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Liability for Misstatement in Prospectus: Where to Stop?

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Introduction

This article focuses on the wide applicability of liability provisions with respect to any misstatement made in the context of a prospectus issued by any company whereby it asks the public to invest money. The liability regime for the misstatement has been fluctuating ever since the time corporate personality came into existence. However, it has always been a moot point to what extent could this liability be stretched and who all could be held responsible. The regime for liability varies nation by nation and thus this article deals with the hardcore legal regime relating to the liability for misstatement in India and then puts the position of law in other two economic power, USA and UK.

A. INDIA

1. What is a Prospectus?

The definition of "prospectus" in the Indian Companies Act, 1956, (the "Act") was based on the definition found in the English Companies Act [Section 455(1)]. It then underwent amendment in 1960 following the recommendation of the Companies Act Amendment Committee of 1957 and also in 1974. The current definition as per Section 2(36) stands as follows:

> "prospectus" means any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a body corporate.

It is doubtful whether a television or film advertisement, as distinguished from radio which appeals to the ear and not to the eye, may be treated as falling within the definition of prospectus, the definition of document in Section 3(18) of the General Clauses Act notwithstanding. On the other hand, a written invitation designed to induce persons invited to submit requests for purchasing or subscribing purchases will be a prospectus if it invites subscription or purchase for cash.[1]

A Prospectus issued by or on behalf of a public company must contain the matters specified in Part I of Schedule II set out the reports specified in Part II of that Schedule and Parts I and II of Schedule II have to be read in conjunction with the clarifications etc. given in Part III of the said Schedule.[2] The power to deal with issue of prospectus is given to SEBI in case of listed public companies and in case of those public companies which intend to get their securities listed on any recognised stock exchange in India and in any other case, the power lies with the Central Government.[3]

1.1 Deemed Prospectus

The Act also deals with the concept of deemed prospectus under Section 64 of the Act. This section is an exception to issue of prospectus. A company may allot or agree to allot any shares or debentures to an "issue house" without there being any intention on the part of the company to make shares or debentures available directly to the public through issue of prospectus. But then it shall, unless the contrary is proved, be evidence that an allotment of, or an agreement to allot, shares or debentures was made with a view to the shares or debentures being offered for sale to the public if it is shown:

(*a*) that an offer of the shares or debentures or of any of them for sale to the public was made within six months after the allotment or agreement to allot; or

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(*b*) that at the date when the offer was made, the whole consideration to be received by the company in respect of the shares or debentures had not been received by it.

1.2 The "Golden Rule" for Prospectus Interpretation

The Golden Rule as regards the drafting of the prospectus was laid down in the leading case *New Brunswick and Canada Railway and Land Co.* v. *Muggeridge,*[4] as:

- Only true nature of the company's venture shall be disclosed;
- Strict and scrupulous accuracy shall be maintained in drafting prospectus as it invites the public to take shares on the faith of the representations contained in the prospectus;
- In addition to the mandatory information required to be given as per Parts I and II of Schedule II of the Act, there must be voluntary disclosures of information as would reasonably constitute a fair representation of facts for the public to act upon.

1.3 What Constitutes an "Offer to Public"

It is important to take a note in the definition of prospectus about the offer being made to the public and about accepting deposits from public. Section 67 of the Act takes an insight into the construction of references to offering shares or debentures to the public. The Act is clear that an offer of shares to the company's shareholders cannot be termed "an offer to the public". It is necessary to understand the meaning of this expression in order to find out as to what constitutes a prospectus. Where an invitation is made by the management of a company to selected persons for subscription or purchase by less than 50 persons receiving the offer or invitation, the shares or debentures and such invitation or offer is not calculated directly or indirectly to be availed of by other persons, such invitation or offer shall not be treated as an offer or invitation to the public. If a prospectus addressed to the general public, or to a section of the public, is published, that no doubt constitutes an offer to the public, even though none of the public come in; but possibly if this offer is made without any intention to let the public take up any of the shares, it might be found as a fact that there was no real offer to the public.[5]

2. Scope of Liability for Misstatement in Prospectus

2.1 What Is misstatement?

As per Section 65 of the Act, a statement included in a prospectus shall be deemed to be untrue, if the statement is misleading in the form and context in which it is included *inter alia* in the prospectus itself or contained in any report or memorandum appearing on the face thereof or by reference incorporated therein or issued therewith and where the omission from a prospectus of any manner is calculated to mislead, the prospectus shall be deemed, in respect of such omission, to be a prospectus in which an untrue statement is included. The liability accrues where any person subscribes for any shares or debentures on the faith of the prospectus for any loss or damage he may have sustained by reason of untrue statement included therein.[6]

Often matters related to representation for the future events have been questioned. A mere representation that something will be done or will happen in future is not a representation of fact which could invoke the liability for misstatement. In order to invoke it, there must be a misstatement as to an existing fact.[7] Representation would invoke the responsibility if it was true only at the time of issue of prospectus and not at the time of allotment.[8] A statement in a prospectus as to the persons who are to be directors is a material statement and if it is untrue, a person subscribing on the faith of it is *prima facie* entitled to rescind.[9] Similarly, an ambiguous statement which carries double meaning and an Applicant who reasonably puts one meaning and is misled would be entitled to relief and the maker of the statement would not be heard to say that some other meaning should have been put upon his words.[10] It has also been held that those who accepted false statements as true were not deprived of their remedy merely because they neglected to go and look at the correctness of the statements.[11] Where the statements in the prospectus are clear but an applicant happens to take a wrong meaning by misreading them he cannot complain so as to get rid of the allotment.[12] Any variation or modification of the terms and conditions of the issued

prospectus and the prospectus approved by CCI would have the effect of misrepresentation.[13]

