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Securities Regulation - Attorney's Liability for Erroneous Opinion Letter - Negligence Standard Is Sufficient for Injunction in SEC Enforcement Action

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relative economic strengths should be balanced, but rather which forum should do the balancing. The involvement of the Board in the give-and-take of negotiation should be less pronounced than its participation in creating and preserving the stage for bargaining.⁷² Presuming that an imbalance of economic power will not be designated unlawful unless it is gross, it would seem that the Board's determinations that certain economic bargaining tactics are unfair labor practices should not be limited on review to the substantial evidence test. The balancing of employer-employee rights should be viewed as a question of law in the broad sense.⁷³

In view of the fictitious framework the Courts of Appeals are to work within, the *Inter-Collegiate Press* decision was progressive and well-reasoned. While the holding permitting the use of temporary labor was a victory for the employer, it may nevertheless be of limited value. It has been suggested that it is difficult and inefficient for an employer to retain temporary replacements.⁷⁴ The impact of the instant case thus depends upon the validity of this particular observation, as a victory which allows one to use such an inefficient and difficult device is merely pyrrhic. Furthermore, if the employer is forced to resort to this type of conduct, its position is probably already precarious, necessitating its possession of a powerful weapon to protect itself from severe harm. Since the prevention of helplessness would clearly seem to be a necessary element in achieving industrial peace and stability,⁷⁵ the decision in *Inter-Collegiate Press* accorded with the policy of the National Labor Relations Act, and consequently should be viewed as a valuable precedent.

Francis P. Newell

SECURITIES REGULATION — ATTORNEY'S LIABILITY FOR ERRONEOUS OPINION LETTER — NEGLIGENCE STANDARD IS SUFFICIENT FOR INJUNCTION IN SEC ENFORCEMENT ACTION.

SEC v. Spectrum, Ltd. (2d Cir. 1973)

The Securities and Exchange Commission (SEC) sought injunctive relief against twelve participants in a partially successful scheme to distribute unregistered shares of stock¹ in violation of the registration and antifraud provisions of the Securities Act of 1933 (Securities Act)² and

72. See Oberer, *supra* note 26, at 499.

73. See *American Ship Bldg. Co. v. NLRB*, 380 U.S. 300, 318 (1965); *NLRB v. Brown*, 380 U.S. 278, 292 (1965).

74. See, e.g., 486 F.2d at 846 n.14; Note, *The Unanswered Questions of American Ship*, 64 MICH. L. REV. 910, 915 (1966).

75. See note 63 *supra*.

1. *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 537 (2d Cir. 1973).

2. Section 5 of the Securities Act of 1933 [hereinafter Securities Act], 15 U.S.C. § 77e (1970), generally provides that a registration statement must be in effect before a security may be offered or sold to the public, unless the security is exempt from registration according to section 3 of the Securities Act, or the transaction involved is exempted under section 4 of the Securities Act, *id.* § 77d. See notes 4 & 10

the antifraud provisions of the Securities Exchange Act of 1934 (Exchange Act).³ A merger of Westward Investment Corporation (Westward) into Spectrum, Ltd. (Spectrum) was planned in order to effectuate a public distribution of Spectrum securities without filing a registration statement as mandated by section 5 of the Securities Act.⁴ First, Westward shareholders were to be issued, by virtue of the merger, unregistered common

infra. Section 7 of the Securities Act, 15 U.S.C. § 77g (1970), states what information is required to be set forth in the registration statement, and the SEC has promulgated Form S-1, 17 C.F.R. § 239.11 (1973), to be used by issuing parties as a means of satisfying the requirements of that section.

The antifraud provision of the Securities Act is contained in section 17(a), 15 U.S.C. § 77q(a) (1970). That section provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain any money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Id.

3. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1973), was promulgated under section 10(b) of the Securities Exchange Act of 1934 [hereinafter Exchange Act], 15 U.S.C. § 78j(b) (1970). Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Id.

4. Section 5 of the Securities Act provides in pertinent part:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

- (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use of medium of any prospectus or otherwise; or
- (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

15 U.S.C. § 77e(a), (c) (1970).

"Security" is defined in section 2(1) of the Securities Act, *id.* § 77b(1). There was no contention in the instant case that the Spectrum securities were not "securities" for purposes of the Securities Act, or that they were exempted under section 3, *id.* § 77c.

While section 5 states that its provisions are applicable to "any person," section 5 provides that section 5 shall not apply to persons other than issuers, underwriters, or dealers. Although not relevant here,

stock of Spectrum,⁵ such stock being exempted from the section 5 registration requirement by the SEC's rule 133.⁶ If the recipient of the unregistered shares were not an issuer,⁷ underwriter,⁸ or dealer⁹ he would then be able to sell them, again without an otherwise-required registration.¹⁰ Marder, a controlling shareholder of Westward, distributed his 1,000,000 shares of Westward stock to friends as holders in name only, intending this ruse to enable him to sell the Spectrum shares received in the merger without registration.¹¹

Spectrum's general counsel Berger issued an opinion letter stating that the merger complied with all rule 133 requirements, and naming the recipients who should receive only "restricted" (not for public sale) shares,¹²

issuers and dealers are afforded additional exemptions as well. *Id.* § 77d(2), (3). See notes 7-9 and accompanying text *infra*.

