

8-1-1972

## Legal Malpractice and Rule 10b-5 Liability: Pitfalls for the Occasional Securities Practitioner

Mitchell L. Lathrop

William F. Rinehart

---

### Recommended Citation

Mitchell L. Lathrop & William F. Rinehart, *Legal Malpractice and Rule 10b-5 Liability: Pitfalls for the Occasional Securities Practitioner*, 5 Loy. L.A. L. Rev. 449 (1972).

Available at: <https://digitalcommons.lmu.edu/llr/vol5/iss3/1>

This Article is brought to you for free and open access by the Law Reviews at Digital Commons @ Loyola Marymount University and Loyola Law School. It has been accepted for inclusion in Loyola of Los Angeles Law Review by an authorized administrator of Digital Commons@Loyola Marymount University and Loyola Law School. For more information, please contact [digitalcommons@lmu.edu](mailto:digitalcommons@lmu.edu).

# LEGAL MALPRACTICE AND RULE 10b-5 LIABILITY: PITFALLS FOR THE OCCASIONAL SECURITIES PRACTITIONER

by Mitchell L. Lathrop\* and William F. Rinehart\*\*

At one time or another, most growing businesses require additional capital for meeting the demands of increasing production, expanding facilities, entering new markets or attending to the myriad exigencies which arise in the day-to-day operation of any business enterprise. Although the issuance of stock is a desirable (as well as often the only practical) means of raising funds, the prohibitive expense of complying with the registration requirements of the Securities Act of 1933<sup>1</sup> (hereinafter "the 1933 Act") may preclude a closely held business from going public with a large interstate offering of securities. Further, the continuing financial and disclosure burdens imposed upon public companies by the Securities Exchange Act of 1934<sup>2</sup> (hereinafter "the 1934 Act") may inhibit other businesses from seeking public capital through the issuance of securities. However, notwithstanding these prohibitive factors, where compelling business exigencies demand acquisition of significant amounts of capital, business enterprises have relied and will likely continue to rely upon the issuance of securities to meet such demand.

There are, in essence, four practical methods of obtaining financing through the sale of securities:<sup>3</sup> (1) a full registration under the provisions of the 1933 Act;<sup>4</sup> (2) an abbreviated registration under a Regulation A filing;<sup>5</sup> (3) a "private placement;"<sup>6</sup> or (4) an "intra-

---

\* B.S. 1959, United States Naval Academy; J.D. 1966, University of Southern California; member of the California and District of Columbia Bars.

\*\* B.A. 1954, LL.B. 1955, Stanford University; member of the California Bar.

1. Securities Act of 1933 §§ 1-26, 48 Stat. 74, 15 U.S.C. §§ 77a-77aa (1970).

2. Securities Exchange Act of 1934 §§ 1-34, 48 Stat. 881, 15 U.S.C. §§ 78a-78hh (1970).

3. There are, of course, alternative means of financing available, e.g., bank financing and short-form Regulation A financing, which is limited to \$50,000 (17 C.F.R. § 230.257 (1971)). These options are not normally exercised in a situation where a sizeable amount of capital must be raised and hence they will not hereafter be discussed.

4. See note 1 *supra*.

5. Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1970), authorizes the Securities and Exchange Commission to exempt any class of securities by rules and

state offering."<sup>7</sup> Although the applicable state Blue Sky laws must be considered in connection with financing through any of these methods,<sup>8</sup> the private placement and the intrastate offering, at least initially, do not involve federal administrative regulation by the Securities and Exchange Commission (hereinafter "the SEC").

While many attorneys whose aid has been enlisted in the raising of venture capital obdurately refuse to undertake the burdens encountered in full registration of a security, they do not hesitate to raise capital through issuance of a security or through a transaction which they believe to be exempt from the registration requirements of the 1933 Act. The literal language of the private placement and intrastate offering exemptions would suggest that the federal securities laws provide liberal methods of acquiring capital without the burdens of full registration. However, this is not the case. Unfamiliarity with these exemptive provisions, as well as inadvertent or purposeful misuse of the Regulation A offering procedure, may breed chaos and financial disaster for the corporate client as well as its shareholders. Moreover, this unfamiliarity and misuse may portend financial ruin for the attorney as well. It is the purpose of this article to suggest and illustrate, through the use of a hypothetical situation, the potential legal malpractice and Rule 10b-5<sup>9</sup> liability of the attorney incognizant of the pitfalls involved in an attempt to acquire capital through a lawful but unregistered issuance of securities.

#### ALTERNATIVES TO REGISTRATION UNDER THE 1933 ACT

The guiding principle of the 1933 Act is reposed in Section 5,<sup>10</sup> which requires the registration of all securities offered or sold through

---

regulations, provided the aggregate amount offered does not exceed \$500,000. Pursuant to this authority, the Commission promulgated Regulation A. SEC Reg. A, 17 C.F.R. §§ 230.251-230.263 (1971). The usefulness of this regulation was enhanced by amendments to Section 3(b) and Regulation A which increased the maximum amount allowable from \$300,000 to \$500,000. Act of Dec. 19, 1970, Pub. L. No. 91-565, 84 Stat. 1480, amending 15 U.S.C. § 77c(b) (1970).

6. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970). See text accompanying notes 21-38 *infra*.

7. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970). See text accompanying notes 39-49 *infra*.

8. For an excellent synopsis of the bewildering variety of state regulatory approaches to securities offerings, see W. CARY, CASES AND MATERIALS ON CORPORATIONS 1477-83 (4th ed. 1969); Ptacek, *Blue Sky Considerations in Structuring a Public Offering*, 21 DRAKE L. REV. 225 (1972).

9. 17 C.F.R. § 240.10b-5 (1971).

10. 15 U.S.C. § 77e (1970).

the use of interstate commerce or the mails, unless the securities are themselves exempt or are offered or sold in an exempted transaction.<sup>11</sup> The registration of securities, unfortunately, is a process which is expensive, time-consuming, and, in many cases, far too elaborate to be of significant advantage to a small business.<sup>12</sup> Although most, if not all, practitioners familiar with federal securities law would concur that full registration is the safest course for an issuer to follow, as a practical matter, the advice given most issuers deals with the seasonable employment of one of the Act's exemptive provisions. This advice should be cautiously proffered since an issuer who improperly relies upon an exemption, and thereby fails to comply with Section 5, is civilly liable under Section 12 of the 1933 Act.<sup>13</sup> Moreover, the ambit of exemptions from Section 5 registration is strictly construed,<sup>14</sup> and the claimant seeking to rely upon an exemption has the burden of proving its availability.<sup>15</sup>

There are seventeen exemptive provisions contained in Sections 3 and 4 of the 1933 Act. Several of these provisions deal with the particular exemption of securities; others exempt certain transactions from the registration requirements of the Act.<sup>16</sup> Of these seventeen provisions, only three are generally encountered by the average practitioner. The private placement and the intrastate offering exemptions

---

11. Section 3 of the 1933 Act exempts certain *securities*. 15 U.S.C. § 77c (1970). Section 4 of the 1933 Act exempts certain *transactions*. 15 U.S.C. § 77d (1970).

12. For the difficulties to be encountered in a full registration, see Wheat & Blackstone, *Guideposts for a First Public Offering*, 15 BUS. LAW. 539 (1960). In 1968, Mr. Blackstone estimated the registration expenses for a \$3,000,000 offering to be between \$60,000 and \$100,000. See Blackstone, *Post-Effective Amendment to "Guideposts for a First Public Offering"*, in SELECTED ARTICLES ON FEDERAL SECURITIES LAW 27 (H. Wander & W. Grienberger eds. 1968).

13. 15 U.S.C. § 77l (1970). The section provides in part:

Any person who—

(1) offers or sells a security in violation of section [5] . . .

. . . .

shall be liable to the person purchasing such security from him. . . .

14. *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 689 (5th Cir. 1971). The *Hill York* court stated: "The Act is remedial legislation entitled to a broad construction. Conversely, its exemptions must be narrowly viewed." See also *SEC v. Sunbeam Gold Mines Co.*, 95 F.2d 699, 701 (9th Cir. 1938).

15. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953). The Court in *Ralston* stated: "Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption [§ 4(2) of the 1933 Act] seems to us fair and reasonable." The federal courts have uniformly followed this statement. See, e.g., *SEC v. North Am. R. & D. Corp.*, 424 F.2d 63, 71 (2d Cir. 1970); *Chapman v. Dunn*, 414 F.2d 153, 159 (6th Cir. 1969); *Pennaluna & Co., Inc. v. SEC*, 410 F.2d 861, 865 (9th Cir. 1969).

16. See note 11 *supra*.

are the most important of these from the standpoint of both popularity and misuse. However, the Regulation A offering is also encountered with sufficient frequency as to merit comment.

Regulation A was promulgated by the SEC<sup>17</sup> in response to the legislative power granted by Section 3(b) of the 1933 Act.<sup>18</sup> It is not a true exemption since a filing, albeit an abbreviated one, is required by the SEC. Securities issued pursuant to a Regulation A filing must not aggregate more than \$500,000 and may not consist of either undivided interests in mineral rights or investment company securities which require registration.<sup>19</sup> The utility of a Regulation A offering is limited, however, in two major respects. First, the exemption must be earned by compliance with all of the detailed provisions of Regulation A. This thicket of technicalities can be almost as cumbersome as a full registration. Second, the game may not be worth the candle since the underwriting commissions as well as the fees of the lawyers and accountants constitute part of the sum which cannot exceed \$500,000.<sup>20</sup>

The private placement is a highly desirable transactional exemption from the standpoint of the new business entity seeking to raise capital by selling securities to a select group of investors. Created by Section 4(2) of the 1933 Act,<sup>21</sup> the provision exempts from registration private offerings in which there is no practical need for the public protection afforded by Section 5. The critical language of the Section 4(2) exemption, "a transaction not involving a public offering", necessarily implies that the offering must be "private." The factors determinative of whether an offering qualifies for exemption as a private placement include: the monetary amount and size of the offering,<sup>22</sup> the number of prospective investors,<sup>23</sup> the purpose for which

---

17. 17 C.F.R. § 252(b)(1)-(2) (1972).

18. 15 U.S.C. § 77c(b) (1970).

19. 17 C.F.R. § 252(b)(1)-(2) (1972). See also Burge, *Regulation A: A Review and a Look at Recent Developments*, 46 L.A. BAR BULL. 290 (1971).

20. 17 C.F.R. § 252(b)(1)-(2) (1972).

21. 15 U.S.C. § 77d(2) (1970).

22. SEC Securities Act Release No. 4552 (Nov. 6, 1962).

23. *Id.* See Op. Gen. Counsel, Securities Act Release No. 285 (Jan. 24, 1935). This opinion suggested as a guideline that "under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number and presumably does not involve a public offering." While the determinative test for a public offering is qualitative and not quantitative (*see SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953)), few lawyers would exceed the arbitrary twenty-five person limit without strong justifying factors. Note also that it is *offerees* rather than *purchasers* who are counted. SEC Securities Act Release No. 4552 (Nov. 6, 1962).

Additionally, it should be remembered that although California presumes an offering to be nonpublic if made to twenty-five persons or less (the presumption is con-

those investors are purchasing (investment versus speculative resale),<sup>24</sup> and the amount of information about the transaction available to the offerees, the purchasers, or both.<sup>25</sup> Further, the existence of a prior relationship between the offeror and offeree<sup>26</sup> and the institutional or non-institutional character of the prospective investors<sup>27</sup> are relevant though non-determinative considerations evidencing the public or non-public character of the offering.