Any misstatement made in an advertisement inviting deposits made *via* Section 58A of the Act would also attract the applicability of liability provisions *vis-à-vis* prospectus.[14]

2.2 Persons Who Could Be Held Liable

- every person who is a director of the company at the time of the issue of the prospectus;
- every person who has authorised himself to be named and is named in the prospectus either as a director, or as having agreed to become a director, either immediately or after an interval of time;
- every person who is a promoter of the company;
- every person who has authorised the issue of the prospectus;
- an expert[15]: the liability of an expert surrounds around Sections 57 and 58 of the Act. These provisions make it clear that the liability would not accrue just because of his position as an expert but would be only for an untrue statement made by him in the capacity of an expert. The expert's consent should be endorsed on or annexed to the registration of the prospectus.[16] By consenting to the issue of the prospectus the expert does not undertake liability in respect of anything in the prospectus except his own statement.[17] This section, adopted from Section 40 of the English Act, 1948, enacts "a wholesome rule intended to protect an intending investor by making the expert a party to the issue of the prospectus and making him liable for untrue statements".[18]

2.3 If Minor Represented as Promoters in the Prospectus Could Be Held Liable for Misrepresentation and Fraud?

This question was dealt in detail by Supreme Court in *Ritesh Agarwal and Anr.* v. *Securities and Exchange Board of India and Ors.*[19], wherein the Court answered it in negative and held that minors having regard to the provisions of the Indian Contract Act, 1872, they could not have been proceeded against strictly in terms of the provisions of the said Act. SEBI, as the regulatory body, may take actions against the persons who undertook those fraudulent actions and they may also be held guilty of making a mis-representation and commission of fraud not only before the prospective purchasers of the shares but also before the statutory authority. The same, however, would itself not mean that a minor would not be penalised for entering into a contract which *per se* was not enforceable. A contract must be entered into by a person who can make a promise or make an offer. If he cannot make an offer or in his favour an offer cannot be made, the contract would be void as an agreement which is not enforceable in law would be void. Section 11 of the Indian Contract Act, 1872, provides that the person who is competent to contract must be of the age of majority. Thus, if it is shown by the birth certificates that the promoters were minor they cannot be held guilty.

2.4 Penalty and Fine:

2.4.1 Any person who could be held liable for prospectus, if he does not mention the salient features in the prospectus which are prescribed,[20] then he shall be punishable with fine which may extend to Rs. 50,000.[21] The liability for this also extends under general law or under any other provision of the Act.[22]

2.4.2 Where any person who acts as an expert and who is or has been engaged or interested in the formation or promotion, or in the management, of the company or where a prospectus is issued which contains a statement made by an expert and the consent to such an effect has not been obtained or has been withdrawn, then the Company and every person, who is knowingly a party to the issue thereof, shall be punishable with find which may extend to Rs. 50,000.[23]

2.4.3 Any person who either by knowingly or recklessly making any statement, promise or forecast which is false, deceptive or misleading or by any dishonest concealment of material facts, induces or attempts to induce another person to enter into or to offer to enter into (*a*)

any agreement for, or with a view to, acquiring, disposing of, subscribing for, or underwriting shares or debentures; (*b*) any agreement, the purpose or pretended purpose of which is to secure a profit to any of the parties from the yield of shares or debentures, or by reference to fluctuations in the value of shares or debentures, shall be punishable with imprisonment for a term which may extend to five years or with fine which may extend to Rs. 1 lac or with both. This liability is intended to apply not merely to company prospectuses but also to any proposal or offer for sale of shares by anybody whatsoever. This provision is expected to serve as a sufficient deterrent to unscrupulous company promoters against making untrue and deceptive statements in prospectuses with a view to obtaining capital from the public.[24]

3. Civil Liability

Section 62 of the Act incorporates the provision relating to the civil liability for misstatement in prospectus. It provides very clearly that where a prospectus invites persons to subscribe for shares in or debentures of a company liability accrues to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus for any loss or damage he may have sustained by reason of any untrue statement included therein. Every person who becomes liable to make any payment by virtue of such misrepresentation may recover contribution as in cases of contract from any other person who, if sued separately, would have been liable to make the same payment unless the former person was and the latter person was not guilty of fraudulent misrepresentation. The measure of damages for the loss suffered by reason of the untrue statement, omission, etc. is the difference between the value which the shares would have had but for such statement or omission and the true value of the shares at the time of allotment.[25] In applying the correct measure of damages to be awarded to compensate a person who has been fraudulently induced to purchase shares, the crucial criterion is the difference between the purchase price and their actual value. It may be appropriate to use the subsequent market price of the shares after the fraud has come to light and the market has settled.[26] The period prescribed for a suit for damage by shareholder is three years as per Article 113 of the Limitation Act, 1963.

