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## Professional Responsibility And Self-Regulation Of The Securities Lawyer

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# PROFESSIONAL RESPONSIBILITY AND SELF-REGULATION OF THE SECURITIES LAWYER

JAMES H. CHEEK, III\*

It is no longer wildly shocking to suggest that attorneys involved in matters concerning the federal securities laws may have substantial responsibilities and liabilities to the investing public in addition to those which are owed to their clients. The notoriety of the complaint filed by the Securities and Exchange Commission ("Commission") against prestigious law firms in the *National Student Marketing* case<sup>1</sup> and the immediate and extensive reaction thereto<sup>2</sup> have made all lawyers keenly aware of, and concerned with, the direction in which professional responsibility seems to be headed. The Commission is without question committed to the proposition that the lawyer representing clients in securities transactions must, in certain circumstances, act as an "independent public attorney" whose standard of conduct must reflect and protect the interests of the investing public.<sup>3</sup>

While the pros and cons of these expanding responsibilities for the attorney are ably presented in the remarkable number of recent and

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<sup>1</sup>SEC v. National Student Marketing Corp., [1971-72 Transfer Binder] CCH FED.SEC.L.REP. ¶ 93,360 (D.D.C., filed Feb. 3, 1972). It must be remembered that this action is still pending and the issues have not been adjudicated to date, and no decisions presently exist which support the position urged by the Commission in its complaint.

<sup>2</sup>See, e.g., Green, "Irate Attorneys," Wall St.J. Feb. 15, 1972, at 1, col. 1; Editorial, "The SEC Finds Some Worthy New Targets," *Fortune*, March 1972, at 46; Karmel, *Attorneys' Securities Law Liabilities*, 27 BUS. LAW. 1153 (1972); *Whistle-Blowing*, BNA SEC. REG. & L. REP. No. 156, A-1 to A-7 (June 14, 1972); Cheek, *Potential Liability of Counsel Named in a Prospectus*, 6 REV. OF SEC. REG. 939 (1973); Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys and the Federal Securities Statutes*, 34 OHIO ST. L.J. 231 (1973); Freeman, *Opinion Letters and Professionalism*, 1973 DUKE L.J. 371.

<sup>3</sup>While to some extent this view was expressed earlier, it is only recently that the Commission has actively pursued this policy via speeches, articles, and administrative and judicial proceedings. See SEC Securities Act Release No. 4445 (Feb. 2, 1962); Sommer, *The Emerging Responsibilities of the Securities Lawyer*, [1973-74 Transfer Binder] CCH FED.SEC.L.REP. ¶ 79,631 (1974); Sommer, *The Commission and the Bar: Forty Good Years*, 30 BUS.LAW. 5 (1974); Garrett, *New Directions in Professional Responsibility*, 29 BUS.LAW. 7 (Spec. Issue 1974); Sonde, *The Responsibility of Professionals Under the Federal Securities Laws—Some Observations*, 68 NW. L. REV. 1 (1973); In re Emanuel Fields, SEC Securities Act Release No. 5404 (June 18, 1973).

varied articles on the subject,<sup>4</sup> few positive and pragmatic responses to this critical problem area for the securities lawyer have been developed. Yet surely now — before the responsibilities being urged by the Commission are crystalized and established by some court as principles of law — is the time for the legal profession to take the initiative and after thorough study formulate standards of professional conduct which realistically respond to the Commission's position and the problems flowing therefrom. If such professional self-regulation is not forthcoming, then by default we of the bar leave the development of our standards of culpability and the ultimate policing of our mistakes wholly to the Commission whose advocacy for the public trust seemingly overrides all other policies, and to the courts where distasteful litigation of hard facts before an unsophisticated judge often makes bad law. This article examines briefly the justifications for and potential difficulties of these new responsibilities being urged by the Commission, as well as the resulting liabilities which may arise for the securities lawyer, both under the federal securities laws and traditional malpractice concepts. It then seeks to formulate in a general sense a workable and meaningful response thereto which is consistent with the professional role of the securities attorney.

## I. THE PRESSURES BEHIND INCREASING PROFESSIONAL RESPONSIBILITY

For almost 40 years, attorneys practiced under the federal securities laws without the spotlight being focused on their obligations to the investing public. This is not to say that such obligations never existed or were being totally ignored; but until recently, no one, including the Commission, viewed these obligations as placing the se-

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<sup>4</sup>The most comprehensive and thoughtful treatment of this subject matter is found in the series of articles published as *ABA National Institute, Proceedings, Advisors to Management — Responsibilities and Liabilities of Lawyers and Accountants*, 30 *BUS.LAW.* 1 (Spec. Issue 1975) [hereinafter cited as *National Institute*]. For other useful articles, see Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 *COLUM. L. REV.* 412 (1974); Lipman, *The SEC's Reluctant Police Force: A New Role for Lawyers*, 49 *N.Y.U. L. REV.* 437 (1974); Johnson, *The Expanding Responsibilities of Attorneys in Practice Before the SEC*, 25 *TEMPLE L.Q.* 637 (1974); Derieux, *Public Accountability under Securities Laws*, 35 *OHIO ST. L.J.* 255 (1974); Small, *An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?*, 61 *CALIF. L. REV.* 1189 (1973); Freeman, *Opinion Letters and Professionalism*, 1973 *DUKE L.J.* 371 (1973); Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys and the Federal Securities Statutes*, 34 *OHIO ST. L.J.* 371 (1973).

curities lawyer in the role of an independent public attorney.<sup>5</sup>

Historically, the bar and the Commission have worked together with an unusual degree of mutual respect and cooperation which has exhibited a "give and take" attitude on both sides. Much of the success experienced by securities regulation in the last 40 years is attributable to the continuing policy of the Commission to consult with members of the bar and the securities industry with respect to overall policy decisions, as well as specific rules, in a common effort to devise policies and rules which will most effectively achieve the goals of the federal securities laws within the existing economic and social climate. In working with the Commission, the securities bar has been remarkably objective in its approach and has generally demonstrated a keen sensitivity of the public interest. Moreover, most securities practitioners reflect that sensitivity in their response to the many judgment questions which arise in practice from the securities transactions contemplated by their clients. Yet, within the last several years, the Commission has apparently decided that the sensitivity exhibited by the bar is not adequate and that attorneys must assume a more active role as guardians of the public interest.

One must wonder what factors underlie this abrupt shift in the thinking of the Commission. Commissioner Sommer suggests that the increased public responsibilities urged by the Commission flow from and are consistent with "the pervading judicial and legislative concern for the interests of the consumer."<sup>6</sup> While it is true that interest in consumer protection is at its highest level today, that protection has to date not been achieved by imposing responsibilities and liabilities upon the attorney for the vendor. The attorney-draftsman of an unconscionable contract, or of instruments which fail to comply with certain consumer laws or which result in an adverse and illegal effects upon consumers may be liable to his client, but there has been no judicial or legislative movement toward making him liable to the consumer misled or harmed by those instruments. Surely more pressing forces exist for the Commission's recent actions; and most likely those forces find their genesis in the Commission's frustration with its inability to protect the financial community from

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<sup>5</sup>Traditionally, even the Commission asserted that the primary duty of the securities lawyer acting as counsel was owed to his client, not the investing public; and thus it was only when the attorney's role was not that of counsel but that of an active participant in a stock fraud that liabilities or sanctions would be imposed. See *American Finance Company*, 40 S.E.C. 1043, 1044 (1962) (attorney's principal concern is with the "interests and rights of his client"); note 29 *infra* and cases cited therein.

<sup>6</sup>Sommer, *The Emerging Responsibilities of the Securities Lawyer*, [1973-74 Transfer Binder] CCH FED.SEC.L.REP. ¶ 79,631, at 83,689 (1974).

the "monstrous financial debacles" which have occurred in the last few years.<sup>7</sup> With its enforcement division constantly reacting to previously committed frauds, rather than preventing their occurrence, the Commission apparently has concluded that its system as a whole, and its enforcement branch in particular, is generally impotent to prevent the inception and execution of huge frauds upon the investing public.<sup>8</sup> Thus, the Commission is forced to examine other alternatives, and presently its plan seems to be to increase the public's protective screen against the imposition of fraudulent schemes by consciously placing extreme pressure upon the professionals involved in securities transactions and thus to intensify their focus upon protecting the public interest.<sup>9</sup>

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<sup>7</sup>The most notorious of these frauds have involved Penn Central, Equity Funding, National Student Marketing, Republic National Life Insurance Company, IOS, Ltd., Stirling Homex, Home-Stake Production, Four Seasons, Performance Systems, Inc., and Westec. See speech by Chairman Garrett, Professional Responsibility and the Securities Laws, State Bar of Texas, July 4, 1974.

<sup>8</sup>The lack of staff and money are, of course, very real problems in the Commission's efforts to prevent frauds. As Chairman Garrett recently stated in his Texas speech:

About 34%, or 652 people, are devoted to fraud prevention — that is, enforcement. But this doesn't mean we have 652 cops on the beat — that number includes enforcement's full administrative slice. We have, at best, half that number of lawyers and investigators, nationwide.

*Id.* Yet if the need exists — as surely it does — the Commission should go to Congress and lobby for a greater budget for enforcement to raise its capabilities to the levels required to do its statutorily-directed job. In lieu of those efforts it should not seek to impose upon the bar the duties which Congress directed the Commission to carry out.

<sup>9</sup>Chairman Garrett expressed this program most clearly in his recent Texas speech, *supra* note 7, as follows:

In fact, any well organized scheme of violation almost surely involves cooperative participation by such professionals [lawyers and accountants]. Simply as a matter of enforcement technique, if we can induce the professionals to be less cooperative, we will prevent many violations that would otherwise occur. And what are the available means to bring this about? Exhortation, injunctive actions and Rule 2(e) disbarment proceedings. The Commission has adopted a conscious program to improve professional performance by the use of these means. Even if certain businessmen are not moved to fear compliance by ethical considerations or the fear of punishment, they will do far less damage if their lawyers and accountants won't play. This is our policy objective. But, of course, we must seek it only through already supportable means as provided by law.

The Chairman's statement seems to be addressed to the intentional, hard-core fraud cases where "cooperative participation" means active and willful participation in fraudulent schemes. If so limited, few professionals would disagree with the Chairman's position. The area of disagreement and concern arises only if "cooperative

It is easy to over-react to the rhetoric and actions of the Commission, especially since the other direct sources of pressure upon the standards and actions of lawyers — the courts and the organized bar — have not to date acted with the same zeal or in the same revolutionary manner as the Commission. Yet the specter of horrendous civil liability which conceivably could flow from the Commission's position should not be accepted as a *fait accompli*, and careful consideration of actual case law and the present ethical positions of the organized bar should be made before standards of professional conduct in this area are formulated to deal with the Commission's programmed offensive on professionals.

## II. STANDARDS UNDER PRESSURE CASE LAW

### A. The Common Law

Under common law principles, the lawyer has traditionally been liable to his client if he fails to possess and use such skill, prudence and diligence as lawyers of ordinary skill and capacity commonly possess and exercise in the performance of the tasks which they undertake.<sup>10</sup> The attorney is not required to be an insurer of results, nor a guarantor of the correctness of his work,<sup>11</sup> but must exercise only ordinary skill and diligence. Courts have generally been reluctant to hold a legal specialist to a higher standard of care. However, since legal specialization is increasingly recognized by the bar and the public,<sup>12</sup> it is likely that as in the medical profession, if one under-

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participation" includes cases of poor judgment or advice where doubts are resolved in favor of a client on such close questions as "materiality" or the definition of "underwriter," and when with the benefit of hindsight it appears that such unintentional conduct aided the perpetration of a Rule 10b-5 violation. If in fact the Commission intends its "policy" to reach these situations — as the *National Student Marketing* complaint suggests it does — then the Commission far exceeds the "supportable means as provided by law" and seeks to establish new law where the primary duty of the securities lawyer runs directly to the investing public in favor of whom all doubts must be resolved.

