registration statement the amount of each class of securities to be offered.” See Simplification of Registration Procedures for Primary Securities Offerings, Sec. Act Release No. 33-6964, 57 Fed. Reg. 48,970, 48,971 (Oct. 29, 1992).

²¹⁵ For example, WorldCom, Inc. filed the shelf registration Form S-3 that it “took down” in its May 19, 2000, bond offering on April 12, 2000. See Young, *supra* note 26, at 524.

²¹⁶ See *Offering Reform*, *supra* note 209, at 44,727.

issuers. . . . And if underwriters say they need more time to conduct due diligence . . . issuers will always find someone who will . . . do it immediately, someone who will sell themselves on how little due diligence they do. . . . The upshot: underwriters are in a no-win situation.²¹⁷

Thus, as Professor Coffee explains:

[The recent WKSIs reforms] only aggravate[] th[e underwriter's dilemma]. Before[,] underwriters and directors had very little time between the filing and the offering to conduct due diligence; after it, those associated with [WKSIs] have none.²¹⁸

Other commentators have expressed similar concerns.²¹⁹ Many have even urged that an expansion of continuous due diligence practices will be required to address these concerns.²²⁰

All of these concerns might be somewhat overwrought, however—at least for the largest WKSIs. The remainder of this article explains why. As a first step towards this end, we must better understand the banks that underwrite securities for the very largest corporations.

II. UNDERSTANDING “UNDERWRITERS”: A LOOK INSIDE THE GLOBAL BANK

As explained above, the so-called “due diligence dilemma” has two factual predicates: (1) that underwriters do not have time to perform adequate due diligence *during* a shelf-registered (or an “automatic”) offering, due to the fast pace of such offerings; and (2) that underwriters perform little, if any, “continuous due diligence” *prior to* such offerings, largely due to increased competition and the increasingly transactional nature of securities underwriting.

Yet, predicate two is premised on a problematic assumption that has been universally ignored by commentators writing about due diligence for shelf-registered offerings. The assumption is that

²¹⁷ O’Leary, *supra* note 19.

²¹⁸ *Safe Harbor*, *supra* note 24.

²¹⁹ Young, *supra* note 26, at 524 (taking SEC to task for granting WKSIs “almost instantaneous access to the market, but fail[ing] . . . to outline the amount of due diligence that is required of underwriters”); Cynthia M. Krus, Harry S. Pangas & Christopher Zochowski, *To Market, to Market: As SEC Steps Back, New Pressure Falls on Private Counsel for Offerings*, LEGAL TIMES, Nov. 21, 2005, at 1 (explaining that, with WKSIs’ “immediate access to the market . . . underwriters . . . will face pressure to conduct their due diligence for securities offerings more rapidly”); see generally Stephanie Tsacoumis, *Impact of Securities Offering Reform on Underwriter Arrangements*, INSIGHTS: THE CORP. & SEC. L. ADVISOR, Oct. 2005, at 22, available at <http://media.gibsondunn.com/fstore/documents/pubs/Tsacoumis-ImpactOfSecuritiesOffrg-LglTms10.05.pdf>.

²²⁰ See, e.g., *NY City Bar Report*, *supra* note 108, at 505; Krus et al., *supra* note 219 at 1 (continuous due diligence “will expand” for WKSIs offerings).

“underwriters,” who (according to predicate two) do not continuously investigate their clients for the purpose of preparing for future securities offerings, *also* do not continuously investigate such clients for *any other* purpose. By so assuming, lawyers and scholars writing about due diligence essentially ignore *other* potential contacts that underwriters have with their clients, which *might*, in turn, provide opportunities for continuous due diligence.

This assumption might well be true if “underwriters” were monolithic, underwriting-only firms. But in fact, many are not. Many WKSIs are giant corporations, like GE (or, in its day, WorldCom), listed on the Fortune 1000 (call them “mega-WKSIs”).²²¹ The financial needs of these massive corporations are served by giant, global financial service firms—known as “global” or “universal” banks—that provide a *vast* array of financial services to their clients.²²² This section takes a look inside the global banks who serve the mega-WKSIs.

A look inside these global banks reveals two key insights. *First*, bankers who have nothing whatsoever to do with underwriting securities nonetheless appear to investigate (or at least, are positioned to investigate) important clients like mega-WKSIs.²²³ *Second*, an internal organizational structure—the “client relationship team”—appears to coordinate (or, at least, is designed to coordinate) the *collection* of information about WKSI clients and the *flow* of that information from bankers who do not participate in securities offerings to the banker who oversees due diligence for securities offerings.²²⁴ Thus, it appears that

²²¹ This article distinguishes between run-of-the-mill WKSIs and the hypothetical “mega-WKSIs,” because presumably not all WKSIs are clients of the giant, full-service global banks. Certainly the world’s largest corporations, like GE, are much sought-after clients of such banks, as are other companies listed in the Fortune 500. See A.T. KEARNEY, INC., GLOBAL INVESTMENT BANKING STRATEGY: INSIGHTS FROM INDUSTRY LEADERS 22 (1998) [hereinafter BANKING STRATEGY] (noting that giant bank JP Morgan’s customer base consists largely of “corporations in the Fortune 500”); see, e.g., Xcel Energy, Inc., Prospectus Supplement to Prospectus Dated January 8, 2008, <http://ccbn.10kwizard.com/xml/download.php?repo=tenk&ipage=5387281&format=PDF> (prospectus supplement dated January 14, 2008, for notes offered by Xcel Energy, Inc., underwritten by large banks such as Morgan Stanley, Citi, JP Morgan & Merrill Lynch); Fortune 500: Our Annual Ranking of America’s Largest Corporations, http://money.cnn.com/magazines/fortune/fortune500/2007/full_list/201_300.html (last visited Feb. 2, 2009) (the “Fortune 500” for 2007, listing Xcel Energy, Inc. as number 251). Yet, companies in the Fortune 500 have a market capitalization that dwarfs run-of-the-mill WKSI. Compare Google Finance, Xcel Energy Inc., <http://finance.google.com/finance?q=xel&hl=en> (last visited Feb. 2, 2009) (listing Xcel Energy, Inc.’s market capitalization of \$8.1 billion as of March 2, 2008), with *supra* note 209 (the minimum market capitalization for a WKSI is \$700 million). As such, it is possible that the average WKSIs does not consume sufficient investment banking services to command the interest and scrutiny of the global banks.

It is unnecessary for the purposes of this article to determine whether the line dividing WKSI from mega-WKSI lies at the Fortune 500, 1000 (or theoretical 2000) mark. Nonetheless, the topic warrants further research.

²²² See *infra* Part II.A.2.

²²³ See *infra* Part II.B & C.

²²⁴ See *infra* Part II.D.

bankers who provide mega-WKSIs with financial products *other* than underwriting of securities may nonetheless perform (or, at least, are in a position to perform) *substantial* continuous due diligence.

This section takes the reader inside the mega-WKSI's underwriter in four steps. First, this section introduces the global banks and briefly describes the breadth of services that they provide to their mega-WKSI clients.²²⁵ Second, this section describes some ways that global bank investment bankers who are *not* involved in underwriting nonetheless appear to investigate (or are positioned to investigate) their mega-WKSI clients.²²⁶ Third, this section introduces the "client relationship team" structure that many global banks employ to coordinate the activities of all of the bankers working on behalf of any particular mega-WKSI.²²⁷ In theory, this team facilitates the collection and flow of information about mega-WKSI clients from team members to the team leader. *Fourth*, this section addresses some questions about whether client relationship teams *actually* function as advertised.²²⁸ Although a full empirical treatment of this question is beyond the scope of this article, anecdotal evidence²²⁹ suggests that global banks *do* use client relationship teams to engage in serious continuous due diligence on mega-WKSIs.

A. Bank Breakdown

1. Here's an "Underwriter": Look Inside and See All the Bankers!

As described above, "underwriter" is a term of art, defined in Section 2(a)(11) of the Securities Act, to include one who buys securities "with a view to . . . distribution."²³⁰ Typically, financial services firms buy securities from an issuer and sell them to the public in a securities offering, so the term "underwriter" is commonly understood to refer to such firms.²³¹

Under Section 11 of the Act, an "underwriter" also is strictly liable for material misstatements or omissions in the registration statement²³² subject to a "due diligence" defense.²³³ As such, commentators who

²²⁵ See *infra* Part II.A.2.

²²⁶ See *infra* Part II.C.

²²⁷ See *infra* Part II.D.

²²⁸ See *infra* Part II.E.

²²⁹ This anecdotal evidence includes the author's personal experience representing a syndicate comprised largely of global banks in the WorldCom litigation.

²³⁰ See *supra* note 39 (citing 15 U.S.C. § 77b(a)(11) (2006)).

²³¹ See *supra* note 38 (citing *WorldCom III*, 308 F. Supp. 2d 338, 343 (S.D.N.Y. 2004)).

²³² 15 U.S.C. § 77k(a)(5) (2006).

²³³ 15 U.S.C. § 77k(b)(3) (2006).

write about due diligence for securities offerings use the term “underwriter” to describe the person that performs due diligence—or, in the case of continuous due diligence, to describe the person who fails to perform such due diligence.

This usage of the term “underwriter,” while correct, fails to distinguish between (1) the bank that is legally responsible for performing due diligence; (2) bankers employed by that bank to execute securities offerings, who actually perform the tasks constituting due diligence for a securities offerings; and (3) *other* bankers employed by the same bank, who provide financial services *unrelated* to securities offerings to the firm’s mega-WKSI clients.

What’s more, since “underwriter” is a legal term of art, not Wall Street jargon, it is not helpful in distinguishing between bankers who execute securities offerings and those who do not. In fact, bankers use different terminology. Bankers who execute securities offerings are often known as “capital markets” bankers (and more specifically, “debt” or “equity” capital markets bankers, depending on whether the banker’s specialty is debt or equity offerings).²³⁴

2. Banks that Underwrite Securities for Mega-WKSIs

What sort of banking firms underwrite securities—and, in particular, *lead* the underwriting syndicates²³⁵—for mega-WKSIs? The answer: “global” banks.²³⁶

a. Before “the End of Wall Street”: Bulge-Bracket Investment Banks

Until September 2008, “Wall Street” was largely comprised of “investment banks”—financial firms that that engaged in securities issuance for corporate clients, but did not take deposits from retail

²³⁴ Among debt capital markets bankers, those who focus on issuing investment-grade debt are typically called “fixed income” specialists, while those who focus on issuing sub-investment grade bonds (*i.e.*, “junk bonds”), are typically called “high-yield” specialists. See JERILYN J. CASTILLO & PETER J. MCANIFF, *THE RECRUITING GUIDE TO INVESTMENT BANKING* 5 (2006).

²³⁵ See *supra* note 55 and accompanying text (lead underwriters perform the bulk of due diligence).

²³⁶ See, *e.g.*, BANKING STRATEGY, *supra* note 221, at 22 (explaining that JP Morgan’s customer base consists largely of “multinational corporations in the Fortune 500”). For example, two bulge-bracket firms, Salomon Smith Barney (now owned by Citigroup) and JP Morgan, led the bond offerings at issue in *WorldCom*. Other top firms that participated in the offerings included Bank of America, Lehman Brothers, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs and UBS Warburg. See *In re WorldCom, Inc. Sec. Litig. (WorldCom II)*, 294 F. Supp. 2d 392, 400 (S.D.N.Y. 2003).

customers, as commercial banks do.²³⁷

Lacking retail deposits, these investment banking firms used their own capital—and, in recent years, enormous amounts of leverage²³⁸—to finance their operations. Further, unlike the parent companies for commercial banks, known as “bank holding companies,” which are subject to strict capital regulation by the Federal Reserve Board, the parent companies for these investment banks were subject to looser, voluntary capital regulation by the SEC.²³⁹

The titans of Wall Street—the largest, most prestigious financial firms—are historically known as the “bulge bracket” (or “special bracket”).²⁴⁰ These banks did more than underwrite securities for their mega-WKSI clients: they advised clients concerning potential mergers and acquisitions, offered derivative products, and provided brokerage services.²⁴¹ However, they did not generally focus on extending large

²³⁷ See BARBARA CASU ET AL., INTRODUCTION TO BANKING 68-69, 485 (2006).

²³⁸ See Stephen Labaton, *The Reckoning: Agency's '04 Rule Let Banks Pile up New Debt*, N.Y. TIMES, Oct. 3, 2008, at A1, available at <http://www.nytimes.com/2008/10/03/business/03sec.html?scp=9&sq=investment%20bank%20leverage&st=cse>.