In its landmark decision in *SEC v. Ralston Purina Co.*,<sup>28</sup> the United States Supreme Court concluded that the "applicability of [the private placement exemption] should turn on whether the particular class of persons affected needs the protection of the Act."<sup>29</sup> In that opinion, the Court, in effect, adopted a two-pronged test to determine whether the particular class of persons affected in fact needed such protection. First, the Court inquired whether the offerees had "access to the same kind of information that the Act would make available in the form of a registration statement."<sup>30</sup> In *Ralston Purina*, this inquiry was answered in the negative.<sup>31</sup> Earlier in the opinion, however, the Court implied that whenever the answer to this first inquiry was in the affirmative, a second interrogatory must follow, namely, whether the

---

clusive if the sale is consummated with ten or fewer individuals), compliance with state regulatory provisions in no way guarantees that one has not violated federal securities law. 10 CAL. AD. CODE § 260.102(2).

24. SEC Securities Act Release No. 4552 (Nov. 6, 1962).

25. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

26. SEC Securities Act Release No. 4552 (Nov. 6, 1962). See also Mulford, *Private Placements and Intrastate Offerings of Securities*, 13 BUS. LAW. 297, 300-01 (1958).

27. The House report on the 1954 amendments referred to the private placement exemption as an avenue for "the making of an offering to a limited number of persons who presumably may be expected to possess some familiarity with the business involved." H.R. REP. NO. 1542, 83d Cong. 2d Sess. 19 (1954). But see *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971) wherein the court states:

The defendants rely most strongly on the fact that the offering was made only to sophisticated businessmen and lawyers and not the average man in the street. Although this evidence is certainly favorable to the defendants, the level of sophistication will not carry the point. . . . [T]he S.E.C. has rejected the position . . . stating: "The Supreme Court's language does not support the view that the availability of an exemption depends on the sophistication of the offerees or buyers, rather than their possession of, or access to, information regarding the issuer. *Id.* at 690, quoting 1 L. LOSS, *SECURITIES REGULATION* 657 n.53 (2d ed. 1961).

*Accord*, Gilligan, Will & Co., SEC Securities Exchange Act Release No. 5689 (1958), *aff'd sub nom.*, Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1959).

28. 346 U.S. 119 (1953).

29. *Id.* at 125 (emphasis added).

30. *Id.* at 125-26.

31. *Id.* at 127.

offerees were shown to be "persons able to fend for themselves."<sup>32</sup> Thus, the *Ralston Purina* opinion suggests that when investors with the "ability to fend for themselves" are given "access to the kinds of information that the Act would make available in the form of a registration statement" the offering qualifies for a Section 4(2) exemption as a "transaction not involving a public offering."

Despite this seemingly clear and justifiable implication from the *Ralston Purina* opinion, issuers and counsel would be ill-advised to construe that case as allowing them to engineer Section 4(2) exemptions by "spoon feeding" offerees the requisite information about the issuer.<sup>33</sup> Although such a construction might satisfy even the most narrow interpretation of the term "access",<sup>34</sup> it completely ignores the requirement that the offerees be "persons with the ability to fend for themselves." The Supreme Court never precisely defined the meaning of the terms "access" and "persons with the ability to fend" as used in the *Ralston Purina* opinion and the SEC has continually taken and urged the courts to take a restrictive view of the meaning of those terms.<sup>35</sup> The SEC has argued that a "person with the ability to fend" is a person with a "relationship to the company tantamount to that of an 'insider' in terms of his ability to know, to understand and to verify for himself all of the relevant facts about the company and its securities."<sup>36</sup> Thus, given the SEC's declared opposition to "spoon feeding"<sup>37</sup>

---

32. *Id.* at 125.

33. The SEC has expressly taken the position that:

The exemption does not become available simply because offerees are voluntarily *furnished* information about the issuer. Such a construction would give each issuer the choice of registering or making its own voluntary disclosures without regard to the standards and sanctions of the Act. SEC Securities Act Release No. 4552 (Nov. 6, 1962).

34. The recent Fifth Circuit decision in *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971), suggests that access in the sense of the mere ability to acquire the requisite information might not be sufficient to qualify the transaction for exemption as a private placement. In a somewhat ambiguous opinion, the *Hill York* court intimated that section 4(2) might not be deemed applicable unless the offerees have *actual possession* of the requisite information. The court implied that without such actual possession the offerees would not be deemed to be sophisticated investors acquiring securities in a nonpublic offering. *Id.* at 690-91.

35. *See, e.g.*, *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 690-91 (5th Cir. 1971); SEC Brief on Appeal, *SEC v. Continental Tobacco Co. of South Carolina, Inc.*, 127 SEC REG. & L. REP. A-17 (Mar. 22, 1972); SEC Securities Act Release No. 4552 (Nov. 6, 1962).

36. SEC Brief on Appeal, *SEC v. Continental Tobacco Co. of South Carolina, Inc.*, 127 SEC REG. & L. REP. A-17 (Mar. 22, 1972). *See also* *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 688 n.6 (5th Cir. 1971); Riccio, *The General Practitioner and the Federal Securities Laws*, 54 MASS. L.Q. 271, 277 (1969). This "privileged relationship" requirement is best constructed in view of the SEC's

and the narrow view taken of "persons with the ability to fend,"<sup>38</sup> it becomes evident that any attempted engineering of a Section 4(2) exemption would be ill-advised. The attorney and issuer who engage in such an attempt would appear to be inviting, at the minimum, SEC investigation and, in most cases, probable litigation and its attendant danger that the issuance will be held not to qualify as a private placement.

Issuance under Section 3(a)(11),<sup>39</sup> the intrastate offering exemption, gives rise to less uncertainty than surrounds issuances under the private placement exemption. The provision exempts from Section 5 registration:

Any security which is part of an issue offered and sold only to *persons resident* within a single State or Territory, *where the issuer of such security is a person resident* and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.<sup>40</sup>

It should be observed that the availability of the intrastate exemption does not depend upon the number of offerees involved, provided all offerees are persons resident within a single state. The limited exemption is thus directed towards ensuring that the effects of the offering are confined within a single state. Accordingly, it is unnecessary to ascertain the public or nonpublic character of the offering as would be the case with an interstate offering of securities.

Notwithstanding the above, some uncertainty does attend intrastate public offerings scheduled in reliance upon the Section 3(a)(11) exemption. These offerings become particularly dangerous when a large number of security purchasers are involved in a plan of financing. The SEC takes the position that the *entire issue* of the securities must be offered and sold exclusively to residents of the state in question.<sup>41</sup> "Consequently, an offer to a nonresident which is considered a

---

statement that "an offering of millions of dollars to *non-institutional* and *non-affiliated* investors . . . would suggest that a public offering may be involved." SEC Securities Act Release No. 4552 (Nov. 6, 1962) (emphasis added). The restrictive intent behind this statement is further evidenced by the SEC definition of an affiliate:

An "affiliate" of, or a person "affiliated" with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under control with, the [issuer]. 17 C.F.R. § 230.405 (1972).

37. See note 33 *supra*.

38. See note 36 *supra*.

39. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77(c)(11) (1970).

40. *Id.* (emphasis added).

41. SEC Securities Act Release No. 4434 (Dec. 6, 1961) provides in pertinent part:

A basic condition of the exemption is that the *entire issue* of securities be offered and sold exclusively to residents of the state in question. Consequently, an offer to a nonresident which is considered a part of the intrastate issue will render the exemption unavailable to the entire offering.



part of the intrastate issue will render the exemption unavailable to the entire offering."<sup>42</sup> It is the long-standing position of the SEC that a *single* offer or sale to a nonresident causes the loss of the Section 3(a)(11) exemption, not only for that individual sale, but for all other securities involved in the issue.<sup>43</sup> Thus, the risk to the issuer relying on the Section 3(a)(11) exemption increases in direct proportion to the number of offerees. The validity of the issuer's exemption will depend upon its ensuring that its entire issuance has taken place within the state.<sup>44</sup> Subsequent resales to non-residents by the original purchasers must not occur before the securities involved have come to rest within the state where the offering was undertaken.<sup>45</sup> Resales by purchasers who acquired securities with a view to sell would be inconsistent with the issuer's assertion that its distribution had already been concluded. Necessarily, if these resales were to nonresidents, the Section 3(a)(11) exemption would be jeopardized because the out-of-state distribution could be attributed to and deemed actuated by the issuer.<sup>46</sup>

Other areas of uncertainty exist with respect to the Section 3(a)(11) exemption. The question of what constitutes a "person resident" within the meaning of the Section is one to which no judicial answer has yet been provided. Although the SEC has taken the position that residence is equivalent to domicile,<sup>47</sup> there exists no decisional law so defining the term, and at least one renowned authority has disputed the SEC's construction.<sup>48</sup> When the issuer is a corporation, Section 3(a)(11) requires that the business be incorporated by and doing business within that state where the offering is made. The incorporation requirement is obvious, but it remains unclear whether the courts will attach a broad or a restricted meaning to the term "doing business." At least one court has apparently construed the doing business requirement as a requirement that the *primary business* of a corporation be carried on in the state where the securities are offered.<sup>49</sup>

---

42. *Id.*

43. *Id.*

44. *Id.*

45. See 1 L. LOSS, SECURITIES REGULATION 591-605 (2d ed. 1961). SEC Securities Act Release No. 4552 (Nov. 6, 1962).

46. Brooklyn Manhattan Transit Corp., 1 S.E.C. 147 (Commission Decision 1935) (exemption is not available where the offering is made to resident underwriters or other intermediaries who promptly resell to nonresidents).

47. SEC Securities Act Release No. 4434 (Dec. 6, 1961).

48. See 1 L. LOSS, SECURITIES REGULATION 598-600 (2d ed. 1961).

49. SEC v. Truckee Showboat, Inc., 157 F. Supp. 824, 825 (S.D. Cal. 1957). See Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969), wherein the "doing business require-

An issuer planning to employ multiple offerings for the purpose of corporate finance should be made aware of the ever present danger that the SEC will take the position that ostensibly separate offerings made for the purpose of corporate finance should be "integrated"<sup>50</sup> for purposes of determining qualification for exemption under any of the exemptive provisions of the 1933 Act. Whether the SEC will integrate depends primarily on whether it appears that the various issuances in question may be said to be parts of a single plan or program of financing.<sup>51</sup> For example, suppose that a corporation, located and doing business within state X, undertakes a private placement of securities in state Y and an intrastate sale of securities in state X. Assuming that all of the requisite procedures and standards involved in making such exempted offerings have been complied with, each issuance, considered separately, would be exempted from application of Section 5 of the 1933 Act. However, if the two offerings are in fact or substance made pursuant to a single plan or program of financing, the SEC may integrate them by specifying each as but one aspect of a larger offering.<sup>52</sup> Should this occur, the intrastate offering exemption would definitely be lost and the same result would be likely with respect to the private placement exemption. This follows from the fact that this larger offering, composed of the two smaller and previously independent offerings, must itself now qualify for exemption.<sup>53</sup> The intrastate offering exemption would be lost because the securities involved in the original private placement in state Y were offered and sold outside state X. The private placement exemption would probably be lost since the tests for determining qualification for that exemption would now be applied to a group of offerees consisting

---

ment" was held not to have been met where all income producing property was outside the state, and where the issuer merely maintained an office and staff in the state from which it offered and sold its securities.

50. See generally SEC Securities Act Release No. 4434 (Dec. 6, 1961); SEC Securities Act Release No. 4552 (Nov. 6, 1962).