4. Criminal Liability

Section 63 of the Act incorporates the provision relating to the criminal liability for misstatement in prospectus. It provides that where a prospectus includes any untrue statement, every person who authorised the issue of prospectus shall be punishable with imprisonment for a term which may extend to two years or with fine which may extend to Rs 50,000 or with both. The offence is compoundable under Section 621A. It has to be noted that under such cases, once the prosecution establishes the falsity of statement in a prospectus signed by a director, etc., the onus is shifted to the defendant of proving either that the statement was immaterial or that he believed it to be true. An expert who has given the consent will not be deemed to be *ipso facto* a person who authorised the issue of prospectus.[27]

5. Defenses:

5.1 Defense vis-à-vis General Liability

A director or other person responsible for the prospectus shall not incur any liability by reason of any non-compliance with, or contravention of, any of the requirements with respect to the matters to be stated and reports to be set out in prospectus:

(*a*) as regards any matter not disclosed, he proves that he had no knowledge thereof; or

(*b*) he proves that the non-compliance or contravention arose from an honest mistake of fact on his part; or

(*c*) the non-compliance or contravention was in respect of matters which, in the opinion of the Court dealing with the case were immaterial or was otherwise such as ought, in the opinion of that court, having regard to all the circumstances of the case, reasonably to be excused, provided that no director or other person shall incur any liability in respect of the failure to include in a prospectus a statement with respect to

the matters specified in clause 18 of Schedule II unless it is proved that he had knowledge of the matters not disclosed.

5.2 Defense Available to Any Person except an Expert vis-à-vis Civil Liability

No person shall be liable if he proves:

(*a*) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent;

(*b*) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave reasonable public notice that it was issued without his knowledge or consent;

(*c*) that, after the issue of the prospectus and before allotment thereunder, he, on becoming aware of any untrue statement therein, withdrew his consent to the prospectus and gave reasonable public notice of the withdrawal and of the reason therefor; or

(*d*) that

(*i*) as regards every untrue statement not purporting to be made on the authority of an expert or of a public official document or statement, he had reasonable ground to believe, and did up to the time of the allotment of the shares or debentures, as the case may be, believe, that the statement was true; and

(*ii*) as regards every untrue statement purporting to be a statement by an expert or contained in what purports to be a copy of or an extract from a report or valuation of an expert, it was a correct and fair representation of the statement, or a correct copy of, or a correct and fair extract from, the report or valuation; and he had reasonable ground to believe, and did up to the time of the issue of the prospectus believe, that the person making the statement was competent to make it and that person had given the consent required by Section 58 to the issue of the prospectus and had not withdrawn that consent before delivery of a copy of the prospectus for registration or, to the defendant's knowledge, before allotment thereunder; and

(*iii*) as regards every untrue statement purporting to be a statement made by an official person or contained in what purports to be a copy of or extract from a public official document it was a correct and fair representation of the statement, or a correct copy of, or a correct and fair extract from, the document.

5.3 Defence Available to an Expert vis-à-vis Civil Liability

An expert who has given his consent under Section 58 of the Act shall not be liable if he proves:

(*a*) that, having given his consent under Section 58 to the issue of the prospectus, he withdrew it in writing before delivery of a copy of the prospectus for registration;

(*b*) that, after delivery of a copy of the prospectus for registration and before allotment thereunder, he, on becoming aware of the untrue statement, withdrew his consent in writing and gave reasonable public notice of the withdrawal and of the reason therefor; or

(*c*) that he was competent to make the statement and that he had reasonable ground to believe, and did up to the time of the allotment of the shares or debentures, believe, that the statement was true.

5.4 Defense Available vis-à-vis Criminal Liability

Any person who could be held criminally liable shall not be deemed to be so if he proves either that the statement was immaterial or that he had reasonable ground to believe, and did up to the time of the issue of the prospectus believe that the statement was true.

LIABILITY FOR MISSTATEMENT IN OTHER COUNTRIES

B. UNITED KINGDOM

The publication in the UK (England and Wales) of offering documents exposes those responsible for their preparation and publication to potential liability for misrepresentation or negligent misstatement. Potentially simpler statutory liabilities arise under the Financial Services and Markets Act 2000 (the "FSMA"), previously contained in the Financial Services Act 1986. FSMA provides the framework within which the Financial Services Authority (the "FSA") will operate as the regulator for the financial services industry in the UK. Criminal liability may also arise, as well as liabilities under the Listing Rules or other self-regulatory schemes. In practice, without clear evidence of fraud, such claims are not clear-cut, and may face complex issues, particularly in relation to causation and reliance, in showing that the misleading information in fact caused the damage, or that the investor in fact relied on the misleading information in entering into the investment. This is presumably why few cases have reached trial in recent years. Faced with technical difficulties on one side, and publicity issues on the other, claims usually settle long before trial.

6. Who May Be Liable?

Section 90 of the FSMA provides that any person responsible for listing particulars[28] is liable to pay compensation to a person who has acquired securities to which the particulars apply and suffered loss in respect of them as a result of:

(*i*) any untrue or misleading statement[29] in the particulars; or

(*ii*) the omission from the particulars of any matter required to be included by Section 80 or 81.

Sections 80 and 81 state that the listing particulars must contain all such information as investors and their professional advisers would reasonably require and if at any time there occurs any significant change affecting any matter contained in those particulars the inclusion of which is mandated by the situation has to be included in unless its not a significant change of if the issuer of the securities is not aware of the change or new matter in question. If in case a person fails to include significant changes, then his liability can be invoked to pay compensation to any person who acquires securities of the kind in question and suffers loss in respect of them as a result of the failure. However, liability under Section 90 does not stop the general liability that may be incurred upon.[30]

6.1 Liability of Promoters

Section 90(8) deals with the liability of promoters as follows:

> No person shall, by reason of being a promoter of a company or otherwise, incur any liability for failing to disclose information which he would not be required to disclose in listing particulars in respect of a company's securities—
>
> (*a*) if he were responsible for those particulars; or
>
> (*b*) if he is responsible for them, which he is entitled to omit by virtue of Section 82.