The terms "sale," "sell," "offers to sell," "offers for sale," and "offer" are defined in section 2(3) of the Securities Act, 15 U.S.C. § 77b(3). The SEC has struggled with the question of whether the issuing of securities to shareholders of the acquired company as the result of a merger, as in the instant case, constitutes a "sale" for purposes of section 5. See note 6 and accompanying text *infra*.

5. 489 F.2d at 538.

6. Rule 133 provided that the exchange of shares between the surviving corporation and the stockholders of the disappearing corporation in a merger would not be considered a "sale." 17 C.F.R. § 230.133 (1973). Rule 133 was rescinded effective January 1, 1973, 37 Fed. Reg. 23,636 (1972), and has been replaced by rule 145 which does not allow the same registration exemption, deeming such an exchange a "sale of securities." 17 C.F.R. § 230.145 (1973).

7. "Issuer" is defined in section 2(4) of the Securities Act to be, with certain exceptions, any entity which issues or proposes to issue any security. 15 U.S.C. § 77b(4) (1970).

8. Section 2 defines "underwriter" as follows:

The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

Id. § 77b(11). SEC Securities Act Release No. 5223 (Jan. 11, 1972) (adoption of rule 144) explains the definition of "underwriter" contained in section 2(11), drawing special attention to the fact that the language used is in the disjunctive; so for one to fall within only one of the enumerated categories is sufficient to qualify one as an underwriter.

9. See section 2(12) of the Securities Act, 15 U.S.C. § 77b(12) (1970), for the definition of "dealer."

10. Since section 4(1), *id.* § 77d(1), states that section 5 shall not apply to transactions by persons "other than issuers, underwriters, and dealers," a person not falling into one of those categories does not violate section 5 when he sells unregistered shares. It should be noted, however, that "underwriter" is broadly defined and encompasses persons not included in the familiar use of the term. See note 8 *supra*.

11. 498 F.2d at 538. If Marder had offered to sell the Spectrum securities himself, he would have been deemed an underwriter under rule 133(c), and, therefore, the shares subsequently offered would not have been exempted from the registration requirement of section 5.

12. The term "restricted securities" is defined in SEC rule 144 as "securities acquired directly or indirectly from the issuer thereof, or an affiliate of such issuer, in a transaction or chain of transactions not involving any public offering." 17 C.F.R. § 230.144(a)(3), (1973). If a person sells restricted securities, he will not be deemed an underwriter for purposes of determining a section 5 violation, provided he meets all the conditions set forth in rule 144.

being underwriters under rule 133.¹³ Berger later wrote a second letter, not in the form of an opinion letter, listing everyone who had received unrestricted shares in the merger.¹⁴ Subsequently, Schiffman, an attorney relying on the Berger letters, but allegedly without any previous involvement or information about the transactions, composed an opinion letter for a nominal owner of some of the Marder shares advising him that he could sell the shares.¹⁵ On these facts, the SEC obtained permanent injunctions against most of the defendants, including Spectrum and Marder.¹⁶ With respect to Schiffman, the United States District Court for the Southern District of New York concluded that there were no material facts in dispute, despite the fact that contradictory affidavits had been filed by Schiffman and the broker-dealer who had hired him, and accordingly denied the SEC's motion for an evidentiary hearing and preliminary injunction.¹⁷ In addition, the district court indicated that Schiffman's conduct, even if negligent, had not amounted to a violation of the securities laws.¹⁸ The United States Court of Appeals for the Second Circuit reversed and remanded the case for an evidentiary hearing on the factual issues, *holding* that it was error for the lower court to have decided such a case where there were material facts in dispute¹⁹ and that the negligent conduct of an attorney in the preparation of an opinion letter in conjunction with a public distribution of unregistered securities may give rise to a violation of the securities laws for purposes of an SEC enforcement action. *Securities and Exchange Commission v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973).

Three methods exist for taking action against an attorney for a violation of the federal securities laws. The first is an SEC disciplinary proceeding under rule 2(e) of the Commission's Rules of Practice,²⁰ which allows the SEC to suspend or disbar anyone from practice before it for committing or aiding and abetting in the commission of a violation of any securities law provision.²¹ The second method is a private action for dam-

13. 498 F.2d at 538. See note 11 *supra*.

14. 498 F.2d at 538.

15. *Id.* at 539.

16. SEC v. Spectrum, Ltd., 54 F.R.D. 70 (S.D.N.Y. 1972).

17. SEC v. Spectrum, Ltd., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,631 (S.D.N.Y. 1972).

18. *Id.* at 92,868. The SEC alleged that Schiffman was an underwriter of the Spectrum distribution and, therefore, was not protected by the section 4(1) exemption from the registration requirements of section 5. Furthermore, the SEC claimed that Schiffman was an aider and abettor of the entire scheme. *Id.* at 92,867-68. See notes 26 & 27 *infra*.

