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Negative Assurance in Securities Offerings

*Special Report of the Task Force on Securities Law Opinions, ABA Section of Business Law**

INTRODUCTION

In 2002, the American Bar Association Section of Business Law adopted Guidelines for preparing legal opinions delivered at the closing of a business transaction by counsel for one party to another party ("closing opinions").¹ These Guidelines replaced the guidelines included in the section's 1991 *Third Party Legal Opinion Report*² and reflected developments in customary practice in the decade since 1991.³ This Report expands upon section 4.5 of the Guidelines, which addresses the negative assurance counsel sometimes provides in securities offerings regarding the disclosure in the prospectus or other offering documents furnished to investors.⁴

HISTORY AND PURPOSE

Historically, underwriters have required, as a condition to closing a registered offering of securities, that counsel⁵ provide them negative assurance regarding the

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1. Committee on Legal Opinions, *Guidelines for the Preparation of Closing Opinions*, 57 BUS. LAW. 875 (2002) [hereinafter *Guidelines*].

2. Committee on Legal Opinions, *Third-Party Legal Opinion Report, Including the Legal Opinion Accord, of the Section of Business Law, American Bar Association*, 47 BUS. LAW. 167 (1991).

3. See, e.g., RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §§ 51(2), 95 (2000); TriBar Opinion Committee, *Third-Party "Closing" Opinions*, 53 BUS. LAW. 591 (1998).

4. See *Guidelines*, *supra* note 1, at 880. Section 4.5 of the *Guidelines*, entitled "Negative Assurance," reads as follows:

Opinion recipients sometimes seek negative assurance from the opinion giver regarding the adequacy of the disclosure in the prospectus or other disclosure documents furnished to investors in connection with a sale of securities. Such negative assurance is not an opinion in the traditional sense. Rather, the practice of providing negative assurance is unique to securities offerings and is intended to assist the opinion recipient in establishing a due diligence or similar defense. A request for negative assurance is appropriate only when it is requested for that purpose in connection with a registered securities offering or, depending on the nature of the disclosure document and the process by which it was prepared, an offering of securities exempt from registration.

Id. The accompanying footnote reads "A request for negative assurance will be appropriate, for example, in many Rule 144A and Regulation S offerings." *Id.* at 880 n.17.

5. Negative assurance by issuer's counsel is discussed under "Guidelines for Issuer's Control," and by underwriters' counsel under "Negative Assurance by Underwriters' Counsel," *infra*.

disclosure in the registration statement and prospectus to help them establish a due diligence defense under sections 11 and 12(a)(2) of the Securities Act of 1933 (“Securities Act”).⁶ Negative assurance is not a “legal opinion.” Rather, it is a statement of belief, unique to securities offerings, based on participation in the intensive process of preparing, reviewing, and revising the registration statement and prospectus customarily conducted in connection with a registered offering.⁷

Today, in some types of unregistered offerings (e.g., Rule 144A and Regulation S offerings), placement agents and financial intermediaries⁸ request negative assurance on the offering documents.⁹ They do so, even though sections 11 and 12(a)(2) of the Securities Act do not apply,¹⁰ to help them establish a defense to possible claims that might be brought pursuant to Rule 10b-5 under the Securities Exchange Act of 1934¹¹ (which requires “scienter”).

This Report proposes guidelines for providing negative assurance in both offerings of securities that are registered and, where appropriate, those that are exempt from registration.¹²

GUIDELINES FOR ISSUER’S COUNSEL

RECIPIENTS OF NEGATIVE ASSURANCE

As stated in section 4.5 of the Guidelines, the purpose of negative assurance is to assist the recipient in establishing a due diligence or similar defense.¹³ That purpose is served when negative assurance is provided to third parties who can avoid liability in securities offerings by establishing such a defense. It is not served by providing negative assurance to ultimate purchasers of securities as opposed to underwriters (or other financial intermediaries). Requests that negative assurance be provided to those persons or to issuers of the securities are inappropriate.

