

7-1-1978

## A Securities Lawyer's Dilemma: The SEC's Policy of Disclosure v. the Attorney-Client Privilege

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### Recommended Citation

Grant B. Luna, *A Securities Lawyer's Dilemma: The SEC's Policy of Disclosure v. the Attorney-Client Privilege*, 15 SAN DIEGO L. REV. 797 (1978).

Available at: <https://digital.sandiego.edu/sdlr/vol15/iss4/8>

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## A SECURITIES LAWYER'S DILEMMA: THE SEC'S POLICY OF DISCLOSURE V. THE ATTORNEY-CLIENT PRIVILEGE

*This Comment discusses the importance of the attorney-client privilege to the securities lawyer and possible infringements on the privilege by the Securities and Exchange Commission. The significance of a settlement in the controversial National Student Marketing case is examined. The Comment also analyzes the basis for the American Bar Association's support for the attorney-client privilege and the rationale for the SEC's disclosure policy. The author concludes that the attorney-client privilege for the corporation is endangered by present disclosure policies and offers suggestions for attorney conduct under the existing state of the law.*

The attorney-client privilege is one of the most sacred and fundamental rules of evidence. An attorney is not permitted, and cannot be compelled, to testify about communications made to him in his professional capacity by his client unless the client consents.<sup>1</sup> The attorney-client privilege is based on the importance of encouraging full disclosure by the client. The client will be more willing to reveal all the facts if he knows that the disclosure will be kept in strict confidence. The privilege is as important to corporations as it is to individuals.<sup>2</sup> The corporation's attorney-client privilege has been upheld in a stockholder suit subject to a showing of good cause.<sup>3</sup> The availability of the privilege to corporate clients has been directly recognized in most jurisdictions.<sup>4</sup>

The Code of Professional Responsibility supports an attorney-client privilege for the corporation. Canon Four provides: "A lawyer

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1. 58 AM. JUR. *Witnesses* § 460 (1948).

2. *American Cyanamid v. Hercules Powder Co.*, 211 F. Supp. 85 (D. Del. 1962). *But see* *Radiant Burners, Inc. v. American Gas Ass'n*, 207 F. Supp. 771 (N.D. Ill. 1962).

3. *E.g.*, *Garner v. Wolfenbarger*, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 101 U.S. 974 (1971).

4. *United States v. Becton & Co.*, 212 F. Supp. 92 (D.N.J. 1962); *City of Philadelphia v. Westinghouse Elec. Corp.*, 210 F. Supp. 483 (E.D. Pa. 1962); *A.B. Dick Co. v. Marr*, 95 F. Supp. 83 (S.D.N.Y. 1950), *appeal dismissed*, 197 F.2d 498 (2d Cir.), *cert. denied*, 344 U.S. 878 (1952).

should preserve the confidences and secrets of a client."<sup>5</sup> The attorney owes a duty of confidentiality to the corporate client.<sup>6</sup> However, the disciplinary rules provide that an attorney may reveal the confidences or secrets of a client when permitted or required by law<sup>7</sup> and prohibit an attorney from knowingly assisting his client in illegal or fraudulent activity.<sup>8</sup> The American Bar Association's support of the attorney-client privilege and the Securities and Exchange Commission's (SEC) policy of disclosure have been the basis of "an estrangement, an interruption of this process [effective communication between the Bar and the Commission], the introduction of static on that line of communication between the Bar and the Commission."<sup>9</sup>

#### THE NATIONAL STUDENT MARKETING LITIGATION

A case which may create an exception to the attorney-client privilege for corporations is *SEC v. National Student Marketing Corp.*<sup>10</sup> This litigation has spawned several court decisions<sup>11</sup> and has received considerable attention from commentators.<sup>12</sup> The case reflects a new role for securities lawyers and a new SEC policy in enforcing this role.

National Student Marketing Corporation (NSMC) sought to merge with Interstate National Corporation (Interstate). Defendant White & Case, a New York City law firm, was NSMC's outside legal adviser; Marion Jay Epley III was a partner in this firm. Interstate was represented by defendant Bissell & Brook, a Chicago law firm, of which Louis Schauer was a member. Interstate hired an investment banking firm to make an investigation into the background, history, and finances of NSMC prior to the merger.

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5. ABA CODE OF PROFESSIONAL RESPONSIBILITY, CANON 4 (1971).

6. Daley & Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 EMORY L.J. 747 (1975).

7. ABA CODE OF PROFESSIONAL RESPONSIBILITY, DR 4-101(C).

8. *Id.*, DR 7-102 (A)(7).

9. Address by SEC Commissioner A.A. Sommers, Jr., The Commission and the Bar: Forty Good Years, Annual Luncheon of ABA Section of Corporation, Banking and Business Law, Honolulu, Hawaii (Aug. 14, 1974), reprinted in Mathews, *Liabilities of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105, 119 (spec. issue Mar., 1975) (brackets original).

10. 360 F. Supp. 284 (D.D.C. 1973).

11. See generally authorities cited notes 15-19 *infra*.

12. See, e.g., Freeman, *Opinion Letters and Professionalism*, 1973 DUKE L.J. 371; Johnson, *The Expanding Responsibilities of Attorneys in Practice Before the SEC: Disciplinary Proceedings Under Rule 2(e) of the Commission's Rules of Practice*, 25 MERCER L. REV. 637 (1974); Karmel, *Attorneys' Securities Laws Liabilities*, 27 BUS. LAW. 1153 (1972); Koch, *Attorney's Liability: The Securities Bar and the Impact of National Student Marketing*, 14 WM. & MARY L. REV. 883 (1973); Lipman, *The SEC's Reluctant Police Force: A New Role for Lawyers*, 49 N.Y.U. L. REV. 437 (1974); Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities Under the Federal Securities Statutes*, 34 OHIO ST. L.J. 231 (1973).

