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David v. Goliath Revisited: Will 10b-5 Become the Security and Exchange Commission's Sling Shot against Securities Lawyers?

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DAVID v. GOLIATH REVISITED: WILL 10b-5 BECOME THE SECURITY AND EXCHANGE COMMISSION'S SLING SHOT AGAINST SECURITIES LAWYERS?

Historically, securities lawyers have been free to practice as counsellors without fear of liability for fraud. As long as they performed as counsellors, not active participants, their duty was only to their client and their ethics. Other parties to a securities transaction have not been permitted this veil of protection.[1] If there is indeed something inviolable about a lawyer's role in society, it will stand only if it can be defined and narrowly circumscribed. Society's interest in full disclosure to avoid securities fraud cuts cleanly through the haze of generalities.[2]

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1. (a) Officers of the corporation: Reynolds v. Texas Gulf Sulphur Co., 309 F. Supp. 548 (D. Utah 1970) (executive vice-president), Sprayregen v. Livingston Oil Co., 295 F. Supp. 1376 (S.D.N.Y. 1968) (president); (b) directors of the corporation: Sprayregen v. Livingston Oil Co., 295 F. Supp. 1376 (S.D.N.Y. 1968); (c) the corporation itself: Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960); (d) any insider with knowledge: SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); (e) controlling shareholder: Gottlieb v. Sandia Am. Corp., 304 F. Supp. 930 (E.D. Pa. 1969); (f) tippers: SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (defendant Darke); (g) tippees: Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967); (h) broker-dealers: Stockwell v. Reynolds & Co., 252 F. Supp. 215 (S.D.N.Y. 1965); SEC v. Broadwall Sec. Inc., 240 F. Supp. 962 (S.D.N.Y. 1965); (i) underwriters: Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); (j) accountants: Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967) (*uninvolved*), H.L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960) (*involved*); (k) stock exchange: Pettit v. Am. Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963). Lawyers involved in the fraudulent practice, however, have had no immunity: SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972); Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969).

2. There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

> This proposal adds to the rule of *caveat emptor*, the further doctrine "let the seller also beware" . . . . It should give impetus to honest dealing in securities and thereby bring back public confidence.

Franklin Delano Roosevelt's Presidential message to the Senate, March 29, 1933, introducing the Securities Act of 1933, 48 Stat. 74 (1933), *as amended*, 15 U.S.C. § 77 (1970), in 2 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 93 (Rosenman ed. 1938). The principle of full disclosure to eliminate fraud and renew public confidence was also a cornerstone in the Securities Exchange Act of 1934, 48 Stat. 881 (1934), *as amended*, 15 U.S.C. § 78 (1970), which applied to securities other than primary issues.

This Comment is an attempt to highlight two issues behind the SEC's attack on lawyer-defendants in *SEC v. National Student Marketing Corp.*[3] First, the SEC has determined that in a securities context knowledge of a client's past misdeeds, without disclosure, is an unlawful offense. An attempt will be made to trace the financial decision in securities cases that brought the SEC to this conclusion. Second, an attempt will be made to analyze the substantive issue behind the SEC's complaint. If, in fact, lawyers have knowledge of a client's past fraudulent activity, society must balance the value of the existing confidential relationship with the need for *full disclosure.*

1968 was the year of awakening for the parties to a securities transactions. *Escott v. BarChris Construction Corp.*[4] defined the liability that arose from the relationship of the different parties to a securities transaction.[5] The court in a lengthy opinion dissected the relationship between the issuing corporation,[6] its officers,[7] its directors,[8] its auditing firm,[9]

3. Civ. No. 72-225 (D.D.C., filed Feb. 3, 1972) [hereinafter *NSMC*]. *Contra,* Note, *A New Ethic of Disclosure—National Student Marketing and the Attorney-Client Privilege,* 48 NOTRE DAME LAW. 661 (1973). The author takes the position that the crime/fraud exception to the lawyer-client privilege may apply. This exception denies the privilege where the fraud or crime has not yet been performed, based on the proposition that the 10b-5 fraud of the client was committed in the issuance of fraudulent statements enclosed in proxies, not in the actual merger closing. For a collection of cases to which the Notre Dame writer refers, *see* Annot. 125 A.L.R. 508 (1940).