NATURE OF TRANSACTION AND DISCLOSURE DOCUMENT

Negative assurance should be limited to registered offerings or to transactions in which an offering document comparable to a statutory prospectus under the

6. 15 U.S.C. §§ 77k, 77l(a)(2) (2000).

7. See Report by the Boston Bar Association Securities Law Committee on Securities Law Opinions in Exempt Offerings, 30 Boston Bar Journal 6, Nov./Dec., 1986.

8. In a Rule 144A offering, the initial sale by the issuer is made to a limited number of financial intermediaries pursuant to the exemption from registration provided by Section 4(2) of the Securities Act. 15 U.S.C. § 77c (2000). These initial purchasers promptly resell the securities to “qualified institutional buyers” pursuant to the resale exemption provided by Rule 144A. Regulation S provides an exemption for certain offshore offerings.

9. Dealer-managers sometimes request negative assurance in exchange offers (which involve both the issuance and purchase of securities) when the process for preparing the disclosure document is comparable to that followed in a registered offering. The practice also has developed for underwriters in offerings of municipal securities sold to the public but exempt from registration under Section 3(a)(2) of the Securities Act to require negative assurance from counsel for the issuer and others. 15 U.S.C. § 77c.

10. See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 581 (1995).

11. 17 C.F.R. § 240.10b-5 (2003).

12. Although many of the basic principles apply, this Report does not address negative assurance in specialized areas such as asset-backed and structured finance transactions.

13. See *Guidelines*, *supra* note 1, at 880.

Securities Act is being delivered and the process for preparing the offering document is comparable to that followed in a registered offering. These transactions include many Rule 144A offerings and some Regulation S offerings.¹⁴

Offerings using short-form registration statements on forms such as Form S-3 and take-downs from shelf registration statements under Rule 415 (as well as comparable non-registered offerings, such as some Rule 144A offerings) often are accomplished within a short time frame and involve not only a document describing the offering but also disclosure documents relating to the Company that are incorporated by reference. Lawyers customarily provide negative assurance in connection with these offerings based on their review, within the limited time available, of the offering document and the documents incorporated by reference, as supplemented by their knowledge of the Company's affairs gained in prior representation.¹⁵

ROLE OF COUNSEL

Negative assurance normally should be provided only by counsel who has overall responsibility for advising the client concerning the preparation of the offering document. When other counsel has been retained to advise the client on a particular aspect of a transaction, e.g., specific contracts or intellectual property or regulatory matters, such counsel usually addresses the portion of the offering document dealing with that matter by rendering an opinion on the accuracy of the description rather than by providing negative assurance.¹⁶

BASIS FOR PROVIDING NEGATIVE ASSURANCE

Counsel is not an insurer of the adequacy of the disclosure in the offering document or a "reputational intermediary," and a statement of negative assurance expresses only the subjective belief (i.e., conscious awareness)¹⁷ of those lawyers in the firm who have actively participated in the preparation of the offering doc-

14. In offerings under Rule 144A, for example, the offering document and the process for preparing it are often comparable to the prospectus and the process followed to prepare the prospectus under the Securities Act. See CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS 428-32 (Aspen Law and Business, 2d ed. 1997) (describing Rule 144A and Regulation S offerings). See also *supra* note 8.

15. In some situations, lawyers who give negative assurance may not have been involved in the preparation of the documents incorporated by reference but base their negative assurance on their review of those documents and on discussions with officials of the company and participation in the preparation of the offering document as described in the negative assurance.

16. Such counsel ordinarily should not be asked to provide negative assurance. Such a request might be made, however, if such counsel has been retained to advise the client regarding the disclosure in a specific legal area material to the company, such as patent or regulatory matters, is sufficiently versed in applicable securities law standards and has had sufficient involvement in the process of preparing the overall disclosure document. When other counsel has been consulted with regard to particular matters, counsel with overall disclosure responsibility may choose to indicate that, to the extent its negative assurance covers those matters, it is basing its belief on the advice of that counsel.