6.2 Director's Liability under Section 463 of the UK Companies Act, 2006

Section 463 applies to directors of all companies. Under Section 463, subject to the knowledge requirement, a director is liable to compensate the company for any loss that the company suffers as a result of any untrue or misleading statement in, or omission from:

- the directors' report (including the business review section);
- the directors' remuneration report;
- a summary financial statement (SFS) so far as it is derived from either of the above reports.[31]

Section 463 provides a safe harbour in that a director is only liable to compensate the company for the loss suffered by the company in reimbursing an investor if the director knew or was reckless as to whether the statement was untrue or misleading or knew the omission to be dishonest concealment of a material fact.[32] The director's liability under Section 463 is limited to the company only and not to shareholders or third parties.[33] A

director may still incur liability for a criminal offence, for example, under Section 397 of FSMA for misleading statements and practices and civil liability for market manipulation.[34]

6.3 Liability for Negligent Misstatement: Tort Liability: Controversy over "duty of care"

The liability under Section 90 revolves around the duty to care since it is based on fraud and negligence. Thus, if any person who was under a duty of care does any omission or fails to perform his duty his liability can be invoked if a loss is suffered due to such omission or failure or negligence. It has been held that if the investor can show that there was a misstatement by the maker of a statement in the offering document who owed him a duty of care, the investor can claim in negligence.[35] But the burden of proof is on the plaintiff that the defendant owed a duty of care towards him. However, a controversy has arose with respect to the position of after market purchasers, since an after market purchaser needs to show that the misleading statement in the particulars still influenced the market he bought, thus, wherein in an *obiter*[36] by Lightman J, he stated that FSMA compensation claim is available to purchasers in the after market, a contrary decision was given in *Al Nakib v Longcroft*,[37] where the Court held that given the difficulty in establishing a duty of care in relation to an unascertained class of people, it is thought that no duty of care is owed to after market purchasers. Thus, it is interesting to note that whether investors make a claim under FSMA or negligence, since FSMA does not require proof of negligence; however, for a wider group, a negligence claim might serve more beneficial.

7. Defence to Section 90 Liability

Schedule 10 of the FSMA frames out the possible situations where a person can save himself from being held liable under Section 90 of the FSMA. The defences provided under FSMA are quite similar to those provided under Indian Companies Act, 1956. It also classifies the different defences available to an expert and non-expert.

7.1 For a Statement Made by a Non-expert

A person does not incur any liability under Section 90 for loss caused by a statement if he satisfies the court that at the time when the listing particulars were submitted to the competent authority, he reasonably believed (having made such enquiries, if any, as were reasonable) that:

- the statement was true and not misleading;
- the matter whose omission caused the loss was properly omitted, and that one or more of the following conditions are satisfied:
    - ✎ he continued in his belief until the time when the securities in question were acquired;
    - ✎ they were acquired before it was reasonably practicable to bring a correction to the attention of persons likely to acquire them;
    - ✎ before the securities were acquired, he had taken all such steps as it was reasonable for him to have taken to secure that a correction was brought to the attention of those persons;
    - ✎ he continued in his belief until after the commencement of dealings in the securities following their admission to the official list and they were acquired after such a lapse of time that he ought in the circumstances to be reasonably excused.
- *Defense by Correction of Statement:* Another defence that is available to a person from incurring the liability is when he satisfies the court that:
    - ✎ before the securities in question were acquired, a correction had been published in a manner calculated to bring it to the attention of persons likely to acquire the securities; or
    - ✎ he took all such steps as it was reasonable for him to take to secure such publication and reasonably believed that it had taken place before the securities were acquired.

7.2 For a Statement Made by an Expert

For FSMA an expert includes any engineer, valuer, accountant or other person whose profession, qualifications or experience give authority to a statement made by him. This definition is similar to that of expert in the Indian Companies Act, 1956.

An expert does not incur any liability under Section 90 for loss in respect of any securities caused by a statement if he satisfies the court that, at the time when the listing particulars were submitted to the competent authority, he reasonably believed that the other person:

- was competent to make or authorise the statement, and
- had consented to its inclusion in the form and context in which it was included, and that one or more of the following conditions are satisfied:
  - he continued in his belief until the time when the securities were acquired;
  - they were acquired before it was reasonably practicable to bring the fact that the expert was not competent, or had not consented, to the attention of persons likely to acquire the securities in question;
  - before the securities were acquired he had taken all such steps as it was reasonable for him to have taken to secure that that fact was brought to the attention of those persons;
  - he continued in his belief until after the commencement of dealings in the securities following their admission to the official list and they were acquired after such a lapse of time that he ought in the circumstances to be reasonably excused.
- *Defence by Correction of Statement:* Another defence that is available to an expert from incurring the liability is when he satisfies the court that:
  - before the securities in question were acquired, the fact that the he was not competent or had not consented had been published in a manner calculated to bring it to the attention of persons likely to acquire the securities; or
  - he took all such steps as it was reasonable for him to take to secure such publication and reasonably believed that it had taken place before the securities were acquired.

7.3 Defence Available to Both, Expert and Non-expert

A person does not incur any liability under Section 90 if he satisfies the court that the person suffering the loss acquired the securities in question with knowledge:

- that the statement was false or misleading; or
- of the omitted matter; or
- of the change or new matter, as the case may be.