Upon receipt of a favorable report, the corporations decided to proceed with the merger. A signed merger agreement between the corporations required receipt by each company of a comfort letter from the independent public accountants for the other company.<sup>13</sup> The comfort letter was to state that the accountants had no reason to believe that the unaudited interim financial statements contained in the NSMC proxy statement were not prepared in accordance with generally accepted accounting principles and that they did not require any material adjustments. An opinion letter from counsel for each company stated that all transactions in connection with the merger had been conducted in full compliance with applicable law.

The closing meeting took place at the office of White & Case in New York City. In attendance were representatives of NSMC; Interstate directors; Schauer, representing Lord, Bissell & Brook for Interstate; and Epley, on behalf of White & Case, which represented NSMC. The accountants for NSMC were to deliver the comfort letter to NSMC's attorneys on closing day. However, by telephone, the accountants advised Epley that certain errors existed in NSMC's prior statements of net income. If corrected, NSMC's net income would be stated at a slight loss rather than at the \$700,000 profit reflected in the proxy material sent to Interstate shareholders for merger approval. A description of the required adjustments was distributed to the representatives of Interstate at the closing meeting prior to consummation of the merger agreement. The description of the required adjustment did not include what the ultimate effect of the change would be in the financial statement.

The accountants for NSMC drafted another paragraph to be added to the comfort letter to explain the effect of the adjustments. This modification was communicated to NSMC's attorneys but was not disclosed to the Interstate directors. NSMC's attorneys told the accountants that the addition required to determine the ultimate effect of the adjustments was not important because anyone could do the arithmetic.

The Interstate representatives decided to proceed with the closing without a board meeting and without giving notice to their shareholders of the adjustments or resoliciting their approval for the merger. Subsequent to the closing, the Interstate directors received a

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13. A *comfort letter* is a written memorandum by an accountant which states that there is no reason to believe the corporation's financial statements were not prepared in accordance with generally accepted accounting principles.

full text of the comfort letter from the accountants but declined to take further action. The adjustments contained in the comfort letter were never disclosed to the public or to the stockholders.

The SEC instituted an injunctive action after investigating the transaction. The SEC alleged that the omissions were material and in furtherance of a fraudulent scheme which violated the securities laws.<sup>14</sup> The gravamen of the SEC charges against the attorney defendants concerning the closing meeting was that they had failed to issue their opinions and to insist that the financial statements be revised and the shareholders be resolicited. Should the parties have refused this advice, the SEC would impose a duty on the attorneys to disclose the misleading nature of the financial statement to the SEC. White & Case and Epley were also charged with continuing to conceal the fraud by failure to refer to the comfort letter in a report to the SEC.

The Court of Appeals for the Second Circuit held that the attorneys serving in their representative capacity could be held accountable under the securities laws. The court dismissed the defendant's motion for summary judgment because the attorney's<sup>13</sup> state of mind in violating the securities laws was a question of fact. The court thus appeared to require some level of scienter before an injunction would issue.

In March, 1975, White & Case and Epley sought production of documents<sup>15</sup> which had been submitted by the SEC for in camera review by the court.<sup>16</sup> At the same time, the SEC filed a motion to dismiss the attorney's defense, which was based on an SEC violation of its own rules in failing to advise defendants of their potential liability and of their right to present views to the SEC. The court denied the attorney defendant's request for production of documents, holding that the documents were protected by the privilege for internal governmental memoranda containing advice or opinions.<sup>17</sup> Furthermore, the court ruled that the defendant's defense was insufficient as a matter of law because the SEC's directive to the staff

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14. The SEC alleged violations and aiding and abetting in violations of the antifraud, proxy, and reporting sections of the securities laws. See 15 U.S.C. §§ 77q(a), 78j(b), 78m(a) (1976).

15. White & Case and Epley sought production of documents relating to the promulgation of the SEC directive concerning notification of defendants, possible notification of the defendants in this case, inquiries from people outside the SEC concerning pre-proceeding notification, recommendations of the Advisory Committee on Enforcement Policies and Practices of the SEC (Wells Committee), and discussions of the Securities Act Release No. 5310 (*Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations*). SEC v. National Student Mktng. Corp., 68 F.R.D. 157 (D.D.C. 1975).

16. *Id.*

17. 5 U.S.C. § 552 (b)(5) (1976).

was only a suggestion that, if available, opposing viewpoints be made known to the SEC. White & Case and Epley were forced to develop a different line of defense.

In June, 1976, the SEC received a setback in the investigation of NSMC. Epley, the co-defendant partner of White & Case, testified before a federal grand jury in connection with an investigation into the affairs of NSMC. Epley was not indicted but gave considerable testimony to the grand jury. The SEC applied for an order authorizing disclosure of Epley's grand jury testimony to refresh his memory in the pending civil litigation.<sup>18</sup> The court held that the grand jury was not an investigative tool at the disposal of the SEC and that it would be an abuse of the grand jury process to allow its work product to be funneled to other governmental agencies having an interest in the subject. Because the SEC failed to show a particularized need which would outweigh the policy of secrecy, the request for disclosure was denied the SEC.<sup>19</sup>

A full hearing on the merits of the SEC claim against White & Case and Epley was scheduled for 1977. In its pretrial brief, the SEC contended that White & Case and Epley were negligent in preparing false opinions and in associating themselves with materially false and misleading statements.<sup>20</sup> The SEC argued that negligence was sufficient for the requested injunction. Even if scienter were required, the SEC would contend that the attorney's gross negligence satisfied this requirement, as the attorneys should have known that their acts would result in violations of the federal securities laws. The SEC stated that the need for an injunction is even greater when the defendants contend that their activities were legitimate.