4. 283 F. Supp. 643 (S.D.N.Y. 1968).

5. Prior decisions had either grounded liability on the individual activities of the respective parties or had described a concerted activity either in the form of "actors in concert" or an actual conspiracy, as opposed to grounding liability directly upon the relationship and duties of the parties plaintiff and parties defendant.

6. As a primary beneficiary of the debentures sold under the fraudulent registration statement, BarChris was primarily liable to its investors and did not have the benefit of the defense of section 11(b), 15 U.S.C. § 77k (1970). However, BarChris had filed a petition for an arrangement under Chapter XI of the Bankruptcy Act on October 29, 1962, and was of little value to the plaintiffs. 283 F. Supp. at 654.

7. Six officers were named as defendants: (1) Vitolo, president; (2) Russo, executive vice-president; (3) Pugiliese, vice-president; (4) Kircher, treasurer; (5) Birnbaum, secretary; and (6) Trilling, controller. These officers were all signers of the registration statement and were related to the other parties to the transaction in one of four ways: (1) They gave false information that was relied upon; (2) they had a duty to investigate matters not within their particular knowledge; (3) they had not kept corporate records up to date; or (4) they had failed to disclose essential information.

8. The directors' relationship to the plaintiffs was the same insofar as the officers of the corporation were directors. The court added, however, that directors who were not officers had a duty to the plaintiffs to investigate and verify information to which they were attesting by their signing of the registration statement. 283 F. Supp. at 688.

9. The role of an auditing firm in any business transaction is to prepare the

its underwriters,[10] and their counsel.[11] It then proclaimed liability for overt acts as well as negligence in the context of the section 11 violation.[12]

In the context of preparation of a registration statement, the lawyer's role came under close scrutiny. A careful examination of this opinion reveals more than its holding or liability for lawyers who become directors of the corporations they advise. If their duty to the purchasers of these securities arises only from their role as directors, then the case is of little importance to securities lawyers; but if the dicta of *BarChris* is upheld in later decisions, all securities lawyers must alert themselves to the court's warnings.

The case involved a complex factual setting.[13] The registration statement was replete with inaccuracies not protected by the "expertised"[14]

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financial statements of its clients. If the audit is certified, the auditor is advising any person who relies on those statements that they and the books which are subsidiary to the statements have been *examined* and are *consistent* with *generally accepted accounting practices* to reflect the financial position of the corporation. This certification creates the relationship between the accountants and both the client and third parties as to the "expertised" portion of the registration statement.

10. The underwriters have a relationship with the buyers of the securities in addition to their obvious relationship with the corporation (selling its securities). They are in an intermediate role in that they are responsible for the validity of the information included in both the registration statement and the prospectus which covers the securities.

11. The counsel of the underwriters have a duty to their clients to perform the investigation delegated to them. In addition to this they have an implied relationship with the buyers of the securities arising from the delegation of duties to them by their clients.

12. 15 U.S.C. § 77k (1970).

13. The BarChris Corporation (hereinafter BarChris) was primarily a construction firm engaged in the building of bowling alleys during the bowling boom of 1946 to 1960. Expansion was begun by a public offering of stock in December, 1959. Basically BarChris built bowling alleys to the specifications of its clients. Construction loans were obtained to finance the buildings and the completed structures were sold under a contract that was immediately discounted with a factor on the basis of a reserve and with a percentage of recourse in default. Rapid expansion taxed the working capital of BarChris and a $3,000,000 debenture issue was planned for 1961. It was during the time between the planning of the debenture issue and its sale that overbuilding in the industry began to have its effect. Substantial delinquencies on the part of BarChris' customers put BarChris in the position of being called upon by its factors to take back many of their contracts. There was at least a strong possibility that within the year BarChris would be, to a substantial degree, in the business of operating bowling alleys. None of this information was disclosed through the registration statement or prospectus to the SEC or subsequent buyers of the debentures.

