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# Obligations and Potential Liabilities of Attorneys in Public and Private Offerings

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# VENTURE CAPITAL
## & Public Offering Negotiation

THIRD EDITION

*VOLUME 2*

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## 1. INTRODUCTION

This chapter examines issues that attorneys face when performing services for developing companies, with particular focus on private offerings and the initial public offering ("IPO"). In private and public offerings, both the securities laws and the issuer's interests mandate that the offering document present full and fair disclosure of the issuer's business and financial condition. In assisting an issuer, attorneys share this goal, and can face liability if they err when providing services in such a transaction.

For the protection of investors, the securities laws place the burden on the issuer, its officers, and its directors to assure that private offering documents and the prospectus in a public offering contain no misstatement of a material fact, or omission of a material fact required to avoid misleading by the statements the company makes. There may be subtle or overt conflicts between the desire to market a company's securities and the need for conservative disclosures. The issuer, the underwriter, the counsel for the issuer and the underwriter, and the company's independent public accountants will often spend hours discussing the required disclosures in an IPO. The inherent risks of an IPO may be exacerbated if management is unfamiliar with the reporting, disclosure, and other obligations of public companies. In assisting companies through the private and public offering process, attorneys should devote significant time to educating management and helping the issuer minimize these risks.

In both public offerings and private placements, attorneys face the usual risks or professional liability and must address the usual rules of ethics. Additional risks result, however, from the specialized nature of the work to be done, the multiple parties involved, the many actual and potential conflicts of interest, the need to consider duties to the public and to government agencies, and the opportunities for legal professionals to profit in offerings by virtue of the ownership of stock in the client or options for such stock. There is also the overarching risk that, if the offering company fails, lawyers for the company will incur defense costs when sued in private securities lawsuits as a deep pocket, even if they have in fact done nothing wrong. Attorneys may in addition face SEC civil actions, professional discipline, or SEC administrative actions.

Attorneys representing start-up companies commonly face conflict of interest issues. The attorneys often work closely with the founders and principal investors on an ongoing basis. Consequently, if the attorneys' roles are not clearly defined, misunderstandings may arise as to whom the attorneys are representing. The attorneys may have an opportunity to invest in a start-up client, or to receive stock or options as partial payment for services. Whether or not to invest requires consideration of ethical issues. A client may wish to have an attorney serve on the client's board of directors or as an officer. This too may

not be advisable without careful consideration of the risks involved in serving both as a director or officer and as legal counsel.

This chapter examines:

- the roles of the attorney and client in private placements and IPOs (section 2);
- the identity of the client and, in particular, potential conflicts between companies and management (section 3);
- the standard of care applicable to work on offerings and the extent to which an attorney may rely on facts provided by the client (section 4);
- liability for federal securities violations (section 5), under Section 11 of the 1933 Act, Section 12 of the 1933 Act, Section 5 of the 1933 Act, SEC Rule 10b-5, and Section 17(a) of the 1933 Act; and discipline under SEC Rule 102(e);
- special risks that an attorney runs in performing due diligence for offerings (section 6);
- an attorney's duties to inform third parties (*e.g.*, investors or the SEC) of facts about a client company, report "up the ladder" inside a client when the attorney learns of wrongdoing within the company and, in the last resort, resign (section 7);
- an attorney's exposure to third parties (*e.g.*, investors) on common law negligence (section 8) and fraud and negligent misrepresentation (section 9) theories; and
- ethical and practical issues to address when an attorney considers investing in a client (section 10) or serving as an officer or director of a client (section 11).

## 2. THE PRINCIPAL ROLES OF THE ATTORNEY IN A PRIVATE OFFERING AND THE IPO

The clients who ask an attorney to assist in a private offering or an IPO may range from the exceptionally sophisticated to the exceptionally naive. Whatever the case, the attorney almost always has at least two advantages: he or she has experience (or access to others' experience) in preparing offerings and is trained to consider the views of investors. The first advantage furnishes the lawyer with wisdom about the mistakes of others, and the common pitfalls likely to be encountered by the company and its management. The second advantage gives