51. SEC Securities Act Release No. 4434 (Dec. 6, 1961). The SEC has cited the following factors as relevant to the question of integration: (1) are the offerings part of a single plan of financing; (2) do the offerings involve issuance of the same class of security; (3) are the offerings made at or about the same time; (4) is the same type of consideration to be received; and (5) are the offerings made for the same general purpose. *Id.*

52. *Id.*

53. SEC Securities Act Release No. 4434 (Dec. 6, 1961) states:

Whether an offering is "a part of an issue", that is, whether it is an integrated part of an offering previously made or proposed to be made, is a question of fact and depends essentially upon whether the offerings are a related part of a plan or program. Thus, the [section 3(a)(11)] exemption should not be relied upon in combination with another exemption for the different parts of a single issue where part is offered or sold to nonresidents (citations omitted).

of not only the offerees involved in the original private placement offering but also those offerees involved in the intrastate offering. Aside from the effect which the addition of this latter group would have on such private placement qualification factors as the number of offerees and the monetary amount and the size of the offering, it is predictable that at least some of the additional offerees would be held to be persons who needed the protection of the Act since they did not possess those attributes<sup>54</sup> which render such protection unnecessary.<sup>55</sup>

Obviously, the prerequisites of the exemptive provisions demand exact compliance. The result of a willful or inadvertent failure to comply with them will result in the non-availability of the respective exemption and, accordingly, an unlawful interstate public distribution of unregistered securities. The consequences of such an illegal distribution could well be disastrous. If, for example, the intrastate offering exemption is lost through an offer or sale to a nonresident, then Section 5 will have been violated. The remedies afforded purchasers of securities issued in violation of Section 5 are rescission or recovery of any losses suffered in connection with the sale, plus interest.<sup>56</sup> A dissatisfied client and disgruntled purchasers will be searching for funds; the former to meet its obligations and the latter to recoup any losses suffered as a result of the violating transaction. Under these circumstances a very real danger exists that either or both might conclude that the attorneys who afforded the legal advice with respect to the unlawful issuance will provide "deep pockets" in which to conduct that search.

#### A HYPOTHETICAL SITUATION

The following hypothetical situation illustrates some of the more common problems which could give rise to claims for legal malpractice

---

54. See text accompanying notes 21-38 *supra*.

55. It should be noted that no court has yet applied the "integration" doctrine. *But cf.* *Bowers v. Columbia General Corp.*, 336 F. Supp. 609, 624-25 (Del. 1971), wherein the court states: "[i]t is fair to assume, however, that a court will ultimately [apply the doctrine] when confronted with a series of offerings of unregistered securities issued pursuant to a single financing plan. . . ." Lack of judicial application of the doctrine has not, however, deterred the SEC from its continued use. *Cf.* *Texas Glass Manufacturing Corp.*, 38 S.E.C. 630, 634 (Commission Decision, 1958), wherein the SEC issued a stop order against an issuer whose prospectus contained statements which were materially misleading, one such statement being the representation that a prior series of related offerings were validly sold under the Section 3(a)(11) exemption.

56. Securities Act of 1933 §§ 5, 12, 15 U.S.C. § 771 (1970); *MacClain v. Bules*, 275 F.2d 431 (8th Cir. 1960); *Wall v. Wagner*, 125 F. Supp. 854 (D.C. D. Neb. 1954), *aff'd sub nom.*, *Whittaker v. Wall*, 226 F.2d 868 (8th Cir. 1955).

and Rule 10b-5 liability in the legal management of securities distributions. At the outset, it should be noted that this situation has innumerable possible variations, any one of which could significantly alter the legal issues presented.

All of the stock of *Fine Lines On Paper Co.* [hereinafter "FLOP"], a California corporation, has been owned by Mr. Jones for some ten years. The corporation manufactures a unique product and has provided a comfortable living for Mr. Jones. However, business is too good! FLOP is deluged with orders which it cannot meet. A larger plant and expensive new equipment are required if the company is to meet the demands of its customers and grow with the times. Although Mr. Jones is financially sound, he is unable to provide the necessary funds for these improvements and the local banks are unwilling to loan him the amount required on acceptable terms. Mr. Jones' next thought is to sell some of his corporation's stock. Accordingly, he seeks the advice and aid of his lawyer, who recommends a private placement of the proposed stock issuance.

Being a man of some means and excellent connections, Mr. Jones interests ten of his wealthier friends, all experienced businessmen, in each purchasing \$100,000 worth of stock in FLOP. He thus raises \$1,000,000 for the expansion of his existing facilities and the purchase of new equipment. Although the ten friends reside in different states, Mr. Jones' lawyer is careful to comply with all of the requirements of the respective Blue Sky laws for each state. The new shareholders are pleased and enthusiastic about the quality of their investment. Mr. Jones' lawyer receives a handsome fee for his work and all seems well.

FLOP proceeds with its expansion plans, but the costs of the necessary improvements are greater than originally projected and it soon becomes apparent that additional capital will be required. Moreover, an opportunity arises to purchase a second factory and thereby further increase production. Once again, Mr. Jones consults his lawyer who by now has become general counsel for FLOP.

It is determined that \$2,000,000 will be needed to complete the expansion plans as revised. Another private offering is ruled out since Mr. Jones has no friends capable of raising so large a sum. The expense entailed in full registration is not an attractive prospect to FLOP since the prospective issue is relatively small. Use of the Regulation A offering exemption is precluded as well since a filing under Regulation A is limited to offerings of less than \$500,000 and involves the arduous task of preparing an offering circular. However, counsel informs FLOP

that there are no legal impediments to an intrastate offering and agrees to prepare the necessary documents.<sup>57</sup> FLOP conducts substantially all of its business in California so the offering is appealing to the corporate officers and directors. They believe the necessary \$2,000,000 can be raised in large part from the many suppliers and customers of FLOP who are already acquainted with its products. Moreover, California is a wealthy state with a large investor population. Therefore, FLOP decides to proceed with an intrastate offering.

Working feverishly to meet the offering schedule, counsel files all the necessary documents with the appropriate California regulatory agency, the Department of Corporations. The securities are slated for sale only in California and to bona fide California residents and the funds received from sales are to be employed to complete the revised plans for expansion. FLOP's accountants prepare detailed financial reports, including a certified report for the current fiscal year, and receive an opinion from counsel that the securities, when issued as contemplated by the offering circular, will be validly and legally authorized and issued, fully paid and nonassessable. Shortly thereafter, the Department of Corporations issues a permit authorizing the sale of the securities.<sup>58</sup>

FLOP advertises in local newspapers and mails copies of the offering circular to its California customers and suppliers. The offering is a huge success—200,000 shares are sold almost immediately for \$10 per share and FLOP appears to be on its way toward becoming a leading manufacturer. Certain brokers specializing in new over-the-counter securities begin to make a market in the stock and it advances to \$20 per share.

A year passes during which FLOP encounters increased production costs, new competition, labor difficulties, and a diminished market for its products. The price of its stock declines from the high of \$20 per share to \$6 per share. Creditors become increasingly impatient and shareholders begin to question the wisdom of their investment. Finally, the local bank, hearing rumors that the SEC may view the two FLOP offerings as being integrated and fearing that the shareholders will exercise their resultant rescission rights, cuts off FLOP's line of credit. FLOP is unable either to pay its debts as they mature or to secure other

---

57. Since this offering is exempt under the federal Securities Acts, an offering circular or prospectus is not required. However, since FLOP Company is a California corporation, the California Commissioner of Corporations may require a prospectus as a condition of qualification. CAL. CORP. CODE ANN. § 25148 (West Supp. 1971).

58. *Id.* § 25113.

credit. It therefore files either a petition seeking an arrangement with its creditors<sup>59</sup> or a petition for corporate reorganization. The creditors are unwilling to accept any proffered plan and FLOP is adjudicated bankrupt.<sup>60</sup>

The shareholders, suddenly faced with a complete loss of a market for their shares, become irate about the turn of events. They file a class action<sup>61</sup> in the United States District Court under Sections 12<sup>62</sup>

---

59. Bankruptcy Act § 322, 11 U.S.C. § 722 (1970).

60. Bankruptcy Act §§ 236(2), 376(2), 11 U.S.C. §§ 636(2), 776(2) (1970).

The trustee in bankruptcy would apparently succeed to the issuer's right of action against the attorney. Bankruptcy Act § 70(a)(6), 11 U.S.C. § 110(a)(6). The right of action would constitute an asset of the estate and any recovery would be distributed for the benefit of all creditors. Dividends would be declared pursuant to the order of priority set forth under Section 60 of the Bankruptcy Act (11 U.S.C. § 96 (1970)).

The injured shareholders' rights to damages would constitute provable claims in bankruptcy. Bankruptcy Act § 63(a), 11 U.S.C. § 103(a) (1970). The enforcement of such claims, however, would likely present somewhat of a problem for the bankruptcy court with respect to the priority to be afforded them. It would seem inequitable to consider the injured shareholders as being of equal priority with general unsecured trade creditors. Thus, the court might, in the exercise of its equity powers, create a special category for the shareholders' claims, subordinating them to those of the general creditors but placing them ahead of other shareholders.

Whether, after bankruptcy proceedings have been initiated, the shareholders would be able to exercise their rescission rights (see note 56 *supra*) is an apparently unresolved question and beyond the scope of this paper.

61. FED. R. CIV. P. 23 enables a defrauded stockholder to bring an action under Rule 10b-5 on behalf of himself and all other stockholders similarly situated. The Advisory Committee Notes to the Amendment to Rule 23 specifically mention that private suits for fraud arising from a common misrepresentation would be properly maintainable as class actions. Report of the Judicial Conference of the United States, Advisory Committee Note, 39 F.R.D. 69, 103 (1966). Prior to the 1966 amendment, such an action was proper as a "spurious" class action under FED. R. CIV. P. 23(a)(3). Amended FED. R. CIV. P. 23, effective July 1, 1966, dispensed with the distinctions drawn in the prior rule between "true," "hybrid," and "spurious" classes. However, substantially the same requirements are present to maintain a class action as were present in the prior rule. In *Mersay v. First Republic Corp. of America*, 43 F.R.D. 465, 467 (S.D.N.Y. 1968), the prerequisites of a class action were stated as follows:

- (1) Joinder of all members of the class must be impossible because the class is so numerous.
- (2) There must be questions of law and fact common to the class which predominate over questions affecting only individual members of the class.
- (3) The claims of the plaintiff must be typical of the claims of the class.
- (4) The plaintiff must show that he will fairly and adequately protect the interests of the class.
- (5) The class action must be found superior to other means available for the fair and efficient adjudication of the dispute.

FED. R. CIV. P. 23.1 was added at the same time FED. R. CIV. P. 23 was changed. This rule requires that the plaintiff in a derivative action be a stockholder at the time of the transaction complained of, or that the share devolve upon him by operation of

and 17<sup>63</sup> of the 1933 Act, Section 10b of the 1934 Act<sup>64</sup> and Rule 10b-5<sup>65</sup> promulgated thereunder.<sup>66</sup> Notably, the attorney is named as one of the defendants in the class action. Additionally, cross-claims alleging a cause of action for legal malpractice against the attorney are filed by his codefendants, the issuer and others also involved in the illegal offering. Facing potential liabilities amounting to millions of dollars, the attorney notifies his insurance carrier who promptly responds with a "reservation of rights" statement. This statement is intended to absolve the insurer from liability for damages assessed pursuant to Section 12 of the 1933 Act for violation of Section 5 or awarded pursuant to the fraud provisions of both the 1933 and 1934 Acts.

#### ATTORNEY MALPRACTICE

Although a corporation, as a client, can maintain a malpractice action against its attorney, the law is unsettled on whether shareholders can maintain a class action against a negligent attorney who renders services in connection with an unregistered public offering. Clearly, the right to maintain an action against the corporation for damages

law. See *Bateson v. Magna Oil Corp.*, 414 F.2d 128 (5th Cir. 1969), *cert. denied*, 397 U.S. 911 (1970).

62. Securities Act of 1933 § 12, 15 U.S.C. § 77l (1970).

63. Securities Act of 1933 § 17, 15 U.S.C. § 77q (1970).

64. Securities Exchange Act of 1934 § 10b, 15 U.S.C. § 78j (1970) provides:

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—

. . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

65. 17 C.F.R. § 240.10b-5 (1971) provides:

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.

66. Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (1970), grants exclusive jurisdiction over securities violations to the federal courts. Where the facts underlying a complaint under Rule 10b-5 would sustain a claim under state common law or statute, the state law count, if susceptible to proof by substantially identical evidence adducible under the federal count, may be included under the rule of pendant jurisdiction. *Wolfson v. Blumberg*, 229 F. Supp. 191, 192-93 (S.D.N.Y. 1964), *citing* *Hurn v. Oursler*, 289 U.S. 238 (1933) as announcing the doctrine of pendant jurisdiction.

resulting from its unlawful distribution of securities exists in the recipient shareholders.<sup>67</sup> However, this right has minimal value when the corporation is in financial difficulty or is already involved in bankruptcy proceedings. Often, the negligent attorney represents the only possible source of recovery for injured shareholders and, accordingly, the developing trend in California is to allow the maintenance of a class action suit in similar situations.<sup>68</sup>

Generally, plaintiff-clients in legal malpractice cases can plead causes of action in both contract and tort.<sup>69</sup> Often, however, a significant impediment to recovery exists when a cause of action in contract is asserted by a plaintiff not in privity of contract with the defendant attorney. The law is well-settled that contractual liability cannot be imposed upon a contracting party by a person not a party to the consensual agreement from which such liability arises.<sup>70</sup> However, virtually all American jurisdictions recognize the right of a third-party beneficiary to enforce through direct legal action the contractual agreement which benefits him.<sup>71</sup> This rule is followed regardless of whether the third party is a donee or creditor beneficiary.<sup>72</sup> Only incidental beneficiaries

67. *Cannon v. Texas Gulf Sulphur Co.*, 47 F.R.D. 60 (S.D.N.Y. 1969). See also Securities Act of 1933 § 12, 15 U.S.C. § 77l (1970) (wherein a rescission is provided against any person who sells a security in violation of the registration requirements); *Harris v. Palm Springs Alpine Estates, Inc.*, 329 F.2d 909 (9th Cir. 1964).

68. See *Vasquez v. Superior Court*, 4 Cal. 3d 800, 484 P.2d 964, 94 Cal. Rptr. 796 (1971), wherein plaintiffs, consumer purchasers of merchandise under installment contracts, were allowed to maintain a class action seeking rescission of the contracts for fraudulent misrepresentation against both the seller and the finance companies to whom the contracts had been assigned. For the federal rules governing class actions, see note 61 *supra*.

69. *Budd v. Nixen*, 6 Cal. 3d 195, 203 n.6, 491 P.2d 433, 438 n.6, 98 Cal. Rptr. 849, 854 n.6 (1971); *Neel v. Magana*, 6 Cal. 3d 176, 182, 491 P.2d 421, 424, 98 Cal. Rptr. 837, 840 (1971); *Heyer v. Flaig*, 70 Cal. 2d 223, 227, 449 P.2d 161, 163-64, 74 Cal. Rptr. 225, 227-28 (1969); *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961). The contract theory of recovery was extended to intended beneficiaries under a negligently drafted will in *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961). The doctrinal validity of this extension has since been questioned. See *Heyer v. Flaig*, 70 Cal. 2d 223, 227, 232, 449 P.2d 161, 164, 167, 74 Cal. Rptr. 225, 228 (1969). There, Justice Tobriner incisively noted that the third-party beneficiary contractual remedy "is conceptually superfluous since the crux of the action must lie in tort in any case; there can be no recovery without negligence." *Id.* at 227, 449 P.2d at 164, 74 Cal. Rptr. at 228.

70. 2 S. WILLISTON, CONTRACTS § 347 (Jaeger, 3d ed. 1959).

71. 4 A. CORBIN, CONTRACTS §§ 772, 774 (1951); 2 S. WILLISTON, CONTRACTS §§ 347, 354, 356 (Jaeger, 3d ed. 1959); RESTATEMENT (SECOND) OF CONTRACTS §§ 133-36 (Tent. Draft No. 3, 1967).

72. RESTATEMENT OF CONTRACTS §§ 133, 135-36 (1932). The donee and creditor third-party beneficiary classifications are now giving way to a single intended beneficiary



have been consistently denied the right to maintain actions as third-party beneficiaries.<sup>73</sup>

The third-party beneficiary principle was extended to encompass the attorney malpractice area in the case of *Lucas v. Hamm*.<sup>74</sup> In that case, the California Supreme Court held, *inter alia*, that the testamentary beneficiaries under a negligently drafted will were not merely incidental beneficiaries, but intended third-party beneficiaries who could therefore sue the testator's attorney *under contract theory* for his error in drafting the will.<sup>75</sup> However, the same court, in the case of *Heyer v. Flaig*,<sup>76</sup> subsequently questioned its earlier reliance on the contract theory of recovery:

Our analysis of the decision in *Lucas* points to the conceptual superfluity of the third-party beneficiary rationale of that case: the right of action sounds in tort and enures by reason of our determination that public policy requires the recognition of a duty of care on the part of the attorney which accrues directly to the third party, the intended beneficiary.<sup>77</sup>

In so analyzing its decision in *Lucas*, the supreme court in *Heyer* implied that in future attorney malpractice litigation the courts will emphasize the tort instead of the contract theory of recovery.<sup>78</sup>

---

classification. RESTATEMENT (SECOND) OF CONTRACTS, Introductory Note, ch. 6, p. 3 (Tent. Draft No. 3, 1967). The scope of the intended beneficiary classification is delimited ultimately only by policy considerations:

[I]f the beneficiary would be reasonable in relying on the promise as manifesting an intention to confer a right on him, he is an intended beneficiary. Where there is doubt whether such reliance would be reasonable, considerations of procedural convenience and other factors not strictly dependent on the manifested intention of the parties may affect the question whether . . . recognition of a right in the beneficiary is appropriate. In some cases an overriding policy, which may be embodied in a statute, requires recognition of such a right without regard to the intention of the parties. *Id.* at § 133, comment *d* at 14-15.

73. RESTATEMENT (SECOND) OF CONTRACTS § 147 (Tent. Draft No. 3, 1967). "An incidental beneficiary is a person who will be benefited by performance of a promise but who is neither a promisee nor an intended beneficiary." *Id.* at § 147, comment *a* at 83.

74. 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961).

75. *Id.* at 590-91, 364 P.2d at 689, 15 Cal. Rptr. at 825.

76. 70 Cal. 2d 223, 449 P.2d 161, 74 Cal. Rptr. 225 (1969).

77. *Id.* at 232, 449 P.2d at 167, 74 Cal. Rptr. at 231.

78. *Cf.* *Budd v. Nixen*, 6 Cal. 3d 195, 491 P.2d 433, 98 Cal. Rptr. 849 (1971); *Neel v. Magana*, 6 Cal. 3d 176, 491 P.2d 421, 98 Cal. Rptr. 837 (1971). Note, however, that where there are no consequential or actual damages suffered as a direct result of the attorney's negligence, a tort cause of action will not lie. In such a situation the plaintiff's only remedy is the contractual one. *Budd v. Nixen*, 6 Cal. 3d 195, 200, 203 n.6, 491 P.2d 433, 436, 438 n.6, 98 Cal. Rptr. 849, 852, 854 n.6 (1971).

While the courts may, in the future, emphasize the tort theory of recovery, the contract theory may and should nonetheless be plead. Negligence on the part of the attorney in rendering legal services, in addition to serving as the foundation of the

By emphasizing the tort theory of recovery, the courts could avoid the necessity of confronting the conceptual difficulties inherent in third-party beneficiary contract theory.<sup>79</sup> Other conceptual difficulties would arise, however, in connection with the application of the various elements of the tort cause of action to the factual circumstances ordinarily involved in a securities transaction. More precisely, such difficulties would arise in connection with the interrelated elements of duty and proximate cause unless and until the courts carry the expansion of the duty concept, as described in the above quotation from *Heyer*, over into the securities area. The duty imposed on the lawyer rendering advice and services with respect to a securities transaction would thus be broadened to encompass the third-party securities purchasers involved in and injured by the lawyer's breach of his obligation to exercise that standard of professional care and expertise expected of the average reasonable securities lawyer rendering like services.<sup>80</sup> While at present there exist no cases directly imposing such an expanded duty, imposition of this duty could readily occur and be justified by the various policy considerations which have in the past led courts to deem a given plaintiff's interest to be entitled to judicial protection.<sup>81</sup> In *Connor v. Great Western Savings and Loan Association*,<sup>82</sup> the California Supreme Court, after rejecting the strictures of the contractual concept of privity, delineated the policy considerations relevant to determining the existence of duty as follows:

(1) the extent to which the transaction was intended to affect the plaintiff, (2) the foreseeability of harm to him, (3) the degree of certainty that the plaintiff suffered injury, (4) the closeness of the connection between the defendant's conduct and the injury suffered, (5) the moral blame attached to the defendant's conduct, and (6) the policy of preventing future harm.<sup>83</sup>

---

tort claim, will constitute a breach of contract for legal services. *Neel v. Magana*, 6 Cal. 3d 176, 181, 491 P.2d 421, 423, 98 Cal. Rptr. 837, 839 (1971). When the corporation contracts with an attorney for legal services to be rendered in connection with a securities offering, it contracts for legal work to be done in such a manner as to result in a lawful and valid issuance of such securities. To the extent that the purchasers benefit from the foregoing implied provision of the contract for legal services, they may be third-party beneficiaries, just as were the beneficiaries under the will in *Lucas and Heyer*.

79. See text accompanying notes 69-75 *supra*.

80. See text accompanying notes 91-93 *infra*.

81. See, e.g., *Heyer v. Flaig*, 70 Cal. 2d 223, 449 P.2d 161, 74 Cal. Rptr. 225 (1969); *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961). See also *Lathrop, Legal Malpractice: Plaintiffs, Limiting Statutes and Heyer v. Flaig*, 37 INS. COUNSEL J. 258 (1970).

82. 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).

83. *Id.* at 865, 447 P.2d at 617, 73 Cal. Rptr. at 377, quoting *Biakanja v. Irving*, 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958).

Applying these factors to the case of purchasers injured as a result of negligent legal services rendered in connection with the issuance of securities would clearly seem to call for recognition of the existence of a duty owed such purchasers by the attorneys rendering such services. The applicability of the interrelated factors, "the extent to which the transaction was intended to affect the plaintiff" and "the foreseeability of harm," seems clear. When an attorney is employed to render legal services and advice in connection with a securities offering, the obvious and hoped for result of his labors is to assist the issuer in bringing about the acquisition of those securities by purchasers. Additionally, in many purported exempted offerings, the attorney will have personal knowledge of the individuals who constitute the intended purchasers. It is common knowledge that the viability of the purchaser's investment often depends upon the legality of the entire stock issuance. Thus, there is little question but that the correctness of the legal work in a securities transaction is intended to and will affect the purchaser of these securities. Considering the foreseeability of harm and given the very nature of securities transactions themselves, it is almost certain that purchasers will be injured by illegal public offerings. The degree of injury is the only real matter of uncertainty. With respect to the question of the closeness of the connection between the conduct of the attorney and the injury suffered by plaintiff purchasers, assuming the issuer would not have intentionally made an unlawful public offering, it could be established that but for the attorney's negligence and miscalculation the harm would not have occurred. There is little question about the existence of a policy in favor of preventing such harm; such a policy is clearly evidenced by the enactment of the 1933 Act, the 1934 Act and Rule 10b-5 promulgated under Section 10b of the latter Act. Perhaps the most difficult factor to be established in the type of case here under consideration is the moral blame attached to the attorney's conduct. The presence or absence of such blame, of course, will vary from case to case, the basic tenet being that employment should not be accepted by a lawyer when he is unable to render competent service.<sup>84</sup> Thus, it could be argued that, both professionally and morally, the attorney should not have accepted the assignment if he was incapable of rendering adequate legal services in connection with such sophisticated transactions. In sum, then, where there is harm which is substantially caused by the

---

84. A.B.A., CODE OF PROFESSIONAL RESPONSIBILITY, Canon 2, Ethical Consideration No. 2-30; see also *Professional Responsibility: Requirement of the Joint Conference*, 44 A.B.A.J. 1159, 1218 (1958).

attorney's negligent performance of legal services rendered in connection with securities transactions, a strong argument exists that the requisite considerations for imposition of a duty towards third-party purchasers are present.