<sup>10</sup>RESTATEMENT (SECOND) OF TORTS § 299 (1965). An action for damages for the breach of this standard may be grounded on tort or contract law, but there are few questions where the form of action is likely to affect the result. For detailed studies of the standard and its application, see Wade, *The Attorney's Liability for Negligence*, 12 VAND. L. REV. 755 (1959); Note, *Attorney Malpractice*, 63 COLUM. L. REV. 1292 (1963); Note, *Professional Negligence*, 121 U.P.A. L. REV. 627 (1973).

<sup>11</sup>See, e.g., *Dorf v. Relles*, 355 F.2d 488 (7th Cir. 1966); *Denzer v. Rouse*, 48 Wis. 2d 528, 180 N.W.2d 521 (1970); *Cook v. Irion*, 409 S.W.2d 475 (Tex.Civ.App. 1966); *Hill v. Mynatt*, 59 S.W. 163 (Tenn.Ch.App. 1900).

<sup>12</sup>Both the California and New Mexico bars now certify members of their bars as specialists in certain fields, and nine other states, including New York and Texas, are

takes to act as a specialist, he will be held to the legal skill and knowledge commonly possessed by such specialists.<sup>13</sup>

Even if the attorney fails to meet the requisite standard of care, in the absence of fraud or gross negligence,<sup>14</sup> he historically has been shielded from liability to anyone other than his client by the bar of privity.<sup>15</sup> But no longer can that principle be safely relied upon by the negligent lawyer. A series of recent cases have clearly lifted the bar of privity to permit recoveries by third parties, at least where they are members of a small and limited class, such as the intended beneficiaries under a negligently drawn will whose individual reliance was specifically foreseen by the negligent attorney.<sup>16</sup> Other cases, primarily involving accountants, have gone even further and suggested that liability for negligence extends to all persons who, although not themselves foreseen, are members of a class which the accountants should have foreseen would rely.<sup>17</sup> Further support for the extension of liabil-

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currently considering the adoption of similar programs. Similarly, new law lists sanctioned by the American Bar Association are being compiled based on the attorney's stated specialty. *See, e.g., ATTORNEY LISTINGS OF LAWYER-TO-LAWYER CONSULTATION PANEL* (2d ed. 1974).

<sup>13</sup>*Cf. SEC v. Management Dynamics Inc., CCH Fed. Sec. L. Rep. ¶ 95,017* (2d Cir. 1975). Similarly, courts have not applied a "community standard" as is often applied in medical malpractice suits. Implicit in those decisions is the questionable theory that the ordinary attorney possesses the same skill and knowledge regardless of where he may practice. This may be another area of the law which may develop in the future.

<sup>14</sup>Such conduct would provide a basis for an action by a third party in tort for deceit. *W. PROSSER, LAW OF TORTS*, 685-86 (4th ed. 1971). *See Ultramares Corp. v. Touche*, 255 N.Y. 170, 179, 186, 174 N.E. 441, 444, 447 (1931); *Maneri v. Amodeo*, 38 Misc. 2d 190, 238 N.Y.S.2d 302 (Sup.Ct. 1963). *Cf. Duro Sportswear, Inc. v. Cogen*, 258 App.Div. 867, 137 N.Y.S.2d 829 (1955); *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938).

<sup>15</sup>This view was first expressed by the Supreme Court in *National Savings Bank v. Ward*, 100 U.S. 105 (1879). *See also Winterbottom v. Wright*, 152 Eng.Rep. 402 (Ex. 1842).

<sup>16</sup>These cases have generally applied a flexible balancing test to determine liability. Among the key factors considered are the extent to which the attorney owed a duty to the third party, the foreseeability of reliance by that party, the closeness of causal connection between his negligence and the injury, and a balancing of the policies of preventing future harm and compensating the third parties with that of imposing an undue burden on the profession. *See, e.g., Woodford v. Sanders*, 248 So. 2d 419 (La.App. 1971); *Donald v. Garry*, 19 Cal. App. 3d 769, 97 Cal. Rptr. 191 (Dist.Ct.App. 1971); *Heyer v. Flaig*, 74 Cal. Rptr. 225, 449 P.2d 161 (1969); *Licata v. Spector*, 26 Conn.Supp. 378, 225 A.2d 28 (1966); *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685 (1961), *cert. denied*, 368 U.S. 987 (1962); *Biakanja v. Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958). *See generally Attorneys — Liability to Third Parties*, 45 A.L.R.3d 1181 (1972).

<sup>17</sup>*See, e.g., Rhode Island Hosp. Trust Nat'l. Bank v. Swartz*, 455 F.2d 847 (4th Cir. 1972); *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968); *Aluma Kraft*

ity to third parties exists in proposed § 552 of the Restatement of Torts which makes one liable to a person or a group (no matter how large) whose reliance upon incorrect information was known or expected.<sup>18</sup>

Operating against this extension of liability for years has been the fear of imposing excessive liability upon the profession, and despite the recent trend to the contrary, some courts continue to apply the privity requirement and thereby refuse to extend the negligent lawyer's liability beyond his client.<sup>19</sup> This commitment to privity to protect professionals from widespread liability for careless error finds its roots in *Ultramares Corp. v. Touche*,<sup>20</sup> in which Judge Cardozo refused to extend the liability of accountants to third party creditors whose reliance on negligently prepared financial statements was found to be unforeseen in fact, though reliance by some creditor was or should have been foreseen. Judge Cardozo raised as a policy base for his decision the specter of horrendous liabilities:<sup>21</sup>

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Mfg. Co. v. Elmer Fox & Co., 493 S.W.2d 378 (Mo.Ct.App. 1973); Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex.Civ.App. 1971); Ryan v. Kanne, 170 N.W.2d 395 (Iowa 1969). *Accord*, Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974); *cert. granted*, \_\_\_ U.S. \_\_\_, 43 U.S.L.W. 3550 (U.S. Apr. 14, 1975).

<sup>18</sup>RESTATEMENT (SECOND) OF TORTS § 552 (Tent.Draft No. 12, 1966), reads as follows:

- (1) One who, in the course of his business, profession, or employment . . . supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon such information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
- (2) Except as stated in subsection (3), the liability stated in subsection (1) is limited to loss suffered
  - (a) by the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it; and
  - (b) through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction. . . .

This section has been recently cited with approval as representing a compromise between a narrow view of *Ultramares* and unlimited extension of liability to all third parties. *Bunge Corp. v. Eide*, 372 F. Supp. 1058 (D.N.D. 1974).

<sup>19</sup>*See, e.g.*, *Koch Industries, Inc. v. Vosko*, 494 F.2d 713 (10th Cir. 1974); *Stephens Industries v. Haskins & Sells*, 438 F.2d 357 (10th Cir. 1971); *MacNerland v. Barnes*, 199 S.E.2d 564 (Ga.Ct.App. 1973); *Investment Corp. v. Buchman*, 208 So.2d 291 (Fla. 1968); *Maneri v. Amodeo*, 38 Misc. 2d 190, 238 N.Y.S.2d 302 (Sup. Ct. 1963). *Cf.* *Bunge v. Eide*, 372 F. Supp. 1058 (D.N.D. 1974); *Milliner v. Fox & Co.*, CCH BLUE SKY L. REP. ¶ 71,178 (Utah Sup.Ct. 1974).

<sup>20</sup>255 N.Y. 170, 174 N.E. 441 (1931).

<sup>21</sup>*Id.* at 448. For a proposed legislative solution to the problems of horrendous



If liability for negligence exists, a faultless slip or blunder, failure to detect a theft or forgery beneath the cover of deceptive entries, may expose the accountants to liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes one to these consequences . . . .

Liability for negligence if adjudged in this case will extend to many callings, other than auditors. Lawyers who certify their opinions as to the validity of municipal or corporate bonds with knowledge that the opinion will be brought to the notice of the public, will become liable to the investors, if they overlook the statute or decision, to the same extent as if the controversy were one between the client and advisor . . . . These illustrations may seem to be extreme, but they go little, if any, farther than we are invited to go now . . . . The law does not spread its protection so far.

Although over 40 years have passed since *Ultramares* and several cases have directly challenged the wisdom of the decision,<sup>22</sup> reports of the demise of its underlying policy are greatly exaggerated.<sup>22.1</sup> There still is no case involving a negligent attorney which extends liability under traditional malpractice concepts beyond a small group of specifically known reliants to a group as large and remote as the investing public. Moreover, the cases imposing liability have generally involved areas of practice where the law is more clearly developed than securities law and thus minimal levels of care and skill can be more certainly determined. Nevertheless, one cannot ignore the danger signals flowing from the recent accounting cases<sup>23</sup> and the Re-

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liability, see ALI FEDERAL SECURITIES CODE §§ 1402-06 (Tent. Draft Nos. 1-3 Revised, 1974) (limiting liability to \$100,000 per defendant).

<sup>22</sup>Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968) ("*Ultramares* constitutes an unwarranted inroad upon the principle that 'the risk reasonably to be perceived defines the duty to be obeyed.'"); Rhode Island Hospital Trust Nat'l Bank v. Swartz, 455 F.2d 847 (4th Cir. 1972).

<sup>22.1</sup>The continued vitality of the policies expressed in *Ultramares* is clearly seen in the recent *Blue Chip Stamps* case where the Supreme Court cites *Ultramares* and its policies with approval. *Blue Chip Stamps v. Manor Drug Stores*, \_\_\_ U.S. \_\_\_, 43 U.S.L.W. 4707, 4714 (U.S. June 10, 1975).

<sup>23</sup>See cases cited in note 17 *supra*. For a superb analysis of these cases and the problem of accountant's liability to third parties, see Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31 (1975). See also Annot., 46 A.L.R.3d 979 (1973).

statement's proposed position, particularly since the rendering of securities law opinions<sup>24</sup> and the drafting of disclosure documents<sup>25</sup> arguably involve large groups of third parties who may be specifically unknown but who could reasonably be expected or foreseen by counsel to rely upon his skill and care in rendering such opinions or in drafting such documents. The bar should react to these signals by formulating standards in these areas, since good faith compliance with such professional standards would clearly meet the requisite standard of care under the common law, even if such third party actions are permitted.

## B. The Federal Securities Laws

### 1. *The Judicial Decisions.*

Except to a limited extent under Section 11 of the Securities Act of 1933,<sup>26</sup> the federal securities laws do not impose any specific liabilities or responsibilities on attorneys as such. Yet lawyers clearly are not exempt from the civil liability and anti-fraud provisions of those laws<sup>27</sup> and indeed have been held liable thereunder for conduct in

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<sup>24</sup>Opinions would relate to such matters as municipal bonds, mergers, public offerings, titles, audits and the sale of unregistered stock. If a third party with the attorney's consent or knowing acquiescence receives copies or summaries of such opinions (as in a prospectus), it would not seem unreasonable to extend his liability if the opinion was negligently rendered. The more troublesome question arises when the third party never sees the opinion or a summary of it yet is within a group (such as the investing public) who clearly should have been foreseen by the attorney as indirect beneficiaries of and reliant upon the attorney's skill and care in rendering the opinion. The policy of *Ultramares* would seem to have greater force to limit liability in this situation. See Freeman, *Opinion Letters and Professionalism*, 1973 DUKE L.J. 371, 387-96. See generally Jennings, *The Corporate Lawyer's Responsibilities and Liabilities in Pending Legal Opinions*, National Institute, *supra* note 4, at 73-80.

<sup>25</sup>Such documents include prospectuses, the 1934 Act reports, proxy statements and perhaps the Annual Report to Stockholders. The element of known reliance may be particularly troublesome in the prospectus situation where loose language is often used in connection with counsel's name. See Cheek, *Potential Liability of a Counsel Named in a Prospectus*, 6 REV. OF SEC.REG. 939 (1973). See generally Small, *The Lawyer's Responsibility as a Draftsman*, National Institute, *supra* note 4, at 81-89.