19. The primary factual issue in dispute was the extent of Schiffman's actual knowledge of the scheme. 489 F.2d at 540-41.

20. 17 C.F.R. § 201.2(e) (1973).

21. *Id.* Actions under rule 2(e) may be divided into four historical periods: 1) prior to 1950; no actions were brought; 2) 1950-1959: only four disciplinary actions were brought, all for intentional and flagrant violations; 3) 1960-1969: extensive use was made of the rule, but only for intentional violations; 4) 1970-present: continued extensive use was made of the rule, but not exclusively for intentional violations. Comment on Proposed Securities Rules and the Federal Security Laws: *The Regulation, Role and Responsibilities of the Attorney*, 1972 DUKE L.J. 969, 982-85 (1972).

ages for violation of the Securities Act²² and the Exchange Act.²³ The third, used in the instant case, is an SEC enforcement action via a civil injunction.²⁴ Of these proceedings, the private action for damages has been the most widely utilized, although often requiring proof of a higher degree of culpability than others.²⁵ For an attorney such as Schiffman who has merely prepared an opinion letter — a necessary step in the public distribution of unregistered securities — erroneously, the theory of culpability under each of these approaches may apply to him in his role as an underwriter in the distribution,²⁶ or as an aider and abettor of those who actually committed the violations.²⁷

22. Several provisions of the Securities Act provide express private rights of action for damages resulting from violations of various provisions of the act. *E.g.*, section 12 of the Securities Act, 15 U.S.C. § 77j (1970) (purchaser of a security offered in violation of section 5 may recover damages from seller). Other sections, while not literally granting a private right of action, have been interpreted as permitting such. For example, section 17 of the Securities Act (*see note 2 supra*), its general antifraud provision, has been construed as allowing a private party to sue for damages resulting from violations thereof. *See L. LOSS, SECURITIES REGULATION* 1784-89 (2d ed. 1961).

23. Section 9(e), 15 U.S.C. § 78i(e) (1970), gives an express private right to sue for damages resulting from activities designed to create the appearance of active trading in any security registered on a national exchange.

An example of a section of the Exchange Act that has been interpreted as granting an implied private right of action is section 10(b) and, promulgated thereunder, rule 10b-5 (*see note 3 supra*), which has continually been utilized in private damage actions and represents the most frequently invoked provisions of the securities laws. *See generally* 2 A. BROMBERG, *SECURITIES LAWS: FRAUD* ch. 8 (1973).

Another remedy which may exist as a private action, in conjunction with the second method mentioned, is an action for tortious misconduct under the second RESTATEMENT OF TORTS, section 552, which imposes liability for misrepresentation without a fraud requirement:

One who, in the course of his business, profession or employment, or in a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

RESTATEMENT (SECOND) OF TORTS § 552 (Tent. Draft No. 12, 1966).

24. Section 20 of the Securities Act, 15 U.S.C. § 77t (1970), and section 21 of the Exchange Act, *id.* § 78u, permit the SEC to enjoin acts and practices in violation of the respective act.

25. *See* text accompanying notes 32-47 *infra*, regarding the degree of involvement and culpability required by the various federal circuits.

26. For the statutory definition of underwriter, *see note 8 supra*. The Second Circuit has defined the term "underwriter" to include:

[A]nyone who directly or indirectly participates in a distribution of securities from an "issuer" to the public; and for this purpose the term "issuer" is defined to include not only the issuer but also affiliates or subsidiaries of the issuer and "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

SEC v. North Am. Res. & Dev. Corp., 424 F.2d 63, 72 (2d Cir. 1970).

In the instant case, the SEC argued that Schiffman was an underwriter because he had had "a direct or indirect participation" in the distribution of the Spectrum securities. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,631, at 92,867. The district court held that he had not been an underwriter because there was no evidence that any Spectrum stock had been sold on the basis of Schiffman's letter. *Id.* The Second Circuit declined to resolve this issue "[b]ecause the record [was] unclear . . ." 489 F.2d at 541 n.11. Had the court determined that he had in fact been an underwriter, Schiffman would clearly have been in violation of section 5. *See note 4 supra*.

27. Although section 17 of the Securities Act, section 10(b) of the Exchange Act, and rule 10b-5 are phrased in terms of "any person," (*see notes 2 & 3 supra*),

The standard which has been applied to determine whether one's conduct qualifies as aiding and abetting is that formula set out in the *Restatement of Torts* section 876.²⁸ The plaintiff has the burden of showing that the principals committed the violation and that the aider-abettor substantially assisted them. Additionally, it must be demonstrated that the aider-abettor acted affirmatively, or failed to act when there existed a legal duty to act, and that the aider-abettor knowingly participated in the fraud.²⁹ Hence, in order to apply this test, one must first be satisfied that plaintiff has established the requisite degree of participation by the attorney. Then, a determination must be made as to whether scienter³⁰ is a prerequisite, or whether mere negligence will suffice to impose liability under this theory.³¹

in practice those sections have been invoked only against individuals who fit within any of four categories: 1) insiders, *i.e.*, those who because of their relationship to the issuer have access to facts not available to the general public, 2) broker-dealers, 3) the corporation whose stock was brought or sold by the plaintiff, and 4) those who conspire with or aid and abet a person within one of the other three categories. Comment, *The SEC and The Securities Bar: Adversaries or Allies?*, 23 CATH. U.L. REV. 122, 125 (1973).