White & Case and Epley argued in their pretrial brief that they acted in accordance with their legal and ethical duties and that there was no evidence that they had any knowledge that any of the parties

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18. *In re* Grand Jury Investig'n, 414 F. Supp. 74 (S.D.N.Y. 1976).

19. Several related actions followed the filing of the initial suit. NSMC stockholders were excluded as plaintiffs from a class action against the defendants. *In re* National Student Mktng. Litig'n v. Barnes, 530 F.2d 1012 (D.C. Cir. 1976). Several Interstate stockholders were joined as defendants and ordered to answer the complaint. *In re* National Student Mktng. Litig'n, 413 F. Supp. 1156 (D.D.C. 1976). Interstate National Corporation Employees Retirement Fund's motion to dismiss was denied because it could be sued directly, not just through a trustee. *In re* National Student Mktng. Litig'n, 413 F. Supp. 1159 (D.D.C. 1976).

20. SEC v. National Student Mktng. Corp., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,784 (D.D.C. 1976).

were engaging in unlawful activities.<sup>21</sup> According to the defendants, they had neither the right nor the duty to substitute their judgment for what Interstate thought should be disclosed. The attorneys maintained that there was no basis for imposing a duty on lawyers to disclose to the SEC under these circumstances. They argued that the added paragraphs explaining the effects of the adjustment were not material and imposed no duty to disclose at the closing meeting. Finally, the defendants stated that to hold their assertion of innocence as a basis for imposing the injunction violated equitable principles.

In May, 1977, the United States District Court for the District of Columbia approved a proposed settlement of the SEC's case against White & Case and Epley.<sup>22</sup> The terms of the settlement are important in determining the new role of the securities lawyer and the SEC's policy of disclosure. Epley consented to the entry of a final judgment of permanent injunction which prohibited him from engaging in future violations of the securities laws. Epley also agreed not to practice before the SEC for 180 days from the date of the entry of the judgment. The SEC agreed that it would not institute any proceedings against Epley under Rule 2(e) of the Commission Rules of Practice based upon the judgment.<sup>23</sup>

The settlement with respect to White & Case involved a stipulation of settlement. No injunction was issued against White & Case. Rather, the firm consented to an order without admitting or denying the allegations in the SEC complaint. By the terms of the order, White & Case agreed not to aid and abet any securities violations in its future representation of NSMC. White & Case further agreed that it would undertake to adopt, to effectuate, and to maintain certain procedures in its representation of all clients in matters involving the federal securities laws. The SEC, in turn, agreed not to institute any proceedings against White & Case under Rule 2(e) of the Commission Rules of Practice based on the allegations.

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21. SEC v. National Student Mktng. Corp., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,912 (D.D.C. 1977).

22. SEC v. National Student Mktng. Corp., [Current] FED. SEC. L. REP. (CCH) ¶ 96,027 (D.D.C. 1977).

23. 17 C.F.R. § 201.2(e)(3)(A)-(B) (1977) provides for the suspension of an attorney from appearing or practicing before the SEC if the attorney has been by name:

(A) permanently enjoined by any court of competent jurisdiction by reason of his misconduct in an action by the Commission from violation or aiding and abetting the violation of any provision of the federal securities laws or the rules and regulations thereunder; or

(B) Found by any court of competent jurisdiction in an action brought by the Commission to which he is a party or found by this Commission in any administrative proceeding to which he is a party to have violated or aided and abetted the violation of any provision of the federal securities laws . . . or of the rules and regulations thereunder (unless the violation was found not to have been willful).

*Id.* (parenthetical original).

Under the terms of this settlement, the SEC imposed disclosure by attorneys of information which may fall within the protection afforded by the attorney-client privilege. In the settlement, White & Case and Epley agreed to make certain information relating to NSMC available for any and all purposes at the request of any party to the action. Such a disclosure requirement could have far-reaching effects on the attorney-client privilege.

#### THE SEC POLICY OF DISCLOSURE

Several basic premises underlie the SEC's imposition of a duty on a lawyer to disclose client conduct. The SEC first points to the indispensable role of the attorney in the administration of the securities laws.<sup>24</sup> Because of this role, the attorney owes a high responsibility to the investing public in disclosure matters.<sup>25</sup> The SEC apparently believes that the duty owed to the investing public takes precedence over the attorney's obligation to the client to preserve confidences of the client.<sup>26</sup>

The SEC supports this position by distinguishing between the lawyer's roles as an advisor and as an advocate. The SEC argues that the securities lawyer does not act in an adversarial role.<sup>27</sup> As an advisor, the securities lawyer is arguably not bound by the attorney-client privilege and could fulfill his professional responsibility to the investing public by disclosing communications with the client. There is a possible waiver of the attorney-client privilege when the corporation authorizes the transmission of a document to the SEC.<sup>28</sup>

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24. Statement by SEC Commissioner P. A. Loomis, Jr., 1971 Securities Regulation Seminar 225-56 (Practicing Law Institute's Transcript Series No. 3, 1972), reprinted in Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412, 425 (1974).

25. Address by SEC Commissioner A.A. Sommers, Jr., The Commissioner and the Bar: Forty Good Years, Annual Luncheon of ABA Section of Corporation, Banking and Business Law, Honolulu, Hawaii (Aug. 14, 1974), reprinted in Mathews, *Liabilities of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105, 119 (spec. issue Mar., 1975).

26. Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412 (1974).

27. *In re Emanuel Fields*, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,407 (1973).

28. Goldberg, *Policing Responsibilities of the Securities Bar: The Attorney-Client Relationship and the Code of Professional Responsibility—Considerations for Expertizing Securities Attorneys*, 19 N.Y. L.F. 221 (1973).



It has also been suggested that the attorney should function more as an auditor, developing a healthy skepticism of the representations of management.<sup>29</sup> This position would force the attorney to investigate his own client, disclosing any material information found in the investigation.<sup>30</sup> One commentator has stated that the securities lawyer does not have a client but is the attorney to "the situation."<sup>31</sup>

The SEC has cited its small staff and limited resources as an additional reason for imposing a rigorous duty of disclosure on the securities lawyer.<sup>32</sup> The SEC intends to enforce this duty through injunctive actions, Rule 2(e) disbarment proceedings, and settlements.<sup>33</sup> The attorney's role is so critical in securities transactions that if he is deterred from aiding in securities violations and discloses information to the SEC, the overall effect will be to reduce fraud in the securities market.

The SEC's policy of disclosure is graphically illustrated in the *NSMC* litigation.<sup>34</sup> According to the SEC, the attorneys for *NSMC* and Interstate should have disclosed the contents of the "comfort letter" to *NSMC* and Interstate shareholders as well as to the investing public.<sup>35</sup> The attorneys should have insisted that the financial statement be revised and that Interstate's shareholders be resolicited.<sup>36</sup> Moreover, the SEC contended that the lawyers should have refused to issue their opinions, which were a condition to the closing.<sup>37</sup> If the clients had refused to revise the financial statements and

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29. Address by SEC Commissioner A.A. Sommers, Jr., *The Emerging Responsibilities of the Securities Lawyers*, before the Banking, Corporation and Business Law Section of the New York State Bar Association (Jan. 24, 1974), reprinted in Mathews, *Liabilities of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105, 117 (spec. issue Mar., 1975).

30. Address by Former SEC Chairman W. J. Casey, 4 CORPORATION COUNSEL'S LAW AND TAX REPORT & THE CORPORATE SECRETARY'S REPORT (Nov. 1, 1971), quoted in Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412, 426 (1974).

31. Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys Under the Federal Securities Statutes*, 34 OHIO ST. L.J. 231, 257 (1973).

32. *In re Emanuel Fields*, SEC Securities Act Release No. 5404 [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,407 (1973).

33. Address by SEC Chairman R. Garrett, Jr., *Professional Responsibility and the Securities Laws*, before the State Bar of Texas (July 4, 1974), reprinted in Mathews, *Liabilities of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105, 118 (spec. issue Mar., 1975).

34. *SEC v. National Student Mktng. Corp.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,784 (D.D.C. 1976); *SEC v. National Student Mktng. Corp.*, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,360 (D.D.C. 1972).

35. *SEC v. National Student Mktng. Corp.*, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,360 (D.D.C. 1972).

36. *Id.*

37. *Id.*

to resolicit the shareholders, the lawyers should have ceased representing the corporation.<sup>38</sup> Finally, the SEC asserted that the attorneys should have brought the matter to the attention of the stockholders or the Commission.<sup>39</sup> This final assertion by the SEC presents its view that the attorney's responsibility to the investing public supercedes the duty owed to the client.

The settlement between the NSMC attorneys and the SEC represents possible infringements on the attorney-client privilege. White & Case and Epley stipulated that they would make themselves and their books, records, documents, correspondence, and other papers relating to NSMC available for any and all purposes connected with the action at the request of any party to the action.<sup>40</sup> Some of this information could fall within the attorney-client privilege. The attorney-client privilege runs to the benefit of the corporation, not the attorney;<sup>41</sup> only the corporation may waive the privilege.<sup>42</sup>

The dilemma of the securities lawyer under the SEC disclosure policy is clear. The attorney may disclose the confidential communication and avoid SEC disbarment proceedings. However, this may subject him to a suit by the client for malpractice in breaching a confidence. The securities lawyer's alternative is to preserve the confidences and to refuse to disclose. Such a decision may subject the attorney to a disbarment or an injunctive action brought by the SEC.

The procedures agreed to by White & Case in representing future clients evinces a new development. A committee of partners of White & Case must review and approve prospective corporate clients who are registered under the federal securities laws.<sup>43</sup> If the committee finds that prior counsel of a prospective client withdrew his representation, a duty arises to investigate the reasons for the prior counsel's termination.<sup>44</sup> The law firm is then required to document the results of the inquiry and to make them available to lawyers representing the prospective client.<sup>45</sup>

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38. *Id.*

39. *Id.*

40. *SEC v. National Student Mktng. Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,027 (D.D.C. 1977).

41. *Burlington Indus. v. Exxon Corp.*, 65 F.R.D. 26 (D. Md. 1974).

42. Annot., 98 A.L.R.2d 241 (1964).

43. *SEC v. National Student Mktng. Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,027, at 91,599 (D.D.C. 1977).