<sup>26</sup>15 U.S.C. § 77K (1933). Under this section, liability (subject to a due diligence defense) may attach to the lawyer as an "expert" with respect to his opinion on the legality of the securities offered (Exhibit 6 to the Form S-1) and as to those legal matters which he is named in the prospectus as having passed upon. No case has to date considered this question. See Cheek, *Potential Liability of a Counsel Named in a Prospectus*, 6 REV OF SEC.REG. 939, 942-43 (1973).

<sup>27</sup>These provisions are principally § 12(2) and § 17(a) of the Securities Act of 1933 and Rule 10b-5 promulgated under the Securities Exchange Act of 1934. For a detailed outline of the whole spectrum of the liabilities of lawyers, see Matthews, *Liabilities of*

connection with a fraudulent securities transaction. Very few cases, however, have involved civil damage claims by non-clients, and no court has held a negligent attorney civilly liable for damages to the investing public where his role was strictly limited to that of an attorney.<sup>28</sup>

Most cases holding counsel liable under the federal securities laws have involved civil injunctive actions under Rule 10b-5 where the attorney was a knowing and active participant in a fraudulent securities transaction,<sup>29</sup> or situations where the attorney was a director or "insider" which status imposed higher responsibilities upon him than if his only relation to the company were that of counsel.<sup>30</sup> Where the

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*Lawyers Under the Federal Securities Laws, National Institute, supra note 4, at 110-155.*

<sup>28</sup>A number of complaints based upon negligent conduct of attorneys *qua* attorneys have been filed by classes whose members might be deemed the relevant "investing public," but these cases either have been settled or are still pending. It is revealing that many of the settlements of these cases have been based upon an assumed exposure to such large classes.

<sup>29</sup>*See, e.g., SEC v. Universal Major Industries Corp., \_\_\_ F. Supp. \_\_\_ (S.D.N.Y. 1975) (knowing use of erroneous opinion letters to further distribution of unregistered stock); SEC v. Century Inv. Transfer Corp., CCH FED.SEC.L.REP. ¶ 93,232 (S.D.N.Y. 1971) (knowing use of clearly erroneous opinion letters relating to distribution of unregistered securities); United States v. Schwartz, 464 F.2d 499 (2d Cir.), cert. denied, 409 U.S. 1009 (1972) (attorney materially involved in all business steps of unlawful hypothecation); Blakely v. Lisac, 357 F. Supp. 255 (D. Ore. 1972) (attorney-director liable for errors in prospectus and annual report as role was "beyond a lawyer's normal one"); Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969) (attorney played major role in most aspects of illegal solicitation); SEC v. Management Dynamics, Inc. [1973-74 Transfer Binder] CCH FED.SEC.L.REP. ¶ 94,468, *aff'd in part*, CCH FED.SEC.L.REP. ¶ 95,017 (2d Cir. 1975) (attorney actively involved in all activities of shell corporation which illegally sold stock); United States v. Benjamin, 328 F.2d 854 (2d Cir. 1964) (active non-legal participation plus clearly erroneous opinions); United States v. Crosby, 294 F.2d 928 (2d Cir. 1961) (active fraudulent selling by attorney and knowingly rendering clearly erroneous opinions). As an analytical matter, liability in these cases was imposed because the attorney was found to be either a primary wrongdoer who owed a direct duty to the plaintiff or an "aider and abettor" who actively and knowingly assisted a primary wrongdoer. *See generally* Ruder, *Multiple Defendants in Securities Law Fraud Cases*, 120 U. PA. L. REV. 598 (1972). *Contra, Hochfelder v. Midwest Stock Exch.*, 503 F.2d 364 (7th Cir. 1974) (certain types of inaction are sufficient to sustain charge of aiding and abetting).*

<sup>30</sup>*See, e.g., Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). Although counsel was not held liable as an attorney in these § 11 cases, the fact that the defendants were attorneys resulted in a substantially higher standard of care being placed upon them than was placed on their fellow outside directors. *Accord, Blakely v. Lisac*, 357 F. Supp. 255 (D. Ore. 1972). *See generally* *Lawyers as Directors, National Institute, supra note 4, at 41-64.*

attorney's conduct was limited to acting purely as a professional adviser to his client, courts have generally refused to impose liability.<sup>31</sup>

A key case involving counsel's exposure to 10b-5 liability is *SEC v. Frank*,<sup>32</sup> a civil injunctive suit brought by the SEC under Section 17(a) of the 1933 Act as well as under Rule 10b-5 against a lawyer for his participation in the preparation of a false and misleading offering circular used in an intrastate offering. The attorney's defense was that the portion of the offering circular alleged to contain the misrepresentations had been prepared by the officers of the issuer and that his sole function had been that of a scrivener helping them to place their ideas in proper form. Although reversing an order granting injunctive relief on an evidentiary point, the Second Circuit rejected defendant's substantive position:

In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." A lawyer has no privilege to assist in circulating a statement with regard to securities that he knows to be false simply because his client has furnished it to him. At the other extreme, it would be unreasonable to hold a lawyer who was putting his client's description of a chemical process into understandable English to be guilty of fraud simply because of his failure to detect discrepancies between their description and technical reports available to him in a physical sense but beyond his ability to understand. . . . [If even a non-expert, however, would recognize the falsity of the representations in such a report,] the Commission would be entitled to prevail; a lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand.<sup>33</sup>

However, in the next sentence the court left open the question of whether an attorney, without actual or implied knowledge, whose activities are no more than those customary for outside counsel can be held liable under Rule 10b-5:

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<sup>31</sup>*See, e.g.,* Nicewarner v. Bleavins, 244 F. Supp. 261 (D. Colo. 1965) (no liability under § 12(1) where defendant did no more than serve as an attorney); Wonneman v. Stratford Securities Co. [1957-61 Transfer Binder] CCH FED.SEC.L.REP. ¶ 91,034 (S.D.N.Y. 1961) (lawyer did only legal work and was a "stranger to the illegal sales"). *Cf. SEC v. Coffey*, 493 F.2d 1304, 1315 n. 24 (6th Cir. 1974); *United States v. Koenig*, CCH FED.SEC.L.REP. ¶ 94,765 (S.D.N.Y. 1974).

<sup>32</sup>388 F.2d 486 (3d Cir. 1968).

<sup>33</sup>*Id.* at 489.

Whether the fraud sections of the securities law go beyond this and require a lawyer passing on an offering circular to run down possible infirmities in his client's story of which he has been put on notice, and if so, what efforts are required of him, is a closer question on which it is important that the court be seized of the precise facts, including the extent, as the SEC claimed with respect to Frank, to which his role went beyond a lawyer's normal one.<sup>34</sup>

To date, no court has considered this question. Thus, except where the attorney actively and knowingly assists in a fraudulent scheme or is an insider of the company, the development of the law under the federal securities statutes with respect to attorney's liabilities to third parties has not departed in any material respect from that existing under common law principles.

Two recent cases, however, suggest that courts may well hold a negligent attorney liable in the future even in the absence of a special relationship or his knowing and active participation. In *SEC v. Spectrum Ltd.*,<sup>35</sup> the Second Circuit considered in the context of an injunctive suit the question left open in the *Frank* case and concluded in a carefully limited opinion that an attorney may be liable as an aider and abettor under Rule 10b-5 if he negligently fails to investigate beyond routine inquiry the facts upon which his opinion is based when that opinion results in an illegal securities distribution. In its opinion, the court sets forth as the policy base for that strict standard of culpability the ultimate public responsibility of the securities lawyer:

The legal profession plays a unique and pivotal role in the effective implementation of the securities laws. Questions of compliance with the intricate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters . . . .

In the distribution of unregistered securities, the preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience. The public trust demands more of its

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<sup>34</sup>*Id.*

<sup>35</sup>[1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,631 (S.D.N.Y. 1972), *rev'd*, 489 F.2d 535 (2d Cir. 1973). See generally Comment, *Securities Regulation*, 87 HARV. L. REV. 1860 (1974).

legal advisers than 'customary' activities which prove to be careless. And, to be sure, where expediency precludes thorough investigation, an attorney can prevent the illicit use of his opinion letter by prohibiting its utilization in the sale of unregistered securities by a statement to that effect clearly appearing on the face of the letter . . . .<sup>36</sup>

Despite being limited to injunctive suits<sup>37</sup> and being a case involving "hard facts,"<sup>38</sup> this decision must realistically be viewed with substantial concern by the securities bar, as the policies resulting in the application of a negligence standard in *Spectrum* arguably could be used to support the imposition of civil damage liability to that indeterminate class of public investors whose reliance on counsel may be "too high to permit due diligence to be cast aside."<sup>39</sup>

Similarly, in the case of *Black & Co. v. Nova-Tech, Inc.*,<sup>40</sup> the presumed reliance by the investing public upon the care of counsel played an important role in the decision which held that for jurisdictional purposes under state blue sky laws, counsel who prepared certain legal papers which were unknowingly used in an illegal securities sale was a "participant" in the illegal sale.<sup>41</sup> The district court also

<sup>36</sup>489 F.2d at 541-42.

<sup>37</sup>The court specifically stated that its decision "should not be construed to apply to more peripheral participants in an illegal scheme or, for that matter, to criminal prosecution or private suits for damages." *Id.* at 542.

<sup>38</sup>The facts present so many red flags regarding the transaction to which the opinion related that the healthy skepticism possessed by the careful securities lawyer would clearly have demanded further investigation of the facts underlying the opinion, particularly where counsel was a stranger to his client. For an in-depth discussion of the "unusual" circumstances existing at the time the opinion was rendered, see Slain, *Spectrum*, 7 REV.OF SEC.REG. 927, 929-30 (1974). Given these unusual facts, the decision perhaps more properly could have fallen into the situation where as set forth in the *Frank* case the lawyer cannot "escape liability for fraud by closing his eyes to what he saw and could readily understand." *Cf.* SEC v. Universal Major Industries Corp., \_\_\_ F. Supp. \_\_\_, (S.D.N.Y. 1975). SEC v. Management Dynamics, Inc., CCH Fed. Sec. L. Rep. ¶ 95,017, at 97,569 (2d Cir. 1975).

<sup>39</sup>One author suggests that the statutes provide no basis for a more strict standard of culpability in suits for injunctive relief than in those for civil damages and suggests that the negligence standard of culpability established by *Spectrum* may well raise the specter of horrendous civil liability to third parties. See Slain, *Spectrum*, 7 REV.OF SEC. REG. 927, 928 (1974). For an application of the negligence standard of *Spectrum* in a context outside its facts, see Maryland Securities Act Release No. 16, 2 CCH BLUE SKY REPTR. ¶ 23,628 (Mar. 9, 1974). *Cf.* SEC v. Coffey, 493 F.2d 1304, 1315 n. 24, 1316 n. 30 (6th Cir. 1974).

<sup>40</sup>333 F. Supp. 468 (D. Ore. 1971).

<sup>41</sup>Applying a strict "but for" test, under the court's reasoning the attorney would have been a "participant" even if he proved that his independent inquiry would not

held that his law partners were "participants" because the firm had authorized the company to include its name as corporate counsel in its annual reports which were used in connection with the unlawful sales. Although the case did not relate to substantive liability and has since been challenged by the Supreme Court of Oregon,<sup>42</sup> the opinion by its very existence causes serious concern as an extreme example of the extent to which some courts may go in these uncharted waters.

It is important to remember that even if actions by large groups of remote third parties are permitted under the federal securities laws, liability will not attach unless the attorney fails to meet the requisite standard of care. While it is clear under common law principles that the standard of care is determined by reference to the care commonly exercised by others of the profession, it is uncertain whether counsel's liability under the federal securities laws will be similarly governed by the ordinary care of the profession. For example, the recent Ninth Circuit decision of *White v. Abrams*<sup>42,1</sup> rejects the traditional concepts of "negligence" or "scienter" as standards of culpability and creates a new "flexible duty" test which requires an ad hoc examination of all the facts and circumstances of the matter in question. This approach leaves the securities lawyer in a quandry with effectively no set standards and with hindsight judging whether or not his conduct was equitable in the context of the particular transaction being challenged. His quandry is further complicated by the fact that, unlike the accountant,<sup>43</sup> he does not have the aid and

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have uncovered the illegality of the sale. *Id.* at 472.