14. 15 U.S.C. § 77k(b) (1970):

> No person, other than the issuer, shall be liable . . . who shall sustain the burden of proof—
>
> > (3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert . . . he had, after

defense, and with non-disclosures.[15]

One major section of the opinion deals with the underwriter (Drexel & Co.) and its counsel (Birnbaum).[16] A lawyer (Coleman) who was a partner in the underwriter subsequently became a director of BarChris. Prior to his directorship he conducted a legal investigation of BarChris for Drexel & Co. Later, because of his close relationship with BarChris, these duties were assigned to a junior assistant (Ballard) in the legal firm which represented Drexel & Co. That assistant failed to verify contracts which supported figures in the prospectus. Ballard also failed to require the production of missing minutes of executive committee meetings which would have disclosed information about loans from officers, delinquencies on notes of customers to the factors upon which BarChris had a contingent liability, and the prospects of a major commitment to the operation of bowling alleys. He also relied heavily upon statements of the officers of BarChris in his findings.

Although Coleman's liability under the statute was grounded on his position as a director, and Drexel & Co.'s on its position as an underwriter, it was the failure of counsel to properly investigate the information behind the registration statement and reliance thereon that created the liability.[17] In this case, although the court did not take the additional step

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> reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statement therein not misleading . . . .

15. The major inaccuracies and non-disclosures found by the court were: (1) the contingent liability of the corporation of construction contracts discounted with its factors; (2) statements regarding a backlog of construction orders not supportable by valid contracts; (3) statements regarding loans from officers being paid, but actually paid by uncashed corporate checks; (4) statements regarding small requirements of repurchase of customer notes from the factors where they were discounted, unqualified by reference to large customer delinquencies on these notes; and (5) the inaccuracies of general statements of the corporation's business as that of "engaged in the design, manufacture, construction, installation, modernization, and repair of bowling alleys" which in fact ignored the potential position of the corporation as the operator of a substantial number of bowling alleys.

16. 283 F. Supp. at 692-97.

17. The court criticized his: (1) failure to inquire into general information in the annual report; (2) failure to inquire into bank account transactions; (3) failure to inquire into contractual relations with factors; (4) reliance on oral statements of officers and directors; (5) permitting junior employees to review minutes of corporate meetings; and (6) failure to require minutes of executive meetings to be written up for examination. The court then posed the question, "is it sufficient to ask questions, to obtain answers which if true would be thought satisfactory, and let it go at that, without seeking to ascertain from the records whether the answers in fact are true and complete?" 283 F. Supp. at 696. The court then concluded that "[t]he purpose of Section 11 is to protect investors. To that end the under-

of attaching liability to the lawyers who were negligent, due to the rigidities of section 11, the inference of risk remains.

Additionally there is substantial dicta in *BarChris* evidencing the court's special attitude toward lawyers.[18] The court implied that because of a lawyer's special training he would be held to a higher standard of care than a layman. There is some indication that the SEC is adopting this approach.

This decision and its dicta raise further questions. If a lawyer has a duty of investigation to the purchaser of a security, in addition to his duty to his client, based on the general intent of section 11 to protect purchasers by full disclosure, what is the status of the information so acquired? To whom must he disclose it—the prospective purchasers, others involved in the transaction, or the public (via the SEC)? Section 11 is too narrow to fully answer these questions because the restrictions of 10b-5[19] may also apply.

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writers are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investor no additional protection." 283 F. Supp. at 697. The court finally adds that these lapses by Ballard caused the liability of Drexel and the other underwriters by reliance thereon and applied the same criticism to Coleman himself for such reliance. "[T]he underwriters' counsel did not make a reasonable investigation of the truth of those portions of the prospectus which were not made on the authority of Peat, Marwick as an expert. Drexel is bound by their failure . . . . When it came to verification, he [Coleman] relied upon his counsel to do it for him. Since counsel failed to do it, Coleman is bound by that failure." 283 F. Supp. at 697.