44. *Id.*

45. *Id.*

This procedure, however, raises a number of questions. First, could the investigation by the law firm into the reason for termination result in an infringement on the attorney-client privilege?<sup>46</sup> After all, former counsel would be required to get a release from the corporation before he could discuss the circumstances surrounding the termination. Second, if the former counsel discloses fraudulent activity by the corporation, will the law firm be compelled to relate that information to the investing public? Third, because the duty of inquiry by White & Case is not part of a court order, how will it be enforced? Finally, is the settlement a violation of the Code of Professional Responsibility, which prohibits an attorney from entering into a settlement restricting his right to practice?<sup>47</sup>

The SEC's policy of disclosure is evident in two recent settlements against law firms. In *SEC v. Petrofunds, Inc.*,<sup>48</sup> a law firm and a corporation it represented were charged with violations of the securities laws by failing to disclose unlawful corporate acts in registration statements, prospectuses, and other communications. A preliminary injunction to prohibit future violations against the corporation was denied.<sup>49</sup> However, the SEC continued to seek injunctive action against the law firm. The law firm stipulated to final orders which required it to take all reasonable measures to assure itself that full and fair disclosure of all material facts would be made in documents filed with the SEC.<sup>50</sup>

In *In re Plotkin, Yolles, Siegel & Turner*,<sup>51</sup> a law firm was charged with failing to reveal to client-investors that two of the partners of the law firm owned common stock in one of the issuers of the securities. The attorneys involved were prohibited from practicing before the SEC for eighteen months.

Although these two cases did not directly involve the attorney-client privilege, they illustrate the relentless enforcement by the SEC and the effect of noncompliance. The SEC's policy of enforcement and the effect of noncompliance could coerce the securities lawyer into violating the privilege.

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46. A letter from White & Case to the SEC stated that the procedure would not be permitted to impair obligations it owed to clients under the Code of Professional Responsibility. *Id.* at 91,601.

47. ABA CODE OF PROFESSIONAL RESPONSIBILITY, DR 2-108(B).

48. SEC Litigation Release [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,616 (1976).

49. *SEC v. Petrofunds, Inc.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,621 (S.D.N.Y. 1976).

50. *SEC v. Petrofunds, Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,098 (S.D.N.Y. 1977).

51. Securities Act Release No. 5841, [Current] FED. SEC. L. REP. (CCH) ¶ 81,236 (1977).

Securities lawyers who have followed the SEC disclosure policy set out in the NSMC settlement have gained apparent immunity from enforcement action. In *Meyerhoffer v. Empire Fire & Marine Insurance Co.*,<sup>52</sup> an attorney became concerned about his excessive fee and requested that it be noted in a registration statement. On the corporation's refusal to include the fee statement, the attorney resigned from the firm and six months later reported the nondisclosure to the SEC.<sup>53</sup> The SEC did not file an injunctive action against the attorney who disclosed the information to it. Although many courts have noted the harmful effect on the corporate client of revealing confidences,<sup>54</sup> the attorney is allowed to exculpate himself revealing confidences obtained in the attorney-client relationship.<sup>55</sup>

The SEC takes the position that there must be disclosure of unlawful conduct which affects the finances of the corporation.<sup>56</sup> The disclosure informs the reasonable investor of the corporation's financial base.<sup>57</sup> The SEC has articulated four standards for materiality requiring disclosure: (1) illegality—for example, a corporation's domestic political contributions are per se material and must be disclosed; (2) ethical materiality—that is, where management knew of or participated in illegal or questionable payments; (3) size of payments or their relation to a significant amount of business; and (4) books and records—for example, an alleged falsification of books and records to conceal unlawful conduct must be disclosed.<sup>58</sup> The SEC fully intends to use these tests of materiality to force disclosure by attorneys.<sup>59</sup>

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52. 497 F.2d 1190 (2d Cir. 1974).

53. *SEC v. Sitomer, Sitomer & Porges*, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,184 (S.D.N.Y. 1973).

54. *Valente v. Pepsico, Inc.*, 68 F.R.D. 361 (D. Del. 1975).

55. *United States v. Amrep Corp.*, 418 F. Supp. 473 (S.D.N.Y. 1976); *Valente v. Pepsico*, 68 F.R.D. 361 (D. Del. 1975).

56. SEC, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, submitted to the Senate Banking, Housing and Urban Affairs Comm., 94th Cong., 2d Sess. (1976), reprinted in SEC REG. & L. REP. (BNA) No. 353 (1976).

57. Address by SEC Chairman Ray Garrett, Jr., Disclosure Rules and New Concerns, before the American Society of Corporate Securities Insurance (Jan. 16, 1973), quoted in Note, *Disclosure of Corporate Payments and Practices: Conduct Regulation Through the Federal Securities Laws*, 43 BROOKLYN L. REV. 681, 709 n.140 (1977).

58. Note, *Disclosure of Corporate Payments and Practices: Conduct Regulation Through the Federal Securities Laws*, 43 BROOKLYN L. REV. 681 (1977).

59. Address by SEC Commissioner Evans, Truth or Consequences, before the Securities Cooperative Enforcement Conference (May 1975), quoted in Note, *Disclosure of Corporate Payments and Practices: Conduct Regulation Through the Federal Securities Laws*, 43 BROOKLYN L. REV. 681, 710 n.142 (1977).