17. The Task Force disagrees with the contrary conclusion reached in *Pioneer Ins. Co. v. Chase Securities*, No. 99-CV-919-K, 2002 U.S. Dist. LEXIS 7562 (N.D. Okla. Mar. 28, 2002), that a reasonableness standard (i.e., what the lawyers reasonably should have known) applies.

ument.¹⁸ That belief is subject to a good faith standard and is based on their familiarity with the Company and what they have learned as a result of the inquiries and reviews described in the negative assurance statement and their work on the transaction, including any consultations with other lawyers in the firm.

LOCATION OF NEGATIVE ASSURANCE

Because negative assurance is not a legal opinion, it is generally provided in a separate letter¹⁹ or in a separate unnumbered paragraph of a closing opinion. Either way, counsel's responsibility and the meaning of the negative assurance are the same.

NEGATIVE ASSURANCE BY UNDERWRITERS' COUNSEL

In transactions in which issuer's counsel provides negative assurance to the underwriters, counsel for the underwriters also normally furnishes negative assurance to the underwriters (but not the issuer). The negative assurance furnished to the underwriters by their own counsel is generally comparable to the negative assurance provided by counsel for the issuer.²⁰

As in the case of counsel for the issuer, the negative assurance furnished by underwriters' counsel expresses the subjective belief of only those lawyers in the firm who have actively participated in the preparation of the offering document. Because of the firm's lack of other involvement with the issuer, those lawyers are likely to be the only lawyers in the firm who are knowledgeable about the issuer. Thus, the issue discussed in note 18, *supra*, is not normally presented when underwriters' counsel furnishes negative assurance.

FORM OF NEGATIVE ASSURANCE—CUSTOMARY EXCEPTIONS, QUALIFICATIONS, INTERPRETATIONS, AND SCOPE LIMITATIONS

Annexed to this Report is a form of negative assurance that reflects the views expressed in this Report.²¹ Whatever its exact language, the negative assurance normally states that:

18. Some underwriters object to the inclusion in the negative assurance statement of "ring fencing" language to this effect and, because that language is not thought to be necessary, many lawyers do not insist on it. On occasion, underwriters have requested a statement that the belief expressed in the negative assurance encompasses all lawyers in the firm who have performed services for the client. Such an approach may be impractical and uneconomic in that it could require the lawyers involved in the offering to canvas every other lawyer in the firm who may be knowledgeable about the client's affairs. In addition, it could be construed to require lawyers in the firm who are not securities lawyers, and have not devoted the necessary attention to the offering document, to review that document and make judgments regarding the application of the federal securities laws.

19. The separate letter approach may help counsel limit the recipients of negative assurance to those for whom it is appropriate. Negative assurance normally should not be directed to all the recipients of a closing opinion or all those identified as entitled to rely on it, such as trustees or transfer agents.

20. Unlike counsel for the issuer who is providing negative assurance to a third party, counsel for the underwriters has professional responsibilities to the underwriters as its client.

21. The form is included solely for illustrative purposes and, as indicated in the notes to the form,

- Counsel is not assuming responsibility for the accuracy, completeness, or fairness of the offering document, except to the extent that specific sections are addressed in a separate opinion or confirmation.²² The negative assurance may go on to point out the limitations on counsel's professional engagement and the fact that many of the disclosures in an offering document are of a non-legal nature.
- Counsel has not undertaken any obligation to verify the facts contained in the disclosure document.
- Counsel's belief is based on a review of the offering document and counsel's participation in its preparation and in discussions that took place in the preparation process among the various participants.²³
- Financial statements are not being covered.²⁴ In addition, because other parts of an offering document, such as Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), usually include financial and accounting information, financial and accounting data are often expressly excluded.²⁵
- "Nothing came to our [counsel's] attention that caused us to believe . . ." or something along those lines.²⁶

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has been drafted to apply only to limited types of offerings. The Task Force is not recommending any particular form of negative assurance. The form makes explicit a number of matters that are understood as a matter of customary practice whether or not stated. In whatever way expressed, negative assurance should be read in light of customary practice except as it expressly varies that practice.