8. Latest Development: Liability of Issuers in Connection with Published Information[38]

In order to clearly frame out the liabilities of issuers, United Kingdom legislation has come up with Financial Services and Markets Act, 2000 (Liability of Issuers) Regulations, 2010. This regime is different from the earlier regime, where liability was dependent on fraud and negligence whereas this new regime provides for the liability of issuers to pay compensation to third parties who have suffered loss as a result of misstatements, or dishonest omissions in information published by the issuer, or dishonest delay by the issuer in publishing information. The purpose of the second set of regulations is to extend the current statutory regime for the liability of issuers for misstatements set out in Section 90A of FSMA. Under the existing statutory regime, issuers of securities traded on regulated markets in the United Kingdom are liable for fraudulent misstatements made to the market in a limited class of publications. The regulations extend the regime to cover issuers of any securities admitted to trading on a securities market in the UK, and issuers for which the UK is the issuer's home state. Claims for misstatement may be brought not only by buyers of securities but

also by sellers and holders of securities, if they have acted in reliance on a fraudulent misstatement and suffered loss as a result.

However, a question has been left to the interpretation: Does that imply that the regulations apply to a new issuer of a security, or to continuing provision of information for a security that has already been issued?

8.1 What Is Published Information?

Published information means information published by the issuer of securities either by recognised means or by other means where the availability of the information has been announced by the issuer by recognised means. It is immaterial whether the information is required to be published by recognised means or otherwise.

8.2 Issuer Is liable to Whom?

An issuer of securities is liable to pay compensation to a person who:

- acquires, continues to hold or disposes of the securities in reliance on published information; and
- suffers loss in respect of the securities as a result of:
    - any untrue or misleading statement in that published information, or
    - the omission from that published information of any matter required to be included in it.

8.3 Plaintiff Has to Prove What?

In order to invoke the liability of the issuer, the plaintiff is required to prove that he suffered loss as a result of the statement or omission and because he acquired, continued to hold or disposed of the relevant securities:

- in reliance on the information in question, and
- at a time when, and in circumstances in which, it was reasonable for him to rely on it.

9. Issuer's Scope of Liability

An Issuer is liable in respect of an untrue or misleading statement only if a person discharging managerial responsibilities within the issuer knew the statement to be untrue or misleading or was reckless as to whether it was untrue or misleading or when there is a dishonest delay in publishing information. His liability extends when in respect of the omission of any matter required to be included in published information only if a person discharging managerial responsibilities within the issuer knew the omission to be a dishonest concealment of a material fact. However, he is not liable for the latter if the published information is contained in listing particulars or a prospectus and the issuer is liable under Section 90 of the FSMA. A person's conduct is regarded as dishonest if and only if it is regarded as dishonest by persons who regularly trade on the securities market in question, and the person was aware or must be taken to have been aware that it was so regarded. A person discharging managerial responsibilities could be any director of the issuer (or a person occupying the position of director, by whatever name called) or in the case of an issuer whose affairs are managed by its members, any member of the issuer or any senior executive of the issuer having responsibilities in relation to the information in question or its publication.

However, this liability does not affect:

- civil liability—
    - under Section 90 (compensation for statements in listing particulars or prospectus),
    - under rules made by virtue of Section 954 of the Companies Act, 2006 (compensation),
    - for breach of contract,

  - ✎ under the Misrepresentation Act, 1967, or
  - ✎ arising from a person's having assumed responsibility, to a particular person for a particular purpose, for the accuracy or completeness of the information concerned;
- liability to a civil penalty; or
- criminal liability.

C. UNITED STATES OF AMERICA

In the United States, the federal Securities Law provides ample opportunities for private claimants to seek remedies through the courts for misleading disclosures in relation to broad range of public statements, both written and oral. The Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") provide aggrieved buyers and sellers of securities with several express and implied causes of action. In addition, the Securities and Exchange Commission ("SEC") can impose sanctions on the offering participants for violations of the Securities Act and the Exchange Act.

10. Types of Statements for which Liability Can Accrue

Federal securities laws provide remedies for misleading disclosure for a broad range of misleading public statements, both written and oral.

10.1 Registration Statements[39]

Registration statements filed with the SEC (including the prospectus contained in the registration statement) can be a source of liability for untrue statements of material fact and materially misleading omissions (Section 11 of the Securities Act). A registration statement means the statement provided for in Section 6, and includes any amendment thereto and any report, document, or memorandum filed as part of such statement or incorporated therein by reference.

10.2 Prospectus Liability[40]

Prospectus means any prospectus, notice, circular, advertisement, letter, or communication, written[41] or by radio or television, which offers any security for sale or confirms the sale of any security. A seller may be liable for a prospectus (or oral communication) containing untrue statements of material fact or materially misleading omissions made in connection with a public offering, whether or not the offering is made pursuant to a registration statement filed with the SEC (Section 12(*a*)(2) of the Securities Act).

10.3 Other Public Statements

Rule 10(*b*)(5) provides one of the most significant remedies for disclosure violations, even extending to secondary market trading. Rule 10(*b*)(5) lawsuits may spring from material misstatements or omissions relied upon by investors, including press releases, financial reports and even analyst reports posted on an issuer's website. Investors may also sue sellers under Section 12(*a*)(1) of the Securities Act if securities were offered in violation of the registration requirements of that Act. A successful suit under Section 12(*a*)(1) gives the investor a "put right" which refunds the purchase price of the securities.

Sections 11 and 12(*a*)(2) and Rule 10(b)(5) do not provide the only statutory remedies for improper disclosure in connection with securities offerings. For instance, Section 17(*a*) of the Securities Act contains a broad anti-fraud provision similar to Rule 10(*b*)(5), which would apply to both public and private offerings as well as secondary trading. Section 17(*a*) does not, however, provide a private right of action, and suits can only be initiated by the SEC. This article therefore focuses only on those remedies provided by Sections 11 and 12(*a*)(2) and Rule 10(b)(5).

