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Case Comments: Securities Law

SECURITIES LAW

The Securities and Exchange Act of 1934 section 10(b), 15 U.S.C. § 78j(b) (1934), requires disclosure of material information in the purchase and sale of securities. In order to state a claim for violations of section 10(b)and its corresponding Rule 10b-5, plaintiffs must allege that the defendant, in the course of a securities transaction, either knowingly made a false statement of material fact or knowingly omitted a material fact that made the transaction misleading, such that the plaintiff suffered a loss. However, the defendant's silence or omission of a material fact only violates section 10(b) if the defendant also has a duty to the plaintiff to disclose the misrepresentation.[55]

The Maryland Rules of Professional Conduct for attorneys impose a similar responsibility on lawyers. That is, an attorney may have an ethical duty either to withdraw from the representation or to disclose a misrepresentation made by one of the parties in a securities transaction.[56] However, the ethical duty the Rules of Professional Conduct impose does not correspond exactly with a legal duty to disclose under the federal securities laws.[57] Although a plaintiff cannot base a claim for a violation of federal securities laws solely on a defendant's violation of ethical standards, this situation obviously creates tension between ethical and legal considerations. The question of whether an attorney owes a duty to third parties, in a business

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employee becomes aware of full impact of harm); Brown v. I.T.T./Continental Baking Co., 921 F.2d 289, 294 (D.C. Cir. 1990) (reaffirming *Stancil*); J.M. Martinac Shipbuilding v. Director of Office of Workers Compensation Programs, 900 F.2d 180, 183-84 (9th Cir. 1990) (citing *Stancil* and concluding that period does not begin until employee is aware or should be aware of impairment of earning capacity); Johnson v. Director of Office of Workers Compensation Programs, 911 F.2d 247, 249-50 (9th Cir. 1990) (noting rule for occupational diseases applies just as well to latent injuries and citing *Stancil* for proposition that "injury" means consequence of accident, which need not occur simultaneously with accident); Brown v. Jacksonville Shipyards Inc., 893 F.2d 294, 296 (11th Cir. 1990) (applying rule of *Stancil*); Bechtel Assoc., P.C. v. Sweeney, 834 F.2d 1029, 1033 (D.C. Cir. 1987) (interpreting 1972 amendment as meaning limitation period begins when claimant knows or should know 1) injury causally related to employment and 2) injury is impairing capacity to earn wages).

55. Chiarella v. United States, 445 U.S. 222, 228 (1980); Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496 (7th Cir. 1986).

56. The Maryland State Bar Committee on Ethics, according to the plaintiffs, ruled that attorneys have an ethical duty to withdraw or disclose misrepresentation in a securities transaction. Schatz v. Rosenberg, 943 F.2d 485 (4th Cir. 1991), *cert. denied sub nom.* Schatz v. Weinberg & Green, 112 S. Ct. 1475 (1992). The court noted that the opinion responded to an anonymous request by the plaintiffs' counsel in the present case. *Id.* at 492.

57. *See, e.g.*, Tew v. Arky, Feed, Stearns, Watson, Greer, Weaver & Harris, P.A., 655 F. Supp. 1573 (S.D. Fla. 1987), *aff'd mem.*, 846 F.2d 753 (11th Cir.), *cert. denied*, 488 U.S. 854 (1988) (holding that violation of disciplinary rule did not create legal duty requiring law firm to disclose information learned in prior business dealing to client's auditors); Bickel v. Mackie, 447 F. Supp. 1376, 1383-84 (N.D. Iowa), *aff'd mem.*, 590 F.2d 341 (8th Cir. 1978) (refusing to use ethical code to define civil liability standards); Merrit-Chapman & Scott Corp. v. Elgin Coal, Inc., 358 F. Supp. 17, 22 (E.D. Tenn. 1972), *aff'd mem.*, 477 F. 2d 598 (6th Cir. 1973) (refusing to use conduct code as standard for civil liability).

transaction involving fraud by the attorney's client, makes the situation more problematic.