18. The court in discussing the liability of the lawyers, one an officer and the other a director, found them liable as "signers of the registration statement. However, when the court discussed their defense of "due diligence," it found higher standards appropriate to lawyers. Criticizing the corporate secretary for reliance upon reassurances of other officers, the court said, "[a]s a lawyer, he should have known his obligation under the statute. He should have known that he was required to make a reasonable investigation of the document which he signed." 283 F. Supp. at 697. Later in the opinion, the court criticized another director who was also a lawyer. It first found that he honestly believed the information in the registration statement was true but denied him the defense for not independently verifying it. The court concluded that "this finding on the evidence in this case does not establish an unreasonably high standard in other cases for company counsel who are also directors." 283 F. Supp. at 692.

19. 17 C.F.R. § 240.10b-5 (1973):

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national secruties exchange,
>
> (a) To employ any device, scheme or artiface to defraud,
>
> (b) To make any untrue statement of any material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

In a second case,[20] which grew out of the debacle of *BarChris*, the court went substantially further than the *BarChris* court to define the duties attendant upon securities lawyers. The court contrasted their roles in 10b-5 and section 11 contexts. To more fully understand the court's distinction, it is once again necessary to delve into the factual setting and the roles of the parties.

The plaintiffs in this action were the owners of Victor Billiard Company, a corporation that sold and manufactured billiard equipment to BarChris and its customers. Victor was also overextended and pressed for working capital. In the spring of 1961, discussions were begun between representatives of both corporations regarding the possibility of merger. The major attraction to Victor's owners was the representation that BarChris could provide them with some cash for working capital and help them arrange financing through BarChris' factors. Additional incentive was found in representations that BarChris stock would be an excellent investment.[21] Further negotiations continued throughout the fall and the court characterized the actions of BarChris' negotiations as comprised of "affirmatively misleading statements and . . . failures to supply material omissions."[22] On December 14, 1961, the closing took place and the stockholders of Victor received 20,428 unregistered shares of BarChris for their Victor shares.[23] During the period of negotiations BarChris' business conditions continued to deteriorate.[24] In 1962, an abortive attempt at a further stock issue collapsed and the corporation ended

(c) to engage in any act or practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

20. Lanza v. Drexel & Co., Civ. No. 64-3557, [1970-1971 Transfer Binder], CCH FED. SEC. L. REP. ¶ 92,826 (S.D.N.Y. 1970) [hereinafter SEC. L. REP.].

21. Kircher (the treasurer of BarChris), Trilling (the controller) and Birnbaum (the secretary) carried on most of the negotiations. On July 28, 1961, a copy of the BarChris May 15, 1961, prospectus was given to Schulman (Victor's accountant and advisor) with all the mis-information decried in *BarChris.* 283 F. Supp. at 653-54. In addition Kircher told Shulman the results for the first six months of 1961 and predicted 1961 earnings as $1 per share. At a subsequent meeting these figures were further discussed and on August 17, 1961, Trilling sent Shulman the six month financial statements to June 30, 1961, and the annual report of 1960. *Id.* at 90,094-95.

22. *Id.* at 90,103.

23. *Id.* at 90,096.

24. Additional lanes required repossession due to default by their owners, the factors had refused to take any new obligations of BarChris' customers, BarChris' officers were again forced to advance money to the corporation, and the bank accounts were substantially overdrawn. Sharp division between officers and directors over poor management and false press releases had caused the resignation of Drexel & Co.'s (underwriter) partner Coleman from the Board.

up in a Chapter XI bankruptcy. The old Victor stockholders negotiated with the receiver in bankruptcy for the return of their Victor shares on the basis of a rescission due to fraud, and arrived at a settlement in which the receiver was given $100,000 and the prior owners were returned their Victor shares.[25]

On the basis of the fraud used to induce the merger, the plaintiffs filed a suit primarily grounded in a 10b-5 right to recovery of their $100,000 and other damages. In this suit they named as defendants BarChris' president, treasurer, controller, secretary, Coleman (director),[26] Ballard (Coleman's counsel),[27] and Drexel & Co.[28] It is at this point with respect to Coleman, Ballard, and Drexel & Co. that *Escott v. BarChris* and *Lanza v. Drexel* meet, if only tangentially.