10.4 Section-11 Liability

Section 11 of the Securities Act creates an obligation of openness and full disclosure in the context of any registered offering. It provides buyers of the securities with an express right of action for damages if any part of the issuer's registration statement (when it is declared

effective by the SEC) contains an "untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading".

To establish a valid Section-11 claim, a plaintiff must show all of the following:

- The registration statement, at the time it became effective, contained a misstatement or omission;
- The misstatement or omission was material;
- The plaintiff bought securities registered pursuant to the misleading registration statement. This includes anyone who bought the security directly from the issuer or underwriter and anyone who bought the security later in the open market;
- The plaintiff has complied with the statute of limitations.

11. Who Is liable?

Section 11 of the Securities Act states that, in the event of a material misstatement or omission in a registration statement, an investor can sue:

- every person who signed the registration statement;
- every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
- every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions or partner;
- every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
- every underwriter with respect to such security.

However, the Securities Act also provides that all or any one or more of the persons who can be liable, shall be jointly and severally liable, and every person who becomes liable to make any payment may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

12. Persons Not Liable

An investor cannot hold a selling stockholder liable for a material misstatement or omission in a registration statement under Section 11, as a selling stockholder does not sign the issuer's registration statement. This applies even where the registration statement only registers stock of selling stockholders and does not register any additional stock of the issuer. A selling stockholder can be liable under Section 11 only if they are also a director or officer and held liable in that capacity. Issuer's counsel and underwriters' counsel are not considered to be either experts or controlling persons where counsel does no more than perform legal services or act only in his professional capacity for its clients which includes preparing the registration statement.

13. Defences to Section-11 Liability

The defendant can avoid liability if it can prove one of the available defences:

13.1 Plaintiff's Knowledge of the Untruth or Omission at the Time It Acquired the Securities:[42]

This defence is available to all defendants, including the issuer. Defendants must show actual, not constructive, knowledge.

13.2 Resignation:[43]

This defence is available to a named party that is, an officer or director of the issuer, the auditor or any other expert identified in the registration statement, who resigns and informs the SEC of the materially false or misleading statement before the registration statement becomes effective.

13.3 Effectiveness without Knowledge:[44]

This defence is available to a named party who upon becoming aware of such fact informs the SEC and the public that a registration statement has become effective without his knowledge.

13.4 Non-causation:[45]

This defence is available to all defendants, including the issuer. The defendant will not be liable if it can prove that the decline in the security's value was due to a general decline in the market and was not a result of any untruths or omissions in the registration statement.

13.5 Due Diligence or Reasonable Investigation:[46]

This defence is available to all parties other than the issuer. The issuer is strictly liable for material misstatements or omissions contained in the registration statement. Each potentially liable party (other than the issuer) can, however, assert a so-called due diligence defence as an escape from liability.[47] To assert a due diligence defence, the defendant must establish that, based on a reasonable investigation, their belief that the registration statement was accurate and complete was reasonable. It is provided that what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property. Due diligence is the term used to describe the process by which parties who may be liable for material misstatements or omissions in a registration statement seek to verify the disclosures in the registration statement. The standard of reasonableness is that required of a prudent man in the management of his own property.[48] The activities that create the reasonable investigation or due diligence defense can also mitigate potential liability under Section 12 of the Securities Act and Rule 10(*b*)(5) of the Exchange Act. Section 12(*a*)(2) expressly provides that a defendant is not liable if he did not know, and in the exercise of reasonable care could not have known, of the misstatements or omissions.

A proper due diligence investigation into the preparation of the issuer's registration statement can effectively minimise potential liability. There is some uncertainty about what is necessary to establish a due diligence defence, since the courts have held that due diligence for a Section-11 person will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data.[49] Accordingly, the SEC issued its own statement on the subject of due diligence.[50] Rule 176 lists circumstances that determine whether an investigation is reasonable and reasonable grounds for belief under Section 11. The SEC has interpreted the rule to allow each person who may have liability under Section 11 to evaluate the surrounding facts, including the extent of his previous relationship with the issuer, and use investigation techniques that are appropriate to the circumstances of the offering. The rule confirms that the degree of investigation is not the same for all Section-11 persons. The availability of the due diligence defence depends on the following factors:

- type of issuer;
- type of person;
- type of security;
- if the person is an officer, the office held;
- if the person is a director or proposed director, the presence (or absence) of another relationship to the issuer;
- reasonable reliance on officers, employees and others whose duties should have given them knowledge of the particular facts (in light of the functions and responsibilities of the person with respect to the issuer and the filing);

- if the person is an underwriter, the type of underwriting arrangement, the role of the person as an underwriter and the availability of information concerning the registration;
- whether the person had any responsibility for a fact or document incorporated by reference at the time of the filing from which it was incorporated.

13.6 Due Diligence Defence for "Expertise"/"Non-expertise" Sections

The due diligence burden also varies with the class of the potential defendant (whether they are an expert or non-expert) and whether the portion of the registration statement giving rise to the potential liability has been expertised. Section 11 divides the registration statement into two types:

13.6.1 Expertised Sections

These are principally the audited financial statements, which include an audit opinion prepared by the auditors. In most underwritten offerings (including an IPO) the only expert involved is the auditor. Auditors and other experts can only be held liable if they are named, with their consent, in the registration statement as having prepared or certified any part of the registration statement or any report or valuation mentioned in it. An expert facing potential liability for statements made on his authority as an expert, or as a copy or extract from his report or valuation as an expert contained in an expertised section of a registration statement, must show one of the following to assert a due diligence defence[51], that:

- he had, after reasonable investigation, reasonable grounds to believe and did believe, at the time the portion of the registration statement giving rise to the potential liability was declared effective by the SEC, that the statements in that portion of the registration statement were true and that there was no omission to state a material fact required to be stated or necessary to make the statements not misleading.
- the portion of the registration statement giving rise to the potential liability did not fairly represent that expert's statement as an expert or was not a fair copy of, or extract from, his report or valuation as an expert.
- *Non-expertised sections:* These are all the other sections of the registration statement. To assert a due diligence defence, a non-expert facing potential liability for statements contained in a non-expertised section of a registration statement must prove that he had, after reasonable investigation, reasonable grounds to believe and did believe, at the time the portion of the registration statement giving rise to the potential liability was declared effective by the SEC, both of the following[52]:

  (*i*) Statements in that portion of the registration statement were true.