In the instant case, the SEC alleged that Schiffman was either an underwriter or an aider and abettor of the illegal scheme. See note 19 *supra*. Presumably, the SEC believed that Schiffman was not in direct violation of section 17, section 10b, or rule 10b-5 as an insider, broker-dealer, or issuer.

The leading case establishing the principle that liability in a securities fraud suit may be imposed upon a secondary participant for aiding and abetting is *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). See 2 A. BROMBERG, *supra* note 23, at §§ 8.5(515), 8.5(530); Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 628-30 (1972).

28. RESTATEMENT OF TORTS § 876 (1939). See 50 TEXAS L. REV. 1265, 1269-70 (1972), and the cases cited therein.

29. 50 TEXAS L. REV. at 1269.

30. "Scienter" has been defined as:

Knowingly. [D]efendant's previous knowledge of a state of facts which it was his duty to guard against, and his omission to do which has led to the injury complained of.

BLACK'S LAW DICTIONARY 1512 (rev. 4th ed. 1968).

31. An attorney's negligence may be measured by a "reasonable man" standard, or by a due diligence test of whether or not after a reasonable investigation on the attorney's part, he had reasonable grounds to believe that the facts as presented were true and he did believe them to be so. Comment, *Securities and Exchange Commission v. National Student Marketing: The Attorney's Duty*, 46 TEMP. L.Q. 153, 156-57 (1972).

The SEC view of the obligation of counsel to investigate before writing an opinion letter is expressed in the following lengthy quotation from a release on unregistered securities:

There have been a number of cases in which dealers have unsuccessfully sought to justify a claim of exemption under Section 4(1) of the Securities Act simply by securing from the sellers, actual or ostensible, representations that such persons are neither officers, directors, nor large stockholders of the issuer, and submitting such representations to an attorney who then gives an opinion to the effect that, assuming the correctness of such representations, exemption under Section 4(1) is available. Obviously, an attorney's opinion based upon hypothetical facts is worthless if the facts are not as specified, or if unspecified but vital facts are not considered. Because of this, it is the practice of responsible counsel not to furnish an opinion concerning the availability of an exemption from registration under the Securities Act for a contemplated distribution unless

Looking to the decisions of the other circuits for guidance as to what degree of fault is necessary to impose liability for damages resulting from violations of the antifraud provisions is not especially helpful, for there is little consistency in their decisional law. The Tenth Circuit has most clearly supported a negligence standard.³² Recently that circuit twice applied its negligence standard by shifting the burden of proof to the defendant to prove that neither did he know, nor could he have known through the exercise of reasonable care, of the alleged misrepresentation.³³ While it has expressed support of a negligence standard only in dicta,³⁴ in *City National Bank v. Vanderboom*,³⁵ the Eighth Circuit specifically stated that it disagreed with the Second Circuit insofar as the latter court would not accept a negligence test.³⁶ Although the Ninth Circuit has also stated in dicta that scienter is not a prerequisite for a private action for damages,³⁷ the existence of scienter had actually been established in each of the Ninth Circuit cases, because all of the defendants involved had had actual knowledge.³⁸ The Seventh Circuit has expressed approval of a negligence standard

such counsel have themselves carefully examined all of the relevant circumstances and satisfied themselves, to the extent possible, that the contemplated transaction is, in fact, not a part of an unlawful distribution. Indeed, if an attorney furnishes an opinion based solely upon hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct.

SEC Securities Act Release No. 4445 (Feb. 2, 1962).

32. *Stevens v. Vowell*, 343 F.2d 374, 379-80 (10th Cir. 1965) (rule 10b-5 suit to recover amount paid for purchase of stock).

33. The court equated the phrase "reasonable care" with "due diligence." See *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 102 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) (stockholders' rule 10b-5 suit against insiders for damages); *Gilbert v. Nixon*, 429 F.2d 348, 357 (10th Cir. 1970) (securities purchaser's rule 10b-5 suit against issuer for damages). For a view in support of shifting the burden of proof, see Comment, *Scienter in Private Damage Actions Under Rule 10b-5*, 57 *Geo. L.J.* 1108, 1115-17 (1969).

34. See *Myzel v. Fields*, 386 F.2d 718, 738-39 (8th Cir. 1967) (stock sellers' rule 10b-5 suit against purchasing insiders for damages), *cert. denied*, 390 U.S. 951 (1968).

35. 422 F.2d 221 (8th Cir.) (rule 10b-5 suit for damages), *cert. denied*, 399 U.S. 905 (1970).

36. 422 F.2d at 229-30. See notes 41-48 and accompanying text *infra*.