<sup>42</sup>Recognizing the implications of the strict liability standard apparently underlying the district court's opinion, the Oregon Supreme Court permitted lack of knowledge to be raised by an attorney as a defense and characterized the *Nova-Tech* opinion as being "over broad, if literally applied." *Adams v. American Western Sec., Inc.*, 265 Ore. 514, 510 P.2d 838 (1973).

<sup>42,1</sup>495 F.2d 724 (9th Cir. 1974). This "flexible duty" standard considers such factors as the relationship of the defendant to the plaintiff, their relative access to information, the benefit denied by the defendant, the reliance of the defendant upon the plaintiff and the knowledge of the plaintiff of such reliance. For a thorough discussion of the flexible duty standard, see Note, *The Development of a Flexible Duty Standard Under SEC Rule 10b-5*, 32 WASH. & LEE L. REV. 99 (1975). In using such an ad hoc balancing test, the Ninth Circuit seems to have followed the pattern set by the recent California common law malpractice decisions. See note 16 *supra*; Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 113-28 (1975). For examples of the present confusion surrounding the degree of culpability required to sustain 10b-5 liability, compare *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), with *SEC v. Dolnick*, CCH FED.SEC.L.REP. ¶ 94,762 (7th Cir. 1974) and *SEC v. Spectrum, Ltd.*, [1972-73 Transfer Binder] CCH FED.SEC.L.REP. ¶ 93,631 (S.D.N.Y. 1972), *rev'd*, 489 F.2d 535 (2d Cir. 1973).

<sup>43</sup>The conduct of accountants is generally governed by a set of auditing procedures

comfort of formal professional standards designed to balance the conflicting responsibilities of the securities lawyer. Certainly as the extent of liability and unpredictability increases, the need for such guidelines by which the attorney arguably is to be judged increases. Moreover, such standards by considering and reflecting the public obligations of the securities lawyer can aid in defining the extent of those obligations. Surely, it is foolhardy to leave the development of operable standards to custom and practice or to ad hoc judicial determinations; the profession should provide a set of standards, particularly with respect to the preparation of disclosure documents and opinion letters related to securities matters.

## 2. SEC Complaints and Proceedings.

The SEC has sought to influence the creation of operable standards for securities lawyers through imaginative and aggressive litigation based primarily on Rule 10b-5<sup>44</sup> and through its own administrative disciplinary proceedings under Rule 2(e) of its Rules of Practice.<sup>45</sup> In recent administrative proceedings, the Commission has begun to take a tougher line with respect to the negligent conduct of counsel,<sup>46</sup> and in so doing has emphasized that the securities lawyer

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known as "generally accepted auditing standards" (GAAS). AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENT ON AUDITING STANDARDS (1974). See generally Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 VAND. L. REV. 201 (1975). While compliance with GAAS has not in every case provided protection from liability under Rule 10b-5, courts have always relied upon the standards in cases based upon common law principles to determine whether the accountant was liable. Compare *U.S. v. Simon*, 425 F.2d 796 (2d Cir. 1969) with *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974), cert. granted, \_\_\_ U.S. \_\_\_, 43 U.S.L.W. 3550 (U.S. Apr. 14, 1975).

"See, e.g., *SEC v. Canusa Holdings*, Civ. Action No. 74-30, (S.D.N.Y. Jan. 2, 1974); *SEC v. Allegheny Beverage Corp.*, [1973 Transfer Binder] CCH FED.SEC.L.REP. ¶ 94,183, (D.D.C. May 11, 1973); *SEC v. R. D. Philpot*, Civ. Action No. 73-543 (S.D.N.Y. Feb. 5, 1973); *SEC v. National Student Marketing Corp.*, [1971-72 Transfer Binder] CCH FED.SEC.L.REP. ¶ 93,360 (D.D.C., filed Feb. 3, 1972); *SEC v. Everest Management Corp.*, Civ. Action No. 71-4932 (S.D.N.Y. Nov. 11, 1971); *SEC v. Universal Major Industries Corp.*, Civ. Action No. 73-3626 (S.D.N.Y. 1973).

<sup>45</sup>17 C.F.R. § 201.2(e) (1974). Under this rule the Commission may "disqualify, and deny temporarily or permanently, the privilege" of practicing before the Commission. For additional discussion of the disciplinary proceedings under this rule, see Johnson, *The Expanding Responsibility of Attorneys in Practice Before the SEC*, 25 MERCER L. REV. 637(1974). See generally Sonde, *Professional Disciplinary Proceedings*, National Institute, *supra* note 4, at 157-62.

<sup>46</sup>While the Commission has long taken the position that negligent conduct could be the basis of a Rule 2(e) proceeding, almost all of its proceedings have involved intentional and active participation in fraudulent schemes. Only recently has the Commission actually proceeded against lesser unintentional conduct. Compare Mur-



has a public duty to assist in the enforcement of securities laws, which may override his duty to his client.<sup>47</sup> For example, in the *Emanuel Fields* proceeding,<sup>48</sup> the Commission consciously set forth in the following footnote its current view of counsel's public responsibilities:

Members of this Commission have pointed out time and time again that the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders. These were statements of what all who are versed in the practicalities of securities law know to be a truism, *i.e.*, that this Commission with its small staff, limited resources, and onerous tasks is peculiarly dependent on the probity and diligence of the professionals that practice before it . . . . This is a field where unscrupulous lawyers can inflict irreparable harm on those who rely on the disclosure documents that they produce. Hence, we are under a duty to hold our bar to appropriately rigorous standards of professional honor . . . .<sup>49</sup>

Moreover, the Commission specifically rejected the suggestion that the standards of conduct set by state courts were controlling in its administrative proceedings. It indicated that a higher level of conduct may be required by "the peculiarly strategic and especially central place of the private practicing lawyer in the investment process and in the enforcement of the body of federal law aimed at keeping the process fair."<sup>50</sup>

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ray A. Kivitiz, SEC Securities Act Release No. 5163 (June 29, 1971), *rev'd*, 475 F.2d 956 (D.D.C. 1973) with Albert D. Fleischmann, 37 S.E.C. 832 (1950). Moreover, the number of proceedings against attorneys has increased dramatically since 1970. See Johnson, *The Expanding Responsibility of Attorneys in Practice Before the SEC*, 25 MERCER L. REV. 637, 644 (1974).

<sup>47</sup>Historically, the Commission sanctioned the view that the attorney's primary duty was to his client, not to the investing public. In *American Finance Company*, 40 S.E.C. 1043 (1962), the Commission set forth this position as follows:

Though owing a public responsibility, an attorney in acting as the client's advisor, defender, advocate and confidant enters into a personal relationship in which his principal concern is with the interests and rights of his client. The requirement of the act of certification by an independent accountant, on the other hand, is intended to secure for the benefit of public investors the detached objectivity of a disinterested person.

See also SEC Accounting Release No. 126, CCH FED.SEC.L.REP. ¶ 72,148, at 62,351 (July 5, 1972).

<sup>48</sup>SEC Securities Act Release No. 5404 (June 18, 1973).

<sup>49</sup>*Id.* at 5.

<sup>50</sup>*Id.* It should be noted that Fields who admitted repeated violations of the securi-

In addition to such statements, which are echoed in recent public speeches by Chairman Garrett and Commissioner Sommer, the Commission recently has begun to use consent sanctions to set forth desired levels of conduct for the securities lawyer irrespective of what standards may be judicially or ethically established.<sup>51</sup> Until 1974, all proceedings imposing remedial sanctions on a professional involved the accounting profession; and given the tendency of the Commission to relate the functions and duties of the attorney in the scheme of securities regulation to those of the independent public auditor,<sup>52</sup> these matters become important background material to an understanding of the significance of the recent consent sanctions including attorneys.

The Commission generally has looked to and relied upon the accounting profession to develop and maintain high quality professional auditing standards.<sup>53</sup> In recent years, however, the Commission has on occasion demonstrated its impatience with their professional self-regulation in certain areas<sup>54</sup> and has increasingly negotiated remedial consent sanctions<sup>55</sup> designed to extract a desired level of care from the

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ties laws did not challenge any factual allegations but chose to fight the Commission's legal power to bar him from SEC practice. In light of the unquestioned misconduct of Fields, the statements quoted in the text apparently were consciously aimed at the bar as a whole.

<sup>51</sup>*In re* McLaughlin & Stern, Ballen and Miller, SEC Securities Exchange Act Release No. 11516 (July 8, 1975); *In re* Jo M. Ferguson, SEC Securities Act Release No. 5523 (Aug. 21, 1974). See also SEC v. Allegheny Beverage Corporation, Civ. Action No. 932-73 (D.D.C. July 8, 1975) (Stipulation and Undertaking of the law firm defendant Wright, Robertson & Dowell, and C. Gordon Haines, a partner).

<sup>52</sup>See, e.g., Sommer, *The Emerging Responsibilities of the Securities Lawyer*, [1973-74 Transfer Binder] CCH FED.SEC.L.REP. ¶ 79,631, at 83,689 (1974).

<sup>53</sup>This policy decision was expressed as early as 1940 in McKesson & Robbins, Inc., SEC Accounting Release No. 19, (1940), as follows:

We have carefully considered the desirability of specific rules and regulations governing the auditing steps to be performed by accountants in certifying financial statements to be filed with us. Action has already been taken by the accounting profession. . . . Until experience should prove to the contrary, we feel this program is preferable. . . .

See also SEC Accounting Series Release No. 150 (Dec. 20, 1973).

<sup>54</sup>The most publicized example of the Commission's action in absence of the action by the profession relates to the use of treasury stock in acquisitions to be accounted for on a "pooling-of-interest" accounting method. See SEC Securities Act Release No. 33-5416A (Apr. 11, 1974). See also SEC Accounting Series Release No. 151 (Jan. 3, 1974) (disclosure of inventory profits due to inflating).

<sup>55</sup>All remedial sanctions have to date been imposed by consent. For a critique of the Commission's use of consent decrees and other enforcement techniques, see Treadway, *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief*,

profession.<sup>56</sup> Generally, these sanctions have been a mixture of "due care" and quality control guidelines, including programs of peer review of auditing procedures with reports to the Commission, the adoption of new auditing procedures, restrictions on accepting new engagements and on merging with other firms, and in some cases a minimum number of hours of continuing professional education. In one of the most significant of these cases, *In the Matter of Touche Ross & Co.*,<sup>57</sup> the Commission commented with respect to these sanctions as follows:

In accepting Touche's undertaking to adopt certain procedures to strengthen its existing ones, the Commission does not contemplate that they will encompass steps which are other than required by generally accepted auditing standards. Rather, Touche and the Commission contemplate these procedures will improve Touche's ability to carry out its responsibility to exercise due professional care in the conduct of its future engagements. While we do not believe that any form of procedure can ever be a substitute for the kind of healthy skepticisms which a good audit requires, we anticipate that these procedures will materially aid in the performance of the firm's responsibility.

Consistent with that statement, the remedial sanctions imposed in the accounting proceedings have generally operated within the framework of the standards set forth by the profession itself.

In August 1974 the Commission for the first time applied the technique of remedial consent sanctions in a Rule 2(e) proceeding involving an attorney. Jo M. Ferguson was bond counsel in connec-

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32 WASH.&LEE L. REV. \_\_\_\_ (1975). The question as to whether a court may require by order a peer investigation and remedial procedures is being litigated. SEC v. Goetek Resources Fund, Inc. Docket No. 73 Civ. 0819 (N.D. Cal. May 17, 1973); SEC v. Talley Indus., Inc. [1973 Transfer Binder] CCH FED.SEC.L.REP. ¶ 94,198, (S.D.N.Y. Oct. 1973). The question as to whether the SEC may order such sanctions has not been raised to date in a Rule 2(e) proceeding. Cf. Heater v. F.T.C., 503 F.2d 321 (9th Cir. 1974). See generally Burton, *SEC Enforcement and Professional Accountants*, 28 VAND. L. REV. 19 (1975).