22. See *Escott v. Barchris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

23. Some lawyers may indicate that they also have reviewed other materials.

24. The reference to financial statements includes the notes and schedules to the financial statements (which sometimes are, but need not be, referred to expressly). These are covered in the accountant's report and comfort letter. See Statement on Auditing Standards No. 72.

25. Some lawyers refer to "information" instead of "data" and, when requested, sometimes limit the clause to data or information "that are derived from the financial statements or the books and records of the Company." Some lawyers also exclude "statistical data" on the ground that a lawyer's professional competence does not extend to that type of information. Even if statistical data or some financial information are not excluded, it is understood that there are limitations on what lawyers can provide in areas outside their expertise.

26. Several formulations of negative assurance are in common use. For example, "led us to conclude" may be used in place of "caused us to believe," and "no facts" in place of "nothing." Further, "nothing that came to our attention caused us to believe" may be used in place of "nothing came to our attention that caused us to believe." These differences in formulation do not change the subjective nature of the negative assurance statement as described in this Report.

ILLUSTRATIVE FORM OF NEGATIVE ASSURANCE

Reference is made to the [Registration Statement and Prospectus—Offering Document].¹ As counsel to [the Company, the Underwriters], we reviewed the [Registration Statement and Prospectus—Offering Document] and participated in conferences with your representatives and representatives of the Company, [its counsel],² [and] its independent public accountants [and your counsel]³ at which the contents of the [Registration Statement and Prospectus—Offering Document] and related matters were discussed.

The purpose of our professional engagement was not to establish or confirm factual matters set forth in the [Registration Statement and Prospectus—Offering Document], and we have not undertaken any obligation to verify independently any of the factual matters set forth in the [Registration Statement and Prospectus—Offering Document]. Moreover, many of the determinations required to be made in the preparation of the [Registration Statement and Prospectus—Offering Document] involve matters of a non-legal nature.

Subject to the foregoing, we confirm to you that, on the basis of the information we gained in the course of performing the services referred to above, nothing came to our attention that caused us to believe⁴ that [the Registration Statement, on the effective date thereof, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading or that]⁵ the [Prospectus] [Offering Document], as of its date, [or as of the date hereof,]⁶ contained [or contains] any untrue statement of a material fact or omitted [or omits] to state any material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading; *provided, however*, that we do not

1. Refer either to the Registration Statement and Prospectus in an offering registered under the Securities Act of 1933 or the Offering Memorandum in a private offering. If documents are incorporated by reference, they should be addressed either by identifying them as included in the defined term or terms or by specifically referring to them in the relevant place.

2. Insert *unless* preparer acted as counsel to the Company.

3. Insert *unless* preparer acted as counsel to the addressee(s).

4. Some lawyers include language that makes clear that “our attention” and “caused us to believe” mean the conscious awareness of those lawyers in the firm who were actively involved in the preparation of the Offering Document. See note 18 of the Report. In addition, some lawyers state that for matters of a non-legal nature they are relying on the judgment of management or others regarding the adequacy of disclosure. For alternative formulations, see note 26 of the Report.

5. Include *only* if the offering is registered under the Securities Act of 1933. This language and the balance of the sentence assume that the Registration Statement is on Form S-1 and, therefore, do not refer to documents incorporated by reference or to Prospectus supplements for shelf takedowns or the dates as of which the negative assurance is effective for incorporated documents.

6. If the bracketed material is added, consider describing any additional work done after the date of the Prospectus or Offering Document.

assume any responsibility for the accuracy, completeness or fairness of the statements contained in the [Registration Statement and Prospectus—Offering Document] (except for _____),⁷ and we do not express any belief with respect to the financial statements⁸ or other financial [, statistical] or accounting data⁹ contained in¹⁰ the [Registration Statement or Prospectus—Offering Document].

7. Refer either to the specific sections of the relevant document or to the specific paragraph or paragraphs of the closing opinion that address those sections.

8. Some lawyers refer here also to the notes to the financial statements and financial statement schedules.

9. See note 25 of the Report.

10. Some lawyers add “or omitted from” to make explicit what is understood without that phrase.