²³⁹ Bank holding companies are subject to the Bank Holding Company Act of 1956, administered by the Federal Reserve Board. See 12 U.S.C. §§ 1841-1850 (2006). (Banks participating in the Treasury Department's “Troubled Asset Relief Program,” see generally Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, are subject to additional oversight. See, e.g., Press Release, U.S. Dep't of Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), available at <http://www.treas.gov/press/releases/tg15.htm>.) By contrast, until September 2008, bulge-bracket investment banks were regulated by the SEC under the *voluntary* “Supervised Investment Bank Holding Companies” and “Consolidated Supervised Entities,” programs. See Jorge E. Viñuales, *The International Regulation of Financial Conglomerates: A Case-Study of Equivalence as an Approach to Financial Integration*, 37 CAL. W. INT'L L.J. 1, 3 (2006); Tzung-bor Wei, *The Equivalence Approach to Securities Regulation*, 27 NW. J. INT'L L. & BUS. 255, 275 (2007). This voluntary regime collapsed into irrelevance in September 2008. See *Chairman Cox Announces End of Consolidated Supervised Entities Program*, Sept. 26, 2008, available at <http://www.sec.gov/news/press/2008/2008-230.htm>.

²⁴⁰ This list is based in part on reputation and in part on the bank's rank in the Thomson League Tables. See, e.g., THOMSON FIN., DEBT CAPITAL MARKETS REVIEW, SECOND QUARTER 2007, available at http://www.thomsonreuters.com/content/PDF/financial/league_tables/de/2007/2Q07_Debt_Capital_Markets.pdf; see also BANKING HANDBOOK, *supra* note 55, at 202 (“league tables” are akin to “sports box scores” that “show the relative ranking of investment banks in all areas of capital raising”); WETFEET INSIDER GUIDE: CAREERS IN INVESTMENT BANKING 20 (2006) [hereinafter WETFEET] (discussing league tables); George J. Papaioannou & Adrian Gauci, *Deregulation and Competition in Underwriting: Review of the Evidence and New Findings*, 5 J. INT'L BUS. & L. 47 (2006).

In addition to the U.S.-based investment banks listed in text, the “bulge bracket” generally was defined to include the securities arms of U.S.-based global banks like JPMorganChase and Citigroup (as successor to Salomon Brothers), as well as the securities arms of foreign global banks like UBS Warburg, Credit Suisse First Boston (as successor to First Boston), ABN AMRO and Deutsche Bank. See *infra* note 245.

²⁴¹ See MARSHALL & ELLIS, *supra* note 55, at 5 fig.1.1, 6 (describing typical investment banking activities to include revenue-generating activities, such as primary market making, secondary market making, trading, corporate restructuring, financial engineering, advisory services, merchant banking, investment management, and consulting, as well as support areas); accord LIAW, *supra* note 204, at 12; see, e.g., BANKING STRATEGY, *supra* note 221, at 37

amounts of credit to businesses.²⁴²

Until recently, the “bulge-bracket” consisted largely of stand-alone investment banks, such as Goldman Sachs, Morgan Stanley, Merrill Lynch, and Lehman Brothers.²⁴³ These investment banks dominated the securities issuance industry²⁴⁴ for much of the past century.²⁴⁵

However, in September 2008, the era of stand-alone bulge-bracket investment banks came to an abrupt end due amidst a major credit crisis.²⁴⁶ Within the space of a week, Lehman Brothers filed for bankruptcy; Merrill Lynch was sold to a bank holding company, Bank of America;²⁴⁷ and Morgan Stanley and Goldman Sachs became bank holding companies, and planned to expand their retail deposit-taking.²⁴⁸ As a result, by October 2008, no stand-alone investment bank remained

(describing Goldman Sachs’ approach to investment banking).

²⁴² See LIAW, *supra* note 204, at 12. Investment banks would sometimes offer clients “bridge” loans as part of larger financing strategies, however.

²⁴³ See LIAW, *supra* note 204, at 18 tbl.2.2.

²⁴⁴ See COFFEE ET AL., *supra* note 1, at 67-68.

²⁴⁵ The list of “bulge-bracket” banks stayed relatively stable for the past half-century or more—and changed little after the advent of shelf registration. See AUERBACH & HAYES, *supra* note 57, at 133, 143; MORRISON & WILHELM, *supra* note 185, at 16, 17-18 tbls.1.4, 1.5 (explaining that the investment banks that appeared in the “top ten” of the “league tables” in the 1960’s either remained in the top ten, or were absorbed by banks that appear in the top ten, as of 2003); cf. LIAW, *supra* note 204, at 12 (listing Goldman Sachs, Morgan Stanley, Merrill Lynch, Citigroup, Credit Suisse, JP Morgan Chase and Bank of America as the “bulge bracket” in 2006); WETFEET, *supra* note 240, at 32 (same); BANKING STRATEGY, *supra* note 221, at 11 (listing top four “bulge-bracket” firms: Merrill Lynch, Goldman Sachs, Morgan Stanley and Salomon Smith Barney); ERNEST BLOCH, *INSIDE INVESTMENT BANKING* 13 (2d. ed. 1988) (listing Dillon, Read; First Boston; Kuhn, Loeb, Merrill Lynch, Morgan Stanley and Salomon Brothers as the “special bracket” firms in 1971; and listing First Boston; Merrill Lynch, Morgan Stanley, Salomon Brothers and Goldman Sachs as the “special bracket” firms in 1978); ECCLES & CRANE, *supra* note 185, at 94 (listing six “special bracket” firms—First Boston, Merrill Lynch, Morgan Stanley, Salomon Brothers, Shearson Lehman Brothers, and Goldman Sachs—as of 1984 to 1986); MARSHALL & ELLIS, *supra* note 55, at 71 n.6 (listing “bulge-bracket” firms in 1991 as: Merrill Lynch, Goldman Sachs, Lehman Brothers, First Boston, Salomon Brothers and Morgan Stanley); PEREZ, *supra* note 185, at 136 (table listing the “bulge” or “special” bracket banks as First Boston, Goldman Sachs, Merrill Lynch, Morgan Stanley and Salomon Brothers); see generally BANKING HANDBOOK, *supra* note 55, at 13-33 (providing a brief history of investment banking in the twentieth century, and the rise of “bulge bracket” firms in particular).

²⁴⁶ See generally Julie Creswell & Ben White, *Wall Street, R.I.P.: The End of an Era, Even at Goldman*, N.Y. TIMES, Sept. 28, 2008, at A2, available at <http://www.nytimes.com/2008/09/28/business/28lloyd.html?scp=3&sq=Vanishing%20Act&st=cse>.

²⁴⁷ Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall St.*, N.Y. TIMES, Sept. 15, 2008, at A1.

²⁴⁸ Andrew Ross Sorkin & Vikas Bajaj, *Radical Shift For Goldman And Morgan*, N.Y. TIMES, Sept. 22, 2008, at A1; see also David Enrich & Damian Paletta, *The Financial Crisis: Walls Come Down, Reviving Fears of a Falling Titan*, WALL ST. J., Sept. 23, 2008, at A6; Fed. Reserve Sys., Order Approving Formation of Bank Holding Companies (Sept. 21, 2008), available at <http://www.federalreserve.gov/newsevents/press/orders/orders20080922a1.pdf>; Fed. Reserve Sys., Order Approving Formation of Bank Holding Companies and Notice to Engage in Certain Nonbanking Activities (Sept. 21, 2008), available at <http://www.federalreserve.gov/newsevents/press/orders/orders20080922a2.pdf>.

in the “bulge-bracket.”²⁴⁹

Yet, the disappearance of the “bulge-bracket” investment bank does not spell the end of *investment banking* services by any means.²⁵⁰ It simply means that the major players in securities underwriting for mega-WKSIs are now all “global” (or “universal”) banks.²⁵¹

b. Global Banks

Ever since the repeal of the Glass-Steagall Act²⁵² in 1999 (and for

²⁴⁹ Compare MORRISON & WILHELM, *supra* note 185, at 297 fig.10.1 (time-line tracing history of bulge-bracket investment banks through 2007), with *Vanishing Act: Wall Street Is Disappearing Through Mergers and Acquisitions—and Recent Failures*, N.Y. TIMES, Sept. 28, 2008, at BU12, available at <http://www.nytimes.com/imagepages/2008/09/28/business/28lloyd.graf01.ready.html> (same chart, updated to reflect the buy-outs and bankruptcies of stand-alone investment banks amidst the credit crisis of September and October 2008).

²⁵⁰ Joshua Brockman, *Death of the Brokerage: The Future of Wall Street*, NPR.ORG, Sept. 22, 2008, <http://www.npr.org/templates/story/story.php?storyId=94894707>. Nor has it meant the end of the stand-alone investment bank; many smaller investment banks, serving smaller clients, remain independent. See Craig Karmin, *Crisis on Wall Street: Investment Banking—Down but Not Out—Boutique Firms, If Not Street Titans, Are Built to Survive*, WALL ST. J., Sept. 23, 2008, at C3. However, the deepening financial crisis has led to a slowdown in new securities issuances. Phil Wahba, *RPT-IPO View-U.S. IPOs Dwindle in Closed Market in 3rd Qtr*, REUTERS, Sept. 28, 2008, available at <http://www.reuters.com/article/newIssuesNews/idUSN2833866720080928>. As such, there can be no certainty that even mega-WKSIs will demand investment banking services in the near future.

²⁵¹ As of this writing it remains an open question whether all of the global banks will remain independent. In January and February 2009, the idea of nationalizing some global banks—particularly Citigroup—was widely debated in the mainstream national press. See, e.g., Associated Press, *Bernanke Again Rejects Bank Takeovers*, N.Y. TIMES, Feb. 26, 2009, at B4, available at <http://www.nytimes.com/2009/02/26/business/economy/26fed.html>; *The Government and the Banks*, N.Y. TIMES, Feb. 22, 2009, at WK9, available at <http://www.nytimes.com/2009/02/22/opinion/22sun1.html>; Paul Krugman, Op-Ed., *Banking on the Brink*, N.Y. TIMES, Feb. 22, 2009, at A27, available at <http://www.nytimes.com/2009/02/23/opinion/23krugman.html>; David Leonhardt, *The Way We Live Now: Banks of America*, N.Y. TIMES MAG., Mar. 1, 2009, at 11, available at <http://www.nytimes.com/2009/03/01/magazine/01wwln-lede-t.html>; David E. Sanger, *U.S. Bank and Trust?*, N.Y. TIMES, Jan. 26, 2009, at A1, available at <http://www.nytimes.com/2009/01/26/business/economy/26banks.html>. But subsequently, in May 2009, when the United States Department of the Treasury announced the results of its “stress test” of the top nineteen U.S. banks, it appeared that on the whole these banks were “in better shape than many had feared.” Louise Story & Eric Dash, *The Great Divide*, N.Y. TIMES, May 8, 2009, at B1, available at <http://www.nytimes.com/2009/05/08/business/08bank.html?sq=&st=Search&%2334;=&%2334;stress%20test=&scp=1&pagewanted=print> [hereinafter *Stress Test*]; see also Edmund L. Andrews, *Banks Told They Need \$75 Billion in Extra Capital*, N.Y. TIMES, May 8, 2009, at A1, available at <http://www.nytimes.com/2009/05/08/business/08stress.html?ref=business> (“The verdict [of the ‘stress test’] was far more upbeat than many in the industry had feared . . . [a]nd the banks that came up short will have to raise much less than some analysts had expected . . .”). However, not all of the global banks fared equally well in the stress tests. Some global banks, like JPMorganChase and Goldman Sachs, were deemed by to be in a far stronger position than others, like Citigroup and Bank of America. See *Stress Test*, *supra*.

²⁵² Glass-Steagall separated “‘commercial banking’ (that is, deposit-taking and loan extension) from ‘investment banking’ (that is . . . corporate securities-related activities).” AUERBACH & HAYES, *supra* note 57, at 34.

some time beforehand),²⁵³ some of the “bulge-bracket” firms have been the securities subsidiaries of “global” or “universal” commercial banks. Global banks are bank holding companies that own both full-service investment banks²⁵⁴ and full-service commercial banks.²⁵⁵ Even before the financial crisis that led to the demise of the remaining stand-alone “bulge bracket” banks, the trend in banking was towards “financial supermarkets”²⁵⁶ with “one-stop shopping”²⁵⁷ for all of the bank’s clients’ financing needs. The financial crisis only exacerbated that trend.²⁵⁸

JPMorganChase, Citigroup, and Bank of America²⁵⁹ are three “financial supermarkets” whose securities subsidiaries fall into the “bulge bracket.” Indeed, these firms—and particularly the JPMorganChase, which purchased Bear, Stearns (a large, formerly-independent investment bank that failed in April 2008),²⁶⁰ and Bank of

²⁵³ Glass-Steagall died a long, drawn-out death. See BANKING HANDBOOK, *supra* note 55, ch. 26 (describing “inroads” by commercial banks into the traditional services of investment banks, such as underwriting, prior to the repeal of the Glass-Steagall Act); LIAW, *supra* note 204, at 13 (describing the exception that permitted subsidiaries of bank holding companies to engage in underwriting, prior to Glass-Steagall’s repeal in 1999); MORRISON & WILHELM, *supra* note 185, at 295-96 (describing the slow erosion of Glass-Steagall); PEREZ, *supra* note 185, at 13 (describing various exceptions to Glass-Steagall which permitted commercial banks to engage in some investment banking activities); BANKING STRATEGY, *supra* note 221, at 12 (same); MARSHALL & ELLIS, *supra* note 55, at 7-9 (detailing the “gradual erosion of the wall between commercial banking and investment banking”); JOHNSON, *supra* note 56, at 1, 4-5, 75-76 (same).