<sup>56</sup>See, e.g., *In re Peat, Marwick, Mitchell & Co.*, SEC Accounting Series Release No. 173 (July 2, 1975); *In re Benjamin Botwinick & Co.*, SEC Accounting Series Release No. 168 (Jan. 13, 1975); *In re Westheimer, Fine, Berger & Co.*, SEC Accounting Series Release No. 167 (Dec. 24, 1974); *In re Arthur Andersen & Co.*, SEC Accounting Series Release No. 157 (July 8, 1974); *In re Touche Ross & Co.*, SEC Accounting Series Release No. 153 (Feb. 25, 1974); *In re Leventhal, Krekstein, Horwath & Horwath*, SEC Accounting Series Release No. 144 (May 23, 1973).

<sup>57</sup>SEC Accounting Series Release No. 153 (Feb. 25, 1974).

tion with an offering of revenue bonds issued in 1972 to finance the construction of a nursing home. The prospectus for the issue contained certain omissions of material facts and Ferguson had the principal legal responsibility for reviewing that document for its completeness and accuracy.<sup>58</sup> The consent order provided that Ferguson should have known of the omissions:

Because of his review of the prospectus, his pre-existing relationship with the developer on other offerings of municipal bonds, and other factors which had come to his attention, respondent [Ferguson] should have known, if he did not know, that the prospectus omitted material facts.

Ferguson was censored, not suspended, in part based upon the voluntary adoption by him and his law firm of "corrective changes in the firm's procedures relative to municipal bonds." Among the agreed upon changes in future firm activities are the following:

1. Every two weeks members of the firm must meet and discuss all of their active cases. Affirmative approval of each partner is required before the issuance of any legal opinion.
2. The firm must undertake an appropriate investigation in connection with acting as bond counsel including, among other things, obtaining independently-audited financial statements and inquiring into the background of the various parties connected with the offering. Written evidence of such investigations and the results thereof will be reviewed by the partners of the firm.
3. An appropriate "engagement letter" will be sent to all interested parties, emphasizing that the firm's duty is to the issuer and the bondholders. It will define the scope of the firm's work as bond counsel and require submission to the firm of certain pertinent information.
4. The firm will require that it receive independently-audited financial statements, representations from appropri-

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<sup>58</sup>Recently, the Commission won its action for a civil injunction against other participants in the offering with the court specifically finding material omissions in the prospectus. As is clear from this decision, Ferguson did not draft the prospectus, but only reviewed it after it had been written by one of the defendants enjoined in this decision. *SEC v. The Senex Corp.*, CCH FED.SEC.L.REP. ¶ 95,001 (E.D. Ky. 1975). Query whether Ferguson would have had due diligence obligations or 10b-5 exposure if in his review he found the document to be completely consistent within his knowledge of the facts, or if he had limited his duties to passing on the legality of the bonds only and disclosed the limited scope of his duties.

ately interested persons concerning the accuracy and completeness of the statements about them in any offering circulars and a statement from counsel for any lessee or guarantor that such counsel has reviewed the offering circular and is aware of no inaccuracies therein.

5. Partners and associates of the firm will attend, at least annually, municipal bond workshops and seminars.<sup>59</sup>

Some of these procedures relate to particular quality control problems of the Ferguson firm, but others relate to general legal "auditing" procedures which the Commission appears to consider an integral part of the professional due care of the municipal bond lawyer.

The remedial sanctions agreed to recently by the law firms who were named defendants in the Commission's 1973 action against Allegheny Beverage Corporation are important indicators of the direction in which the Commission appears to be headed. The defendants, who acted strictly in a representative capacity as outside counsel for the issuer and for the underwriter in connection with a registered public offering, allegedly failed to detect the sham nature of certain transactions at the closing of the offering. Counsel for the underwriter agreed to an order pursuant to Rule 2(e) which censured the firm for the inadequate supervision of its associate who attended the closing and who failed at the closing to conduct "a more detailed inquiry" which would have disclosed the sham nature of the closing. The Rule 2(e) order requires, among other things, the firm's adoption of certain internal supervisory procedures "designed to strengthen its existing procedures in connection with securities matters handled by the firm."<sup>60</sup> In a stipulation and undertaking filed in federal court as part of a final order of dismissal, counsel for the issuer also agreed to the adoption of such supervisory procedures, and in addition agreed that it would not accept any new clients involving practice before the Commission during the 60-day period in which such procedures were

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<sup>59</sup>It is interesting to note that the Supreme Courts of Iowa, Minnesota and Washington are in the final stages of adopting unprecedented rules which will require members of their respective bars to complete a certain number of hours of continuing legal education each year.

<sup>60</sup>*In re McLaughlin & Stern, Ballen and Miller, SEC Securities Exchange Act Release No. 11516 (July 8, 1975)*. The procedures to be adopted specifically require that a partner experienced in the federal securities laws attend all securities closings, approve all securities opinion letters, and review and adequately supervise all associates' work involving the federal securities laws. In addition, the firm must review its procedures used in connection with its representation of issuers and underwriters in public offerings of securities and implement such further procedures as it deems appropriate.

being adopted and implemented.<sup>59,2</sup> Neither consent order, however, requires a peer examination of present procedures or a peer or Commission review of those procedures ultimately adopted and implemented, as have often been required in similar settlements involving accounting firms.

The use of remedial measures as a settlement technique is likely to be continued in future settlements of legal as well as administrative proceedings,<sup>60</sup> and thereby may ultimately affect the standard of care which may be applied by the courts in securities actions by civil litigants for private damages. Unlike the accounting profession, the legal profession has precious few written procedures within which the Commission can frame remedial consent sanctions. This absence of written procedures eases the way for the Commission to develop minimal levels of conduct on an ad hoc basis, and its recent activity in this area clearly increases the need for the profession to act quickly and responsibly to fill the void existing with respect to the appropriate level of due care required in securities matters.

### III. DEVELOPING APPROPRIATE STANDARDS OF CONDUCT

The foregoing analysis of the present conditions under which the securities lawyer practices demonstrates the following:

1. The Commission is most serious when it states that attorneys involved in securities transactions must act as guardians of the interests of the investing public, and intends to effect that policy through judicial and administrative proceedings.
2. The nature and extent of the responsibilities of the securities lawyer to the public, and any civil liabilities which

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<sup>59,2</sup>SEC v. Allegheny Beverage Corp., Civ. Action No. 932-73 (D.D.C. July 8, 1975) (Stipulation and Undertaking of the law firm defendant Wright, Robertson & Dowell, and of C. Gordon Haines, a partner).

<sup>60</sup>Since the *Ferguson* order was released, an Associate Director of the Division of Enforcement of the Commission has publicly emphasized that the procedures adopted by the *Ferguson* firm were done voluntarily prior to the Commission's proceeding and would have little value as precedential guidelines which establish due care. Such guidelines will flow on a case-by-case basis although no one should look to the Commission to establish an ethical code of conduct. Remarks of Wallace Timmeny, SEC Speaks - 1975 (Practicing Law Institute, March 1, 1975); Remarks of Wallace Timmeny, Municipal Bonds Workshop - 11th (Practicing Law Institute, February 19, 1975). Cf. Burton, *SEC Enforcement and Professional Accountants*, 28 VAND. L. REV. 19, 24-26 (1975).

may flow therefrom, are in an embryonic stage of development and their boundaries are by no means fixed or immutable.

3. The courts have given remarkably little consideration to the requisite level of care and have generally looked to expert testimony to establish on an ad hoc basis whether challenged conduct departs from the due care commonly exercised by other members of the legal profession, although recent discussions under the federal securities law indicate that courts may well apply to the securities lawyer a higher standard of care than that set forth as the norm by expert testimony.

The message should be crystal clear; the profession should act now to formulate balanced and functional standards to guide professional conduct in this area — much as the accounting profession has done for years in its statements on auditing standards.

There are two principal objections which may be raised against this approach. First, some would argue that standards should develop on a case-by-case basis, thereby permitting the judicial system to respond to the changing needs and demands of society. They argue further that any set of guidelines would be horribly complex traps for the unwary, creating *prima facie* cases of professional negligence for any departures therefrom.<sup>61</sup> With respect to the first part of that objection, the formulation of guidelines in this area surely would not impede the ability of the judicial system to stay in step with society any more than does judicial precedent or existing professional standards. Unquestionably, for the guidelines to be workable they must continually reflect and react to the expectations of society by balancing critical interests in an independent and objective fashion. Certainly, as vividly evidenced by several recent accounting cases,<sup>62</sup> if the standards set by the profession fail in this regard, the courts will not hesitate in requiring higher standards. On the other hand, if the standards do reflect the interests of society, the courts are likely to respect them as creating a presumption of requisite due care. The second part of this objection assumes the formulation of a highly detailed set of rules, which is neither desirable nor expected. Standards should be flexible guides with sufficient content to be meaningful in specific situations but with enough room to permit the exercise of responsible judgment in handling the many close questions pre-

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<sup>61</sup>See, e.g., Sommer, *Professional Responsibility: How Did We Get Here?*, National Institute, *supra* note 4, at 95-103.

<sup>62</sup>See *U.S. v. Simon*, 425 F.2d 796 (2d Cir. 1969); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, CCH FED.SEC.L.REP. ¶ 94,574 (S.D.N.Y. 1974).

sented by our complex society. So formulated, the standards will aid, not trap, the bar. Moreover, any departures therefrom should not automatically create liability but should simply shift the burden to the attorney to prove that such departures are justified under the particular circumstances.

The second objection to the formulation of standards relating to securities work flows from the proposition that any lawyer, including the securities lawyer, is responsible only to his client and to no one else. Proponents of this view argue that the formulation of standards reflecting public responsibilities would dilute the absolute duty owed to the client, and would seriously erode the attorney-client privilege, all in contradiction to their reading of the Code of Professional Responsibility.<sup>63</sup> It is of course clear that under the Code a lawyer is bound to represent his client zealously within the bounds of the law, which requires him to render his professional judgment within those bounds solely for the benefit of his client and free of compromising influences and loyalties.<sup>64</sup> Yet, it is equally clear — and even recognized by existing professional standards<sup>65</sup> — that public responsibilities do exist and may require independent conduct within the parameters of that Canon. This is particularly true where the lawyer acts in the private legal process as an adviser, rather than in the public

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<sup>63</sup>The most outspoken proponent of this view is Dean Monroe H. Freedman who categorically rejects the concept of the attorney aiding the Commission as a policeman of the securities laws. He further refuses to recognize any distinction in the roles of the office lawyer and the trial lawyer. *See, e.g., Freedman, A Civil Libertarian Looks at Securities Regulation*, 35 OHIO ST. L.J. 280 (1974).

<sup>64</sup>ABA CODE OF PROFESSIONAL RESPONSIBILITY, Canon 7 (1971) [hereinafter cited as ABA CODE]. However, the absolute duty thereunder is qualified by applicable Disciplinary Rules which state that an attorney cannot assist his client in illegal or fraudulent conduct and requires withdrawal rather than further assistance of such conduct. ABA CODE, DR 7-102. In applying this Disciplinary Rule to securities matters, considerable controversy has developed, particularly over the meaning of DR 7-102(B)(1) which requires the lawyer to report fraud to the affected person or tribunal when a client refuses to stop or rectify the fraud, "except where the information is protected as a privileged communication." *See generally Responsibility of Lawyers Advising Management, National Institute, supra note 4*, at 13-29; Bialkin, *The Code of Professional Responsibility and the Responsibility of Lawyers Engaged in Securities Law Practice*, 30 Bus. Law. 1289 (1975).