## THE ABA RESPONSE TO THE SEC

Opposition to the SEC disclosure policy has centered on the overall effects upon the securities lawyer's relation with the corporate client. The American Bar Association's objection is that allowing disclosure would destroy the vital confidences necessary for effective representation of the client.<sup>60</sup> The increased pressure will cause the attorney to sacrifice his independent judgment and to act in his own best interest by making disclosures.<sup>61</sup> The loss of independent judgment by the attorney will be observed by management, and the corporation will be less likely to heed the attorney's advice or to share its confidences.<sup>62</sup>

Indirect effects of the SEC policy have also been noted. The disclosure policy will encourage private plaintiffs to join corporate counsel as a defendant. The attorney is then coerced into further breaches of the attorney-client privilege to exonerate himself.<sup>63</sup> Expanding liability for securities lawyers will increase the expense of representation because of litigation costs and insurance premiums.<sup>64</sup> Excessive attorney liability will discourage entry into the field by professionals and encourage competent securities lawyers to leave. Finally, there is a fear that the use of the federal securities laws to regulate attorney conduct will cause the disclosure scheme to collapse of its own weight as it becomes too unmanageable.<sup>65</sup>

There has been a search for guidelines where the SEC disclosure policy is inadequate or too expansive. One commentator has suggested that it is the duty of the SEC to establish rules governing the duties and liabilities of attorneys.<sup>66</sup> Other commentators have noted that the guidelines are too important to be left to a governmental agency hungry for power.<sup>67</sup> Neither the SEC, the ABA, nor the courts should be allowed to lock the securities lawyer into a detrimental

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60. *ABA Report to the House of Delegates—Section of Corporation, Banking and Business Law—Recommendation*, 31 *BUS. LAW.* 544 (1975).

61. *ABA CODE OF PROFESSIONAL RESPONSIBILITY*, CANON 5.

62. Note, *Outside Directors: More Vulnerable Than Ever*, 51 *HARV. BUS. REV.* 107 (1973).

63. Note, *Disclosure of Client Confidences by Securities Attorney Named as Defendant in a Civil Action Does Not Violate Code of Professional Responsibility*, 29 *U. MIAMI L. REV.* 376 (1975).

64. Myers, *The Attorney-Client Relationship and the Code of Professional Responsibility: Suggested Attorney Liability for Breach of Duty to Disclose Fraud to the Securities and Exchange Commission*, 44 *FORDHAM L. REV.* 1113 (1976).

65. Note, *Disclosure of Corporate Payments and Practices: Conduct Regulation Through the Federal Securities Laws*, 43 *BROOKLYN L. REV.* 681, 745 (1977).

66. Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys Under the Federal Securities Statutes*, 34 *OHIO ST. L.J.* 231, 257 (1973).

67. Small, *The Lawyer's Responsibility as a Draftsman*, 30 *BUS. LAW.* 81 (spec. issue Mar., 1975).

position by the use of sweeping generalizations regarding the importance of the attorney in the disclosure process.<sup>68</sup>

The SEC is reluctant to develop specific guidelines for lawyers' conduct. Such an undertaking would result in voluminous attempts to cover every possible situation and would lead to further confusion.<sup>69</sup> In addition, SEC guidelines may lull the bar into a false sense of security that compliance gives immunization.<sup>70</sup> The guidelines could become a laundry list for prospective plaintiffs to consult in looking for a defendant to sue. Finally, the SEC guidelines would arrest the dynamic development in the area of reasoned analysis based on the particular facts in each case.<sup>71</sup>

The ABA maintains that the Code of Professional Responsibility is the authoritative source for guidance in this area. The Code is now in force in all states in some form.<sup>72</sup> Congress felt that surveillance by state bar associations was a sufficient guarantee of professional conduct<sup>73</sup> which should preclude the SEC from establishing separate professional standards.<sup>74</sup> After all, the statutes administered by the SEC grant no power to compel disclosure by attorneys concerning their clients.<sup>75</sup>

The ABA's position is that the securities lawyer has neither the obligation nor the right to make disclosure when any reasonable doubt exists concerning the client's own obligation of disclosure.<sup>76</sup> The client's course of conduct should not be narrowed by an attorney motivated only by SEC threats of his own liability. The attorney is bound only by the considerations in the Code in outlining a course of action to his client. In stockholder suits against the corporation, good cause should be shown before disclosure, and the court should make use of in camera proceedings.<sup>77</sup>

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68. *Id.* at 85.

69. Sommer, *Professional Responsibility: How Did We Get Here?*, 30 BUS. LAW. 95 (spec. issue Mar., 1975).

70. *Id.* at 99.

71. *Id.* at 101.

72. See Panel Discussion, *Responsibility of Lawyers Advising Management*, 30 BUS. LAW. 13 (spec. issue Mar., 1975) (statement of L. Van Dusen, Jr., *The ABA Code of Professional Responsibility*).

73. H.R. REP. NO. 1141, 89th Cong., 1st Sess., reprinted in [1965] U.S. CODE CONG. & AD. NEWS 4170.

74. Daley & Karmel, note 6 *supra*.

75. *ABA Report to the House of Delegates—Section of Corporation, Banking and Business Law—Recommendation*, 31 BUS. LAW. 544 (1975).

76. *Id.*

77. *Garner v. Wolfenbarger*, 430 F.2d 1093 (5th Cir. 1970), cert. denied, 401 U.S. 974 (1971).

Under certain circumstances, the Code may impose a duty on the attorney to resign and possibly to disclose; however, the delineation of these circumstances is a source of controversy. Specific provisions within the Code give some direction to securities lawyers in deciding on a course of conduct. A lawyer may reveal communications obtained in confidence to exculpate himself.<sup>78</sup> A lawyer is permitted, not required, to reveal both the intention of a client to commit a crime and the information necessary to prevent the crime.<sup>79</sup> Because only an intentional filing of misleading information is considered criminal conduct, the attorney would be required to make a finding to this effect before he would be permitted to make any disclosures.