²⁵⁴ See LIAW, *supra* note 204, at 14; MARSHALL & ELLIS, *supra* note 55, at 7 (contrasting “full-service shops” with boutiques). Technically, commercial banks still may not engage in securities underwriting. See LIAW, *supra* note 204, at 12-13. However, bank holding companies may have separate operating subsidiaries which engage in investment banking and in commercial banking. See *id.*; see also *supra* note 253.

²⁵⁵ *Recombining Banking*, *supra* note 113, at 43 (commercial banks have largely added investment banking to their repertoire after the repeal of Glass-Steagall by purchasing securities firms).

²⁵⁶ Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 255 (2002) (“Most ‘global’ banks operate as ‘financial supermarkets’ offering a wide range of ‘commodity-like financial products’ for consumers and a full menu of capital markets services for mid-sized and large businesses.”); see, e.g., BANKING STRATEGY, *supra* note 221, at 37 (describing Chase Bank, a giant commercial bank that merged with JP Morgan to form JPMorganChase in 2000).

²⁵⁷ See BANKING RELATIONSHIPS, *supra* note 186, at 26 (“Investment banking is becoming a global one-stop business. Mergers, acquisitions, equity and bond issues, placing power and special products—all are taken for granted by larger companies.”); LIAW, *supra* note 204, at 13 (explaining that the Gramm-Leach-Bliley Act of 1999, which repealed Glass-Steagall, “has enabled a financial services firm . . . to become a one-stop shop that can supply all of its customer’s needs”).

²⁵⁸ This could change fast, of course—especially if some global banks do not survive the ever-widening global financial crisis. Some commentators believe that the financial crisis has doomed the global bank. See, e.g., Gretchen Morgenson, *The End of Banking as We Know It*, N.Y. TIMES, Jan. 18, 2009, at BU1 (asserting that the “concept of these financial supermarket . . . bit the dust” when Citigroup announced that it was selling some of its troubled operations). Only time will tell.

²⁵⁹ LIAW, *supra* note 204, at 14 (table 2.1).

²⁶⁰ Landon Thomas, Jr., *At Bear, an Apology Is Met with Silence*, N.Y. TIMES, May 30, 2008,

America, which purchased Morgan Stanley—now *dominate* the “bulge bracket.”²⁶¹

3. Many Services Means Many Specialists

Due to the wide range of services provided by universal banks, individual bankers working for these global banks often specialize in providing particular financial services to the bank’s clients. Hence, many of the individual bankers working for what lawyerly commentators call an “underwriter” may in fact focus on providing clients with financial services that are *completely unrelated* to securities underwriting. Commentators writing about due diligence have, to date, completely ignored the different types of bankers working for an “underwriter.”

B. *Specialization Matters: More Contacts Means More Investigation*

This failure of legal scholars and securities lawyers to recognize the existence of specialization among the bankers working for global banks leads such commentators to conflate the actions and motivations of debt capital markets bankers with the actions and motivations of the “underwriter”—the global bank itself. Thus, when commentators say that “underwriters” do not perform, and have no incentive to perform, continuous due diligence, they are referring only to the debt capital markets—yet, they are attributing those bankers’ actions and motivations to the entire bank itself. As a result, these commentators completely ignore the possibility that *other* investment bankers (*e.g.*, bankers specializing in mergers and acquisition) perform, or have an incentive to perform, continuous due diligence on the global bank’s mega-WKSI client.

In particular, when commentators write that “underwriters” have no incentive to perform continuous due diligence on an issuer in between its shelf-registered offerings, due to the rise of “transactional”²⁶² (as opposed to “relationship”)²⁶³ banking and the resulting increased competition for underwriting fees, these commentators mean to say that debt capital markets bankers do not

at C6; Landon Thomas Jr. & Eric Dash, *Seeking Fast Deal, JPMorgan Quintuples Bear Stearns Bid*, N.Y. TIMES, Mar. 25, 2008, at C1.

²⁶¹ *BofA + Merrill = League Table Champion*, NYTIMES.COM, Sept. 15, 2008, <http://dealbook.blogs.nytimes.com/2008/09/15/bofa-merrill-league-table-champion>.

²⁶² See *supra* note 187 and accompanying text.

²⁶³ See *supra* note 186 and accompanying text.

perform such due diligence and have no incentive to do so. Yet, it does not necessarily follow, as a matter of logic, that simply because *underwriting* has become a more competitive or transactional business that *other* investment banking services have *also* become more competitive or transactional. In fact, while debt underwriting (and investment grade debt underwriting in particular) has become more commoditized—and indeed, may be low-margin or loss-leading business²⁶⁴—*other* investment banking services, like advising on mergers and acquisitions, reportedly remain highly-sought after, high-margin services.²⁶⁵

Moreover, regardless of whether global banks' other lines of business are transactional- or relationship-based in nature, it does not necessarily follow that, when debt capital markets bankers are supposedly sitting on their hands between shelf-registered offerings, *other* investment bankers (e.g., M&A specialists) are not investigating the mega-WKSI for *their own* purposes. Other bankers' contacts with a mega-WKSI client (even if their relationships are transactional) are not defined in terms of securities offerings and periods between offerings, but rather, in terms of time when their own deals are on-going or not. Such deals may or may not occur at the same time as securities offerings.

If anything, the "financial supermarket" model suggests that, when a mega-WKSI client is not purchasing one financial service (i.e., securities underwriting) from a global bank, the mega-WKSI client may be purchasing another financial service from that global bank—and bankers specializing in *that* product may be executing a transaction for the mega-WKSI client²⁶⁶ (or, bankers with other specialties may be actively seeking business from the mega-WKSI client).²⁶⁷ Thus,

²⁶⁴ See DAVIS, *supra* note 34, at 22 fig.3.2 (noting that underwriting investment grade debt is seen as a commoditized, loss-leading business); MORRISON & WILHELM, *supra* note 185, at 241-42 (discussing commoditization of bond offerings under shelf registration). *But see* AUERBACH & HAYES, *supra* note 57, at 58 (arguing that those which describe securities offerings as commoditized "ignore the [A]ct's true heritage and throw away the most valuable defense the industry has had over the years to charges of unfair monopolistic practice," referring to *United States v. Morgan*).

²⁶⁵ See BANKING STRATEGY, *supra* note 221, at 29-30; Peter Lorange et al., *Corporate Acquisitions: A Strategic Perspective*, in THE MERGERS & ACQUISITIONS HANDBOOK 24-25 (Milton L. Rock et al. eds., 2d ed. 1994) [*hereinafter* M&A HANDBOOK] (describing mergers & acquisition as a "high-margin" business).

²⁶⁶ Some mega-WKSIs may schedule multiple major financing transactions to occur at one time. *See, e.g., WorldCom*, 346 F. Supp. 2d at 651 (WorldCom, Inc. restructured and renewed of its \$10.25 billion "backstop" credit facility at nearly the same time that it offered \$11.9 billion in bonds in May-June 2001). In this case, information about the issuer collected by bankers who were executing the other transaction would constitute offering-time due diligence rather than continuous due diligence.

²⁶⁷ "Pitching" business can involve an investigation of the client's business and financial circumstances. *See infra* Part II.C.1.

investment bankers of varying specialties may interact with a mega-WKSI client at any given time, regardless of whether or not a securities offering is ongoing.

Hence, that global banks are comprised of bankers who specialize in areas other than securities underwriting means that *some* bankers may well be working with a mega-WKSI client (or potential client), despite that no securities offerings is occurring or on the horizon. In so doing, that investment banker likely needs to understand the client's business for the purposes of her own transaction. As a result, she likely will perform some investigation of the mega-WKSI client by using some of the same techniques that the SEC has urged underwriters to use when performing continuous due diligence.²⁶⁸ Hence, bankers working for an "underwriter" who *do not* execute securities offerings may nonetheless investigate a client, in ways that look like *conventional* continuous due diligence, but at *different times* than and for *different purposes* than a debt capital markets banker might engage in continuous due diligence.²⁶⁹

C. *Under-the-Radar Investigation: Ways That Bankers Investigate a Mega-WKSI That Have Escaped Legal Scholars' Notice*

The existence of bankers of different specialties not only means *more* contacts (and more potential for investigation) employing the *traditional* means of continuous due diligence. It also means *different types* of contacts, and *different types* of investigation. These types of investigation have, to date, been entirely ignored by commentators as a potential source of continuous due diligence.

What follows is a discussion of three client investigation techniques—cross-pitching, modeling, and credit analysis—that have largely remained "under the radar" of legal scholars and securities practitioners writing about continuous due diligence.

1. Cross-Pitching

Since global banks provide services other than underwriting, they generally attempt to expand their relationships with mega-WKSI clients

²⁶⁸ For example, reviewing the client's yearly and quarterly public filings, reviewing reports of analysts who follow the client or the client's industry, reading the client's public information book, and attending the client's investor relations seminars and/or quarterly earnings conference calls.

²⁶⁹ This effect is, in theory, multiplied to the extent that two or more global banks collaborate to lead a financing (and perform due diligence) as co-managers or co-book runners.

by providing more—and different—financial services.²⁷⁰ A bank's successful execution of one transaction for a client may lead to other, different types of business from that client:

Advice to a potential issuer on capital structure and financing strategies can produce . . . additional revenues for the banker and demonstrate its awareness of the state of the art and its ability to devise even further innovation.²⁷¹

Hence, shelf offerings may “feed into and support[] a securities firm's system of interrelated investment banking activities” on behalf of a particular client.²⁷²

One way that global banks deepen their existing client relationships, and develop new relationships, is by meeting with clients to pitch business. These pitches usually involve cross-selling.²⁷³ That is to say, when a client is considering whether to issue securities, rather than send just a single debt capital markets banker to meet with the client, a global bank may send a team of bankers to “pitch” the client on a whole range of additional or alternative financial services.²⁷⁴ For example, the global bank may send bankers specializing in commercial lending, derivatives, mergers & acquisitions, equity capital markets, debt capital markets, and any other financial services that the bank believes will assist the client with its financing needs. One purpose²⁷⁵ of sending in multiple different investment bankers with different specialties is to take a holistic approach and develop the right package of financing alternatives to meet that particular client's financing needs.²⁷⁶

²⁷⁰ Cf. DAVIS, *supra* note 34, at 22-23 (describing “marginally profitable or loss services” such as “plain vanilla lending” employed by “bankers eager to win or retain relationships”); *see, e.g., Recombining Banking*, *supra* note 113, at 45 (“[s]ome large commercial banks appear to be materially underpricing the standby bank lines that they write for corporate customers’ short-term commercial paper operations as an inducement to obtain” investment banking business); *id.* at 44-45 (“Many potential securities issuers now expect any vendor soliciting their investment banking business to provide . . . sweetened lending facilities as a *quid quo pro*.”).

²⁷¹ *See* AUERBACH & HAYES, *supra* note 57, at 132-33; ECCLES & CRANE, *supra* note 185, at 184-85 (stating “[p]roduct specialists are especially important in developing relationships with new customers” because “[t]he only way to break into an account is to offer an . . . appealing deal,” and describing anecdotal evidence of this).

²⁷² AUERBACH & HAYES, *supra* note 57, at 133.

²⁷³ *See* Papaioannou & Gauci, *supra* note 245, at 47 (“[M]oving into the securities business enables banks to operate as a ‘one-stop shop’ and capture additional business from existing or new clients through cross-selling.”); *cf.* DAVIS, *supra* note 34, at 39 (“Now investment bankers have to go for everything . . . must be motivated to cross-sell and optimize the total relationship.” (quoting a Merrill Lynch banker)).

²⁷⁴ *See* NEIL HARRIS, *GETTING INTO THE CITY* 6 (2d ed. 2001) (describing investment banks in London, and noting that investment bankers “do not wait to be approached by firms that want to take over other companies or float or raise funds; instead they often generate ideas themselves and sell them to their clients”).

²⁷⁵ Another purpose, obviously, is to increase the revenue stream from that client.