Escott v. BarChris held Coleman and Drexel liable under section 11 on two bases: (1) that Coleman had signed the registration statement as a director and Drexel was the lead underwriter; and (2) that neither had fulfilled their duty of investigation into the facts behind the registration statement through their counsel Ballard. *Lanza v. Drexel* releases all three from liability under 10b-5 and the court's reasoning, as well as dicta, is significant to later events.

The plaintiff's case against the defendants is based on a theory that Coleman was under a duty to investigate the information his corporation was or was not giving in the merger negotiations. He had a further duty to advise the plaintiffs or see that they were advised of this information. Judge Frankel analyzed this claim as follows:

> Whatever requirement of due diligence there is under Rule 10b-5, it was satisfied by Coleman's personal *inquiries to the responsible parties* within the corporation. While, as found in *Escott*, Coleman's inquiry was not satisfactory for the due diligence requirement of § 11(a) of the Securities Act of 1933, that high standard—designed as it was to put a heavy burden of accurate disclosure on those seeking to register a new public issue—is not incorporated in Rule 10b-5, which applies to *all* corporate documents and releases, not just to registration statements or prospectuses.[29]

25. SEC. L. REP. ¶ 92,826 at 90,100.

26. Coleman was a partner in Drexel & Co., the firm that had been the lead underwriter in BarChris' debenture issue which became the subject of *Escott v. BarChris*. Coleman had also been a director in BarChris during part of the time negotiation with Victor and rejoined BarChris as a director after the merger to help bail out BarChris.

27. Ballard was a lawyer in the firm representing Drexel & Co. and had participated as counsel to Coleman.

28. Drexel & Co. had been the lead underwriter on BarChris' prior debenture issue.

29. SEC. L. REP. ¶ 92,826 at 90,105 (emphasis added).

Judge Frankel, however, by way of dicta, went further and slightly reopened the door he had just closed:

> This is not to say without qualification that an outside director like Coleman could never have a duty to warn or inform a third party about to be injured by misleading statements or omissions. It is only to say that the facts of the present case, on the law as it now stands, appear to justify no such unusual (and risky) responsibility.[30]

Because neither *Lanza* nor *BarChris* deal directly with the responsibility of the securities lawyer when he finds himself in a compromising situation with his client, the SEC must feel that there is still ambiguity with reference to this duty under Rule 10b-5.

The SEC now takes the position that when the public buys shares in a corporation, either for cash or for other shares through a merger, they are entitled to a full disclosure by all parties having knowledge of the transaction. From *BarChris* the SEC takes the special judicial view of lawyers, adds its duty of investigation, and implies that shares exchanged in a merger require full new issue scrutiny. From *Lanza* the SEC ignores "10b-5 due diligence" described by Judge Frankel, but uses the judge's dicta description of a duty to "warn or inform." These ingredients combine to bring the SEC to the point of *SEC v. National Student Marketing Corp.*[31] The SEC position is that lawyers, being *BarChris* special people, have a *BarChris* duty to investigate and a *Lanza* duty to inform. To enforce this position, the SEC uses Rule 10b-5 to charge a lawyer, who has knowledge of past client fraud, with a duty of such disclosure.[32]

In 1972, the SEC filed the *National Student Marketing* case in the district court of Washington, D.C.,[33] which should begin to unpack the remaining ambiguities of 10b-5 with reference to securities lawyers. As a

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30. *Id.* at 90,104-05.