37. *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1209 (9th Cir. 1970) (rule 10b-5 suit for damages); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 212 (9th Cir. 1962) (stock purchaser's rule 10b-5 suit for damages); *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961) (stock buyer's damage suit under sections 12(2), 17(a) and rule 10b-5).

38. The Ninth Circuit recently clarified its position on the scienter requirement by reiterating its rejection of a fraud standard and establishing a "flexible duty" rule which does not depend upon a strict finding of scienter or causation. *White v. Abrams*, 495 F.2d 724, 734-36 (9th Cir. 1974). The court stated:

In this circuit, we have never adhered to the requirement of scienter in the common law fraud sense. While we did not apply liability without fault, our language in *Ellis* and *Royal Air* was apparently construed by the district court to create such a standard. Such a construction is erroneous. It is also erroneous to construe those cases as imposing a negligence standard or any other standard that focuses solely upon state of mind and its various compartmentalizations. We believe that the cases and commentators demonstrate that any attempt to limit the scope of duty in all 10b-5 cases by the use of one standard for state of mind or scienter is confusing and unworkable. Consequently, we reject scienter or any

without regard to scienter, but only in a case primarily concerned with the applicable statute of limitations for a securities law violation.³⁹ Both the Third and Fifth Circuits have required the presence of fraud without defining what constituted culpably fraudulent conduct.⁴⁰

The Second Circuit has been the setting for most of the litigation in the area of securities law violations; it has also been the most conservative in granting relief, particularly in private actions. In 1971, the court in *Shemtob v. Shearson, Hamill & Co.*⁴¹ emphasized the need for a showing of scienter.⁴² *Shemtob* involved a rule 10b-5 suit against a brokerage firm for failing to sell out the plaintiffs' account promptly and for eventually selling out their account without providing an opportunity to post additional margin.⁴³ The circuit court affirmed the district court's dismissal for failure to state a cause of action, stating:

[P]laintiff's claim is nothing more than a garden-variety customer's suit against a broker for breach of contract, which cannot be bootstrapped into an alleged violation of § 10(b) of the Exchange Act, or Rule 10b-5, in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud. It is insufficient to allege mere negligence, . . . breach of contract or breach of a stock exchange rule . . .⁴⁴

In *Lanza v. Drexel*,⁴⁵ the Second Circuit reiterated that *Shemtob* had removed any question that scienter was required in private actions in that circuit.⁴⁶ However, the *Lanza* court did state that the negligence standard for liability was permissible in SEC enforcement actions.⁴⁷

other discussion of state of mind as a necessary and separate element of a 10b-5 action. The proper standard to be applied is the extent of the duty that rule 10b-5 imposes on this particular defendant. In making this determination the court should focus on the goals of the securities fraud legislation by considering a number of factors that have been found to be significant in securities transactions. *Id.* at 734-35 (footnotes omitted). The factors that the court considered would be relevant in defining this duty were:

the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.

Id. at 735-36 (footnotes omitted).

39. *Parrent v. Midwest Rug Mills, Inc.*, 455 F.2d 123, 126 (7th Cir. 1972) (stock purchasers' section 17(a) and rule 10b-5 suit for damages).

40. *Landy v. FDIC*, 486 F.2d 139, 160-61 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974) (insolvent bank's shareholders' rule 10b-5 suit for damages against bank president for misuse of bank funds); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 269 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972) (shareholders rule 10b-5 suit for damages resulting from misleading proxy statements); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970) (stockholders rule 10b-5 suit for damages).

41. 448 F.2d 442 (2d Cir. 1971).

42. *Id.* at 445.

43. *Id.* at 444.

44. *Id.* at 445.

45. 479 F.2d 1277 (2d Cir. 1973) (en banc) (stock purchasers' section 17(a) and rule 10b-5 suit for damages).

46. *Id.* at 1304.

47. *Digital Equipment Corp. v. SEC*, 458 F.2d 1082, 1096 n.15 (2d Cir. 1972).

The instant case was remanded for a factual determination on the negligence issue.⁴⁸ The court noted that had the injunction been denied merely due to the failure to demonstrate a propensity for future violations on the basis of *SEC v. Bangor Punta Corp.*,⁴⁹ the decision might not have been disturbed.⁵⁰ It was the district court's disregard of the existence of a factual dispute evidenced by the conflicting affidavits as to the extent of Schiffman's involvement that mandated the remand here.⁵¹ Citing *SEC v. Manor Nursing Centers, Inc.*,⁵² *Hanly v. SEC*,⁵³ and *SEC v. Texas Gulf Sulphur Co.*,⁵⁴ the court indicated that the appropriate standard to be applied in an enforcement proceeding seeking prophylactic relief was one of negligence, predicated in the instant case upon an aiding and abetting theory.⁵⁵

Texas Gulf Sulphur is a leading case, having established the rule that

[i]n an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful.⁵⁶

The instant court used this language to support Schiffman's liability for negligence as an aider and abettor, not as an insider as was the case in *Texas Gulf Sulphur*;⁵⁷ therefore, viewing this language within *Texas Gulf Sulphur's* narrow factual setting, the quotation is not wholly apposite to *Spectrum*. Yet it would appear that a negligent aider and abettor in this situation should not be treated differently from the negligent insider himself if the objective in each case is to broaden protection for the investing public. In addition, *Texas Gulf Sulphur's* theme of "protection for the investing

48. 489 F.2d at 537.