<sup>65</sup>The Ethical Considerations, Disciplinary Rules, and Formal Opinions issued under Canon 7 reflect to varying degrees the interests of the public. *See, e.g., ABA CODE, EC 7-3, EC 7-5, EC 7-15, DR 7-102, Formal Opinion No. 335.* Additionally, as the Canon itself reflects, the lawyer is not the alter ego of his client's desires, but is limited by the "bounds of the law" which most certainly reflect public interests, particularly where the law is designed to protect the public from fraud in securities transactions.



process as an advocate. The late esteemed Professor Cheatham and Dean Patterson in their book *The Profession of Law* succinctly summarize the distinct difference in the standards applicable to these roles as follows:<sup>66</sup>

The roles of the lawyer in these processes differ widely. . . . These roles, their settings, and the responsibilities they entail vary. Standards grow out of responsibilities, and they too, must vary, for the standards of the lawyer are, and must be, functional. . . .

. . . .  
 Trial standards are designed for adversary proceedings, and they relate primarily to the conduct of the lawyer, not to the conduct of the client. The trial is concerned only with a determination of the consequences of the client's past actions, and the lawyer is not free to sit in judgment on those actions. . . .

In the unstructured setting of the private legal and administrative processes, the conduct of the client is relevant to the lawyer's standards, for the lawyer outside the trial most often looks to the future, not the past. He is not only free to judge his client's proposed actions, it is part of his job to do so. . . .

. . . .  
 This difference has not ordinarily received from the organized bar the consideration in difference of standards which its fundamental importance calls for . . . .

To suggest that all standards should focus only on the lawyer's duties to his client to the exclusion of others is to ignore these materially different roles and to overlook the larger concepts and goals of our legal system. The bar cannot afford to ignore its existing duties to the public in today's society which does in fact demand in certain situations the independent conduct of the securities lawyer.

In summary, there are substantial and conflicting responsibilities for the securities lawyer acting in the private legal process which raise difficult questions as to what he should and should not do. Affirma-

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<sup>66</sup>R. PATTERSON & E. CHEATHAM, *THE PROFESSION OF LAW* 62, 70, 47 (1971) [hereinafter cited as R. PATTERSON & E. CHEATHAM]. The legal adviser does not stand in the position of trying to get whatever he can in any way he can for his client, for it is clear that the "reasons that justify and even require partisan advocacy in the trial of a cause do not grant any license to the lawyer to participate as legal adviser in a line of conduct that is immoral, unfair, or of doubtful validity." *Professional Responsibility: Report of the Joint Conference*, 44 A.B.A.J. 1159 (1958). The Code in a limited fashion does recognize this vital distinction. See, e.g., ABA CODE, EC 7-3.

tive standards are surely desirable to aid him and the courts in answering these questions. The need for such standards is succinctly stated by Professor Cheatham and Dean Patterson:<sup>67</sup>

These loyalties, as do the basic policies underlying our legal system, all conflict in some measure. The lawyer needs affirmative guides in the form of standards to aid him in resolving these conflicts. The stated standards create for him a level of expectations, a matter of fundamental importance, for lawyers, as do all men, tend to act as others expect them to act.

Simply stated, a lawyer's standards are an integral part of the law itself and reflect expected levels of conduct, and where there are no defined levels of expectation the very order and stability of our legal system is endangered. The need for such standards relating to certain difficult areas of securities law is therefore clear and must be met.

#### A. The Organized Bar and the Formulation of Guidelines

The bar has not totally ignored the problems of formulating appropriate guidelines in this area, but to date it has been slow and limited in its reactions. The most recent professional standards of the organized bar are set forth in the Code of Professional Responsibility of 1969.<sup>68</sup> The Code contains nine Canons, each of which is accompanied by a number of "Ethical Considerations" and "Disciplinary Rules." The former represent objectives toward which each member of the profession should strive, while Disciplinary Rules are mandatory and state minimal levels of permissible conduct.<sup>69</sup> Supplementing these are formal opinions issued by the ABA's Committee on Ethics and Professional Responsibility to interpret the principles in difficult practical problem areas. Unfortunately, most of the Code and the principles and opinions relating thereto have historically concentrated on the problems of the courtroom lawyer as an advocate in the public judicial process and little attention has been given the lawyer whose responsibilities and problems arise from his role in the private legal and administrative processes.<sup>70</sup>

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<sup>67</sup>R. PATTERSON AND E. CHEATHAM, *supra* note 66, at 62.

<sup>68</sup>Other statements of standards by the ABA are the CANONS OF PROFESSIONAL ETHICS OF 1908 and PROFESSIONAL RESPONSIBILITY: A STATEMENT OF 1958. Of the three statements only the one issued in 1958 attempts to handle in detail the problems of the office lawyer in the private legal process. For a complete analysis of these standards and their applicability to the profession, see R. PATTERSON & E. CHEATHAM, *supra* note 66.

<sup>69</sup>ABA CODE, "Preliminary Statement."

<sup>70</sup>R. PATTERSON & E. CHEATHAM, *supra* note 66, at 68-72.

Nevertheless, there are positive signs of an increasing awareness of the need to provide standards for the office lawyer, including the securities lawyer. On February 2, 1974, the Committee on Ethics and Professional Responsibility issued Formal Opinion No. 335 which is the first formal statement by the organized bar giving consideration to the unique responsibilities and roles played by attorneys rendering opinions relating to transactions involving sales of unregistered securities.<sup>71</sup> The Opinion is explicitly and carefully limited in three respects:

1. It relates only to transactions involving sales of unregistered securities.
2. It is designed to provide guidelines, not standards for determining negligent conduct, which is deemed to be an issue "for the trier of fact under a particular set of facts."<sup>72</sup>
3. It is based upon Ethical Considerations and goes further than the mandatory duties set forth in applicable Disciplinary Rules.<sup>73</sup>

Within these limitations, the Opinion discusses the professional standards of inquiry and verification which should be followed in preparing opinions relating to sales of unregistered securities and is presented as a direct reaction to the following statement by the Commission:<sup>74</sup>

"If an attorney furnishes an opinion based solely on hypothetical facts which he has made no effort to verify, and if he knows his opinion will be relied upon as the basis for a substantial

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<sup>71</sup>ABA COMM. ON ETHICS AND PROF. RESPONSIBILITY, OPINIONS, No. 335 (1974) reprinted in 60 A.B.A.J. 488 (1974). For more detailed guidelines which are applicable to the preparation of all types of opinion letters, see Freeman, *Opinion Letters and Professionalism*, 1973 DUKE L.J. 371, 433-39.

<sup>72</sup>This limitation is consistent with the Preliminary Statement to the Code itself which states that the Code does not "undertake to define standards for civil liability of lawyers for professional conduct." Yet, hopefully, unless the guidelines are not functionally realistic, compliance with such standards should create a rebuttable presumption to be used by the trier of fact to test the conduct of the attorney in the particular set of facts before him.

<sup>73</sup>Specifically, the Opinion is based upon EC 6-1, EC 6-4, EC 6-5, EC 7-5, EC 7-6, EC 7-8, EC 5-1 and EC 1-5 of the ABA Code. The Opinion also cites the following Disciplinary Rules as applicable to this situation: DR 7-102(A)(5) (knowledge of falsity of opinion); DR 7-102(A)(7) (knowledge of client's illegal or fraudulent conduct); and DR 6-101(A)(2) or (3) (conscious disregard of duties to client).

<sup>74</sup>SEC Securities Act Release No. 4445 (Feb. 2, 1962). See also SEC Securities Act Release No. 5168 (July 7, 1971).

distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct.”

In responding to that question, the Committee emphasizes that counsel's responsibility is to render to the client his considered, *independent* opinion and clearly recognizes that “while the responsibility that a lawyer has is to his client, he must not be oblivious of the extent to which others may be affected if he is derelict in fulfilling that responsibility.” That general proposition underlies each of the following guidelines set forth in the Opinion:

1. The lawyer must consider what facts are relevant to the giving of the requested opinion and must make a reasonable inquiry from his client to obtain such facts as are not within his personal knowledge.
2. He must test answers he receives from his client by reviewing such appropriate documents as are available.
3. The lawyer cannot always assume and rely upon the representations of his client and must make further inquiry (or independent investigation) where (a) the facts presented are incomplete in a material respect, or (b) the facts presented are suspect or open to question, or (c) the facts presented are inconsistent.<sup>75</sup>
4. The degree of further inquiry (or independent investigation) varies with the circumstances which include the lawyer's knowledge of the reputation and attitude of his client and the general trading conditions of the security involved.
5. If further inquiry (or independent investigation) is required and is not undertaken or is not satisfactory, no opinion should be rendered.<sup>76</sup>

The Opinion is silent with respect to any obligation which might arise in the circumstances of an unsatisfactory further inquiry; *i.e.*, whether the lawyer must resign or disclose to the Commission such facts as he might discover which render the expressing of his opinion impossible.<sup>77</sup> It is unfortunate that the Opinion fails to treat that

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<sup>75</sup>In the absence of such suspicious circumstances, the lawyer may assume the accuracy of the facts presented to him and no “audit” of his client's affairs is required.

<sup>76</sup>In such circumstances, an unverified opinion using limiting phrases such as “based upon the facts as you have given them to me” or “apart from what you have told me, I have not inquired as to the facts,” should not be rendered.

<sup>77</sup>For an analysis of the applicability of Disciplinary Rule 7-102 to this question, see Lipman, *The SEC's Reluctant Police Force: A New Role for Lawyers*, 49 N.Y.U. L. Rev. 437, 454-62 (1974).

thorny problem or the questions surrounding other types of opinions relating to securities matters. It is also regrettable that the guidelines could not have been stated in a more binding fashion,<sup>78</sup> for if the bar is to lead the way in setting levels of conduct in such matters, it should act positively and forcefully so that everyone, including the Commission or any court, is absolutely clear as to the expected level of conduct.<sup>79</sup> Yet irrespective of their non-mandatory nature, the guidelines represent a balanced and reasonable approach and, as such, may be relied upon by a court in determining proper conduct in rendering opinions. Thus, a lawyer who renders an opinion without adequate factual inquiry and investigation where circumstances are such as to raise suspicions similar to those in the *Spectrum* case<sup>79.1</sup> will incur serious risk of liability if the opinion proves erroneous. But where no reasonable cause exists to doubt facts which later prove erroneous, it is doubtful that a court would or should impose liability upon the attorney.

In addition to the Committee on Ethics and Professional Responsibility, other bar groups are specifically studying the feasibility of setting forth guidelines in difficult problem areas.<sup>80</sup> For example, on

<sup>78</sup>Alternatively, the opinion could have been based upon existing Disciplinary Rules, or a new Disciplinary Rule relating to such opinions could have been fashioned with the formal opinion then being based upon that rule. One method of handling unique problems which may result in a departure from such mandatory guidelines is to permit departures but only if the attorney can demonstrate unusual circumstances which justify the departure. Cf. AICPA RESTATEMENT OF THE CODE OF PROFESSIONAL ETHICS, Rule 203 (1972).

<sup>79</sup>It of course is clear from the Preliminary Statement to the Code itself and from recent accounting cases that such professional standards will not necessarily be binding upon the courts or the Commission. See *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, CCH FED. SEC. L. REP. ¶ 94,574 (S.D.N.Y. 1974); *U.S. v. Simon*, 425 F.2d 796 (2d Cir. 1969). Yet in substantially all cases it is submitted that such standards would be adopted by the courts. Cf. *Dorf v. Relles*, 355 F.2d 488 (7th Cir. 1966); *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968) ("accountants should not be held to a standard higher than that recognized in their profession"). See generally Earle, *The Fairness Myth*, 28 VAND. L. REV. 147 (1975); Hawes, *Truth in Financial Statements*, 28 VAND. L. REV. 1 (1975).

<sup>79.1</sup>*SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973). See notes 35-39 and accompanying text *supra*. See also note 76 and accompanying text *supra*.