²⁷⁶ *See* MARSHALL & ELLIS, *supra* note 55, at 63 (explaining that investment bankers generally propose to a potential client a “preliminary financing plan” that “typically involve[s] a

The “pitch book”—typically a spiral-bound, glossy slide-show presentation—is a key tool used to cross-pitch banking business. When bankers meet with clients, the pitch book serves as the focus for the discussion. Among other things, a pitch book typically contains a description of the client, its industry, and its financing needs.²⁷⁷ As a result, according to some investment bankers, preparing a pitch book requires a substantive investigation of the client’s business and financial situation.²⁷⁸

Pitching new business to a client is not the type of activity that lawyers have in mind when they think of “due diligence,” since the SEC said nothing about that activity when it admonished underwriters to perform more “continuous due diligence.” Nonetheless, pitching new business to a mega-WKSI client arguably requires *some* investigation of the client.²⁷⁹

2. Modeling

As part of its assessment of the financial needs of a client, a global bank may build a financial model²⁸⁰ of that client, using data from the financial statements in the client’s latest public filings (or any inside data to which the bankers may be privy). In order to stay current, these models typically are kept on file and updated each quarter.²⁸¹

According to at least some bankers, modeling involves a detailed analysis of the client’s business and financial position.²⁸²

number of financing alternatives, with associated scenarios and the accompanying pros and cons of each”; this plan may include “a wide assortment of financing strategies”).

²⁷⁷ See JOHN ROLFE & PETER TROOB, *MONKEY BUSINESS: SWINGING THROUGH THE WALL STREET JUNGLE* 108-11 (2000).

²⁷⁸ See WET FEET, INC., *THE GOLDMAN SACHS GROUP: THE WET FEET GUIDE* 75 (2006 ed.) (observing that junior bankers “learn a lot about a company and an industry” when preparing a pitch book). Whether pitch books typically reflect a serious investigation of the issuer or merely a recitation of basic facts easily discovered in its public filings is an empirical question that warrants further study. See *infra* note 327 and accompanying text.

²⁷⁹ In the author’s personal experience, however, the section of a pitch book describing the client’s business often contains a detailed analysis of the client, its position in the industry and its financial situation.

²⁸⁰ A financial model is a “financial representation of some, or all, aspects of the firm,” generally on a spreadsheet. Investopedia, *Financial Modeling*, <http://www.investopedia.com/terms/f/financialmodeling.asp> (last visited Feb. 3, 2009).

²⁸¹ See CASTILLO & MCANIFF, *supra* note 234, at 9.

²⁸² See JOHN A. KNEE, *THE ACCIDENTAL INVESTMENT BANKER* 27 (2006) (describing research and analysis performed by investment bankers on clients, including “sophisticated software applications. . . . to analyze potential mergers and leverage buyouts” and the “seamless[] integrat[ion of] key third-party information . . . with proprietary internal . . . information”); see, e.g., Anna Mednikova, *Investment Banking: An Inside Story*, *THE BIZZ* (O-Week, 2004), available at <http://thebizz.uchicago.edu/> (last visited Nov. 2, 2008) (personal account of a junior investment banker, who reports that modeling requires “knowledge of the company’s operations, accounting [and] corporate finance”; “and that a good model allows [the investment banker] to

3. Credit Analysis

In an attempt to do more business with a client, global banks also may provide traditional lending services (*e.g.*, backstop credit facilities)²⁸³ to the client.²⁸⁴ Before doing so the bank generally must perform an analysis of the client's creditworthiness. Such an analysis involves investigation of the issuer's business and financial position.²⁸⁵ Further, if the commercial banking function has been folded into the investment banking hierarchy,²⁸⁶ the credit analysis information conceivably may be available to investment bankers.

Of these three types of investigation, the credit analysis seems most fertile for due diligence. Since the bank's own money is on the line when it is lending, the product specialist performing a credit analysis has an incentive to perform at least as thorough an investigation as an investor purchasing the issuer's securities would demand from an underwriter.

D. *Coordinating the Investigation: the "Client Relationship Team"*

Of course, the observation that bankers of varying specialties investigate a bank's mega-WKSI clientele (or potential clientele) does not, without more, establish that such investigation constitutes

test [her] assumptions and analyze their impact on the company").

²⁸³ Backstop credit facilities are a type of revolving line of credit. See Investopedia, Credit Facility, <http://www.investopedia.com/terms/c/creditfacility.asp> (last visited Feb. 3, 2009). Issuers typically must have such a credit facility in order to qualify as investment grade issuers of commercial paper. See BANKING HANDBOOK, *supra* note 55, at 261.

²⁸⁴ Traditional lending business is not necessarily profitable for global banks. However, banks nonetheless pursue such business because it serves as a "loss leader" to help establish or deepen the bank's relationship with a client—and lead to provision of more profitable services. See Matthew J. Restrepo, *The Convergence of Commercial and Investment Banking Under the Gramm-Leach-Bliley Act: Revisiting Old Risks and Facing New Problems*, 11 L. & BUS. REV. AM. 269, 287 (2005) (asserting that "many believe" that Citibank's securities affiliate, Salomon Smith Barney, became an industry leader in underwriting revenues because Citi "promises firms barely profitable loans . . . if the firm allows it to provide underwriting services"; and that JP Morgan Chase also seeks to use lending "to further develop its investment banking activities").

²⁸⁵ See JACOB, *supra* note 54, at 54 (comparing credit analysis and underwriters due diligence, and asserting that the matters reviewed are "similar," with lending investigation focusing specifically "on identifying potential credit 'black holes,' confirming matters stated in the information memorandum and confirming that known liabilities . . . [are] reflected in the business model"); see, *e.g.*, HARRIS, *supra* note 274, at 10 (interview with banker who developed bank's internal credit ratings for firms seeking loans) ("I analyse their accounts, investigate their levels of debt and business strategies for the future . . . [and] talk[] to managers in the firms to discuss their plans.").

²⁸⁶ See CASTILLO & MCANIFF, *supra* note 234, at 4 n.6 fig.I.I (illustrating that some 'universal banks' fold their corporate/commercial banking function into the investment banking group).

“continuous due diligence.” Absent a mechanism for *coordinating* this investigation and *funneling* information from various specialists who do not participate in due diligence for securities offerings to the specialists who do participate in such offerings, arguably none of the specialists’ investigation is “due diligence.” Without such a mechanism, it simply does not matter, for continuous due diligence purposes, whether one banker or many investigate the client.

But there *is* such a mechanism within many global banks—and it has been completely overlooked by lawyers writing about continuous due diligence. Today, many global banks’ provision of financial services to important clients like mega-WKSIs is handled by a “client relationship team” that both coordinates the pitching of business to new and existing clients²⁸⁷ and funnels information²⁸⁸ about the clients back to the team leader.

The investment banking arms of most (but not all)²⁸⁹ global banks are organized, to some degree, into client relationship teams.²⁹⁰ These teams focus on providing a range of financial services to meet the varied needs of their mega-WKSI clients.²⁹¹ Although each bank’s client relationship team is structured somewhat differently,²⁹² some

²⁸⁷ See *infra* notes 294-301 and accompanying text.

²⁸⁸ See *infra* note 304 and accompanying text.

²⁸⁹ Not all global banks employ the client relationship team model. See ECCLES & CRANE, *supra* note 185, at 135-36 (describing five other structures, in addition to “customer-focused units” (*i.e.*, a client relationship team) among the banks studied by the authors).

²⁹⁰ See LIAW, *supra* note 204, at 40 (describing “team” focus at many full-service investment banks, and Goldman Sachs in particular); see also ECCLES & CRANE, *supra* note 185, at 179 (“A recent survey found that 85 percent of [issuers] reported that . . . one person from [its] lead investment bank . . . normally coordinated all contacts” with the bank (citing Michelle L. Collins and Michael F. Goss, *The Impact of Relationships on the Investment Banking Industry: Exhibit and Tables 2* (May 5, 1986) (unpublished manuscript))).

²⁹¹ See *infra* notes 294-301 and accompanying text.

²⁹² See ECCLES & CRANE, *supra* note 185, at 179-80 (concluding, after studying various full service investment banks, that none structured client relationship teams in exactly the same way); MARSHALL & ELLIS, *supra* note 55, at 27 (there is no “typical” investment banking organization). Some banks separate relationship management and product specialization into different departments without any explicit team concept. See CASTILLO & MCANIFF, *supra* note 234, at 4-6 & fig.I (describing a typical structure of an investment bank as including “relationship bankers” and “product specialists”—yet, separating out “product groups” and “coverage groups”); KNEE, *supra* note 282, at 82 (describing “most banks” as having a “corporate finance” department in charge of “managing client relationships” and executing certain types of transactions, which then calls upon various other departments that focused on specific products, such as debt capital markets). Other banks do not involve relationship managers in transactions at all. See BANKING RELATIONSHIPS, *supra* note 186, at 34 (describing organizational structures at major investment banks that resemble the client-relationship team, except that relationship managers sometimes participate in “key transactions”); ECCLES & CRANE, *supra* note 185, at 179 (explaining that, while “all of the largest firms distinguished between relationship managers and product specialists, many of the so-called relationship managers had product responsibilities on at least some accounts . . .”); *id.* at 191-98 (describing four client relationship team models in which relationship managers exert varying levels of control over client interaction and have varying levels of product responsibility).

generalizations are possible.

First, client relationship teams in most major investment banking subsidiaries²⁹³ generally are composed of two types of bankers: (1) “product specialists” (e.g., debt capital markets bankers), who focus on executing transactions involving particular financial products; and (2) “relationship managers” (a.k.a. “client bankers” or “relationship bankers” or “coverage bankers”), who coordinate the firm’s interactions with a particular client.²⁹⁴ The relationship manager manages all aspects of the client relationship, and rarely specializes in execution or selling a particular product.²⁹⁵ The product specialists, by contrast, focus narrowly on developing expertise on a particular financial product (underwriting securities, advising on mergers & acquisitions, selling derivative products, etc.).²⁹⁶

Second, for each client team, there are typically many specialists and one (or perhaps two²⁹⁷) relationship manager(s).²⁹⁸ The relationship

Yet, these different structures may be distinctions without difference: In each system, one banker specializes mainly in clients and one specializes mainly in products—and a client banker pulls the strings. Alternatively, what appears to be different systems at different banks may simply be a function of different commentators characterizing similar structures in different ways. Compare KNEE, *supra* note 282, at 82, 84 (describing Goldman’s form as “fundamentally different” from most investment banks in separating relationship managers from products specialists), and ECCLES & CRANE, *supra* note 185, at 179-80 (explaining that many banks had explicitly rejected Goldman’s model of not having relationship managers participate in transactions) *with id.* at 187-90 (the Goldman model is the basis for the “hub-and-spoke” model of relationship managers and product specialists emulated by other investment banks).

²⁹³ See BANKING RELATIONSHIPS, *supra* note 186, at 33 (noting that relationship managers exist “[i]n the largest banks”); ECCLES & CRANE, *supra* note 185, at 51 (observing that relationship managers are “[e]specially common in large firms”).

²⁹⁴ See BANKING RELATIONSHIPS, *supra* note 186, at 33 (noting that “relationship managers . . . look after . . . clients and potential clients . . . [and] are responsible for co-ordinating the whole of the bank’s resources to service the needs of the client.”); *id.* at 69 (distinguishing between “relationship banker[s],” who focus[] on clients, and “product bankers,” who focus on selling products); CASTILLO & MCANIFF, *supra* note 234, at 6 (observing that coverage bankers do not “focus[] on a particular product,” but instead “focus on building relationships with clients”; meanwhile, “product bankers” “specialize in either advisory work or capital markets work”).

²⁹⁵ See CASTILLO & MCANIFF, *supra* note 234, at 4 (explaining that coverage bankers do not “focus[] on a particular product,” but instead “focus on building relationships with clients”; meanwhile, “product bankers” “specialize in advisory work or capital markets work”); *but see* ECCLES & CRANE, *supra* note 185, at 191-94 (describing various roles for relationship managers, including some that have product responsibilities).

²⁹⁶ DANIEL H. BAYLEY ET AL., INSIDE THE MINDS: LEADING INVESTMENT BANKERS—THE ART & SCIENCE OF INVESTMENT BANKING 46 (2002) (“Product specialists have a narrow, highly specialized area of financial expertise and a tremendous amount of experience executing deals. . .”).