49. 331 F. Supp. 1154 (S.D.N.Y. 1971), *aff'd sub nom.* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 393-95 (2d Cir.), *cert. denied*, 414 U.S. 924 (1973). *Bangor Punta* placed the burden upon the Commission to establish by persuasive evidence that defendant had a propensity or natural inclination to violate securities laws. 480 F.2d at 1162-63.

50. 489 F.2d at 540. The court did indicate, however, that it would not exclude from evidence the fact that Schiffman previously had been enjoined for securities laws violations twice, and had pleaded guilty to a third such violation. *Id.* at 542. Such evidence may be indicative of a propensity to commit further securities laws violations.

51. *Id.* at 540, *citing* Dopp v. Franklin Nat'l Bank, 461 F.2d 873, 879 (2d Cir. 1972) (evidentiary hearing deemed essential for resolving a credibility gap over a dispute as to the occurrence of crucial events); *quoting* Sims v. Greene, 161 F.2d 87, 88 (3d Cir. 1947).

52. 458 F.2d 1082 (2d Cir. 1972).

53. 415 F.2d 589 (2d Cir. 1969).

54. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

55. 489 F.2d at 541. The court acknowledged that Schiffman's status as an underwriter was uncertain. *Id.* However, liability as an underwriter was and remains a strong possibility here, considering the nexus between Schiffman's role of writing the necessary opinion letter and the stock distribution. *See* notes 8 & 26 *supra*.

56. 401 F.2d at 854-55 (citations omitted; emphasis added).

57. The defendants in *Texas Gulf Sulphur* were officers and employees of the company who purchased stock of the company without disclosing to the sellers material inside information concerning mineral exploration results which would have influenced the decision to sell. *Id.* at 839-47.

public" via the Securities and Exchange Acts⁵⁸ has been approved by the Supreme Court. The Court stated in *SEC v. Capital Gains Research Bureau Inc.*,⁵⁹ that the provisions against fraud were to be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes."⁶⁰

In the second case cited by the *Spectrum* court, *Hanly v. SEC*, the Second Circuit imposed a duty on brokers and salesmen to investigate the validity of representations made by the issuer concerning the securities that the broker-dealer is offering, and, in the context of an SEC action to revoke the broker-dealer's registration, defined a violation of that duty as one involving willful misconduct.⁶¹ The *Hanly* court expressed a belief that a "securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents he has an adequate basis for the opinions he renders."⁶² The analogy to the position of trust occupied by an attorney is clear.⁶³

Third, in *SEC v. Manor Nursing Centers, Inc.*, the defendant-attorney's contention that good faith should preclude liability under the antifraud provisions of the federal securities laws was rejected as a defense by the Second Circuit, since a violation of the securities laws did not require all the elements essential to common law fraud.⁶⁴ Therefore, if Schiffman had raised a defense of good faith reliance upon the Berger letters, he would have failed on the defense by authority of *Hanly* and *Manor Nursing Centers*.⁶⁵ Thus the *Spectrum* court, in stating that it did not believe the

58. The *Texas Gulf Sulphur* court also stated:

[T]he implementation of a standard of conduct that encompasses negligence as well as active fraud comports with the administrative and legislative purposes underlying [rule 10b-5].

Id. at 855 (footnote omitted).

59. 375 U.S. 180 (1963).

60. *Id.* at 195. See *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). In discussing Rule 10b-5 in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, *rehearing denied*, 407 U.S. 916, 408 U.S. 931 (1972), the Court said that "[t]hese proscriptions, by statute and rule, are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive." 406 U.S. at 151. See generally H.R. REP. No. 85, 73d Cong., 1st Sess. (1933); H.R. REP. No. 1382, 73d Cong., 2d Sess. (1934), for the legislative histories of the Securities Act and of the Exchange Act, respectively.

61. 415 F.2d at 595-96.

62. *Id.* at 596.