The Fourth Circuit, in *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991), *cert. denied sub nom. Schatz v. Weinberg & Green*, 112 S. Ct. 1475 (1992), considered whether an attorney who failed to disclose material information to a third party in a securities transaction had violated a legal or ethical duty to disclose. Ivan and Joann Schatz, the plaintiffs, sold several businesses to Mark E. Rosenberg and MER Enterprises, a holding company Rosenberg had created for the purchases. The Schatzes sued Rosenberg, MER Enterprises, and Rosenberg's law firm, Weinberg & Green, alleging that the defendants had violated Federal securities laws.

The case against Weinberg & Green stems from Rosenberg's purchase of two companies owned by the Schatzes. In December 1986, MER Enterprises (MER) bought an eighty percent interest in the two Schatz companies, paying for the purchase with $1.5 million in promissory notes. Rosenberg personally guaranteed the notes. The Schatzes relied on a financial statement from March 1986, and an update letter delivered on the closing date. These documents, indicating Rosenberg's net worth to be more than $7 million, contained several misrepresentations. In fact, Rosenberg's largest business filed for bankruptcy in September 1987, and Rosenberg himself filed for personal bankruptcy soon afterward. Weinberg & Green represented Rosenberg throughout.

Rosenberg defaulted on his promissory notes, never paying the Schatzes. In addition, the Schatzes lost $150,000 that they had loaned to the company formed by merging their companies (of which Rosenberg owned eighty percent) with another Rosenberg company. Rosenberg siphoned off much of the operating capital from the Schatz companies, used some of the cash reserves to pay Weinberg & Green's legal fees, and generally rendered the companies worthless by the time he filed for bankruptcy in 1987.

The Schatzes filed a seven-count complaint, including three counts against Weinberg & Green. The Schatzes alleged that the law firm violated section 10(b) of the Securities and Exchange Act (Count III); that the firm aided and abetted Rosenberg in his securities violations (Count IV); and that the firm was guilty of common law misrepresentation (Count VII). The Federal District Court referred the case to a magistrate judge, who recommended that all three counts against the law firm be dismissed.

The magistrate dismissed Count III, finding that the plaintiffs did not state a cause of action for violation of section 10(b). In order to state a claim, the Schatzes would have had to allege either that Weinberg & Green owed the Schatzes an independent duty to disclose, or that the law firm had made some affirmative misrepresentation about Rosenberg's financial situation. Similarly, the magistrate dismissed Count VI because the plaintiffs did not allege that Weinberg & Green had "caused," or aided and abetted, Rosenberg's fraud. Finally, the magistrate dismissed Count VII, common-law misrepresentation, because absent a duty to disclose to third parties, mere silence or failure to disclose is not a fraud.

The district court accepted the magistrate's recommendation to dismiss the complaints against Weinberg & Green. The Schatzes moved for reconsideration after obtaining an opinion from the State Bar Committee on Ethics, concerning the law firm's duty to disclose. The district court denied the motion, and the Schatzes appealed to the Fourth Circuit. Reviewing *de novo* the district court's decision, the Fourth Circuit affirmed the dismissal of all three complaints against the law firm.

The Schatzes argued that the firm committed fraud by remaining silent about Rosenberg's financial insolvency and false financial statements, and that the firm's representation of Rosenberg involved them throughout in the transactions between the Schatzes and Rosenberg. The firm prepared closing documents for the sale, and forwarded to the Schatzes both those documents and a separate letter from Rosenberg stating that his financial situation had not changed adversely since the March 1986 report. The firm also agreed to language in the purchase agreement stating that Rosenberg's financial representations were accurate in all material respects.