²⁹⁷ See DAVIS, *supra* note 34, at 65-66. Many global banks, like Citigroup, use a “dual coverage” model in which “a commercial banker . . . and an investment banker . . . co-lead each client relationship,” or have separate client relationship teams for investment banking and commercial banking. *Id.*

²⁹⁸ See DAVIS, *supra* note 34, at 62 (observing that clients “demand a single relationship manager”); *see, e.g., id.* at 65-66 (noting that JP Morgan has a single, integrated client relationship coverage model for the entire global bank). *But see* BANKING STRATEGY, *supra* note

manager serves as the team leader.²⁹⁹ She develops “a deep understanding of the client’s strategy”³⁰⁰ and brings in the product specialists as necessary.³⁰¹ As such, the “client relationship team” generally is a hub-and-spoke structure, with the relationship manager at the hub and the product specialists on the rim.³⁰² Ideally, the team works as a “cohesive unit” to gather information about and provide

221, at 49 (describing the “most appealing model” as one which employs “one client manager who is responsible for the entire customer relationship, calling on geographic or product expertise as needed”—and describing such a strategy, in its purest form, as “not only almost impossible to accomplish but also expensive”).

²⁹⁹ See BANKING RELATIONSHIPS, *supra* note 186, at 91; DAVIS, *supra* note 34, at 62 (describing the relationship manager as a “team leader”) (quoting investment banker from Morgan Stanley); *id.* at 64 (describing the “account manager” as “CEO of this firm for his client” who “run[s] the team”) (quoting investment banker from JP Morgan); see also *id.* (describing similar structures at Societe Generale and Deutsche Bank).

³⁰⁰ DAVIS, *supra* note 34, at 62; accord BAYLEY ET AL., *supra* note 296, at 46–47 (quoting a senior investment banker: “Relationship bankers have a deep and involved understanding of their clients and broad knowledge of the financial products that are available.”); HARRIS, *supra* note 274, at 6 (describing investment banks in London, and noting that “a relationship manager’s job is “gaining an understanding of the clients’ business needs and seeking opportunities where the bank can add value” by “analysing the [clients] financial situations . . . , gaining an understanding of their strengths and weaknesses and looking for ways in which their business could be improved”).

³⁰¹ See BAYLEY ET AL., *supra* note 296, at 46–47 (quoting a senior investment banker: “Relationship bankers . . . ensur[e] that the client receives the attention they need from the appropriate specialists”); DAVIS, *supra* note 34, at 39 (“The successful relationship manager . . . tries to get all the specialists lined up for the client”); *id.* at 62 (the relationship manager’s role is “to build a close relationship with the client . . . to identify marketing opportunities, and to bring to bear the . . . resources of his firm to exploit these opportunities.”); ECCLES & CRANE, *supra* note 185, at 136 (relationship managers are commonly “responsible for coordinating the activities of the specialists”); *id.* at 179 (“Relationship managers are responsible for integrating the efforts of all specialists within the firm who share a common customer.”); HARRIS, *supra* note 274, at 6 (describing investment banks in London, and noting “[r]elationship managers . . . put clients in touch with the person in the bank who can best meet their needs, whether it be . . . a proposed acquisition, a loan or an investment”); see, e.g., Anthony Currie, *The World’s Best Credit Bond House: Citigroup/Salomon Smith Barney*, EUROMONEY, July 2001, at 61 (quoting Citigroup’s then-head of US investment grade debt: “We have relationship managers who know all the products we can offer They bring in the product specialists as needed.”); Yvette Kantrow, *The New Relationships*, INV. DEALERS’ DIG., Apr. 1, 1996, at 14 (noting that the job of the “top relationship banker . . . [is] that of a gatekeeper, making sure . . . the right product specialists are in there pitching the right products at the right time” and as “a traffic cop for understanding what is being brought and shown to clients”).

³⁰² See, e.g., DAVIS, *supra* note 34, at 62; *id.* at 66 (chart, “Figure 5.3 JP Morgan integrated client relationship model” showing a circle of concentric rings with the “client” (*i.e.*, client banker) at the center, and product specialties (*e.g.*, “equity,” “M&M,” “debt”) in the next ring); accord BAYLEY ET AL., *supra* note 296, at 47 (quoting a senior investment banker: “An effective way [to] . . . best serve the clients is through a ‘hub-and-spokes’ model The spokes represent the product specialists . . . which are . . . all called upon when appropriate. The relationship banker is the point-person for the client . . . coordinating all the activity”); but cf. DAVIS, *supra* note 34, at 63 (flow chart, “Figure 5.1 Structure of a full-service securities firm,” showing “client coverage” (*i.e.*, relationship manager) on top of a number of product specialties (*e.g.*, “[r]eal estate financial,” “[n]ew securities issues,” “M&A”) within the bank’s “[g]lobal corporate finance” structure—but showing a separate organizational structure entitled “global capital markets” for trading and the like).

services to the client.³⁰³

Third, as the head of the client relationship team, the relationship manager plays two important roles: (1) a repository of information about the client developed through interaction and analysis of the client by various product specialists;³⁰⁴ and (2) the team's point of contact with both the client and firm management.³⁰⁵ In that role, the relationship manager decides whether or not to commit the firm's resources to an undertaking on behalf of the client.³⁰⁶

As a result, when an underwriter offers a mega-WKSI's securities to the public, the relationship manager presumably oversees the offering³⁰⁷ and takes the lead on due diligence.³⁰⁸ Since the relationship manager is both the repository of information about the client from bankers of all specialties, and also heads up due diligence, any information provided to the underwriter from the client relationship team is therefore "due diligence."³⁰⁹

Fourth, most global banks have a formal "commitment committee," consisting of the client's relationship manager and the heads of various investment banking departments, that approves

³⁰³ BAYLEY ET AL., *supra* note 296, at 46; ECCLES & CRANE, *supra* note 185, at 180-81 (stressing "the importance of sharing information among specialists" to best serve the client's—and the bank's—interests).

³⁰⁴ BANKING RELATIONSHIPS, *supra* note 186, at 91 (observing that a "good relationship banker is . . . the repository of knowledge" about the client); *see also supra* note 300; *cf.* ECCLES & CRANE, *supra* note 185, at 180-81 (stressing "the importance of sharing information among specialists" to best serve the clients'—and the bank's—interests).

³⁰⁵ *See* HARRIS, *supra* note 274, at 6 (describing investment banks in London) (relationship managers are the "contact point" for each client and the "first port of call when a company wants a banking service"); BAYLEY ET AL., *supra* note 296, at 47 (quoting a senior investment banker) (relationship banker is "the central point of contact" for the client and "a bridge between the client and the investment bank"); *cf.* ECCLES & CRANE, *supra* note 185, at 184 (an investment bank's CEO "exercises control over the firm . . . through relationship managers"); *id.* at 51 (relationship bankers take "a firmwide perspective," balancing resource allocation and the needs of specific clients).

³⁰⁶ *See* ECCLES & CRANE, *supra* note 185, at 50-51 ("Relationship managers are responsible for how the resources at their disposal . . . are used in relation to the customers to which they have been assigned.").

³⁰⁷ *See* ECCLES & CRANE, *supra* note 185, at 180-81 (in most large banks, relationship managers oversee transactions); *but see id.* at 180-81, 189-90 (relationship managers at Goldman Sachs do not do so).

³⁰⁸ There is anecdotal evidence to support this conclusion (*e.g.*, the author's personal experience representing a syndicate comprised largely of global banks in the WorldCom litigation).

³⁰⁹ This includes any information that the relationship manager obtains by reading research reports prepared by research analysts who covers the client/issuer. Thus, although research analysts employed by the investment bank can no longer actively participate in due diligence due to the wall of separation between investment banking and research imposed by the global settlement, *see* U.S. Sec. & Exch. Comm'n, SEC Fact Sheet on Global Analyst Research Settlements, <http://www.sec.gov/news/speech/factsheet.htm> (last visited Feb. 3, 2009), input from research analysis (albeit indirect) remains an important component of the client relationship team's continuous due diligence investigation.

securities issuance business.³¹⁰ As part of this process, in the author's experience, the commitment committee generally prepares a memorandum reflecting some portion of the bank's institutional knowledge about the potential issuer. The committee generally meets to evaluate the merits of the proposed offering, including any potential red flags for due diligence. This commitment committee process is, similarly, "due diligence" by another name.

E. *Skepticism About the Client Relationship Team, and Some Responses*

In the client relationship team model described above, specialists investigate the client and funnel information to the relationship manager, who coordinates the investigation and takes the lead in due diligence for securities offerings. This, of course, is the ideal form. One might well be skeptical that client relationship teams *actually* operate this way in practice. This section asks—and attempts to answer, at least initially—several questions about the function of client relationship teams at the global banks that underwrite securities for mega-WKSIs.

The existence of the client relationship team model raises a number of empirical questions about the efficacy of its investigation, including: Do product specialists *actually* investigate clients (and potential clients)—despite the supposed rise of "transactional" banking and the "death" of "relationship" banking? Do clients share information with product specialists—and do *they* share information with relationship managers? Are product specialists' client investigations *substantive* or *superficial*? Are the investigations performed by product specialists who *do not* engage in securities underwriting sufficiently similar in focus to continuous due diligence as traditionally understood, so that they can properly be viewed as continuous due diligence? Can continuous due diligence by the client relationship team largely replace offering-specific due diligence, despite that there is no registration statement to investigate (and thus, no specific statements to verify)? Finally, what about global banks that do not employ the client relationship model? If one or more of these questions are answered in the negative, then the client relationship team may not result in much additional continuous due diligence, after all.

An exhaustive treatment of all these topics is beyond the scope of this article. Yet, the available anecdotal evidence suggests an initial,

³¹⁰ See, e.g., THE INSIDER'S GUIDE TO THE TOP 20 CAREERS IN BUSINESS AND MANAGEMENT 143 (Tom Fischgrund ed., 1994); ANDY KESSLER, WALL STREET MEAT 115 (2004).

affirmative answer to each question.

1. What About the “Death” of Relationship Banking?

The first reason to doubt the client relationship team’s continuous due diligence is the supposed demise of relationship banking.³¹¹ If relationships are dead, and there is little chance of repeat business with a mega-WKSI client, then why bother investigate the client?

Yet, it seems that the supposed “death” of relationship banking—and the purported ascendance of transactional banking—has been greatly exaggerated.³¹² Although the “relationship banking” model may no longer completely describe a banking industry changed by mergermania and competition,³¹³ banks in the highest tier nonetheless attempt to cultivate close client relationships with important clients. Today, most investment banking relationships “fall between the two extremes” of transactional and relationship banking.³¹⁴ And, to the extent such

³¹¹ See *supra* notes 185-187 and accompanying text.

³¹² See BANKING RELATIONSHIPS, *supra* note 186, at 17 (explaining that “the high point of transactional banking” in the United States occurred in the late 1980s, but the “most extreme forms of transaction banking” ended by 1990-91 recession); ECCLES & CRANE, *supra* note 185, at 55 (concluding that relationships nonetheless remain important in investment banking); Dwight B. Crane & Robert G. Eccles, *Customer Relationships in the 1990s*, in FINANCIAL SERVICES: PERSPECTIVES & CHALLENGES 131-32 (Samuel L. Hayes, III ed., 1993) (re-examining relationships after the end of the 1980s bull market and concluding, after conducting follow-up interviews, that “the pendulum is swinging away from a transaction orientation . . . to a greater relationship orientation”); MARSHALL & ELLIS, *supra* note 55, at 61 n.3 (noting that, while the “ability of investment banks to exploit client relationships has declined considerably,” nonetheless, “the importance of client relationships should not be underestimated”); M&A HANDBOOK, *supra* note 265, at 24 (“Despite the historic trend towards ‘transaction’ banking, primary emphasis on financial advisory relationships is reemerging.”).

³¹³ See Bharat N. Anand & Alexander Galetovic, *Relationships, Competition, and the Structure of Investment Banking Markets*, 54 J. INDUS. ECON. 151, 159 (2006) (“Until about 25 years ago, the rule . . . was that a corporation would establish a relationship with only one investment bank.”).