63. See note 31 *supra*.

64. 458 F.2d at 1096, quoting *Globus v. Law Res. Serv., Inc.*, 418 F.2d 1276, 1290-91 (2d Cir. 1969). The SEC sought injunctive relief, alleging violations of sections 5(b)(2) and 17(a) of the Securities Act and section 10(b) of the Exchange Act, arising from the sale of newly issued securities. Essentially, the defendants failed to conform to the terms of the offering, as contained in the registration statement, that any funds received through the sale would be returned to the purchasers if two conditions were not met by a specified date: (1) the entire offering was purchased; and (2) all proceeds from such sales were received. 458 F.2d at 1088-94. The defendant-attorney prepared all the necessary documents, including the registration statement, and was directly involved in the sale of the securities. *Id.*

65. The court in *Manor Nursing Centers* pointed out that the defendant's background as an experienced securities lawyer belied his claim of good faith. *Id.* at 1096. The court also considered Schiffman's past experience with SEC injunctions (see note 50 *supra*), that consideration may be applicable in the proceedings on remand in the instant case as well.

imposition of a negligence standard for secondary parties in the instant case was too strict, was consistent with the trend of the case law to greatly expand attorneys' liability.⁶⁶

The following three cases are particularly indicative of this trend to expand attorneys' liability, and although the latest of the three awaits resolution by the courts, they nevertheless give a firm indication of the SEC's idea of the proper application of the securities law provisions in this area: In 1968, the SEC in *SEC v. Frank*,⁶⁷ sought injunctive relief against an attorney for his participation in the preparation of an allegedly misleading offering circular.⁶⁸ The SEC's position was that the attorney had been furnished with information that even a nonexpert would suspect contained false representations.⁶⁹ The Second Circuit agreed, stating that "no more than others" could a lawyer "escape liability for fraud by closing his eyes to what he saw and could readily understand."⁷⁰

Second, the duty of an attorney to investigate the accuracy of the registration statement was explicitly described in *Escott v. BarChris Construction Corp.*⁷¹ In that case, two attorney-directors, among others, were held liable under section 11⁷² for damages resulting from a false and misleading registration statement.⁷³ In finding the attorneys liable as directors of the issuer for their having signed the false registration statement,⁷⁴ the

66. 489 F.2d at 541. Recently, commentators have supported that belief. For example:

Since there is no reason to lower the standard of care from that applied in a non-securities law context, an attorney should at least be held responsible to the client for whom he prepares a legal opinion as to the due issuance of securities or the nonapplicability of the 1933 Act if he acts negligently

When an attorney *knows* that his opinion is being utilized to effect a sale of securities unlawful under the 1933 Act, or does not undertake the inquiry necessary to permit him to express an honest and informed opinion that the sale is exempt from registration, or is in possession of facts which would cause a prudent lawyer to make further inquiry, or otherwise acts in a reckless manner, his degree of culpability may suggest that the balance be struck in favor of holding him liable to a larger class of plaintiffs.

Small, *An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?*, 61 CAL. L. REV. 1189, 1197-98 (1973).

67. 388 F.2d 486 (2d Cir. 1968).

68. The SEC alleged that the offering circular contained misleading statements in violation of section 17(a) of the Securities Act and section 10(b) of the Exchange Act, and sought to enjoin the attorney from drafting any documents containing untrue statements or omissions which would make the document appear not to be misleading. *Id.* at 487.

69. *Id.* at 489.

70. *Id.*

71. 283 F. Supp. 643, 690 (S.D.N.Y. 1968).

72. 15 U.S.C. § 77k (1970). Section 11 expressly permits a person acquiring a security to sue, *inter alia*, every person who signed the registration statement, and every person who was or was about to become a director, for damages, if the registration statement contained false or misleading statements at the time it became effective. *Id.* § 77k(a). Each of the persons liable under this section is provided a "due diligence" defense which generally allows no recovery against the defendant if "he had, after reasonable investigation, reasonable ground to believe, and did believe" that the registration statement was accurate. *Id.* § 77k(b)(3).

74. 15 U.S.C. § 77k(a)(2) (1970). See note 72 *supra*.

court utilized a test which placed upon them a duty to investigate the truth of the financial statement more thoroughly than nonattorney directors.⁷⁵

However, it was in *SEC v. National Student Marketing Corp.*⁷⁶ (NSMC), which is still pending final resolution, that the SEC sought to impose the greatest duty upon attorneys in the securities law field. In this action, the SEC charged two established law firms⁷⁷ and several of their respective partners individually with failing to disclose material financial information received from an accounting firm prior to closing a merger.⁷⁸ The SEC maintained that the law firms should have refused to issue the misleading opinion letters, and should have insisted that the incorrect financial statement be revised and the shareholders resolicited. If such advice had been ignored, the SEC claimed, the attorneys should have stopped representing their clients and informed the SEC of the misleading transaction.⁷⁹ Thus, it was this attempt to charge the attorney with a "policeman" role which was the most novel aspect of this complaint, for

75. With respect to one of the attorneys who was an "outside" director (not an officer of the issuer), the court stated:

After making all due allowances for the fact that [the issuer's] officers misled him, there are too many instances in which [the attorney] failed to make an inquiry which he could easily have made which, if pursued, would have put him on his guard. In my opinion, this finding on the evidence in this case does not establish an unreasonably high standard in other cases for company counsel who are also directors.

283 F. Supp. at 692. Concerning the second director-attorney, who was also an officer, the court believed that "[a]s a lawyer, he should have known his obligations under the statute. He should have known that he was required to make a reasonable investigation of the truth of all the statements in the unexpertised portion of the document which he signed." *Id.* at 687.