#### DR 7-102(B)(1): THE PREFERRED APPROACH

The controversy surrounding the attorney's duty of disclosure and the attorney-client privilege has focused on Disciplinary Rule 7-102(B)(1). This Rule provides:

A lawyer who receives information clearly establishing that:

- (1) His client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal, except when the information is protected as a privileged communication.<sup>80</sup>

Disclosure by the attorney is mandatory if all the elements are present. To show the value of this rule in the securities market and its impact on the attorney-client relationship, a further dissection of the Rule and a discussion of each element is required.

The attorney is only forced to disclose under the Rule if the information is *clearly fraudulent* or *clearly material*. If the attorney does not know that it is fraudulent or material he will be required to make a judgment.<sup>81</sup> The information is material if the reasonable investor would consider it important in deciding whether to invest.<sup>82</sup> The lawyer should request that the client disclose if in the lawyer's view it is clear that the matter is of material importance and that there can be no reasonable doubt that the nondisclosure would be a violation of the law giving rise to a material claim.<sup>83</sup> If the information is arguably neither material nor fraudulent, there is no duty to disclose.<sup>84</sup>

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78. ABA CODE OF PROFESSIONAL RESPONSIBILITY, DR 4-101(C)(4).

79. *Id.*, DR 4-101(C)(3).

80. *Id.*, DR 7-102(B)(1).

81. Brakin, *The Securities Laws and the Code of Professional Responsibility*, 30 BUS. LAW. 21 (spec. issue Mar., 1975).

82. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

83. ABA [Proposed] *Statement of Policy Regarding Lawyer's Responses to Auditor's Requests for Information*, 31 BUS. LAW. 565 (1975).

84. Daley & Karmel, *supra* note 6, at 755.

The securities lawyer can urge any permissible construction of law for his client.<sup>85</sup>

A good faith judgment about the materiality of the information should not subject the attorney to liability if he is wrong.<sup>86</sup> An attorney is not an insurer of the soundness of his opinion.<sup>87</sup> The attorney is not even liable to his client for a good faith error in judgment.<sup>88</sup> The scienter requirement is consistent with a rule requiring that the fraud be clearly established before imposing upon the attorney a duty to reveal the fraud.<sup>89</sup> A different standard would subject the securities lawyer to a different and higher standard than attorneys in other fields.

If the information is clearly material, the violation must also have *occurred during the attorney's representation of the client*. If the attorney learns of a material misrepresentation that occurred prior to his representation of the corporation, there is no duty to disclose. Technically, there would have been no fraud perpetrated in the course of the attorney's representation.<sup>90</sup> The SEC position, however, is that there is a duty to correct and to reveal the past errors because a past fraud may still be reflected in a statement and could affect the market.<sup>91</sup> One commentator has urged that in such a situation there is a continuing materiality occurring during the attorney's representation which requires termination of employment or disclosure.<sup>92</sup>

The attorney must confront the client with the material information or fraud and request disclosure or correction. This step provides the corporate client the benefit of the lawyer's consultation and allows the client to rectify errors.

The attorney must reveal the fraud to the *affected person or tribunal*. The SEC is not a tribunal; therefore, the attorney only owes a

85. ABA CODE OF PROFESSIONAL RESPONSIBILITY, EC 7-4.

86. Note, *The Private Action Against a Securities Fraud Aider and Abettor: Silent and Inactive Conduct*, 29 VAND. L. REV. 1233 (1976).

87. Panel Discussion, *supra* note 72, at 18 (statement of L. Van Dusen, Jr., *The ABA Code of Professional Responsibility*).

88. Daley & Karmel, *supra* note 6, at 750.

89. Myers, *The Attorney-Client Relationship and the Code of Professional Responsibility: Suggested Attorney Liability for Breach of Duty to Disclose Fraud to the Securities and Exchange Commission*, 44 FORDHAM L. REV. 1113, 1144 (1976).

90. *Id.* at 1135.

91. Shipman, *The Need for SEC Rulemaking Concerning the Duties and Civil Liabilities of Attorneys*, 30 BUS. LAW. 34 (spec. issue Mar., 1975).

92. Cooney, *The SEC's Enforcement Theory*, 30 BUS. LAW. 29 (spec. issue Mar., 1975).



higher duty to the court.<sup>93</sup> A disclosure to the court is more likely to keep the communications confidential and to gain for the client and for the attorney the benefit of another point of view regarding the disclosure. The ABA insists that the attorney does not have to accept the SEC position on materiality and has no duty to inform to this agency.<sup>94</sup>

There is no duty to reveal if the information is protected as a *privileged communication*. This provision was added to the Rule in 1974.<sup>95</sup> If under state law the information is privileged, disclosure is not required by the Code.<sup>96</sup> The attorney will have to consult the statutes in his jurisdiction to find the applicable rule.

DR7-102(B)(1) provides guidelines from which a securities lawyer can structure an appropriate course of conduct. The Rule sets out a system of disclosure which protects public investors yet preserves the attorney-client privilege in critical situations. The Rule also gives the legislatures of each state the flexibility necessary to define the conduct which would fall under each privilege.

#### CONCLUSION

The deceptively simple, startling, and novel proposition that an attorney has a responsibility to the SEC and to the investing public for enforcing the securities laws has far-reaching implications.<sup>97</sup> An attorney's duty is to get the best results for his client within the bounds of the law rather than to bankrupt his client for the sake of the public investor.<sup>98</sup> To the extent that the SEC holds an attorney to a higher duty to the public, it is usurping a judicial function.<sup>99</sup> It would be anomalous for the SEC to impose a strict liability on attorneys for their judgments while refusing to accept responsibility for the issuance of legal opinions of the SEC staff in "no action" letters.<sup>100</sup>

The attorney should neither be protected for his own wrongdoing nor be held liable when he acts within the bounds of the law to uphold the best interests of his client. Between these two extremes is

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93. Daley & Karmel, *supra* note 6, at 755.