  (*ii*) There was no omission to state a material fact required to be stated or necessary to make the statements not misleading.

  To assert a due diligence defense, a non-expert facing potential liability for statements contained in an expertised section of a registration statement must show that he had no reasonable grounds to believe and did not believe, at the time the portion of the registration statement giving rise to the potential liability was declared effective by the SEC, any one of the following[53]:

  (*i*) The statements were untrue.

  (*ii*) There was an omission to state a material fact required to be stated or necessary to make the statements not misleading.

  (*iii*) That portion of the registration statement did not fairly represent the statement of the expert or was not a fair copy of, or extract from, the report or valuation of the expert.
- For expertised sections, non-expert defendants are not required to conduct a reasonable investigation to have reasonable grounds for their belief, but they must investigate "*red flags*" in expertised sections, including the financial statements. A red flag would include anything that would indicate that the expertised section should not be relied on. Red flags depend on the circumstances unique to each defendant. In

the WorldCom decision, Judge Cote described a red flag for the financial statements as "any information which strips, or should strip, underwriters of their confidence in the accuracy of an offering memorandum premised on audited financial statements".[54] This defense is commonly referred to as the reliance defense, as the non-expert defendant relies on the authority of an expert for certain parts of the registration statement.

14. Section-12 Liability

Section 12(*a*)(1) of the Securities Act imposes absolute liability on any person who offers or sells a security in violation of the registration requirements of Section 5[55] of the Securities Act. A "seller" is any person who successfully solicits a purchase of securities on the basis of a desire to serve the person's own financial interests or those of the owner of the security. Effectively, this means that underwriters, broker-dealers, selling agents and others directly involved in the selling process are exposed to liability under Section 12(*a*)(1) for any violation of the registration requirements. Under Section 12(*a*)(1), a seller can be held strictly liable to any purchaser of securities who can prove that he purchased securities that were sold by the seller that should have been registered under Section 5 of the Securities Act but were not. The seller has the burden of proving either of the following:

- there was a valid exemption from registration;
- the purchaser was responsible for the violation.

Section 12(*a*)(2) of the Securities Act supplements liability under Section 11 by imposing on any seller potential liability for material misstatements or omissions made by that seller in any prospectus or oral communication in the offer or sale of the issuer's securities, whether or not those securities are exempt from registration (subject to limited exceptions for certain government exempt securities). It is the only provision of the federal securities laws that provides a broad, express remedy to purchasers of securities. Traditionally, Section 12(*a*)(2) was given broad scope with courts interpreting it to apply to public offerings, private transactions (exempt offerings) and ordinary aftermarket trading so long as the purchaser could show, among other things, that the seller sold by means of a communication that included a material misstatement or omission. However, in *Gustafson v Alloyd Co.*,[56] the Supreme Court held that Section 12(*a*)(2) only applies in the case of a public offering by an issuer, not private placements or ordinary aftermarket trading. The court concluded that Section 12(*a*)(2) did not apply to the privately negotiated stock purchase agreement (for a secondary market sale of securities) at issue in the case. The court's decision in *Gustafson* leaves unclear the applicability of Section 12(*a*)(2) to private offerings. Accordingly, until *Gustafson* is overturned, it appears that Section 12(*a*)(2) only applies to public offerings. Following *Gustafson*, a Plaintiff that purchases securities in an exempt offering (such as a Section 4(2) private placement or Rule 144A offering) should bring its federal securities law claims under Rule 10(*b*)(5), which shifts the burden of proof to the plaintiff to show *scienter* (the intent to deceive, manipulate or defraud) on the part of the defendant. Parties who are potentially liable under Section 12(*a*)(2) can rely on the same defences available under Section 11, including the due diligence defence.

15. Section 10(*b*) of the Exchange Act and SEC Rule 10(*b*)(5) Liability

Section 10(*b*) of the Exchange Act makes it unlawful for any person "to use or employ in connection with the purchase or sale of any security any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors". Section 10(*b*) applies to all registered and unregistered offerings of securities (debt and equity). However, the statute requires the SEC to prescribe rules to implement it. There are 14 of these rules in force under Section 10(*b*), the most important of which is Rule 10(*b*)(5), the general anti-fraud rule. Rule 10(*b*)(5) prohibits any of the following in connection with the purchase or sale of a security:

- fraudulent devices and schemes, material misstatements and omissions of any material facts;
- acts and practices that operate as a fraud or deceit on any person.

Unlike Sections 11 and 12 of the Securities Act, neither Section 10(*b*) nor Rule 10(*b*)(5) provides an express private right of action to securities buyers injured by a violation. However, an implied right of action has developed over time in the federal courts based on basic common law principles used in fraud cases. For civil liability to attach under Section 10(b) and Rule 10(*b*)(5):

- there must be a false statement about, or omission of, a material fact;
- the false statement or omission must be made with *scienter*;
- there must be evidence that the plaintiff justifiably relied on the statement or omission;
- there must be evidence that reliance on the false statement or omission caused damages.