In *Heyer*, the California Supreme Court succinctly stated the rationale for the imposition of a duty upon attorneys which would protect the certain and foreseeable rights and interests of persons other than the client:

[T]he duty . . . stems from the attorney's undertaking to perform legal services for the client but reaches out to protect the intended beneficiary. We impose this duty because of the relationship between the attorney and the intended beneficiary; public policy requires that the attorney exercise his position of trust and *superior knowledge* responsibly so as not to affect adversely persons whose rights and interests are certain and foreseeable.<sup>85</sup>

This rationale is clearly applicable to purchasers injured as the result of negligent legal services rendered in connection with the issuance of securities. Purchasers in such transactions are certainly persons whose rights and interests are "certain and foreseeable." The attorney actually preparing the documents and legal strategy required for any offering certainly knows that the eventual purchasers will be among those relying on his superior knowledge and legal skills. As pointed out above, injury to such purchasers is readily foreseeable if errors are made which are likely to affect the legal status and financial viability of the securities purchased. Further, the gravity of the potential harm to be suffered is greater in the case of a person injured by an unlawful issuance of securities than in the case of a testamentary beneficiary damaged by the loss of a portion of an intended bequest. In the former case, the purchaser of the unlawfully issued securities suffers an actual out-of-pocket loss, whereas, in the latter case, the testamentary beneficiary suffers no such loss and normally places no substantial reliance on the proceeds not yet in hand.

Whether the attorney is ultimately held to owe a duty only to the issuer-client or to both the issuer-client and the third-party purchasers as well, it must be determined what is the standard or degree of care and skill to which the attorney should be held with respect to the fulfillment of such duty or duties. It appears to be the current rule in California that attorneys are required to render services with that degree of "skill, prudence and diligence as lawyers of ordinary skill and

---

85. 70 Cal. 2d at 228-29, 449 P.2d at 165, 74 Cal. Rptr. at 229 (emphasis added).

capacity commonly possess and exercise in the performance of the tasks which they undertake."<sup>86</sup> However, considering the fact that the responsibility for compliance with the requirements for securities distributions under the 1933 Act rests with the attorney, it would seem appropriate to expect the attorney to exercise that degree of skill and care exhibited by the average practitioner *specializing in the law of securities regulation*.<sup>87</sup> Significantly, physicians practicing in a recognized area of specialization are required to perform at a level of competence exemplified by the average specialist's performance of like procedures.<sup>88</sup> The medical specialist analogy has been recognized by at least one California appellate court, at least with respect to the rules of evidence for legal malpractice cases:

This rule has been applied in California to medical malpractice cases, and while no cases have been found in this state applying the rule to legal malpractice, there is no reason why the rules of evidence for malpractice against a lawyer should not be the same as those governing cases against doctors. It has been so held in other jurisdictions.<sup>89</sup>

It is contended that the attorney rendering legal services in connection with the issuance of securities is practicing in an area which should be recognized as one of specialization. Thus, the general practitioner who offers legal advice concerning the intricate and specialized securities regulation laws should be held to a standard of skill and care consistent with the practices of a securities law specialist performing in a like transaction.<sup>90</sup>

---

86. *Neel v. Magana*, 6 Cal. 3d 176, 180, 491 P.2d 421, 422-23, 98 Cal. Rptr. 837, 838-39 (1971).

87. See Annot., 17 A.L.R.3d 1442 (1968).

88. Cf. *Belshaw v. Feinstein*, 258 Cal. App. 2d 711, 65 Cal. Rptr. 788 (1968); *Quintal v. Laurel Grove Hosp.*, 62 Cal. 2d 154, 159-60, 397 P.2d 161, 164, 41 Cal. Rptr. 577, 580 (1964); *Sansom v. Ross-Loos Medical Group*, 57 Cal. App. 2d 549, 555-56, 134 P.2d 927, 931 (1943); *Slimak v. Foster*, 106 Conn. 366, 138 A. 153 (1927).

89. *Lysick v. Walcom*, 258 Cal. App. 2d 136, 156, 65 Cal. Rptr. 406, 419 (1968).

90. See *Neel v. Magana*, 6 Cal. 3d 176, 188, 491 P.2d 421, 428, 98 Cal. Rptr. 837, 844 (1971); Note, *Attorney Malpractice*, 63 COLUM. L. REV. 1292, 1302-04 (1963). While lawyers are licensed generally in virtually all jurisdictions and are presumably "qualified" to practice in any area of the law, there is a growing trend toward certification of lawyers as specialists in certain areas. Pedrick, *Collapsible Specialists*, 55 A.B.A.J. 324, 325 (1969). The California State Bar is currently considering the certification of lawyers for specialized practice in the fields of criminal law, taxation and workmen's compensation. The authors believe that the area of securities transactions under the 1933 and 1934 Acts should be added to this list of fields being considered for certification.

Once such a standard is recognized, it will be necessary to determine the size of the geographical unit upon which the standard should be based. During the evolution of medical malpractice law, it was argued, in an attempt to limit the physician's liability, that the standards determinative of whether a breach of duty had occurred were those recognized in the local geographic area in which the act was committed.<sup>91</sup> A growing number of courts, however, have rejected this argument and held defendants in medical malpractice suits to a duty of care evidenced by *national* standards of practice, which were to be determined by reference to the state of scientific knowledge in existence at the date of the alleged malpractice.<sup>92</sup> Since the federal securities statutes are intended to regulate securities transactions throughout the country, it is reasonable to insist that attorneys render legal services at a level of competence consistent with a national standard. Further, there would appear to be no substantial problems involved in ascertaining such a national standard since private securities law specialists, as well as attorneys employed by governmental agencies, could be utilized as expert witnesses to facilitate the ascertainment of the standard.<sup>93</sup>

---

91. See PROSSER, LAW OF TORTS § 32 (3d ed. 1964).

92. See, e.g., Pederson v. Dumouchel, 72 Wash. 2d 73, 431 P.2d 973, 978 (1967), wherein the court stated:

The degree of care which must be observed is, of course, that of an average, competent practitioner acting in the same or similar circumstances. In other words, local practice within geographic proximity is one, but not the only factor to be considered. No longer is it proper to limit the definition of the standard of care which a medical doctor or dentist must meet solely to the practice or custom of a particular locality, a similar locality, or a geographic area.

See also Darling v. Charleston Community Memorial Hospital, 50 Ill. App. 2d 253, 200 N.E.2d 149 (1964), *aff'd*, 33 Ill. 2d 326, 211 N.E.2d 253 (1965), *cert. denied*, 383 U.S. 946 (1966); Dickinson v. Mailliard, — Iowa —, 175 N.W.2d 588, 596-97 (1970). California adopted the broader standard in 1956. Leonard v. Watsonville Community Hospital, 47 Cal. 2d 509, 519, 305 P.2d 36, 42 (1956).

93. Until recently, the question of negligence or want of skill by an attorney was considered to be a question of law by the California courts. Gambert v. Hart, 44 Cal. 542, 552 (1872). Expert testimony on the question was therefore excluded as an inadmissible expression of opinion. *Id.* at 549, Note, 15 HAST. L.J. 584 (1964). Now, however, it is recognized that attorney malpractice is governed by the same principles as any other negligence action, and that breach of duty is a factual issue for the jury. Ishmael v. Millington, 241 Cal. App. 2d 520, 525-29, 50 Cal. Rptr. 592, 595-97 (1966). Accordingly, expert testimony concerning the degree of skill expected of an ordinary attorney is now admitted. See Lysick v. Walcolm, 258 Cal. App. 2d 136, 155-56, 65 Cal. Rptr. 406, 419-20 (1968). Furthermore, such testimony, being concerned with matters not within the common knowledge of laymen, is conclusive and cannot be disregarded by the jury. *Id.* Some courts have even held that expert testimony is indispensable in attorney malpractice actions. Annot., 17 A.L.R.3d 1442, 1443-44 (1968). *But see id.* at 1444; 17 A.L.R.3d 60-61 (Supp. 1972).

Thus far, we have been concerned only with possible legal malpractice liability of counsel for failure to adequately or properly qualify his client for the exemptive provisions of the federal securities law, and more particularly, failure to supervise his client's plan of financing. The unfortunate lawyer in the hypothetical situation proceeded in blissful ignorance of the integration problem as well as countless other potentially troublesome issues such as: the questions of servicemen purchasers,<sup>94</sup> purchases by partnerships having partners outside the state,<sup>95</sup> and purchases by resident agents for nonresident principals,<sup>96</sup> to mention but a few. These and other foreseeable problems should have been noted, examined and taken into consideration by the attorney in advising his client. At this point, however, let us leave our consideration of the legal malpractice area and focus attention on another possible cause of action which might exist against the occasional legal "specialist" with respect to his advice and services rendered in connection with the issuance of securities.

#### RULE 10b-5 LIABILITY

Irrespective of the viability of an action based upon traditional principles of legal malpractice, it is possible that an action against an attorney who renders negligent advice and services in connection with an issuance of securities, resulting in injury to the issuer-client and the purchasers of the securities issued, may be maintained under Section 10b of the 1934 Act and Rule 10b-5 promulgated thereunder by the SEC. Some experienced securities law analysts, however, have suggested that an action brought against the attorney under Section 10b and Rule 10b-5 should and would be rejected by the courts.<sup>97</sup> On

---

94. See Op. Gen. Counsel, SEC Securities Act Release No. 1459 (May 29, 1937); SEC v. Big Top, Inc., SEC Litigation Release No. 2756 (Oct. 2, 1963).

95. See, e.g., 1 L. LOSS, SECURITIES REGULATION 600 (2d ed. 1961). Consider the dangers presented where members of the purchasing partnership are residents of several states. While the issue does not appear to have been litigated, it is arguable that sale to such a partnership could result in the loss of the intrastate exemption. McCauley, *Intrastate Securities Transactions under the Federal Securities Act*, 107 U. PA. L. REV. 937, 948 (1959).

96. See text accompanying notes 45-46 *supra*.

97. Marsh, *What Lies Ahead Under Rule 10b-5?*, 24 BUS. LAW. 69 (1968). Professor Marsh postulates an involved fact situation in which a corporation violates Section 16b of the 1934 Act as the result of a series of corporate purchases. A shareholder then brings an action against corporate counsel under Section 10b and Rule 10b-5 alleging that counsel represented that he would give competent legal advice to the corporation and would ensure that the corporation would avoid liability under Section 16b. Professor Marsh concluded that he was not willing to say that the federal courts would take jurisdiction of such an action as of the date the article was

the other hand, other such analysts have taken note of the expanding applicability of both the Section and the Rule and have indicated that a deluge of such actions should not be unexpected.<sup>98</sup> There is little question but that the SEC concurs with the latter position, as evidenced by its recent action against two prominent law firms for securities fraud under Section 10b and Rule 10b-5.<sup>99</sup>

Generally, the success of a lawsuit based upon the implied civil liability arising from a violation of Section 10b and Rule 10b-5 is dependent upon the plaintiff's ability to establish "fraud . . . or deceit . . . in connection with the purchase or sale of any security."<sup>100</sup> Succinctly, this involves the satisfaction of three distinct statutory prerequisites to the successful maintenance of a Rule 10b-5 cause of action. There must be: (1) a fraud or other deceitful practice (2) perpetrated in connection with (3) the purchase or sale of any security. Further, a judicial rule requires the plaintiff to be either a purchaser or seller of the security which was the subject of the fraud or deceitful practice.<sup>101</sup> Notably, Rule 10b-5 is applicable regardless of whether the purchase or sale is conducted through a securities exchange, an organized over-the-counter market, or in a private transaction.<sup>102</sup>

It is well-settled that it is not necessary to allege all of the traditional elements of common law fraud to maintain an action under Rule 10b-5.<sup>103</sup> However, the necessity of alleging one particular element,

---

written. *Id.* at 72. See also Lathrop, *Legal Malpractice: Plaintiffs, Limiting Statutes and Heyer v. Flaig*, 37 INS. COUNSEL J. 258, 263 (1970).