³¹⁴ BANKING RELATIONSHIPS, *supra* note 186, at 17 (observing how companies now attempt to develop a “core” group of banks “with which confidential information [can] be shared”); M&A HANDBOOK, *supra* note 265, at 24 (“[W]ith regard to sensitive issues, clients generally look to a few advisors . . . with whom they feel comfortable about sharing information.”); see also BANKING HANDBOOK, *supra* note 55, at 56-57 (concluding, based on survey data, that “[d]espite the use of multiple firms . . . established relationships are still given considerable importance. [Firms’] overwhelming policy preference is to conduct most of their business with their traditional investment banks”); BANKING RELATIONSHIPS, *supra* note 186, at 54 (describing a company’s normal “set of banking relationships”); ECCLES & CRANE, *supra* note 185, at 74-79 (describing the “dominant bank” and “core group” models); Wayne E. Baker, *Market Networks & Corporate Behavior*, 96 AM. J. SOC. 589, 595, 606 (1990) (concluding that, as of 1990, most investment banks have “hybrid interfaces” with clients, characterized by a blend of a “relationship orientation” and a “transactional orientation”); Crane & Eccles, *supra* note 312, at 131-32 (noting that “the promiscuity of the 1980s is being replaced . . . with a controlled form of polygamy,” in that “[m]ost of an issuer’s domestic business is done with a small group, perhaps two to five” investment banks—a “core group”); but cf., e.g., JOHNSON, *supra* note 56,

banks fear their practice is too transactional, their preferred solution is to build relationships.³¹⁵

Thus, while clients and bankers alike mourn the loss of long-term relationships,³¹⁶ relationships nonetheless remain important in investment banking.³¹⁷ And, while investment banking may be more transactional and less “relationship” oriented than in the distant past, banks that underwrite securities today clearly do not eschew relationships altogether. Indeed, banks may react to the increasingly transactional nature of securities issuance by attempting to build new (or re-build old) relationships.³¹⁸ This may be particularly true for bulge-bracket banks.³¹⁹ Further, according to some commentators, often the best way to build client relationships is to better understand the client.³²⁰ Whether this will remain true in the future is, of course, an

at 10 (describing J.P. Morgan as poised, in 1996, to become a “global investment bank” due in part to its focus on “relationship banking”).

³¹⁵ See ECCLES & CRANE, *supra* note 185, at 55 (bankers’ “strategy [] for coping with” the perceived change in clients to prefer so-called ‘transactional’ banking “was to build relationships”); see also BANKING RELATIONSHIPS, *supra* note 186, at 56 (urging that firms are best served by a small number of relationship banks).

³¹⁶ See, e.g., ECCLES & CRANE, *supra* note 185, at 55; *Foreword* to MARSHALL & ELLIS, *supra* note 55, at vii (a senior Bear, Stearns & Co. banker, surveying 26-year career and opining that “[c]lient relationships, while still important, are now less so as the [investment banking] business has become more transaction driven”).

³¹⁷ See BANKING HANDBOOK, *supra* note 56, at 59-60 (describing survey in which CFOs expressed that the most important factor in choosing an investment banker is “understand[ing] the company”); MARSHALL & ELLIS, *supra* note 55, at 61 n.3 (noting that, while the “ability of investment banks to exploit client relationships has declined considerably,” nonetheless, “the importance of client relationships should not be underestimated”); Anand & Galetovic, *supra* note 313, at 159 (“While relationships have varied in strength over time, they still remain important today.” (internal footnotes omitted)).

³¹⁸ See AUERBACH & HAYES, *supra* note 57, at 131-32 (“[W]hen a traditional investment banking client is involved, underwriters would be motivated to bid on shelf securities even in the face of difficult market conditions. . . . If a valued client . . . files [a shelf registration], its traditional investment bankers would be loath to risk their future banking relationship by adopting a . . . time-consuming investigative stance on the offering. They would . . . likely feel compelled to bid aggressively [for the business] . . . whether or not the [terms were] attractive. The prospect of another investment banker[] . . . establishing . . . a relationship with the client is usually unpalatable.”); cf. MORRISON & WILHELM, *supra* note 185, at 78 n.10, 80 (describing how investment banks participate in deals as low-level “co-managers” in order to gain a foothold with the issuer, show off their abilities—and possibly lead later offerings).

³¹⁹ See generally Vincent A. Warther & Vikram Nanda, *The Price of Loyalty: An Empirical Analysis of Underwriting Relationships and Fees* (Mar. 8, 1998), available at <http://ssrn.com/abstract=107468> (studying client loyalty to investment banks for the period 1970-1996, and finding a decrease in loyalty over the sample period—but with the larger and more prestigious investment banks tending to have more loyal clients).

³²⁰ Cf. BANKING HANDBOOK, *supra* note 56, at 59-60 (describing a survey in which CFOs expressed that the most important factor in choosing an investment banker is “understand[ing] the company”); see also *infra* note 327. Thus, to the extent that securities issuances are not profitable, banks may use them as loss-leaders to build the relationships necessary for other—more lucrative—types of business. See AUERBACH & HAYES, *supra* note 57, at 133. Indeed, in the dominant bank/lesser bank model, lesser banks work *harder to develop* their relationships with the client—and thereby, learn more about the client—than the dominant bank works to *keep*

open question.³²¹

2. Does the Client Share Information with the Team—and Does the Team Pass Information Along to the Relationship Manager?

Anecdotal evidence suggests that banks with an existing relationship with a client seem to have “comparative[ly] advantage[ous]” access to company information.³²² That is to say, issuers appear to provide their core group of banks with important, inside information for purposes of obtaining advice.³²³ And at least in some banks, information about clients appears to be widely shared among various team members.³²⁴ Hence, at first glance, it appears that at least some client relationship teams have the potential to gather information as advertised—i.e., from client to product specialist to relationship manager.

3. Is the Team’s Investigation Substantive or Superficial?

Another reason to doubt the continuous due diligence of the client relationship team model is the possibility that, in practice, product specialists’ investigations of their clients (be it through pitching, modeling, performing credit analyses, etc.) are just too slapdash or too focused on narrow financial products to pass for continuous due diligence. If product specialists’ own investigations of their clients barely scratch the surface or are focused on information that is irrelevant to underwriters, then such investigations cannot be deemed continuous due diligence.

Certainly, there is anecdotal evidence to suggest that product

the relationship. *See, e.g.*, ECCLES & CRANE, *supra* note 185, at 67 (citing an example where a bank’s persistence and careful study of a potential client eventually won it the business).

³²¹ One also might wonder whether banks seek to provide their issuer clients with non-underwriting services *regularly* enough (*i.e.*, does continuous investigation by product specialists occur with sufficient volume and frequency?) to be useful in due diligence. In the author’s personal experience, at least one mega-WKSI in the late 1990’s—WorldCom—had a voracious appetite for investment banking services and was frequently studied by numerous product specialists looking to do any number of financial transactions. Whether WorldCom was a typical mega-WKSI’s consumer of investment banking services at the time, and whether, in the changed financial climate of 2008-09, mega-WKSIs will continue to behave as WorldCom did, are questions for further study.

³²² BANKING RELATIONSHIPS, *supra* note 186, at 55.

³²³ *See id.* at 56.

³²⁴ *See, e.g.*, BANKING STRATEGY, *supra* note 221, at 52 (describing Goldman Sachs’s success as being largely premised largely on information sharing among team members); KNEE, *supra* note 282, at 27 (describing a “culture of communication” at Goldman Sachs that “allowed [one] to quickly collect whatever institutional knowledge already existed about . . . company”).

specialists do a great deal of “selling” but little “investigating.” For example, some former investment bankers have intimated that pitch books contain little substantive information.³²⁵ Also, some commentators have noted that bankers sometimes seem focused on pushing particular products on all of their clients, rather than studying a particular client to determine its individual needs.³²⁶

However, other commentators see things differently. They urge that the best way to “pitch” the client is to know the client’s business inside and out. According to these authors, clients view “the single most important factor in determining the effectiveness of an investment banker’s presentation was [her] understanding of the company and its industry.”³²⁷ Thus, anecdotal evidence supports both views of pitching.

In any event, even if pitching is largely “selling,” the other two types of client analysis described above—modeling and credit analyses—would seem to involve *no* selling at all. Indeed, credit analyses, which a bank performs when providing a line of credit—that is, when its own funds are at stake—are *directly* akin to a prudent person” watching *her own* money.

Hence, even if the jury remains out on “pitching,” all indications are that modeling and credit analysis involve a serious investigation of the client.

4. Are Other Bankers’ Investigations Too Dissimilar to Due Diligence?

Obviously, product specialists who *do not* focus on underwriting (e.g., bankers who focus on M&A or extending credit) investigate their clients for *different* reasons than an underwriter investigates a client in due diligence. For example, an M&A banker will study its client and its client’s competitors to ascertain the best merger partners for the client—*not* to ascertain whether or not the client’s public filings are truthful. Yet, in reviewing the company’s information, undoubtedly the M&A

³²⁵ See generally KNEE, *supra* note 282; ROLFE & TROOB, *supra* note 277.

³²⁶ See ECCLES & CRANE, *supra* note 185, at 56 (observing how some bankers have a “Deal of the Week” mentality).

³²⁷ BANKING RELATIONSHIPS, *supra* note 186, at 88 (explaining that the best marketing strategy involves “a very deep understanding of a corporate client” and “involves far more than simply reading financial statements and reports about the industry” and urging that only a bank that “fully understands the company’s basic financial position and risks” can help it develop appropriate funding strategies); ECCLES & CRANE, *supra* note 185, at 56. Further, while some have argued that banks only “follow[] companies they are ‘courting’” and therefore cannot possibly “develop a ‘reservoir of knowledge’ for all companies whose securities it might underwrite at sometime in the future,” Nicholas, *supra* note 42, at 30-31, the simple solution is that banks ought to underwrite securities only for companies they follow, or else risk liability for inadequate continuous due diligence.

banker must thoroughly understand the client's financial position—and must understand any weaknesses in the client's business or financials. Surely the client's business and financial position is of vital importance to the merger's success (and may come up in merger due diligence)—and surely, any weaknesses in the client's financial position may inform the M&A banker's approach to finding a match for the client.³²⁸

Accordingly, it makes sense to believe that a thorough understanding of the company and its business—which is, traditionally, at the heart of the underwriter's due diligence inquiry³²⁹—is crucial for any *other* banker trying to sell services to the client.

5. Can Continuous Due Diligence Largely Replace Offering-Time Due Diligence?

Another argument against the client relationship team's investigation being due diligence is that, in order for the team's investigation to obviate the due diligence dilemma, continuous due diligence by the team would have to *almost entirely replace* traditional due diligence. And, it could be argued that continuous due diligence—which is less adversarial in nature than traditional due diligence (i.e., much more like doing homework on the issuer than playing devil's advocate to the issuer)—is simply not an adequate substitute for the real thing.³³⁰

This is a strong argument. However, this argument is not really a complaint about the nature of the client relationship team's due diligence, but rather, a complaint about shelf (and automatic) registration in general. After all, in adopting shelf registration and integrated disclosure, the SEC anticipated that continuous due diligence would become paramount and offering-time due diligence would decline in importance. This argument against continuous due diligence was made—and was implicitly rejected by the SEC—when shelf

³²⁸ The same can be said for a banker performing a credit analysis of the client: while the focus of the credit banker's inquiry may be whether the client will default on a loan, rather than the truthfulness of the client's public reports, certainly the client's business and financials are nonetheless central to the credit analysis inquiry.

³²⁹ See *supra* notes 60 to 61 and accompanying text.

³³⁰ See Langevoort, *supra* note 72, at 66 (arguing that anticipatory diligence is “quite different from due diligence as conventionally understood, which involves a form of devil's advocacy”). Continuous due diligence is, by its very nature, less adversarial than traditional due diligence. In traditional due diligence, the underwriter and issuer draft a disclosure document for which both parties are strictly liable in the event of a material misstatement—and as such, both parties have maximum incentive to test the accuracy of the assertions in that document. This same incentive is not present, for example, when the investment banker advises a client concerning a potential merger.

registration was adopted.³³¹ The SEC would seem hard-pressed to change its position now, absent reason to conclude that it was wrong about the efficacy of continuous due diligence in the first place.³³²

What's more, with the rise of shelf registration, the bulk of the content of the registration statement is incorporated by reference. As a result, when the underwriter is performing its continuous due diligence "homework" on the issuer by reading past public filings, the underwriter *is* reading the registration statement. Thus, while continuous due diligence on the issuer's public filings did not, prior to shelf registration, constitute due diligence on the offerings documents, that has changed. For integrated disclosure, continuous due diligence is *real* due diligence—just without the probing questions.

Does this mean that there is no role for offering-time due diligence? Not at all. Some offering-time due diligence will *always* be necessary, if simply to investigate material changes to the issuer since the filing of documents that are incorporated by reference—and to ask questions about the documents incorporated by reference that have arisen during the banker's continuous due diligence. Therefore, it simply would be inadequate for an underwriter to perform continuous due diligence on the issuer without at least an "updating" call to press the issuer on questions that arose during that continuous due diligence.

6. What About Global Banks that Do Not Employ the Client Relationship Team Model?

Finally, what about global banks that do not employ the client relationship model—what are the implications of this model for them?

This question is a red herring. The extent to which a particular global bank has no client relationship team does not speak to the value of the model itself. In theory, such banks could follow the lead of other banks and develop a client relationship team.³³³

³³¹ See *supra* note 123 and accompanying text. There is little reason to doubt that the SEC expected that continuous due diligence would be less adversarial than traditional due diligence. On this point, the methods of continuous due diligence suggested by the SEC itself are telling, as they focus on developing a "reservoir of knowledge" rather than on playing "devil's advocate." Cf. *supra* Part I.D.