16. Liability of Control Persons

Control person liability can arise under Section 15 of the Securities Act or Section 20 of the Exchange Act. Section 15 of the Securities Act provides that any person who controls a person liable under Sections 11 and 12 is jointly and severally liable with, and to the same extent as, the controlled person. The term "controls" is broadly defined by the SEC; it can include directors, officers and principal stockholders, depending on the facts and circumstances. Rule 405 of the Securities Act defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." However, a controlling person will not be held liable under Section 15 if he can prove that he had no knowledge of, or reasonable grounds to believe in the existence of, the facts that make the controlled person liable. This is an affirmative defence, to be pleaded and proved. On the other hand, Section 20(*a*) of the Exchange Act imposes liability on any person who directly or indirectly controls any person liable under Section 10(*b*) or Rule 10(*b*)(5). This controlling person can be held liable to the same extent as the controlled person. This provision does not require *scienter* or negligence. However, the controlling person is not liable if he acted in good faith and did not induce the acts on which the liability of the controlled person is founded. This is an affirmative defense, to be pleaded and proved by defendants.

Section 15 of the Securities Act and Section 20 of the Exchange Act have been interpreted as parallel statutes. Since Sections 15 and 20 are secondary liability provisions, a primary violation must be established before liability arises under Section 15 or Section 20. However, the controlled person does not need to be held primarily liable to be joined in an action under Section 15 or Section 20.

Endnotes

1. *Government Stock and other Security Investment Co. Ltd.* v. *Christopher*, (1956) 26 Com Cases 210.
2. Section 56 of the Act.
3. Section 55A of the Act.
4. (1860) 1 Dr. & Sm. 363, 381.
5. Palmer's Company Precedents, 59 (17th edn., 1956).
6. Section 62 of the Act.
7. *Bentley* v. *Black*, (1893) 9 TLR 580 (CA).
8. *Rajagopala Iyer* v. *The South Indian Rubber Works*, AIR 1942 Mad 656.
9. *Ibid.*
10. *R.* v. *Kylsant*, (1932) 1 KB 442.
11. *Smith v Chadwick*, (1882) 20 Ch D 27, 57.
12. *Bansidhar Durga Dutt v Tata Power Co. Ltd.*, AIR 1925 Bom 272.
13. *N. Parthasarathy* v. *CCI*, AIR 1991 SC 1420.
14. Section 58-B of the Act.

15. The expression "expert" includes an engineer, a valuer, an accountant and any other person whose profession gives authority to a statement made by him.
16. Section 60(1) of the Act.
17. Sections 62(1) and 63 (2) of the Act.
18. Company Law Committee Report, para 59.
19. MANU/SC/7687/2008: (2008) 8 SCC 205.
20. See Form 2A under Companies (Central Government's) General Rules & Forms, 1956.
21. Section 56(3) of the Act.
22. Section 56(6) of the Act.
23. Section 59(1) of the Act.
24. Company Law Committee Report, Para 62.
25. *McConnel v Wright*, (1903) 1 Ch 546.
26. *Smith New Court Securities Ltd.* v. *Scrimgeour Vickers (Asset Management) Ltd.*, (1997) 1 BCLC 350 (HL).
27. Company Law Committee Report, Para 62.
28. As per Section 79(2), "Listing particulars" means a document in such form and containing such information as may be specified in listing rules.
29. FSMA classifies the responsibility that can be incurred on account of statements made by any person. The two categories are experts and non-experts. Thus, a statement which is not made by an expert has been defined as: any untrue or misleading statement in listing particulars or the omission from listing particulars of any matter required to be included by Section 80 or 81.

    A statement by an expert which incurs liability upon him means a statement included in listing particulars which purports to be made by, or on the authority of, another person as an expert and is stated to be included in the listing particulars with that other person's consent.
30. Section 90(6)
31. Sections 463(1) and (2),UK Companies Act, 2006.
32. Section 463(3), UK Companies Act, 2006.
33. Section 463(4), UK Companies Act, 2006.
34. Section 463(6), UK Companies Act, 2006.
35. *Hedley Byrne* v. *Heller* [1964] AC 465.
36. *Possfund Custodian Trustee Limited* v. *Diamond* [1966] 2 All ER 774.
37. [1990] 3 All ER 321.
38. Inserted by Section 1270 of the UK Companies Act, 2006 and to be effective from 1st October 2010.
39. Defined in Section 2(8) of the Securities Act, 1933.
40. Defined in Section 2(10) of the Securities Act, 1933.
41. The term "write" or "written" shall include printed, lithographed, or any means of graphic communication.
42. Section 11(*a*), Securities Act.
43. Section 11(*b*)(1), Securities Act.
44. Section 11(*b*)(2), Securities Act.
45. Section 11(*e*), Securities Act.
46. Section 11(*b*)(3), Securities Act.
47. Section 11(*b*)(3), Securities Act.
48. Section 11(*c*), Securities Act.
49. *Feit* v. *Leasco Data Processing Equipment Corp.*, 332 F. Supp. at 577 (EDNY 1971).
50. Rule 176, Securities Act.
51. Section 11(*b*)(3)(B), Securities Act.
52. Section 11(*b*)(3)(A), Securities Act.
53. Section 11(*b*)(3)(C), Securities Act.
54. *In re Worldcom, Inc. Sec. Litig.* 346 F.Supp. 2d 628 (SDNY) 2004.
55. Prohibitions Relating to Interstate Commerce and the Mails.
56. 513 US 561 (1995).