The Fourth Circuit considered each of the Schatzes' arguments in turn. To resolve the issue of Weinberg & Green's alleged violation of section 10(b) of the Securities and Exchange Act, the Fourth Circuit borrowed a test from the Seventh Circuit. Citing *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 943 (7th Cir. 1989), the court laid out the required elements of a claim for violations of section 10(b) and of Rule 10b-5. The plaintiff must allege that the defendant (1) knowingly omitted or knowingly made a false statement of material fact, (2) during a securities transaction, (3) causing the statements in the transaction to be misleading, (4) and causing the plaintiff's loss. However, the court first must determine whether the defendant had a duty to disclose information to the plaintiff.

In applying this test, the Fourth Circuit first considered whether Weinberg & Green's silence about Rosenberg's financial condition violated section 10(b). Citing *Chiarella v. United States*, 445 U.S. 222, 228 (1980), the court agreed that a firm would have a duty to disclose if a confidential relationship existed, but questioned whether the duty would exist absent such a relationship. The court declined to follow several district court decisions cited by the plaintiffs, including *Rose v. Arkansas Valley Environmental & Utility Authority*, 562 F. Supp. 1180 (W.D. Mo. 1983). Instead, the court held that a lawyer or law firm cannot be held liable for section 10(b) misrepresentation absent some fiduciary or other confidential relationship creating a duty to disclose.

The court cited *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496 (7th Cir. 1986), for the proposition that a duty to disclose results from the confidential attorney-client relationship, rather than from any federal securities law requirement. Thus, silence alone, absent a confidential or fiduciary relationship, does not violate section 10(b). Quoting *Barker* the court stated, "[n]either lawyers nor accountants are required to tattle on their clients in the absence of some duty to disclose. To the contrary, attorneys have privileges not to disclose."[58] The court cited deci-

58. Schatz v. Rosenberg, 943 F.2d 485, 491 (4th Cir. 1991) (citations omitted), *cert. denied sub nom.* Schatz v. Weinberg & Green, 112 S. Ct. 1475 (1992).

sions from other circuits to support this holding, including Renovitch v. Kaufman, 905 F.2d 1040 (7th Cir. 1990); First Interstate Bank v. Chapman & Cutler, 837 F.2d 775, 780 n.4 (7th Cir. 1988); and Abell v. Potomac Insurance Co., 858 F.2d 1104 (5th Cir.), *reh.denied*, 863 F.2d 882 (5th Cir. 1988), *vacated on other grounds sub nom.* Fryar v. Abell, 492 U.S. 914 (1989).

The plaintiffs used several strategies to argue that Weinberg & Green in fact did have a duty to the Schatzes. The plaintiffs tried to base the duty to disclose on Maryland's Rules of Professional Conduct. The plaintiffs argued that the Rules required the law firm either to withdraw from representing Rosenberg or to disclose. The plaintiffs based their argument on an advisory opinion by the State Bar Committee on Ethics, handed down as a result of an anonymous request by the plaintiffs' attorneys. However, the Fourth Circuit rejected the plaintiffs' arguments, relying on contrary decisions from the Eighth, Sixth, and Eleventh Circuits as well as from district courts. Instead, the court held that ethical codes cannot be used to define civil liability standards for attorneys, nor can the codes be used as the basis for securities fraud or other misrepresentation claims.

Second, the Fourth Circuit considered whether, even absent a duty to disclose, the law firm's involvement in drafting documents for the sale constituted affirmative misrepresentation in primary violation of section 10(b). The Fourth Circuit read *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1124-25 (5th Cir.), *reh'g denied*, 863 F.2d 882 (5th Cir. 1988), *vacated on other grounds sub nom. Fryer v. Abell*, 492 U.S. 914 (1989), to hold attorneys liable to third parties only when the attorney has prepared an opinion letter explicitly giving the attorney's legal opinion, specifically for the use or benefit of the third party. In the present case, by contrast, the court found only that the law firm "failed to tattle on their client", who himself misrepresented his financial status. Weinberg & Green did not actually solicit the deal or take affirmative steps to misrepresent Rosenberg's financial condition, but only "papered the deal." Thus, the court refused to hold the firm liable for primary violations of section 10(b). Citing *Friedman v. Arizona World Nurseries, Ltd.*, 730 F. Supp. 521 (S.D.N.Y. 1990), *aff'd sub nom. Clark v. Arizona World Nurseries Ltd.*, 927 F.2d 594 (2d Cir. 1991), the court held that drafting and forwarding documents which contain a client's misrepresentations did not violate securities regulations. The court also used *Friedman* to hold that under agency theory, a law firm that acts as a scrivener for a deal already substantially complete is not liable for violations of section 10(b). As a matter of law, the court held that an attorney's transmission of inaccuracies does not transform the client's misrepresentation into an affirmative misrepresentation by the attorney.