³³² There is no basis for the SEC to conclude that continuous due diligence is by its nature inadequate, since no case to date has passed on an underwriter's continuous due diligence. See *infra* note 360.

³³³ Indeed, one could argue that *all* of the foregoing questions about the *actual* efficacy of client relationship teams are red herrings for this same reason. Even if investment banks' client relationship teams do not actually perform as advertised, the model suggests that client relationship teams *have the potential to* conduct due diligence. And it therefore should be up to each bank to ensure that its client relationship teams live up to their full potential.

III. IMPLICATIONS OF THE CLIENT RELATIONSHIP TEAM: BETTER
DOCUMENTATION, CLEARER REGULATION—AND NO SAFE HARBOR
(YET)

This article proposes that the client relationship team model may provide the investment banking arms of global banks with an opportunity to engage in substantially more continuous due diligence than commentators currently suppose.

This is a hypothesis (albeit with anecdotal support), not a conclusion; obviously, it must be tested. The impetus for such testing is on the global banks: Absent favorable regulatory intervention, the client relationship team model may be global banks' only way to negate the due diligence dilemma. Hence, global banks that have implemented the client relationship team model ought to purposely leverage the model as a tool for continuous due diligence; and those that have not implemented the model ought to do so, immediately.

Since the proposition that the client relationship team leads to substantial due diligence is merely a hypothesis, no hard-and-fast conclusions are possible regarding how completely the model negates the due diligence dilemma. Yet, the model's mere existence does have consequences for regulators and for underwriters' counsel.

First, if the client relationship team model negates the due diligence dilemma, then it is not clear that there is an immediate need for safe harbor to protect underwriters from Securities Act liability. Hence, the mere existence of the model—and its untested status—counsels against haste in promulgating a safe harbor. Let the global banks test the model first.

Of course, it is not fair to ask banks to test the client relationship team model if courts will not recognize client relationship team-based continuous due diligence. But that could be remedied if the SEC provided guidance concerning Rule 176 that explicitly recognized the value of continuous due diligence, regardless of who performs it or in what context.

Second, some advice for global banks in testing the model: In order to take full advantage of the model's capabilities, underwriters' counsel—and bankers—must develop a new attitude towards *what constitutes* and *who performs* "continuous due diligence." And they must change how they document due diligence accordingly.

The remainder of this section explores each of these conclusions in turn.

A. *Underwriters May Not Need a “Safe Harbor” —at Least Not Yet*

1. Distant Rumbings: The Coming Push for a Safe Harbor

In response to *WorldCom*, a student commentator has called upon the SEC to promulgate a “safe harbor” to protect underwriters from the supposed “due diligence dilemma.” According to this author:

In the wake of *WorldCom* . . . the SEC must adopt a safe harbor rule that allows underwriters to undertake shelf registration offerings with . . . confidence that they conducted a reasonable investigation and satisfied the due diligence requirement.³³⁴

Such a safe harbor undoubtedly would provide that, if the underwriters undertake specific tasks, and do not know of any material misstatement or omission in the registration statement, they have performed reasonable due diligence as a matter of law.³³⁵

For now, this call for a safe harbor has gone unanswered. The SEC does not appear to be actively considering the issue of a safe harbor. In fact, the SEC had the opportunity to revise Rule 176 (to create a safe harbor or otherwise) in its release implementing “automatic” registration in August 2005—and it explicitly declined to make any changes.³³⁶

Yet, although a safe harbor is not currently on the table, there are rumbings in the distance. Practitioners have argued for a safe harbor, both pre-*WorldCom*³³⁷ and post-*WorldCom*.³³⁸ Further, in light of the academic recognition of the due diligence dilemma, few expect the securities bar to sit on its hands. According to Professor Coffee:

[T]he bar and the securities industry are likely to want a strong safe harbor rule to protect underwriters and directors from Section 11 liability The usual bar associations will predictably support (and probably draft) an ironclad safe harbor rule . . . [to] protect . . .

³³⁴ Young, *supra* note 26, at 548. This commentator’s arguments are not new, however; they simply restate arguments made by the SIA/BMA as amicus in the *WorldCom* litigation. *See, e.g., id.* at 544 (repeatedly citing and quoting Brief for Sec. Indus. Ass’n & Bond Mkt. Ass’n as Amici Curiae Supporting Underwriter Related Defendants, *WorldCom*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004) (No. 02 Civ. 3288 (DLC)), available at http://www.sifma.org/regulatory/briefs/Due_20Diligence_20Brief.pdf [*hereinafter* SIA Brief]).

³³⁵ *See infra* note 343 (quoting letter from securities defense bar requesting safe harbor).

³³⁶ *See* Securities Offering Reform, Exchange Act Release No. 33-8591, 70 Fed. Reg. 44,722 at 44,770 (stating that the SEC would “not . . . propose modifications to Rule 176 at this time”).

³³⁷ *See, e.g.,* Cohen, *supra* note 107, at 993 (describing how underwriters “have suggested that they need relief from [the due diligence] obligation unless there is some retreat from the present reach of . . . integrated disclosure”).

³³⁸ *See* Rossell & Stemmer, *supra* note 171 (“Because the *WorldCom* decision fails to provide guidelines as to what acts would constitute a sufficient due diligence investigation, the industry may wish to consider imploring Congress to ‘modernize’ underwriters’ due diligence requirements in the context of shelf offerings.”) (citing Bobelian, *supra* note 178).

underwriters from any Section 11 liability.³³⁹

Certainly there is little doubt that the securities industry wants a safe harbor.³⁴⁰ SIFMA's predecessors have repeatedly argued—both in comment letters to the SEC³⁴¹ and an *amicus* brief to the WorldCom court³⁴²—that underwriters face a due diligence dilemma. And the SIA specifically proposed a safe harbor in a comment letter to the SEC in 1999³⁴³—as it did previously, when shelf registration was first promulgated.³⁴⁴ Although its requests for a safe harbor were denied in

³³⁹ *Due Diligence*, *supra* note 50.

³⁴⁰ Indeed, some have argued for the elimination or downsizing of an underwriter's liability under Section 11 for material misstatements or omissions in the registration statement. See John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 *BUS. LAW.* 1195, 1211 (1997) ("Many argue that serious due diligence efforts are simply not feasible within the time constraints of shelf registration. Given these constraints, they claim that the solution lies in downsizing the threat under section 11."); see, e.g., Langevoort, *supra* note 72, at 67 ("[T]here is a strong practical case to be made for absolving underwriters of all inquiry obligations short of recklessness As underwriter involvement diminishes in significance relative to the deal as a whole, it becomes that much more problematic to apply a negligence-based standard in the first place.").

³⁴¹ See Letter from Sarah M. Starkweather, Regulatory Counsel, Bond Mkt. Ass'n, to Jonathan G. Katz, Sec'y, SEC (Jan. 31, 2005) ("The increased speed of the automatic shelf registration system will exacerbate the pressures underwriters already face in performing [due diligence] . . . [by] plac[ing] additional burdens on underwriters . . . who may have less time to conduct the . . . investigation . . . necessary to establish their due diligence defense and may . . . pressure [underwriters] to limit their diligence procedures [O]ur members report that there are a limited but increasing number of instances in which issuers attempt to limit or truncate [due diligence] review."); Letter from Stanley Keller, Chair, Comm. on Fed. Regulation of Sec., to David B.H. Martin, Dir., Div. of Corp. Fin., SEC, Aug. 22, 2001 ("It is not possible for underwriters . . . to meet th[e applicable] standard [for due diligence] in the current financing environment."); SIA Brief, *supra* note 334, at 11 (arguing that "[t]ime-consuming due diligence procedures by underwriters . . . would prevent issuers from gaining rapid access to the markets" via shelf registration and that "full-blown due diligence of the type done before integrated disclosure and shelf registration . . . can hardly be considered reasonable in the context of a shelf offering").

³⁴² See SIA Brief, *supra* note 334, at 1-2 (arguing—unsuccessfully—that Rule 176 should be interpreted to allow a reduced level of due diligence in shelf-registered offerings, because "[i]f underwriters were required to utilize the same time-consuming diligence procedures" for shelf-registered offerings as for non-shelf deals, "then either underwriters would have to be willing to proceed without [a] diligence defense . . . or issuers would not be able to have the benefit of underwritten financing off of a shelf registration").

³⁴³ See Letter from Lee B. Spencer, Jr., Chairman, SIA Fed. Regulation Comm., to Jonathan G. Katz, Sec'y, SEC, May 12, 1999, at 20-21, available at http://www.sifma.org/regulatory/comment_letters/comment_letter_archives/30977833.pdf (arguing that the SEC should create a "safe harbor for underwriters . . . in connection with registration statements," by modifying Rule 176 to "expressly provide that what constitutes 'reasonable investigation' . . . in the context of offerings on short-form registration statements is substantially less than in other registered transactions such as [IPOs]").

³⁴⁴ See Nicholas, *supra* note 40, at 27 n.75 (discussing the SIA's 1978 request for a safe harbor with respect to Form S-16, the predecessor shelf-registration form to Form S-3); Greene, *supra* note 71, at 800-01 (same); Frerichs, *supra* note 88, at 396-97 (same); Bogen, *supra* note 40, at 783 n.102 (same); FIPPINGER, *supra* note 144, § 7:7.1 n.346 (same) (citing *Reasonable Investigation*, *supra* note 120, at 42,018 n.39).

the past,³⁴⁵ the industry may see commentators' outcry about the due diligence dilemma as an indication that the time is right to try again. Therefore, it would seem that the proper question is not *whether* the industry will lobby for a safe harbor, but *when*.³⁴⁶

2. No Rush to the Harbor

Yet, if the due diligence dilemma is overstated, then so is the case for a safe harbor. Since a properly-implemented client relationship team might permit underwriters to perform substantial continuous due diligence on the issuer, thereby negating the supposed dilemma they face, then there is no need to "protect" them from Section 11 liability.

Thus, to the extent that the client relationship team's theoretical value as a mechanism for continuous due diligence requires testing, the banks are well-suited to do that testing. The burden ought to be on the banks to justify any deviation from the status quo.³⁴⁷

Thus, the proper approach for the SEC—particularly in light of the global financial crisis of 2008-09, which presents far more pressing issues—is to wait and see.³⁴⁸ Let the global banks attempt to use their client relationship teams to the fullest to perform continuous due diligence. If they try and fail, their pens will be swift and their comment letters many.

B. *Tweaking the Rules: Explicitly Acknowledging the Team*

One regulatory tweak may be in order, however. Rule 176 says nothing whatsoever about whether, when evaluating an underwriter's due diligence, courts may consider an investigation of an issuer by bankers who *do not* engage in securities underwriting. Nor does Rule

³⁴⁵ See Nicholas, *supra* note 40, at 27 n.75.

³⁴⁶ But see McLaughlin, *supra* note 3, at 546 ("Asking the SEC for 'safe harbors' for shelf underwritings has gone nowhere in the past and is not likely to succeed at any time in the near future."); Bobelian, *supra* note 178 (positing, at the time of the investment banks' settlements in the WorldCom litigation, that a SIFMA-led campaign for a safe harbor was "not imminent"); but cf. Catherine T. Dixon, *Assessing the Strict Liability Implications for Outside Directors of a Newly Streamlined Shelf Registration System*, THE SEC. REP., Fall 2005, at 26 ("Perhaps wisely, the SEC has declined commenters' invitation to exercise its broad exemptive power to create a 'due diligence' safe harbor.")

³⁴⁷ Since underwriters generally require that issuers indemnify them against loss for Section 11 liability," see Frerichs, *supra* note 88, at 407; accord Jacob, *supra* note 54, at 41, this is a low-risk experiment for underwriters—at least to the extent that such agreements are enforceable, but see Frerichs, *supra* note 88, at 408, and to the extent that there is little risk of issuer insolvency, see *id.* at 409.

³⁴⁸ This is particularly true in light of the current financial crisis. The SEC has far more important issues facing it than the question of whether to adopt a safe harbor for underwriters.