94. *Id.*, at 757.

95. Panel Discussion, *supra* note 72, at 17 (statement of L. Van Dusen, Jr., *The ABA Code of Professional Responsibility*).

96. *Id.*, at 19.

97. Hershman, *Introduction to the Institute*, 30 BUS. LAW. 1 (spec. issue Mar., 1975).

98. Myers, *The Attorney-Client Relationship and the Code of Professional Responsibility: Suggested Attorney Liability for Breach of Duty to Disclose Fraud to the Securities and Exchange Commission*, 44 FORDHAM L. REV. 1113, 1130 (1976).

99. Daley & Karmel, *supra* note 6, at 765.

100. *Id.*, at 812.

the real world in which the securities lawyer must operate. There are practical considerations which transcend the boundaries of any one rule. For example, what is the securities lawyer's responsibility to a corporate client who has completed a security sale and failed fully to disclose possible adverse developments, when the security is proving to be a good investment and the statute of limitations on the original offering is about to run?<sup>101</sup>

There are some practices the securities lawyer might consider to facilitate complete service to the client and yet to limit liability for himself. The attorney should recognize his own limitations. A complete mastery of the voluminous securities laws is not expected by the client. Yet, some attorneys, from pride or from fear of losing clients, muddle through a transaction and render advice on an issue on which they are not competent.<sup>102</sup> This course of action is a breach of the attorney's responsibility to the client and may subject both the attorney and the client to litigation.<sup>103</sup> Only when the securities lawyer recognizes his own limitations can he competently identify material information and determine whether it is protected by the attorney-client privilege.

In approaching a possible disclosure, the attorney must determine the areas which need investigation and, if necessary, conduct an independent inquiry. The attorney should be able ethically to limit the objective of the inquiry by clear communication with the client.<sup>104</sup> If the lawyer discovers information which he feels may be material, he should urge disclosure.<sup>105</sup> The attorney must be alert to the pressures of management and must not serve as a rubber stamp. The attorney should exercise independent, professional judgment on behalf of his true client, the corporate entity.<sup>106</sup> The attorney should advise how the material information may be disclosed as factually as possible. In the long run this approach would better serve the client by minimizing the possibility that the corporation itself will be sued. The attorney should not allow his name to appear on the disclosure

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101. Panel Discussion, *supra* note 69, at 33 (statement of Donald J. Evans).

102. *Id.*, at 16 (statement of L. Van Dusen, Jr., *The ABA Code of Professional Responsibility*).

103. ABA CODE OF PROFESSIONAL RESPONSIBILITY, DR 6-101(A).

104. Small, *The Lawyer's Responsibility as a Draftsman*, 30 BUS. LAW. 81 (spec. issue Mar., 1975).

105. Shipman, *The Need for SEC Rulemaking Concerning the Duties and Civil Liabilities of Attorneys*, 30 BUS. LAW. 34, 38 (spec. issue Mar., 1975).

106. ABA CODE OF PROFESSIONAL RESPONSIBILITY, EC 5-18.

document, thus avoiding the impression that he is vouching for the accuracy of everything in it.<sup>107</sup>

Even in following the above procedures, the securities lawyer may find himself defending a suit by stockholders or by the SEC. There are some practical considerations in defending such a suit. The attorney should urge that the landmark case of *Ernst & Ernst v. Hochfelder*<sup>108</sup> imposes a strict scienter requirement in SEC injunctive actions as well as in private claims for damages. Therefore, the good faith of client and attorney should be an adequate defense. Defense counsel must insist on and negotiate for less onerous terms of settlement.<sup>109</sup> The adverse effects of an injunction should be pointed out to the court.<sup>110</sup> The securities lawyer can either defend against the SEC injunction or, possibly, settle. Settlement is faster and less expensive than defending on the merits. However, the settlement becomes the standard for disclosure and further encroaches on the attorney-client privilege.

The issues raised in this Comment remain unresolved. A simple resolution by resorting to any one rule will not provide an adequate answer. DR 7-102(B)(1) lends some insight into what acceptable attorney conduct should be. There are assertions by the SEC and its opponents that lack proof. The SEC's contention that the securities lawyer owes a higher duty to the investing public than to his client is unprecedented and revolutionary.<sup>111</sup> The only effective answer that opponents can give to the SEC is that the public interest in effective law enforcement will be harmed by requiring attorneys to divulge confidential communication. Unless the legal profession can convince the courts that maintaining confidences in the attorney-client relation does in fact have a positive effect on compliance with the law, the privilege is in danger.

GRANT B. LUNA

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107. Small, *The Lawyer's Responsibility as a Draftsman*, 30 BUS. LAW. 81, 83 (spec. issue Mar., 1975).

108. 425 U.S. 185 (1976). In *Hochfelder*, the Supreme Court held that scienter is required in a private claim for violation of the securities laws. Several recent decisions have interpreted *Hochfelder* to require scienter in an SEC injunctive action. SEC v. Cenco, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,133 (N.D. Ill. 1977); SEC v. American Realty Trust, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,913 (E.D. Va. 1977); SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976).

109. Mathews, *Liabilities of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105 (spec. issue Mar., 1975).

110. See generally, Mathews, *Effective Defense of SEC Investigations: Laying the Foundation for Successful Disposition of Subsequent Civil, Administrative and Criminal Proceedings*, 24 EMORY L.J. 567 (1975).

111. Panel Discussion, *supra* note 72, at 29 (statement of J. Cooney, *The SEC's Enforcement Theory*).