The plaintiffs also argued that the firm had affirmatively violated section 10(b) by acting negligently. The court disposed of this claim by returning to their finding that the firm owed no duty to the plaintiffs. The court distinguished the present case, where Weinberg & Green represented only

Rosenberg, from the case cited by plaintiffs, wherein an attorney tried to represent both sides in a securities transaction.[59]

The plaintiffs' claim for tortious misrepresentation in violation of Maryland law also depended on the law firm's having a duty to disclose the misrepresentation. Finding no such duty to the Schatzes, the court dismissed this claim. Similarly, the court found that the plaintiffs did not state valid claims that the firm had aided and abetted Rosenberg's violations. First, the firm had no duty to the Schatzes, and second, the firm had not provided "substantial assistance" to Rosenberg, but had only acted as a scrivener. The court held that the "substantial assistance" requirement of the aiding and abetting claim was not satisfied unless the law firm assisted in the actual securities law violation, rather than merely assisting the person who committed the violation. The court affirmed the district court's dismissal of the claims against the law firm without concurring or dissenting opinions. The Supreme Court denied the plaintiffs' petition for certiorari in *Schatz v. Weinberg & Green*, 112 S. Ct. 1475 (1992).

The Fourth Circuit's dismissal of the claims against Weinberg & Green brings the Circuit into line with several other Circuits whose decisions are cited by the court in *Schatz*.[60] The Seventh Circuit has cited *Schatz* with approval, in *Ackerman v. Schwartz*, 947 F.2d 841, 846 (7th Cir. 1991). The effect of the decision, which dismisses claims against a law firm that failed to "blow the whistle" on a client's fraudulent financial representations, creates a tension between the legal standard and ethical codes of attorney conduct requiring withdrawal or disclosure. The Fourth Circuit, aware of this conflict, referred to the possibility of some form of non-legal sanction for this type of unethical conduct. Reluctant to overreach by incorporating ethical standards into securities laws, the court concluded, "an award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards . . . . Liability depends on an existing duty to disclose. The securities laws therefore must lag behind ethical and fiduciary standards."[61]

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59. *See* Crest Inv. Trust, Inc. v. Comstock, 327 A.2d 891, 906 (Md. App. 1974) (holding that attorney's duty to disclose to clients on both sides of transaction created conflict of interest).

60. *See* Renovitch v. Kaufman, 905 F.2d 1040, 1048 (7th Cir. 1990) (holding attorneys, like accountants, not liable for failure to disclose to non-client third party); First Interstate Bank v. Chapman & Cutler, 837 F.2d 775, 778 (7th Cir. 1988) (same); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1135 (5th Cir.) (same), *reh. denied*, 863 F.2d 882 (5th Cir. 1988), *vacated on other grounds sub nom.* Fryar v. Abell, 492 U.S. 914 (1989); Friedman v. Arizona World Nurseries, Ltd., 730 F. Supp. 521, 531 (S.D.N.Y. 1990) (holding attorney who drafted and forwarded documents not liable for client's misrepresentations contained therein), *aff'd sub nom.* Clark v. Arizona World Nurseries, 927 F.2d 594 (2d Cir. 1991).

61. Schatz v. Henderson, 943 F.2d 485, 498 (4th Cir. 1991), *cert. denied sub nom.* Schatz v. Weinberg & Green, 112 S. Ct. 1475 (1992), *quoting* Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 497 (7th Cir. 1986).