Compare these standards to that applied to the nonattorney, outside director: "He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property." *Id.* at 688. Clearly, then, the director was held to a duty to conduct a more thorough investigation due his position as an attorney. As one commentator noted, in the *Bar Chris* case, "The lawyer-director was the only outside director cited for failing to examine written records." Comment, *Bar Chris: Easing the Burden of "Due Diligence" Under Section 11*, 117 U. PA. L. REV. 734, 741 (1969).

76. Civil No. 225-72 (D.D.C., filed Feb. 3, 1972). For the text of the complaint, see [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,360.

77. The law firms charged were White & Case (New York), representatives of NSMC since 1968; and Lord, Bissell & Brook (Chicago), representatives of an NSMC subsidiary since 1952. [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,360, at 91,913-3.

78. As a condition of the merger presented in the proxy statement, the law firms were required to issue an opinion stating that all steps had been validly taken to consummate the merger and that no state or federal statute had been violated to the law firms' knowledge. Although the law firms had received information from the accounting firm that had prepared the financial statements that those financial statements included in the proxy materials were inaccurate, they nevertheless issued the opinion letter. [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,360, at 91,913-16 to 17. The SEC alleged that the firms had violated, directly, and indirectly as aiders and abettors, the proxy provision of the Exchange Act, section 14(a), 15 U.S.C. § 78(m) (a) (1970), and rule 10b-5, when shareholders of the target company exchanged their shares for shares in NSMC. [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,360, at 93,913-15.

79. [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,360, at 91,913-17.

the assertion has been made that most attorneys do not expect to be held accountable for their written opinions.⁸⁰

The trend toward applying a negligence standard to all defendants has been acknowledged and supported by commentators and courts alike.⁸¹ Certainly, since *Texas Gulf Sulphur* the negligence test has been held sufficient for enforcement actions,⁸² and some circuits apparently consider it to be sufficient in private actions.⁸³ If the *NSMC* guidelines for attorney conduct as set forth by the SEC were to be consistently enforced, the only uncertainty which would remain would lie within the traditional concept of the attorney-client privilege. It is questionable whether the duty to report violations of the securities laws to the SEC would constitute a breach of that confidential relationship.⁸⁴ However, if it were made known exactly what conduct was expected under the SEC provisions, and such conduct were consistently exhibited and approved, uncertainty would no longer be a problem, even under the attorneys' *ABA Code of Professional Responsibility*.⁸⁵ Adherence to the requirements of the SEC expressed in *NSMC*,

80. Corso, *Opinions of Counsel: Responsibilities & Liabilities*, 17 CLEV.-MAR. L. REV. 375 (1968). See also Karmel, *Attorneys' Securities Laws Liabilities*, 27 BUS. LAW. 1153 (1972), questioning the SEC's attempts at having private attorneys act as securities law enforcers.

If the SEC's position in *NSMC* is upheld by the courts, it may result in more attorneys, particularly those not associated with a large firm, hesitating to undertake any securities work. Not to escape the pressure, the larger firm still willing to work in the securities field will see its malpractice insurance rates substantially increase.

81. See, e.g., *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057 (1969); Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965). See notes 56 & 66 and accompanying text *supra*.

82. See note 56 and accompanying text *supra*.

83. See notes 32-40 and accompanying text *supra*.

84. A recent decision of the Second Circuit suggests that such disclosure would not be a breach of professional ethics. In *Meyerhofer v. Empire Fire and Marine Ins. Co.*, 497 F.2d 1190 (2d Cir.), cert. denied, 95 S. Ct. 314 (1974), an attorney resigned from his firm because of a dispute over whether to disclose in the registration statement an excessive fee arrangement between the firm and the issuer it was representing. The attorney reported his objections concerning the registration statement to the SEC, and subsequently, upon discovering that he was a defendant in a suit by Meyerhofer, a purchaser of the issuer's stock, gave the same information to the plaintiff's attorneys to demonstrate his lack of culpability in the matter. 497 F.2d at 1193. The court held that by making these disclosures, the attorney was not in breach of Canons 4 and 9 of the ABA CODE OF PROFESSIONAL RESPONSIBILITY, because under Disciplinary Rule 4-101 he was entitled to reveal "[c]onfidences or secrets necessary . . . to defend himself . . . against an accusation of wrongful conduct." 497 F.2d at 1195, quoting ABA CODE OF PROFESSIONAL RESPONSIBILITY D.R. 4-101(c)(4). The attorney was, however, prohibited from acting as an attorney for a party in any action which should arise from the facts and circumstances he disclosed, and from further revealing this or any other information except upon discovery or at trial. *Id.* at 1196.

85. Disciplinary Rule 4-101 provides, in pertinent part:

A lawyer may reveal . . .

- (2) Confidences or secrets when permitted under Disciplinary Rules or required by law or court order.
- (3) The intention of his client to commit a crime and the information necessary to prevent the crime.

ABA CODE OF PROFESSIONAL RESPONSIBILITY D.R. 4-101 (emphasis added). Disciplinary Rule 7-102(B) must also be complied with.

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 . . . promptly call upon his client to rectify the same, and if his client refuses or is unable