176 explicitly recognize any of the three unconventional methods of due diligence mentioned above: cross-pitching, modeling and credit analysis. Although these activities undoubtedly involve some investigation of the issuer, the activities differ starkly from traditional forms of continuous due diligence promoted by the SEC (*i.e.*, meetings by the issuer, reading analysis reports, etc.).³⁴⁹

Since the SEC has not explicitly recognized that these activities constitute continuous due diligence (or that bankers who do not focus on underwriting may perform due diligence), absent some guidance, courts might discount or even ignore continuous due diligence performed by members of the client relationship team who do not underwrite securities. Therefore, the SEC should issue an interpretive release concerning Rule 176 to clarify that courts may consider any investigation of the issuer, regardless of *who* performs it or in *what* context it arises—so long as that information reaches the banker who oversees due diligence.³⁵⁰

Adding such an interpretive gloss on Rule 176 would be a minor change. Unlike a safe harbor, this change would not exempt underwriters for liability based on certain specified acts; it would merely admonish courts that they must consider information produced by the client relationship team in its overall assessment of due diligence. Courts would have the final say regarding whether and to what extent they considered each aspect of the client relationship team's investigation to be continuous due diligence, adequate to satisfy the prudent person standard. Hence, unlike amending Rule 176 to make it a safe harbor, which would exempt underwriters from liability and deprive securities purchases of an important gatekeeper,³⁵¹ simply recognizing that courts may consider a previously-unacknowledged form of due diligence has no possibility of undermining investor protection.

Of course, one might argue that the aforementioned interpretive guidance does not “protect” underwriters from Section 11 (or Section 12(a)(2) litigation. Only a safe harbor can do that, the argument goes, because the fact-based reasonableness inquiry can rarely be decided on summary judgment.³⁵² As such, whether or not courts consider

³⁴⁹ See *supra* Part I.D (discussing SEC suggestions for due diligence).

³⁵⁰ The SEC should make clear that such information need not be in writing—because, in the author's personal experience, busy investment bankers rarely commit information to paper. That being said, busy investment bankers are nonetheless advised to better document their due diligence. See *infra* Part III.C.

³⁵¹ *Due Diligence*, *supra* note 50.

³⁵² See FIPPINGER, *supra* note 144, § 7:7.2 n.359 (“[A] subject like due diligence, which is a facts and circumstances inquiry as to reasonableness, is likely not to be decided for the underwriter at the summary judgment stage on the theory that the factual matters are for a jury. Thus, a court may not be willing to weigh Rule 176 ‘relevant circumstances’ at the time of summary judgment.”); Dixon, *supra* note 346, at 26 (“SEC Rule 176, containing a list of factors

continuous due diligence performed by the client relationship team, and whether or not the proposed language is added to Rule 176, courts will continue to allow cases to go to a jury (as the *WorldCom* court did).³⁵³

This is all true. However, it is not an indictment of the proposed guidance or the lack of a safe harbor, but of the design of the Securities Act itself and the nature of the due diligence defense. This is not a problem posed by *WorldCom* or the due diligence dilemma—or even by shelf-registration. Summary judgment was no more available to underwriters arguing that they had satisfied the due diligence as a matter of law in the days prior to shelf registration than it is today. Shelf registration (and “automatic” shelf registration) requires that underwriters perform due diligence earlier, but it does not follow that underwriters who raise the due diligence defense can escape a lawsuit earlier. A stronger argument, one that impugns the value of due diligence itself, is therefore necessary in order to justify a safe harbor.³⁵⁴

C. *Diligence, Diligence Everywhere—and Not a Document to Reflect It*

As explained above, the client relationship team’s potential for continuous due diligence has been all but ignored by legal commentators, including underwriters’ counsel writing in practice guides. These commentators are not alone: bankers do not necessarily think of their client relationship team investigation as “due diligence,” either.³⁵⁵ For them, the investigation is simply the learning curve necessary to pitch business and execute transactions.

designed to provide guidance to courts assessing the diligence obligations of various gatekeepers in a rapid shelf context, is widely viewed as ineffective because its ‘facts-and-circumstances’ approach generally militates against pre-trial dismissal of private Section 11 claims.”).

³⁵³ *But see* Schor, *supra* note 177, at 8 (“[I]t appears likely that *WorldCom* will make summary judgment more difficult to obtain and that underwriters will face greater settlement pressure as a result.”).

³⁵⁴ One such argument was thoroughly articulated nearly a quarter century ago. *See* Banoff, *supra* note 99, at 180-84 (arguing that due diligence is unnecessary because investors can more cheaply avoid company-specific risk by diversifying their portfolios). Some commentators have recognized that this argument has greater salience today than ever before, arguing that underwriters’ due diligence plays a diminished role in providing information to the market about issuers—especially WKSI issuers, about whom much information is available. *See, e.g.,* HAFT & HUDSON, *supra* note 54 § 2:1 (“As a result of the integrated disclosure system, shelf registration, the rise of other ‘sponsors’ (such as rating agencies), and investors’ more equal access to information, there are now many types of underwriting transactions where the underwriter is no longer a true ‘sponsor’ of the issuer or its securities and where it has a much diminished ability to obtain and verify relevant information and to influence an issuer’s disclosure.”).

³⁵⁵ *See, e.g.,* Rossell & Stemmer, *supra* note 171 (“Although investment banks routinely follow and analyze comparable company financials in particular industries, they typically have focused on this analysis for valuation purposes, not as an integral element of the due diligence investigation.”). This conclusion also comports with the author’s personal experience.

In order for the client relationship team to be an effective tool for continuous due diligence, bankers and their counsel also must re-envision “continuous due diligence” to include the activities of the client relationship team. Importantly, underwriters’ counsel must advise their clients to thoroughly document any and all research on the issuer performed by the client relationship team outside of the context of a securities offering.

This may require a change in some underwriters’ policies concerning documentation of due diligence. Historically, many underwriters and their outside or inside counsel only kept limited hard-copy due diligence files, because of some counsel’s fears that documents will be misinterpreted and used to harm the underwriter in later litigation.³⁵⁶ This position is not sound, however, because the due diligence defense is an *affirmative* defense, and it is likely that memories will have faded and personnel left the bank by the time the deal goes sour and the due diligence defense must be raised.³⁵⁷ Moreover, the view is unrealistic in light of modern electronic discovery techniques: if the file existed on the bank’s or law firm’s server, or in an email, it likely is backed up somewhere on tape—and plaintiffs will ask for it.

More important, however, underwriters’ documentation of due diligence policies only generally apply to those events that underwriters and their counsel consider to be *offering-specific* due diligence; in the author’s experience, all of the disparate information obtained by the client relationship is not kept in a “due diligence file,” nor is there any record of whether it was seen by the relationship manager. Hence, not only is there no central repository for documents reflecting the client relationship’s team’s investigation of its mega-WKSI clients, there is no recognition of the need for documentation of the investigation itself.³⁵⁸

³⁵⁶ See HAFT & HUDSON, *supra* note 54, § 2:1 (noting that there are two views on documentation of due diligence, and discussing the view that “any permanent records beyond the registration statement . . . are extraneous and can be misleading and misunderstood in the context of later litigation”); Jack C. Auspitz & Susan E. Quinn, *Litigators’ View of Due Diligence*, in CONDUCTING DUE DILIGENCE 2003, at 107, 177 (noting that there are two views, and offering arguments for keeping only a memo summarizing what was done and not original notes and other matters); see also FIPPINGER, *supra* note 144, § 7:5.1 (noting that “reasonably thoughtful policies” can differ markedly on the question of whether to retain due diligence notes, checklists and draft documents).

³⁵⁷ See HAFT & HUDSON, *supra* note 54, § 2:1 (discussing the second view, that “it is critical to maintain detailed documentation” of all due diligence, including what “meetings were conducted . . . and who participated, what tasks were performed, who was interrogated, and what information was secured—because “due diligence must be affirmatively proved”); Auspitz & Quinn, *supra* note 356, at 177 (discussing the second view, that and offering arguments why to keep all notes and contemporaneous records of due diligence).

³⁵⁸ Some underwriters’ counsel have begun to advise their clients to seek information about the issuer from many sources within the bank as part of the due diligence process. See, e.g., Cleary Gottlieb Steen & Hamilton LLP, *Diligence in Securities Offerings After WorldCom*, in

This must change.

Simply put, if bankers—and counsel—do not begin to view the client relationship team’s investigation as due diligence, evidence of due diligence will be lost. Counsel and bankers alike must change these practices; if they do not, they risk another *WorldCom*.

CONCLUSION: THE IRRELEVANCE OF *WORLD COM*?

Every so often, a case comes along that fundamentally alters the law. Commentators have universally hailed *WorldCom* as such a decision. They urge with near-unanimity that *WorldCom* confirmed the existence of the long-feared “due diligence dilemma,” necessarily portending a sea change in the way that underwriters perform due diligence.

All of these commentators may be wrong. In fact, the *WorldCom* decision may say nothing about how due diligence must change. It may be that the only lesson to be drawn from *WorldCom* derives not from decision itself, but rather, from the fact that the underwriters claimed to have evidence of continuous due diligence yet settled rather than take that chance at trial. The lesson of *WorldCom* may be that no matter how mighty the underwriters’ defense team, it is well nigh impossible to raise a defense based on continuous due diligence when almost nobody—not regulators or courts, nor scholars or underwriters’ counsel, or even the bankers themselves—thinks of the client relationship team’s investigation of an issuer as “due diligence.”³⁵⁹ The lesson of *WorldCom* may be that, in order for underwriters to escape the due diligence dilemma, everyone involved—regulators, underwriters’ counsel, and bankers themselves—must re-envision *what constitutes* and *who performs* continuous due diligence.

In sum, this article might have been entitled *The Irrelevance of WorldCom*, because it calls into question both whether the *WorldCom* decision created a “due diligence dilemma” for underwriters and whether the *WorldCom* opinion will have any effect whatsoever on underwriters’ due diligence practices. Due to the existence of the client relationship team model at global banks, it is possible that underwriters have been performing adequate continuous due diligence *all along*—

37TH ANNUAL INSTITUTE ON SECURITIES REGULATION 1185, 1211 (2005) (urging that “greater effort . . . be made to ensure that all internal sources of information about the [issuer] are checked as part of the due diligence process” including “internal credit ratings” and “research reports”).

³⁵⁹ Litigation counsel may recognize that the client relationship team’s investigation is properly viewed as due diligence. Yet, by the time that the underwriters have retained litigation counsel to defend themselves against a Section 11 lawsuit, it is too late to properly document the client relationship team’s investigation.

and the next time, if they document their investigation properly, they will be able to marshal it in court, rendering *WorldCom* moot.³⁶⁰

Some underwriters' counsel already appear to know this, if one only asks.³⁶¹

³⁶⁰ The underwriters did plan to raise a defense based on continuous due diligence at trial in the WorldCom litigation—but their case never went to trial. See *NY City Bar Report, supra* note 108, at 505 n.290 (“Continuous due diligence was in use by WorldCom, according to the contentions of the underwriter-defendants in the WorldCom class action securities litigation. That litigation was settled before judge or jury had occasion to rule on the underwriters’ argument that their ‘continuous due diligence’ met the standard of ‘reasonable investigation’ required to establish a defense under the 1933 Act”); accord *WorldCom*, 346 F. Supp. 2d at 684 (“The Underwriter Defendants contend that they will be able to show at trial that the continuous due diligence that they performed with respect to WorldCom amounted to a reasonable investigation for both Offerings.”). The public will therefore never know for sure how much continuous due diligence was performed on WorldCom.

However, even based solely on the public record, one can speculate. WorldCom, Inc. was a frequent user of investment bank services, whether for M&A or its tracking stock—and thus, members of the client relationship teams from the various global banks in the underwriting syndicate had an opportunity to investigate the company in numerous contexts. See *id.* at 682 (“[The underwriters] emphasize that J.P. Morgan and SSB had recently had occasion to work closely with WorldCom on other projects. The two firms had participated in the two tracking stock realignment of WorldCom announced in November 2000, and J.P. Morgan had acted as a lead manager and sole book-runner for WorldCom’s \$2 billion private placement in December 2000. They point to these activities as part of their continuous due diligence for WorldCom.”). In light of these contacts, one might presume that the lead underwriters’ continuous investigation of WorldCom, Inc. was substantial. Had a jury considered the underwriters’ continuous due diligence, there is no telling how a trial would have ended.

³⁶¹ According to one (now-former) SIFMA lawyer, “[m]any of our members are already doing a good job of performing continuous due diligence on frequent issuers.” Stuart, *supra* note 200 (quoting Marjorie Gross). Presumably this lawyer—a former in-house counsel at one of WorldCom’s lead underwriters, see Press Release, SIFMA, Experienced Senior Bond Market Attorney, Marjorie Gross, Named as The Bond Market Association’s New Regulatory Counsel (Mar. 2, 2004), available at <http://www.sifma.net/story.asp?id=613> (reflecting Ms. Gross’s hiring by the BMA and that Ms. Gross formerly was in-house counsel at J.P. Morgan), who was involved with SIA’s amicus brief in *WorldCom*, see SIA Brief, *supra* note 334 (Ms. Gross’s name is on the brief)—is intimately familiar with *WorldCom*.

So, perhaps SIFMA is well aware of the client relationship team’s investigation, and will not seek a safe harbor after all. Only time will tell.