<sup>80</sup>Both the ABA Section on Corporation, Banking and Business Law and the Association of the Bar of the City of New York have specially designated committees on the responsibilities and liabilities of counsel. To date, neither has made any public statements setting forth suggested guidelines, although the ABA Committee has recently prepared an article dealing with the ABA Code and the duty of lawyers with special reference to the securities laws. Bialkin, *The Code of Professional Responsibility and the Responsibility of Lawyers Engaged in Securities Law Practice*, 30 Bus. Law. 1289 (1975). In areas other than securities law, imaginative responses to difficult

October 20, 1974, the ABA Section on Corporation, Banking and Business Law circulated for comment a revised exposure draft of proposed guidelines designed to resolve the problem of lawyers responding to auditors' requests for information.<sup>81</sup> Framed ultimately to be "the policy of the American Bar Association," the proposed guidelines seek to "provide greater precision to the responsibilities of the bar in an area characterized by vagueness," while at the same time resolving the conflicts between the two polarized viewpoints of the accounting and the legal professions with respect to the former's full disclosure obligations and the latter's confidential attorney-client relationships. In balancing these conflicting responsibilities, the proposed guidelines introduce the concept of "obligatory public disclosure" which explicitly evidences an overriding concern with the public interest where a client has publicly traded securities outstanding.<sup>82</sup> If a client fails to make obligatory public disclosure when advised by his attorney that such disclosure is obligatory, then the attorney should disclose in his response to an auditor's request for information the contingent liability which the failure to disclose raises. While the proposed guidelines are not directly tied to the Code of Professional Responsibility or their underlying principles, they do represent one type of creative approach which could be utilized by the bar to guide conduct in the securities area.

These initial efforts by the organized bar demonstrate an ability to balance competing interests and responsibilities in a functional manner and should be continued in order to provide guidance in those cases where the expected levels of care remain muddled and undefined. While the formulation of a code of professional standards designed to cover all aspects of a securities practice is probably impractical as well as undesirable,<sup>83</sup> certain areas of that practice need attention and are ripe for the formulation of general guidelines. These

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problems are being fashioned by state bar associations in the form of guidelines to Disciplinary Rules. See, e.g., Carpenter, *The Negligent Attorney Embezzler: Delaware's Solution*, 61 A.B.A.J. 338 (1975).

<sup>81</sup>30 Bus. LAW. 513 (1975). See also Deer, *Lawyers' Responses to Auditors' Requests for Information*, 28 BUS.LAW. 947 (1973); McRae, *Representation Letters from a Company's Legal Counsel*, 136 J. OF ACCOUNTANCY, Nov. 1973, at 76.

<sup>82</sup>"Obligatory public disclosure" is defined to exist "where the matter is of such importance and seriousness, and there could be no reasonable doubt that its nondisclosure would give rise to material claims, but rejection by the client of the advice would in all probability require the lawyer's withdrawal from employment in accordance with the Code of Professional Responsibility." 30 BUS.LAW. 513, 526 (1975).

<sup>83</sup>There is nevertheless recent precedent which supports the establishment of standards specially designed to cover all aspects of a specific role of a lawyer. See ABA STANDARDS RELATING TO THE PROSECUTION FUNCTION IN CRIMINAL JUSTICE (1971).

areas, which are the ones most exposed to possible third party actions, are the issuing of opinion letters and the drafting of disclosure documents required by the federal securities laws. While Opinion No. 335 sets forth guidelines for rendering opinions relating to the sales of unregistered securities, no such guidelines exist as to opinions on such matters as municipal bonds, merger or acquisition situations involving securities and public offerings of securities.<sup>84</sup> Complex questions of policy and conflicting duties exist with respect to the standards to be followed in rendering these opinions, and affirmative guidance is particularly needed in the following areas:

1. *The Proper Scope and Uses of an Opinion* — While the extent of an opinion and any limitations on its use are clearly matters subject to variation through negotiation, a guideline should emphasize the need to define precisely and to set forth in the opinion the scope and the limitations agreed upon by the parties and should further deal with the tough policy question of whether circumstances may exist which would render stated limitations on use nugatory.

2. *The Need for Documentation* — While the requirement of specific checklists should probably be avoided and left to the development of individual firms or practitioners, a guideline should generally require the use of work sheets and other types of memoranda to substantiate the investigation required to render the particular opinion.

3. *The Need for Inquiry (or Independent Investigation)* — A guideline would not be able to cover specifically all situations which raise a duty of inquiry or of independent investigation, but should set forth, much as in Opinion No. 335, the general circumstances which require affirmative independent investigation. Many factors such as past relationships between counsel and client, past financial and business history, the nature of public reports and the nature of the transaction involved will be determinative of the extent of inquiry or

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<sup>84</sup>This discussion concerns only formal written opinions, and is not directed towards oral opinions or informal written advice. Among the various formal opinions covered are those required to be filed as exhibits to registration statements relating to the legality of the issue, material litigation, taxes, or title to property; those rendered to underwriters pursuant to an Underwriting Agreement; and those relating to tender offers. For some suggested guidelines in these and other areas unrelated to securities matters, see Freeman, *Opinion Letters and Professionalism*, 1973 DUKE L.J. 371, 434-39; ABA COMM. ON PROFESSIONAL ETHICS OPINIONS, No. 314, 51 A.B.A.J. 671 (1965) (tax opinions); Sellin, *Professional Responsibility of the Tax Practitioner*, 52 TAXES 584 (1974).

investigation, and thus, in that limited sense, a guideline will be unlikely to improve the "flexible duty" approach of *White v. Abrams*.<sup>85</sup>

4. *The Use of Assumptions* — Some circumstances will necessitate the use of assumptions; however, it is doubtful whether one can blindly assume key facts so that the opinion becomes a meaningless restatement of the issues to be answered. Moreover, the permissible use of assumptions will often be directly dependent upon the existence or non-existence of a duty of inquiry or independent investigation.

5. *The Reliance Upon Opinions of Other Firms and Certificates of Others* — Any guidelines which relate to reliance upon officers' certificates should be intimately tied to the factors determining the appropriate level of inquiry or independent investigation. Reliance upon local or special counsel is entirely proper under most circumstances and may even be required under some circumstances, but counsel should not always be able to insulate himself from liability by such reliance, particularly if the matter opined upon is in fact outside the competence of counsel being relied upon.

6. *The Use of Disclaimers and Qualifications* — A guideline can be fairly specific as to circumstances under which an opinion must be qualified or not rendered. Although normally set forth with the statement of opinion, disclaimers are more accurately a method of defining the scope of an opinion and should be so used. A lawyer, of course, may not limit his liability for malpractice under the present Canons.<sup>86</sup>

7. *The Effect of Subsequent Events and the Duty to Correct* — This problem may arise as a result of an opinion which is subsequently discovered to be erroneous, in which case there should be a duty to correct, or as a result of subsequent events which make the opinion erroneous, in which case there may be a duty to correct even if the opinion is accurate as of its date and disclaims any responsibility as to subsequent events.<sup>87</sup>

8. *The Degree of "Independence" Required* — Opinion No. 335 requires an opinion on the sale of unregistered securities to be an "independent" one, and it is likely that all opinions relating to securities

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<sup>85</sup>495 F.2d 724 (9th Cir. 1974).

<sup>86</sup>ABA CODE, Canon 6, EC 6-6, DR 6-102(A).

<sup>87</sup>*Cf.* SEC v. Manor Nursing Centers, Inc. 458 F.2d 1082, 1096-97 (2d Cir. 1972); *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967); AICPA, STATEMENT ON AUDITING STANDARDS No. 1, § 561 (1974).



matters should also be. Yet nowhere is the concept of "independence" explained. Guidance is needed, particularly with respect to the effect of stock ownership or corporate directorships on the "independence" of the opinion.<sup>88</sup>

9. *The Requirement of Professional Competence* — Canon 6 states that a lawyer should represent his client competently, which properly interpreted may require association of experienced securities counsel.<sup>89</sup> A common situation in which this problem may exist is the syndication of limited partnership interests in real estate, where a real estate lawyer may overlook or misunderstand the application of the federal securities laws.

10. *The Use of Quality Controls* — While a guideline most assuredly should not undertake to set specific quality controls for law firms, it should discuss generally the need for standardized procedures under which opinions are prepared and reviewed.<sup>90</sup>

11. *The Drafting of Sample Forms* — Since the form of opinion letters as to these matters varies widely from firm to firm,<sup>91</sup> sample forms of opinion letters should be drafted and appended to the guidelines to encourage uniformity and thereby increased certainty of meaning.<sup>92</sup>

In contrast to his posture in the opinion letter context, the securities lawyer as a draftsman or reviewer of the disclosure documents required by the federal securities laws presently has no guidelines at all to give him comfort in his desire to meet the expected level of care.<sup>93</sup> The securities lawyer is frequently called upon to draft or

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<sup>88</sup>*Cf.* SEC Securities Act Release No. 5094 (Oct. 24, 1970) (disclosure of counsel's interest in registrant).

<sup>89</sup>ABA CODE, Canon 6, EC 6-1, 6-4, DR 6-101(A).

<sup>90</sup>See text accompanying note 103 *infra*. *cf.* AICPA, STATEMENT ON AUDITING STANDARDS No. 4 (1974).

<sup>91</sup>The tendency of old line investment banking firms and law firms is to "set in concrete" their style and form of opinions, particularly public offering opinions, and to require others dealing with them to follow that form. Yet, surely the form is too important in establishing what responsibility the opiner has assumed simply to accede to the statement or proposition that "this form of opinion is what we always use." *Cf.* *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 696 (S.D.N.Y. 1968).

<sup>92</sup>This suggested technique was used in the Revised Exposure Draft setting forth appropriate responses for lawyers to give to auditors' requests for information. 30 BUS. LAW. 513, 533 (1975).

<sup>93</sup>The willful and knowing participation in the preparation or distribution of false or misleading disclosure documents is clearly prohibited. This discussion is concerned solely with the lawyer acting strictly as a lawyer who unwittingly participates in

review 1933 Act prospectuses, offering circulars for securities or transactions exempt from 1933 Act registration, 1934 Act reports, proxy statements, annual reports and press releases. As a pragmatic matter, the techniques used today in drafting and reviewing these documents vary materially from firm to firm and in some cases from partner to partner within a firm. The most uniformly applied techniques are unquestionably those used to prepare prospectuses for underwritten public offerings, where fairly standardized procedures of due diligence have been generally established and well publicized by the bar ever since the *BarChris* decision slammed home the need to check the written record and to document all investigatory and verification efforts.<sup>94</sup> No other disclosure document, however, begins to receive the attention that the prospectus of an underwritten public offering does. Since the responsibilities undertaken by the lawyers who draft and review these other disclosure documents are increasingly similar to those they have historically undertaken in the preparation of registration statements, affirmative guidelines should be formulated to insure that the care exercised in drafting and reviewing becomes more standardized and meets the expected level of care.

In formulating guidelines, the aim should not be to develop absolutes but should be to provide in general terms a functional statement of legal and professional responsibilities and the effects thereof as applied to the lawyer's work as a draftsman or reviewer.<sup>95</sup> Within that general framework, certain fundamental concepts of due diligence can and should be set forth, not as specific rules to be applied in every case but as guidelines whose application to individual facts and circumstances must be considered in every situation. To engage in such a task will require analytical and pragmatic consideration of the following major problem areas:

1. *The Scope of the Lawyer's Engagement and the Extent of his Attesting Function Thereunder* — While unquestionably a lawyer should be able to limit his obligation to act as an "independent audi-

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drafting or reviewing a false or deficient disclosure document. See generally Small, *The Lawyer's Responsibility as a Draftsman*, National Institute, *supra* note 4, at 81-89.

<sup>94</sup>Many institutes and seminars have focused on the requirements of Section 11 of the 1933 Act and on the due diligence techniques designed both to support the legal opinions given in public offerings and to aid others in meeting their due diligence defense provided by Section 11. See, e.g., *Techniques of Due Diligence*, P.L.I., Course HANDBOOK No. 112 (1973).

