

## D&O Securities Claims – The Act of 1933

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

### Registration Requirements

The 1933 Act and supporting rules govern the registration process and require (among other things) that a registration statement be filed with the SEC. The registration statement is a SEC-prescribed form that contains certain information about the business of the issuer company, the security being sold, and additional information about the management of the company and certified financial condition. It is different than the actual sales document for investor use, which is called the prospectus (or offering document). In simplest form, the prospectus is the sales/marketing presentation, while the registration statement is the covering form seeking SEC approval to the sale.

### Enforcement

The SEC has the power to bring civil enforcement actions for violations of the 1933 Act. Although it can seek to impose monetary fines or penalties, disgorgement of funds or injunctions limiting future violations (including prohibitions of further securities sales, or holding official positions in SEC-regulated companies), it cannot cause anyone to be jailed. Only the US Department of Justice, charged with enforcement of the criminal laws, can bring an action seeking incarceration.

Private investors may also bring civil lawsuits seeking redress for violations of some, but not all, of the 1933 Act. Any action must be brought within two years of the plaintiffs becoming aware of the

cause of action, but in no event beyond five years of the registration statement date. Those causes of action that investors may sue upon include:

#### Section 11

Section 11 creates civil liability if a registration statement (which generally includes the prospectus attached thereto) contains untrue statements of material fact or which omit to state a material fact. To ensure that full and complete disclosure occurs, Section 11 imposes strict liability on the issuer and any person or expert (e.g., accountants and attorneys) who signs the registration statement. In addition, the directors of the issuer will be held strictly liable as well, even if they did not sign the documents. Generally, only those who purchase the infected offering may sue, although subsequent purchasers may bring a lawsuit if they can track their securities to the original offering (called “tracing”).

As a strict liability statute, purchasers do not need to prove causation or reliance. If a materially inaccurate misstatement or omission occurred, liability is assumed and damages are calculated by determining the difference between the offering price in the initial public offering and the value of the shares at the time of the purchaser’s lawsuit. All defendants are jointly and severally liable for all damages.

Defences to Section 11 include: (a) no material misrepresentation or omission occurred; (b) the presumed damages were actually caused by other, unrelated causes

(the “negative causation” defence); (c) as for individual defendants only, they conducted a reasonable investigation and had a reasonable basis to believe that the documents were accurate (the “due diligence” defence); and (d) as for those portions of the registration statement that contained expert opinions, the non-experts had no basis to believe that the expertised portions were inaccurate.

#### Section 12

Section 12 addresses misrepresentations or omissions outside the registration statement.

#### Section 15

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

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

### Contact Us

#### Sedgwick UK:

Sarah Hills and Chen Foley

sarah.hills@sdma.com; chen.foley@sdma.com  
 Fitzwilliam House, 10 St Mary Axe  
 London, EC3A 8BF England  
 tel: 44.20.7.929.1829

#### Sedgwick Bermuda:

Mark Chudleigh

mark.chudleigh@sedgwick-chudleigh.com  
 Mercury House, Fourth Floor  
 101 Front Street, Hamilton HM12 Bermuda  
 tel: 441.296.9276

#### Sedgwick US:

Joseph M. Smick

joseph.smick@sdma.com  
 125 Broad Street, 39th Floor  
 New York, New York 10004  
 tel: 212.422.0202

# D&O Securities Claims – The Act of 1934

The Securities Act of 1934 (“1934 Exchange Act”) was intended to regulate the securities brokers, dealers and post-offering trading of securities in the public markets. Unlike the 1933 Act, the 1934 Exchange Act regulates the corporate statements and disclosures made after a security has been issued.

## Enforcement

The SEC has the power to bring civil enforcement actions for violations of the 1934 Exchange Act, but cannot cause any violator to be incarcerated. Rather, the SEC can seek the imposition of monetary fines or penalties, disgorgement of funds or injunctions limiting future violations. It is the role of the US Department of Justice to criminally prosecute violations of the US laws, including the 1934 Exchange Act.

Private investors may also bring civil lawsuits seeking redress for some violations of the 1934 Exchange Act. Like the 1933 Act, the statute of limitations requires suit to be brought within two years of the plaintiffs becoming aware of the misconduct, and in no event after five years of the statement or omission.

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

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

In order for a Section 10(b) claim to succeed, securities must have been purchased by the plaintiff; a material misrepresentation or omission must have been intentionally made by the defendant while knowing (or recklessly disregarding) the truth; and the plaintiff must have relied upon that misrepresentation or omission. In addition, provable damages must also have resulted.

As it is the burden of the plaintiff to establish each of these elements, it is possible to defeat a Section 10(b) claim on a number of different grounds. For example, the plaintiff must show that an actual misstatement or

omission of a material fact occurred. Similarly, in that liability is based on fraud, the plaintiff must prove that each named defendant possessed a culpable state of mind (“scienter,” which is an intentional or recklessness standard). So, too, must the plaintiff establish that the damages resulted from the alleged misstatement or omission, causing the losses suffered. Competent damage computations, reflecting the difference between the actual trading value of the securities, and the “true” value that the securities would have traded at absent the fraud, are required. The failure of any of these prima facie elements renders the case dismissible.

Unless the defendant intentionally (and not recklessly) violated Section 10(b), the defendant is responsible only for that portion of the liability or damages ascribed to his, her or its misconduct.

As defences to Section 10(b), the defendants cannot only attempt to disprove the prima facie elements, but also assert that either (a) the statements or omissions were already publicly known; (b) the statements arose as to future predictions or events, and not current facts; or (c) sufficient warnings were given at the time of the disclosure (the “bespeaks caution” or “safe harbor” defences).

Section 10(b) and Rule 10b-5 have been interpreted to prohibit the trading of securities on material non-public information (i.e., insider trading or tipping others). The test under Rule 10b-5 is whether the information is the kind that might affect the judgment of reasonable investors (both conservative and speculative).

## Section 14(a)

Section 14(a) generally regulates the solicitation of shareholder votes in proxy statements, setting forth minimal disclosure standards. Like SEC Rule 10b-5, SEC Rule 14a-9 broadly prohibits any solicitations that contain a materially misleading fact or statement, or omits to state any material fact that would be necessary to ensure that the facts and statements disclosed are

not misleading. Like an action under Section 10(b), the plaintiff bears the burden of proving that a misstatement or omission occurred, the materiality of that statement or omission, causation and damages.

## Section 16(b)

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

## Section 20(a)

Section 20(a) imposes secondary liability on those persons who “control” the alleged violators. The plaintiff must establish that someone else is a primary violator of the 1934 Exchange Act, and that the secondary actor has sufficient “control” over the primary violator so as to be accountable as well.

A Section 20(a) claim can be defeated if it can be shown that no primary violation occurred; that the controlling person did not have the power to direct or cause the other defendant to commit the primary violation; and/or the controlling person did not directly or indirectly induce the other defendant to commit the primary violation but instead acted in good faith.

## Section 20A

Section 20A was enacted due to the inability of certain securities counterparties to have sufficient “standing” to bring a claim alleging “insider trading” or “tipping” violations of Section 10(b).

Section 20A allows any person who purchased or sold securities at the same time some prohibited trade occurred, as well as counterparties to the prohibited trade, to sue. Liability also attaches to those who obtained the inside information.