98. See Marsh, *supra* note 97, at 69, wherein Professor Marsh notes facetiously:

Several weeks ago I told one of the ablest and most experienced corporate counsel in California that my assigned topic was "What lies ahead under Rule 10b-5?" He advised me to stand up and say: "Chaos!", and then sit down. Another friend of mine who is a corporate lawyer said: "Really, it seems to me that it is quite simple. Under Rule 10b-5 whenever stock is sold, if the price goes up—the seller can sue the buyer; if the price goes down—the buyer can sue the seller; if the price remains absolutely the same, each one can sue the other for interest!"

99. SEC v. National Student Marketing Corp., Civil No. 225-72 (D.D.C., filed Feb. 3, 1972).

100. 17 C.F.R. § 240.10b-5 (1972). See Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971), wherein Justice Douglas reiterates the requirements from Rule 10b-5 itself and states that they are to be construed "flexibly."

101. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952). For an interesting discussion of the viability of the "purchaser/seller" requirement see Boone, *Standing To Sue Under SEC Rule 10b-5*, 49 TEX. L. REV. 617 (1971). Notably, the Ninth Circuit has reaffirmed the validity of the Birnbaum doctrine in Mount Clemens Industries, Inc. v. Bell, 464 F.2d 339 (9th Cir. 1972).

102. See Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 10 (1971), *citing* Hooper v. Mountain States Securities Corp., 282 F.2d 195, 201 (5th Cir. 1960).

103. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 (2d Cir. 1968), *cert. denied*,



namely scienter, the guilty knowledge of the defendant and the intent to deceive, has long been debated. The lower federal courts have not been uniform in determining the showing of scienter required in an action under Section 10b and Rule 10b-5.<sup>104</sup> While a specific intent to deceive may not be required in any federal jurisdiction,<sup>105</sup> the Second Circuit has consistently maintained that some degree of scienter must be *alleged* and *proven*.<sup>106</sup> The Seventh,<sup>107</sup> Eighth,<sup>108</sup> Ninth,<sup>109</sup> and Tenth<sup>110</sup> Circuits have no such requirement. This

394 U.S. 976 (1969); *Stevens v. Vowell*, 343 F.2d 374, 379 (10th Cir. 1965); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 212 (9th Cir. 1962). *Cf.* *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963).

104. *See Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (S.D.N.Y. 1969), wherein the court noted:

Until the "great debate over ordinary negligence versus scienter in private actions under 10(b) and Rule 10b-5", . . . is resolved, this court will adhere to the most recent views expressed by this Circuit, that plaintiffs must show more than that the . . . press release was negligently prepared. They must show some degree of scienter. *Id.* at 1343-44, quoting *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1291 (2d Cir. 1969).

The Supreme Court, in construing the antifraud provision of the Investment Advisors Act of 1940, which is similar to Rule 10b-5, declared that the manifest purpose of that Act would be defeated were they to hold that "Congress in empowering the courts to enjoin any practice which operates 'as a fraud or deceit' . . . intended to require proof of intent to injure and actual injury to the client." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

105. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), wherein the court said:

However, whether the case before us is treated solely as an SEC enforcement proceeding or as a private action, proof of a specific intent to defraud is unnecessary. In 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. A similar standard has been adopted in private actions, for policy reasons which seem perfectly consistent with the broad Congressional design ". . . to insure the maintenance of fair and honest markets in . . . [securities] transactions." *Id.* at 854-55 (citations omitted).

106. *Id.* at 855:

This requirement [some form of the traditional scienter requirement], whether it be termed lack of diligence, constructive fraud, or unreasonable or *negligent* conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule (emphasis added).

107. *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963) (neither knowledge of the falsity nor bad faith intent to deceive are necessary to prove a violation under Rule 10b-5 in a civil action for damages).

108. *See Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (innocent nondisclosures which amount to deceptive conduct are prohibited under Rule 10b-5).

109. *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 212 (9th Cir. 1962); *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961) (unnecessary for the plaintiff to allege common law fraud to sustain a cause of action).

110. *Stevens v. Vowell*, 343 F.2d 374, 379 (10th Cir. 1965):

It is not necessary to allege or prove common law fraud to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact.

does not mean, however, that all or most of these circuits are moving toward the imposition of strict liability under the Rule. Rather, they have approached the problem by shifting the burden of proof to the defendants. For example, once the plaintiff has shown a material misrepresentation or omission of fact, the burden shifts to the defendants to establish that they did not know, and in the exercise of reasonable care could not have known, of the material misrepresentation or omission.<sup>111</sup> Arguably, the result is that the same proof must be adduced as to the ultimate issue of the existence of fraud or deceitful practice regardless of the forum. As a practical matter, however, under the rule followed in the Second Circuit, a plaintiff may expect to encounter great difficulty in getting past law and motion proceedings in the absence of specific allegations of scienter. Although, as pointed out above, none of the circuits have actually imposed strict liability under the Rule, it should be noted that the Eighth Circuit has propounded a rationale that could evolve into the imposition of strict liability upon a finding of material misrepresentation or omission. In *Myzel v. Fields*,<sup>112</sup> the court stated, by way of dicta, that:

[S]uch conduct [innocent nondisclosures which may amount to manipulative or deceptive conduct] is prohibited within the definition of Rule 10b-5. The violation of the Rule connotes "unfairness" or "wrongdoing."<sup>113</sup>

Turning to a consideration of the "in connection with" requirement of the Rule, it now appears that as a result of the Supreme Court's decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,<sup>114</sup> the prerequisites for meeting this requirement have been

---

111. *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 102 (10th Cir. 1971), quoting *Gilbert v. Nixon*, 429 F.2d 348, 357 (10th Cir. 1970):

One is not to be held liable \* \* \* because of his misleading misrepresentation or omission of material fact, the truth of the matter being unknown to the purchaser, if the party responsible for the misrepresentation or omission sustains the burden of proving that he did not know, and in the exercise of reasonable care could not have known that it was a misrepresentation or omission.

112. 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

113. *Id.* at 748.

114. 404 U.S. 6 (1971). Although the facts are highly involved, it is well worth sorting them out to understand the extension of the "in connection with" requirement. For purposes of clarity, the facts may be outlined in step transactions as follows:

(1) Begole and Bourne (B&B) enter into an executory contract with Bankers Life to purchase that company's wholly owned subsidiary, Manhattan, for five million dollars.

(2) Irving Trust agrees to issue an as yet unfunded check for the above amount (check #1) to B&B.

(3) At the closing, check #1 is delivered to Bankers Life who then gives B&B

relaxed. In that case, the securities sale was apparently legitimate, but the seller did not receive any proceeds from the sale due to a sophisticated and allegedly fraudulent scheme which surrounded it. The Court concluded that the overall transaction was effected through an act or practice which allegedly operated as a fraud or deceit.<sup>115</sup> The Court stated that "[t]he crux of the present case is that Manhattan [the seller] suffered an injury as a result of deceptive practices touching its sale of securities as an investor."<sup>116</sup> A lower court has

---

all the stock of Manhattan.

(4) After the closing, but on that same day, the new president of Manhattan, installed by B&B, has over four and one-half million dollars worth of Treasury Bonds in Manhattan's portfolio sold in a bona fide transaction.

(5) The proceeds from the sale, plus enough cash from Manhattan to amount to five million dollars are deposited in an account in Irving Trust in Manhattan's name. Check #1 is credited against this account.

(6) To conceal this loss of assets, a round robin financing scheme is devised. Irving Trust issues check #2 in the amount of five million dollars payable to Belgian Trust.

(7) Manhattan exchanges this check with Belgian Trust for a six-month certificate of deposit worth five million dollars.

(8) Manhattan assigns the certificate of deposit to New England Note Company (whose president is Bourne). While the certificate of deposit is carried on the books at full value, the assignment is not revealed.

(9) New England Note then assigns the certificate of deposit to Belgian Trust in exchange for a five million dollar loan.

(10) New England Note uses the proceeds of the loan to cover check #2 issued by Irving Trust.

The sale that is being litigated under § 10(b) is step (4), i.e., the sale of the treasury bonds in a bona fide transaction. The asserted "fraud" was that the seller of the bonds, Manhattan, was "duped into believing that it . . . would receive the proceeds." *Id.* at 9. Thus, although the actual sale was legitimate, the aura of fraud surrounding it was sufficient for redress under § 10(b).

Professor Bromberg stated, during a discussion with one author on March 17, 1972, that the decision in *Bankers Life* was "not that much of a surprise" when considered against the background of earlier cases in the field.

Morton J. Schlossberg, counsel for the successful petitioner in *Bankers Life*, believes an expansion of the classes of proper parties plaintiff can be expected in the future as a result of the *Bankers Life* decision. He suggested that creditors of corporations may eventually be proper plaintiffs although both Professor Bromberg and Mr. Schlossberg agreed that may be some ways off.

It is interesting to consider the possible ramifications of an action brought directly by creditors against the lawyers for the issuer, as in the situation where the corporate issuer is in bankruptcy proceedings. However, in such a situation it is arguable that a purchase or sale of securities would not be involved. Both Professor Bromberg and Mr. Schlossberg agree that a purchase or sale of securities must be involved somewhere before a 10b-5 action can be maintained. (Conversation with one author March 17, 1972).

115. 404 U.S. at 12-13.

116. *Id.* (emphasis added).

construed the *Bankers Life* decision to mean that "where there is a causal connection between the purchase or sale of stock, the alleged fraud or breach of fiduciary duty, and plaintiff's loss then federal jurisdiction under 10b-5 exists."<sup>117</sup> Obviously, if this liberal construction of the "in connection with" requirement is affirmed, the number of potential 10b-5 plaintiffs will be increased.

In order to maintain a successful 10b-5 action for fraud or deceit based upon misrepresentation or omission of matter in the information conveyed which causes such information to be misleading,<sup>118</sup> there exists the additional requirement that such omission or misstatement be "material."<sup>119</sup> Numerous definitions of materiality have been formulated and employed by the courts.<sup>120</sup> For example, profit and loss data accumulated over a very short period of time may not be material if the variance from prior periods is slight. On the other hand, a severe loss might be of tremendous materiality even though a brief time period is involved.<sup>121</sup> In *SEC v. Texas Gulf Sulphur Co.*,<sup>122</sup> the lower court defined material facts as those which "if disclosed would have had a substantial impact on the market price of TGS stock."<sup>123</sup> On appeal, the Second Circuit substantially modified the test, defining materiality as "not only information disclosing the earnings and distributions of a company but also those facts which may affect . . . the desire of investors to buy, sell, or hold the company's securities."<sup>124</sup>

---

117. *Tully v. Mott Supermarkets, Inc.*, 337 F. Supp. 834, 842 (D.N.J. 1972). This court also held that the purchaser-seller requirement first enunciated in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952) was no longer determinative of federal jurisdiction in the light of *Bankers Life*. *Tully*, *supra* at 839. It is interesting to note that the Second Circuit, when urged by the SEC to review its own doctrine in *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972), refused to do so.

118. 17 C.F.R. § 240.10b-5(b) (1971).

119. *Id.*

120. R. JENNINGS & H. MARSH, *SECURITIES REGULATION CASES AND MATERIALS* 1127-32 (3d ed. 1972) [hereinafter cited as JENNINGS & MARSH]. Professor Bromberg posits that materiality can be expected to be a "hard-fought" issue in nearly every Rule 10b-5 case. 2 A. BROMBERG, *SECURITIES LAW FRAUD SEC RULE 10b-5*, § 8.3, at 202 (1971) [hereinafter cited as BROMBERG].

121. JENNINGS & MARSH, *supra* note 120, at 1127-32. See *Weitzen v. Kearns*, 271 F. Supp. 616, 619-20 (S.D.N.Y. 1967).

122. 258 F. Supp. 262 (S.D.N.Y. 1966).

123. *Id.* at 282. It is interesting to note that California has adopted a similar test of materiality in its insider trading provisions of the California Corporate Securities Law of 1968. CAL. CORP. CODE §§ 25402, 25502 (West Supp. 1971).

124. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Cf. 17 C.F.R. § 230.405(l) (1971), wherein the SEC

Thus, facts are material if a "reasonable man would attach importance [to them] in determining his choice of action" with respect to any given securities transaction.<sup>125</sup>

It is well-settled that an attorney who has *actively* participated in a fraudulent<sup>126</sup> scheme or practice is a proper defendant in a Rule 10b-5 action.<sup>127</sup> The question thus arises as to what constitutes "active" participation on the part of an attorney in such a scheme or practice. The limited case law touching on the question reveals an apparent divergence of judicial opinion.<sup>128</sup>

In the recent case of *Black & Co. v. Nova-Tech, Inc.*,<sup>129</sup> several members of a California law firm were named as defendants in a Rule 10b-5 action merely because the firm's name was mentioned in the corporate client's annual report as counsel for the company. The federal district court held that the "firm's designation on Nova-Tech's published reports as Nova-Tech's corporate counsel is enough . . . to make the firm's partners 'participants' in any unlawful securities transactions in which the annual reports were used for promotional pur-

---

defines materiality under the 1933 Act:

The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably be informed before purchasing the security registered.

Plaintiffs are not required to show that they relied on the material misstatement "whenever a device was employed 'of a sort that would cause reasonable investors to rely thereon, and . . . purchase or sell a corporation's securities.'" *Gottlieb v. Sandia American Corp.*, 452 F.2d 510, 515-16 (3d Cir. 1971), quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968).

125. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) quoting *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1968).

126. It should be noted that the term "fraudulent" is here being used in the securities law instead of the common law sense. See text accompanying notes 103-13 *supra*.

127. See, e.g., *Hooper v. Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960) (holding a lawyer to be a proper defendant where he falsely wrote a letter to the transfer agent stating in his opinion the transaction in question was exempt from SEC registration); cf. *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2d Cir. 1969) (lawyer held for trial for alleged liability under § 12(1) of the '33 Act as a party to a solicitation to buy); *Gottlieb v. Sandia American Corp.*, 304 F. Supp. 980 (E.D. Pa. 1969), *rev'd on other grounds*, 452 F.2d 510 (3d Cir. 1971) (special counsel to corporation who was also a controlling stockholder held liable under Rule 10b-5 for participation in fraud). See generally 2 BROMBERG, *supra* note 120, at § 8.5, ¶ 515; Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972).

128. Compare *Black & Co. v. Nova-Tech, Inc.*, 333 F. Supp. 468 (D. Oregon 1971), with *SEC v. Frank*, 388 F.2d 486 (2d Cir. 1968).

129. 333 F. Supp. 468 (D. Oregon 1971).

poses" for purposes of the Oregon jurisdictional statutes.<sup>130</sup> In denying the firm's motion to quash service of process and dismiss the action, the Oregon court opined:

It is not disputed that defendant . . . prepared the legal papers necessary for Nova-Tech to complete the sale of its securities. Even if [the lawyer] did not know and *could not have known* of Nova-Tech's failure to register the securities, he was a participant in the sale because, without his assistance, the sale would not have been accomplished.<sup>131</sup>

Thus, the court effectively dispensed with any requirement that, as a prerequisite to a finding of "active" participation, the attorney be shown to have had knowledge, either actual or constructive, of the fraudulent<sup>132</sup> nature of the transaction in connection with which he rendered legal advice or services. This rationale, if followed generally, would make every lawyer who prepares a registration statement, or any documents utilized in a supposedly exempt transaction, a proper party defendant in a Rule 10b-5 lawsuit.

The Second Circuit has apparently adopted what would seem to be a far more reasonable approach to the problem. In *SEC v. Frank*,<sup>133</sup> the SEC exhibited its intention to regulate the conduct of attorneys involved in securities transactions by seeking an injunction against the attorney there involved for violation of Section 10 and Rule 10b-5.<sup>134</sup> The attorney had assisted in preparing an allegedly misleading offering circular in connection with an intrastate offering. In his defense, he asserted that the misleading statements concerning the company's products had been prepared by the corporate client and that his "function had been [merely] that of a scrivener helping to place [the client's ideas] in [sic] proper form."<sup>135</sup> On appeal of the lower court's order granting a preliminary injunction, the court stated that:

A lawyer has no privilege to assist in circulating a statement with regard to securities which *he knows to be false* simply because his client has furnished it to him.<sup>136</sup>

---

130. *Id.* at 472. Although this was an action under Rule 10b-5, it should be noted that the court was here construing certain Oregon statutes. (ORE. REV. STAT. §§ 59.115 (3), 59.155).

131. 333 F. Supp. at 472, citing *Adamson v. Lang*, 236 Ore. 511, 516, 389 P.2d 39, 41-42 (1964) (emphasis added).

132. See note 126 *supra*.

133. 388 F.2d 486 (2d Cir. 1968).

134. *Id.* at 487.

135. *Id.*

136. *Id.* at 489 (emphasis added).

However, in reversing the grant of the preliminary injunction on procedural grounds, the court circumscribed the above pronouncement by directing that, if the information was so expertised as to be beyond the reasonable non-expert's ability to understand, then the defendant could not be held liable for fraud merely because he included it in the offering circular. If, however, the information in the offering circular was such that a non-expert could recognize its falsity, then the defendant lawyer should be held to have been a direct participant in the fraudulent practice of conveying misleading information.<sup>137</sup> In short, the Second Circuit would apparently require a finding of knowledge, actual or constructive, as a prerequisite to a finding of "active" participation.

Even in jurisdictions in which knowledge is required as a prerequisite to a finding of active participation, it is likely that in order to qualify for the lack of knowledge defense, the attorney will be required to have made some effort to ascertain the veracity of at least easily verifiable statements and matters which were to be included in the documents associated with the securities transaction for which his services were utilized. An indication of this may be gleaned from the recent case of *Escott v. BarChris Construction Corp.*<sup>138</sup> Although that case was not a 10b-5 action but rather an action brought for violation of Section 11 of the 1933 Act,<sup>139</sup> the court's expression of its sentiments to the effect that an attorney would be required to show greater efforts to establish the statutory defense of due diligence is of particular importance to the present discussion. Significantly, the *BarChris* court stated:

It is claimed that a lawyer is entitled to rely on the statements of his client and that to require him to verify their accuracy would set an unreasonably high standard. This is too broad a generalization. It is all a matter of degree. To require an audit would obviously be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable. Even honest clients can make mistakes. The statute imposes liability for untrue statements regardless of whether they are unintentionally untrue. The way to prevent mis-

---

137. *Id.* "[A] lawyer [cannot] escape liability for fraud by closing his eyes to what he saw and could readily understand."

138. 283 F. Supp. 643 (S.D.N.Y. 1968). In *BarChris* the company's attorney was held liable for a violation of Section 11 of the 1933 Act. However, it should be noted that the attorney was also a director and thus his position as a person liable was determined by the statute itself.

139. Securities Act of 1933 § 11, 15 U.S.C. § 77(k) (1970).

takes is to test oral information by examining the original written record.<sup>140</sup>

In discussing the specific conduct of Mr. Birnbaum, house counsel for BarChris, the court went on to state:

As 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. Having failed to make such an investigation, he did not have reasonable ground to believe that all these statements were true. Birnbaum has not established his due diligence defenses.<sup>141</sup>

Thus, at least one court has expressly recognized that an attorney rendering advice or services in connection with a securities transaction may have a responsibility beyond that of a mere scrivener.

The analysis employed by the *BarChris* court with respect to the question of due diligence would be equally applicable to the question of knowledge on the part of attorneys rendering services in situations involving potential 10b-5 liability.<sup>142</sup> The attorney who participates in the preparation of an offering circular or prospectus should be deemed to owe certain duties to the public with regard to the accuracy and completeness of the material contained in such documents. Even assuming that the courts would not find active participation on the part of an attorney in the rare situation in which his sole function is that of a mere scrivener, the average legal practitioner should take little comfort in the likelihood that the question of "active" participation is to be resolved, if at all, as a matter of degree. Although the existence and extent of a duty owed the prospective offerees would be dependent upon (1) the degree of participation by the lawyer in other than so-called "lawyer tasks;" (2) the degree of his non-attorney involvement with the issuer; and (3) the materiality and type of misrepresentations or omissions alleged, it is not unusual for an attorney rendering his services in connection with a securities transaction to be involved beyond the scrivener level—usually because the clients are totally unfamiliar with what is involved in financing through either a private or public

---

140. 283 F. Supp. 643, 690 (S.D.N.Y. 1968).

141. *Id.* at 687.

142. *See* SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968), wherein Judge Friendly, citing § 11 of the 1933 Act, suggested that in situations involving potential 10b-5 liability the lawyer may have an affirmative duty to investigate when put on notice.



offering. This is true to an even greater extent in those situations in which no underwriter is involved and the company is having its first public issue. Further, in many cases, the company's house counsel may be substantially involved in the business aspects of an offering. Such involvement, while not necessarily unusual in security transactions, may be sufficient to place the lawyer in the position of an "active" participant. Thus, while no direct authority exists for the proposition that shareholders damaged by Rule 10b-5 violations can recover directly from the attorney involved, absent facts which make the attorney an "active" participant, it appears that the courts will take a rather broad view of what may constitute such "active" participation.

Considering the hypothetical situation in terms of the attorney's potential Rule 10b-5 liability, an interesting dilemma arises regarding exactly what should be disclosed to the various groups of securities purchasers. Ostensibly, the attorney is not a direct participant in any palpably fraudulent scheme or practice. The lawyer has, however, knowingly assisted his corporate client in acquiring capital while circumventing the requirements of registration under the 1933 Act by reliance on the restrictive exemptive provisions. Obviously, the attorney realized that the offerings made pursuant to Sections 4(2) and 3(a)(11) would result in the acquisition of substantial amounts of capital within a very brief period. Undoubtedly, the security purchasers will be made aware of the exemption under which their particular security is exempted from the registration requirements. However, it is doubtful, especially for those who purchased pursuant to the private placement, that they will be informed of the other supposedly exempt offering and sale. Further, when considering the intrastate offering, the attorney certainly should have recognized and disclosed the potential integration of offerings problem, which would pose a continuing threat to the validity of either or both of the issuances sought and accomplished, as well as to the financial stability of the corporation. It is likely that the various groups of purchasers would have been deterred from their investment had they been aware of this possible corporate liability and its attendant consequences. Instead, they were left uninformed at the time of their purchases, and were in fact assured that the corporation was legally acquiring capital for its expansion. Obviously, there is a need to protect investors from such practices, whether designed or inadvertent, and it is not reasonable to exculpate the attorney who is usually an indispensable factor in determining the method used by the issuer in distributing its securities.

## INSURANCE

In view of the above discussed potential liabilities faced by attorneys rendering advice and services in connection with the issuance of securities, it seems appropriate to include at least a brief discussion of the question of insurance with respect to such liabilities. With respect to coverage in regard to any attorney liability arising out of an action based upon legal malpractice, it seems clear that such liability would be covered by the attorney's professional liability insurance. However, coverage is not so clear with respect to any liability arising out of a Rule 10b-5 action. This stems from the fact that many professional liability policies, while ostensibly covering securities work, contain specific exclusions for "dishonest, fraudulent, criminal or malicious acts or omissions."<sup>143</sup> Further, many such policies contain exclusions regarding situations wherein the lawyer is merely involved in a business transaction rather than the practice of law.<sup>144</sup> Since Section 10b and Rule 10b-5 are securities *fraud* provisions, the questions arise as to whether any liability arising under Rule 10b-5 is covered by the lawyer's policy and whether he is entitled to be defended by his insurer.