<sup>95</sup>In this connection, it would seem prudent to borrow on the experience of the accounting profession and to carefully consider the content and form of its generally accepted auditing standards and procedures.

tor" of the non-legal matters in disclosure documents,<sup>66</sup> that limitation should be adequately documented and communicated to his client and in some cases to the public. Where the assumed duties are so narrowly confined, he should not permit a contrary impression to be created in the minds of either his client or the public, and thus should be most careful about the manner in which his or his firm's name is used in the disclosure document. Where he has so limited his role to being simply a reviewer, as often is the case with respect to an annual report on Form 10-Q, he should be freer to assume the accuracy of the information given him than when he acts as a draftsman where he should generally have an attesting duty. Yet, even where his role is so limited that no duty of independent investigation is affirmatively assumed, he should not be able to ignore matters which he knows or suspects to be erroneous or misleading and should make further inquiry and investigation as to those matters.<sup>67</sup> At all times, irrespective of the limited scope of his engagement, he should maintain a high degree of skepticism; but, under no circumstances should he be viewed as the guarantor of the accuracy or completeness of the document, nor as one who relieves others of their responsibilities and liabilities with respect thereto.

2. *The Nature of a Required Legal Audit* — Some degree of legal audit should be required whenever the lawyer acts as primary draftsman of a disclosure document and may be required under certain circumstances when he acts only as a reviewer. "Legal audit" is used to describe the process of verifying or testing information provided by the client or others and of independently investigating material factual matters.<sup>68</sup> The extent of any legal audit should be determined by the facts and circumstances of the situation faced by the lawyer and should be viewed as a matter of professional judgment. Nevertheless,

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<sup>66</sup>As to the legal matters contained in most disclosure documents, it is doubtful that a lawyer could or should be able to limit his responsibilities. Similarly, the lawyer-director may not be able to limit his verification or investigatory duties even with respect to non-legal factual matters. *Cf. Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

<sup>67</sup>Judgment decisions will of course continue to pervade the actual investigation. For examples of how courts can differ on the adequacy of such an investigation, compare *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973) with *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971).

<sup>68</sup>The concept of a "legal audit" is not new and has been urged as a prophylactic procedure which should be done annually to determine the legal health of a business, including whether further legal work needs to be done and whether the legal risks of the business are being adequately determined and valued. *See Brown, Legal Audit*, 38 S.CAL.L.REV. 431 (1965).

audit standards and procedures, including the enumeration of key factors to be considered in determining the type and degree of investigation or verification,<sup>99</sup> should be developed.<sup>100</sup> Sample check lists for the various disclosure documents should also be developed to be used not as the ultimate mechanical check but only as a skeletal format within which any investigation or verification efforts may be structured.

3. *Questions of Materiality* — The lawyer as a draftsman or a reviewer must continually decide what matters are or are not material and ripe for disclosure, and those decisions should be viewed as matters of professional judgment. Yet any set of standards and guidelines developed by the bar should not ignore this critical problem area, but rather should discuss in detail the relevant policies and the framework within which these considered and independent judgments should be made.<sup>101</sup>

4. *Duty to Correct* — Where a disclosure document reviewed or drafted by a lawyer contains a misleading or false material statement which is later discovered to be so, the lawyer should take immediate corrective steps. Similar corrective responsibilities may arise where subsequent events occur which render statements in the disclosure document false or misleading, and those circumstances which create a duty to correct should be thoroughly discussed.

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<sup>99</sup>Examples of some factors which might be included are the experience and history of the client and of the attorney-client relationship, the type of industry or business in which the client is engaged, the financial condition and prospects of the client, the nature of the transaction and the degree of materiality of the matter under investigation or suspicion. Professional judgment should clearly be determinative of the application and balancing of any such factors, but it is equally clear that such judgment should be applied in an independent and objective fashion.

<sup>100</sup>Such standards and procedures should cover the need for proper supervision and review of the investigatory procedures and the results thereof. The importance of compiling adequate documentation to afford reasonable support for the actions taken should also be stressed. The files should leave no doubt as to why and what investigatory or verifying steps were taken, the reasons for omitting or departing from any standards or procedures set forth by the bar, and what facts and factors were considered in reaching the professional judgment decisions involved in the matter. Cf. SEC v. National Student Marketing Corp., [1973-74 Transfer Binder] CCH FED.SEC.L.REP. ¶ 94,610 (D.D.C. 1974) (law firm required to show its files where it is a named defendant).

<sup>101</sup>As difficult as it may seem to establish materiality criteria, there is recent precedent which indicates the type of useful discussion which could be included in a set of standards or guidelines. See Financial Accounting Standards Board, *Criteria for Determining Materiality (Discussion Memorandum 1975)*, noted in BNA SEC.REG. & L.REP. 297: D-1 (Apr. 9, 1975).

5. *The Concept of "Independence"* — The concept of independence is well developed for the accounting profession, but as applied to the legal profession has generally been ignored or vehemently rejected as being in direct conflict with the lawyer's duty of loyalty to his client. Increasingly, however, the lawyer dealing with securities matters which directly affect the public is expected to render objective judgments, such as the "considered, independent opinion" called for by Formal Opinion No. 335. Serious questions may be raised as to the "independence" of counsel's judgment where he has a material stock ownership or serves as a director at the request of a management.

By setting forth reasonable and objective standards for these and other problem areas, the bar will exhibit the type of responsible professional self-regulation which will establish levels of care that demand respect from the Commission and the judiciary. Indeed, Commissioner Sommer has stated that "the Commission is not going to sue lawyers because they make honest mistakes of judgment in good faith,"<sup>102</sup> and compliance with such standards presumably would establish the requisite good faith. The courts should also react positively to such standards, certainly with respect to malpractice actions which look solely to professional standards to determine culpability and most likely with respect to actions based upon the federal securities laws under a "flexible duty" or any other test of culpability. To be effective, however, the standards must not be self-serving, but must balance objectively the relevant conflicting responsibilities and ideally should reflect the input of the Commission and other interested parties. To gather that input, the technique of issuing exposure drafts, as was done with respect to the formulation of lawyers' responses to auditors' requests, should be extensively used. Such responsible self-regulation will hopefully relieve the tensions which exist today due to the inability of anyone, including the Commission and the courts, to say with certainty what is and should be the appropriate level of expectations in this area.<sup>103</sup>

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<sup>102</sup>Sommer, *The Commission and the Bar: Forty Good Years*, 30 BUS.LAW. 5, 8 (1974). See also Remarks of Commissioner Pollack, SIXTH ANNUAL INSTITUTE ON SECURITIES REGULATION (P.L.I. Nov. 7-9, 1974).

<sup>103</sup>Equally important as the development of functional standards is the development of effective enforcement techniques. Our profession has historically failed in enforcing its professional standards and in instilling in its members the importance of standards in their work. See ABA, PROBLEMS AND RECOMMENDATIONS IN DISCIPLINARY ENFORCEMENT (1970); ABA, STANDARDS RELATING TO THE PROSECUTION FUNCTION AND THE DEFENSE FUNCTION 10 (T.D. 1970). If the traditional means of sanctions through bar committees and the courts cannot put the needed force behind the standards, other

## B. The Individual Bar and the Formulation of Guidelines

Irrespective of whether the organized bar formulates general guidelines and standards in this area, individual members of the bar and their firms should develop and maintain policies and procedures which will insure that their work reaches the level of professional care required to meet their responsibilities under the federal securities laws. Thus, members of the individual bar should give serious attention to the development and maintenance of internal quality controls, a concept used for years by the accounting profession to assure high standards but one generally ignored by the legal profession.<sup>104</sup>

Law firms are highly individualistic and specific quality controls should be tailored to the peculiar characteristics of a firm. However, as a general proposition, most quality control procedures should be aimed in at least three different directions. First, a control system should have an internal focus to assure the maintenance of a high level of professional competence in each lawyer. This system would be primarily concerned with the selection process of new associates, the training and supervision of associates and junior partners and the continuing legal education of each lawyer through his attendance at institutes and seminars, his outside professional reading and his participation in internal programs and communications which highlight professional ethics and standards as well as new developments of substantive law.

Equally important is the formulation of quality controls aimed externally in the sense that they are designed to make certain that the work actually produced for clients by the firm is of the highest professional quality. Two of the most critical components of such controls are the use of standard forms for opinion letters from which deviation is permitted only upon the approval of certain partners, and the effective use of internal review procedures which challenge and verify the procedures used in reaching legal opinions or approving disclosure documents. The verification process should include an in-

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drastic measures such as the use of peer review programs and panels of independent experts should be instituted to insure that professional practice is being conducted in compliance with professional standards. Otherwise, we leave to the courts and the Commission our own housekeeping chores. For the difficulties surrounding the concept of voluntary peer review, see Andrews, "Peer Review Plan for Accounting Firms Loses Only Volunteer in Disclosure Row", *Wall St.J.*, March 24, 1975, at 18, col. 2.

<sup>104</sup>See, e.g., *Quality Control Considerations for a Firm of Independent Auditors*, AICPA STATEMENTS ON AUDITING STANDARDS No. 4, (1974); ALEXANDER GRANT & COMPANY, *QUALITY CONTROL* (1974). For the only detailed analysis of the subject with respect to the legal profession, see F. Wozencraft, *Self-Policing by Law Firms*, SIXTH ANNUAL INSTITUTES ON SECURITIES REGULATION (P.L.I. Nov. 7-9, 1974).

dependent review by a partner not directly (or indirectly through stock ownership) connected with the client or particular deal.

The last and perhaps most important type of quality control concerns the institution of policies and procedures designed to assure that the firm is representing, and will continue to represent, "quality" clients whose integrity can be relied upon. Such procedures should include internal reviews of all material new business by senior lawyers and the periodic review of old business to discover and react to any circumstances which have resulted in an erosion of a lawyer's confidence in a particular client's integrity.

Obviously the investment of time and money required to implement and maintain a well-designed system of quality controls is substantial and even creates certain risks of liability in the event of a failure to apply such controls to a situation which by hindsight involved a violation of the federal securities laws. Yet such an investment should provide compensating benefits in improving and maintaining the quality of professional service by providing a means to substantiate the existence of due care in any administrative or judicial proceeding which the Commission or any private litigant might seek to institute.<sup>105</sup>

#### IV. CONCLUSION

The circumstances under which a securities lawyer practices today are in a state of tumultuous change and uncertainty. While no court has held that an attorney is liable to the investing public for negligent acts performed solely as an attorney, storm clouds generated primarily by isolated dicta and Commission commentary and proceedings surround the issue, and realistically the securities lawyer must view such potential liability with seriousness and take all possible steps to assure that his conduct meets the requisite standard of care. Since that standard of care has not been given shape or definition by formal guidelines, his conduct is presently guided wholly by his best understanding of the informal and often conflicting peer standards of the securities bar; and if his conduct is challenged in

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<sup>105</sup>The instigation of quality controls by the law firm in the *Jo Ferguson* matter apparently was the most significant factor in the Commission's determination to settle the matter, with Ferguson receiving only a censure. See text accompanying note 59 *supra*. It should also be noted that in the *National Student Marketing* complaint the Commission seeks to impose responsibility upon all the partners of a law firm for the alleged misconduct of one partner; surely it would be helpful in defending against such an attack if the firm could point to firm quality controls designed to minimize such misconduct.

court, he must rely upon the expert testimony of his peers to prove to the court that his conduct under the facts and circumstances of the particular case was that which society did expect, and should have expected, from him.

The predominant theme of this article is that the legal profession should act to provide guidance as to the appropriate level of expectations through the formulation of standards by which its members are to be judged, much as the accounting profession has historically done. By setting functional and balanced standards, the profession would provide a healthy framework within which the securities lawyer could practice with confidence and in which the Commission and the judiciary, as well as the public, could place their confidences and thereby their respect. To reach this goal, however, requires the bar to recognize explicitly that lawyers, and particularly securities lawyers, do have certain responsibilities to the public which from time to time will conflict with the desires or interests of their clients. The balancing of these complex interests in a responsible and objective fashion can only be achieved through vigorous debate over exposure drafts or proposed standards by members of the bar, the Commission and other interested parties, but it is the bar which should bear the ultimate responsibility of giving shape and definition to the obligations of its members. The costs of this undertaking will be extensive, but the benefits will also be extensive not only for the individual practitioner but also for the investing public. The profession should remember that it is not self-contained; but is only an instrument of society to whose needs and interests it must be responsive.