In a recent New York supreme court case, *St. Paul Fire & Marine Insurance Co. v. Clarence-Rainess & Co.*,<sup>145</sup> it was held that an accountant's insurer was required to defend the insured against a Rule 10b-5 action, even though the policy contained exclusions for fraudulent practices. The court recognized three separate Section 10b and Rule 10b-5 claims against the accountant: the common law doctrine of fraud, misstatements of material facts (which may or may not have been made in good faith), and the omission to state facts necessary to make such omission not misleading. The court concluded that liability predicated on the first claim of common law fraud would fall within the policy exclusion. However, the court asserted that the insurer's obligation to indemnify the insured against losses resulting from adverse judgments on the second and third claims would depend on the facts adduced at trial. Accordingly, the court directed the insurer to defend, and stated that "it was unnecessary that every claim en-

---

143. The language most commonly found in lawyers' professional liability policies is: This policy does not apply: (a) to any dishonest, fraudulent, criminal or malicious act or omission of the insured, any partner or employee; (b) to the conduct or any business enterprise owned by the insured or in which the insured is a partner, or which is controlled, operated or managed by the insured, either individually or in a fiduciary capacity, including the ownership maintenance or use of any property in connection therewith; . . .

144. See note 143 *supra*.

145. 335 N.Y.S.2d 169 (1972).

compassed by the complaint be within the ambit of the protection purchased."<sup>146</sup> If the trial court were to make specific findings that the attorney was guilty of actual, willful fraud, it seems probable that he would be without insurance coverage.<sup>147</sup> On the other hand, where the decision of the court is either silent on the basis for the imposition of liability or specifically finds negligent misrepresentation or omission, it would seem that a good case can be made for insurance coverage under most of today's professional liability policies.

It is most unlikely that the draftsmen of most lawyers' professional liability policies even considered the potential coverage problem presented by the fraud exclusion provision. Prior to the 1968 case of *Escott v. BarChris Construction Co.*,<sup>148</sup> there existed no reported cases holding an attorney liable for "securities fraud" arising out of negligent misrepresentations or omissions in the various documents associated with a securities transaction. Even in *BarChris*, it is by no means clear that the attorney involved would have been held liable absent his status as a director of the issuer. Common law fraud and securities fraud are not the same, although common law fraud is included within the ambit of securities fraud.<sup>149</sup> With the advent of the possibility that attorneys may be held liable for "securities fraud" arising out of negligent misrepresentations or omissions, the meaning of the term "fraud" as used in the exclusion provisions of the typical professional liability policy has become ambiguous. In cases in which the meaning of language in insurance policies is unclear, the law is well settled that such questions should be resolved against the insurer:

In interpreting an insurance policy we apply the general principle that doubts as to meaning must be resolved against the insurer and that any exception to the performance of the basic underlying obligation must be so stated as clearly to apprise the insured of its effect.<sup>150</sup>

---

146. *Id.* at 173.

147. *See, e.g., State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co.*, 9 Cal. App. 3d 508, 88 Cal. Rptr. 246 (1970); *Underwriters at Lloyd's of London v. Huncfeld*, 230 Cal. App. 2d 31, 40 Cal. Rptr. 659 (1964); *cf. Fullerton v. Houston Fire & Cas. Ins. Co.*, 234 Cal. App. 2d 743, 44 Cal. Rptr. 711 (1965).

148. 283 F. Supp. 643 (S.D.N.Y. 1968). *See* text accompanying notes 138-41 *supra*.

149. *See* text accompanying notes 103-13 *supra*.

150. *Gray v. Zurich Insurance Co.*, 65 Cal. 2d 263, 269, 419 P.2d 168, 171, 54 Cal. Rptr. 104, 107 (1966). *See also, Atlantic Nat'l Ins. Co. v. Armstrong*, 65 Cal. 2d 100, 416 P.2d 801, 52 Cal. Rptr. 569 (1966); *Continental Cas. Co. v. Phoenix Constr. Co.*, 46 Cal. 2d 423, 296 P.2d 801 (1956); *State Farm Mutual Auto Ins. Co. v. Allstate Ins. Co.*, 9 Cal. App. 3d 508, 88 Cal. Rptr. 246 (1970); *Fireman's Fund Ins. Co. v. Chasson*, 277 Cal. App. 2d 801, 24 Cal. Rptr. 726 (1962); *Neal v. State Farm Ins. Co.*, 188 Cal. App. 2d 690, 10 Cal. Rptr. 781 (1961); Note, *The Insurer's Duty to Defend Made Absolute: Gray v. Zurich*, 14 U.C.L.A. L. Rev. 1328 (1967).

Thus, with respect to whether the term "fraud," as used in the exclusion provisions of the typical professional liability policy, excludes from coverage liability arising out of both common law and securities fraud, it appears likely that the courts would resolve the doubts as to meaning against the insurer and limit the term to the exclusion of common law fraud alone.

Analogizing to the *St. Paul Fire and Marine Insurance Co.* case, a strong argument can be made that attorneys with the misfortune of becoming defendants in a Rule 10b-5 lawsuit should be afforded the same protection as was afforded to the accountants therein. Further, most insurers today agree to provide defenses in questionable cases on a reservation of rights basis, leaving the question of coverage for resolution following the conclusion of the original action. Thus, as a practical matter, it is likely that in 10b-5 actions the insurer will *defend* although there remains uncertainty as to the precise effect which the common law fraud—securities fraud distinction will have on insurance *coverage*.

#### CONCLUSION

It is conceded that the portion of this article dealing with legal malpractice *vis-à-vis* securities law problems has been bottomed largely on California decisions. This is primarily due to the fact that so many recent appellate pronouncements on the subject have been made in that jurisdiction. There is, however, no reason to suppose that other jurisdictions will be unwilling to follow the California trend, particularly in light of the growing national trend in securities cases to hold lawyers answerable.

It is well-settled that an aggrieved client may sue a negligent attorney for malpractice. As discussed earlier in this article, intended beneficiaries of the attorney's services should also be permitted to maintain such an action, either in tort or contract,<sup>151</sup> against the negligent attorney. The California Supreme Court has provided some definite guidelines for determining who should constitute such an intended beneficiary: (1) the attorney must have undertaken the performance of legal services for the client;<sup>152</sup> (2) the attorney must be negligent in performing such services;<sup>153</sup> and (3) the possibility of injury to the third

---

151. See text accompanying notes 67-86 *supra*.

152. *Heyer v. Flaig*, 70 Cal. 2d 223, 228-29, 449 P.2d 161, 165, 74 Cal. Rptr. 225, 229 (1969).

153. *Id.*

persons must be foreseeable.<sup>154</sup> Thus, in situations in which the attorney's malpractice causes loss to purchasers of securities issued pursuant to offerings ostensibly but not in fact exempt from the registration requirements of the 1933 Act, a strong argument can be made that the attorney should be held liable to such injured purchasers. Further, in cases in which the invalidity of the issuance and its attendant consequences result in the financial failure of the issuer, the same considerations as applied with respect to the shareholders could be applied to the question of possible attorney liability to the creditors of the issuer. While no cases have yet imposed a duty on the attorney with respect to the creditors of the issuer, the creditors satisfy the requisites of the current tests determinative of the existence of a duty<sup>155</sup> as well as the shareholders. Just as the shareholders stand to lose their investment as a result of the attorney's negligence, the creditors stand to lose the monies due them from the insolvent corporate client. Assuming public policy compels imposition of a duty, the main impediment to the maintenance of a creditor action against the attorney would be the establishment of proximate cause. If the attorney's negligence could be shown to be the proximate cause of the failure of the corporate client, then the negligent practitioner may well find himself liable for far more than the mere value of the securities issued.

With respect to possible 10b-5 actions against the attorney arising out of services rendered for the purpose of accomplishing an exempted securities offering, it must be remembered that the SEC has only recently instituted a major action against two large and prestigious law firms seeking permanent injunctions against alleged Rule 10b-5 violations.<sup>156</sup> While this was not an action for rescission or money damages, the SEC has certainly made allegations which would be equally applicable in a private 10b-5 action seeking either of those remedies.<sup>157</sup> Thus far, however, very few private 10b-5 actions have been tried to a conclusion, many of the reported decisions being the result of preliminary motions and appeals taken from interlocutory rulings. Perhaps the enormous exposure of the litigants is in itself a deterrent to prolonged trials and possible adverse final judgments.

---

154. *Id.*

155. See text accompanying note 83 *supra*.

156. SEC v. Nat'l Student Marketing Corp., Civ. No. 225-72 (D.D.C., filed Feb. 3, 1972).

157. See complaint filed by SEC in SEC v. Nat'l Student Marketing Corp., Civ. No. 225-72 (D.D.C., filed Feb. 3, 1972).

To the lawyer against whom a judgment is entered, it makes little difference whether the theory of recovery was contract, tort, or liability under Rule 10b-5, except insofar as his malpractice insurance may be affected. However, the availability, or lack thereof, of insurance is not the answer to the problem of attorney liability. The real solution lies in the exercise of greater diligence and professional responsibility on the part of the attorney himself. Arguing that the SEC's stand on the responsibility of lawyers "will put a severe strain on the confidential attorney-client relationship"<sup>158</sup> begs the question and ignores the very existence of the issues which have brought about the growing tide of actions against lawyers. While the authors in no sense agree that an attorney should be required to inform the SEC of clients who are about to violate the law,<sup>159</sup> as the SEC seems to suggest, the Code of Professional Responsibility seems to require that a lawyer faced with such a situation advise the client of the consequences of the unlawful act, and if the client thereafter persists in following the unlawful course of conduct, *then* the attorney should report the matter as non-privileged material.<sup>160</sup> An alternative procedure for the lawyer might

---

158. *Wall Street Journal*, Feb. 15, 1972, at 18, col. 3.

159. *Id.* at col. 1.

160. ABA CANON OF PROFESSIONAL ETHICS No. 37 relates to the confidences of a client, and contains the following limitation:

The announced intention of a client to commit a crime is not included within the confidences which he [the lawyer] is bound to respect. He may properly make such disclosures as may be necessary to prevent the act or protect those against whom it is threatened.

This limitation is based on sound public policy forbidding an attorney to assist in the commission of a crime or to permit the attorney-client relationship to conceal a wrongdoing. ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 155 (1936). The attorney is only bound to disclose such confidences when the facts in the attorney's possession indicate beyond reasonable doubt that a crime will be committed. ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 314 (1965).

But the lawyer also "owes entire devotion to the interests of the client, warm zeal in the maintenance and defense of his rights . . . to the end that nothing be taken or be withheld from him save by the rules of law, legally applied." ABA CANON OF PROFESSIONAL ETHICS No. 15. Thus a lawyer may freely urge such disclosures to the SEC by his client which are most favorable to him as long as there is a reasonable basis for those positions. ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 314 (1965). Since potential violations of the Securities Acts often involve highly complex problems of statutory interpretation, the lawyer should be able to rely on the most favorable interpretation for his client, notwithstanding that he personally harbors grave doubts as to whether there was a violation.

The difficult question occurs where the client has in fact misled, either by misstatement or omission, but without the lawyer's knowledge or participation. In this situation, upon discovery of the misrepresentation, the lawyer must advise the client to correct the misstatement. *Id.* If the client refuses, the lawyer may have a duty to disclose if in fact a criminal violation is being perpetrated. The circumstances of

be to simultaneously advise the client of the unlawful nature of the client's intended representations or omissions under the circumstances of the particular transaction, and at the same time withdraw as counsel, thereby terminating the attorney-client relationship. If the client follows the attorney's advice, the problem is solved and the relationship may be resumed, the client willing. If the client does not, he proceeds at his own risk and the attorney should be held blameless.

---

each case may vary so greatly that no general rule may be set forth.

In addition to the lawyer's own ethical considerations, the lawyer must also bear in mind that the SEC, under its *Rules of Practice* (17 C.F.R. § 201 (1971)), reserves the right to disbar from practice before it any lawyer whom the SEC decides, by its own hearing, has engaged in unethical or improper professional conduct. 17 C.F.R. § 201.2(e)(1)(ii) (1971). Thus the onus is much greater on the attorney in what would otherwise be arguable circumstances where the SEC has taken the position that he has a duty to disclose to the SEC any potential violation.