31. Civ. No. 72-225 (D.D.C., filed Feb. 3, 1972).

32. It is interesting to note that the relief sought and language used by the SEC in *National Student Marketing* seems to be derived from a recent securities fraud decision. SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972). The language and relief while reasonable in the context of active lawyer participation in a fraudulent scheme, seems strained when applied to lawyers with mere knowledge of a client's fraudulent activities. One wonders if the SEC is straining to fit the alleged wrongs of *National Student Marketing* into the entirely different circumstances of *Manor Nursing Centers*; if the SEC is describing with tongue-in-cheek the activities of *NSMC* lawyers (because of lack of proof); or finally if the SEC is, in fact, of the opinion that mere knowledge of fraudulent activities is tantamount to active participation in the fraud as their tortured reasoning would appear.

33. SEC v. National Student Marketing Corp., Civ. No. 72-225 (D.D.C., filed Feb. 3, 1972). All lawyer-defendant motions for summary judgment or dismissal were denied March 21, 1973. Pretrial conferences and discovery were in progress in February 1974.

general description of unlawful acts, Rule 10b-5 is broad enough to encompass anything. "It shall be unlawful for any person, directly or indirectly . . . to omit to state a material fact necessary in order to make the statements made . . . not misleading"[34] or "[i]t shall be unlawful for any person, directly or indirectly . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. . . ."[35] Due to prior broad court interpretations of these provisions concerning what parties to a securities transaction fall within its ambit,[36] what type of statements[37] or lack of statements[38] are misleading, and what constitutes fraud[39] or deceit,[40] the securities lawyer has been awakened to a re-examination of his role.

In *SEC v. National Student Marketing Corp.*[41] two sets of lawyers are involved. The case arose from a merger between National Student Marketing Corporation (hereinafter NSMC) and Interstate Insurance Corporation (hereinafter INC). The firm of Lord Bissell & Brook repre-

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34. 17 C.F.R. § 240.10b-5 (1973).

35. 17 C.F.R. § 240.10b-5 (1973).

36. *See generally* cases cited note 1, *supra.*

37. Most common misrepresentations concern the financial condition of the corporation whose securities are involved; Dauphin Corp. v. Redwall Corp., 201 F. Supp. 466 (D. Del. 1962) (valuation property); Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1961) (income projection); H.L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960) (poor financials from accountants). Other types of misrepresentations, however, have been included: SEC v. North Am. Research & Dev. Corp., 424 F.2d 63 (2d Cir. 1970) (false progress report); Ruszkowski v. Hugh Johnson & Co., 302 F. Supp. 1371 (W.D.N.Y. 1969) (assurance that company would get favorable bank loan).

38. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (inside information undisclosed); SEC v. Broadwall Sec., Inc., 240 F. Supp. 962 (S.D.N.Y. 1965) (financial condition); SEC v. Rapp, 304 F.2d 786 (2d Cir. 1962) (losses); Speed v. Transamerican Corp., 99 F. Supp. 808 (D. Del. 1951) (undisclosed appreciation of inventory); *In re* Ward La France Truck Corp., 13 S.E.C. 373 (1943) (nondisclosure of increased earnings and intent to liquidate).

39. The courts have widely defined fraud.

> [W]e believe that section 10(b) Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employer involve a gardentype variety of fraud, or present a unique form of deception.

A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967) (emphasis added). *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (lack of diligence); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951) (negligent misrepresentation or omission).

40. Deceit is usually based on intent to defraud as opposed to negligent or innocent misrepresentations. This is contrasted by the United States Supreme Court in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

41. Civ. No. 72-225 (D.D.C., filed Feb. 3, 1972).

sented INC which was to be merged into NSMC, represented by the firm of White and Case.

The portion of the complaint directed at the securities lawyer arises from information[42] gained at the closing. The court is being asked to define the lawyer's duty with regard to information about client's business transactions and financial statements.[43] This information must be analyzed using the interpretations made by the courts under 10b-5. The courts have defined what information would be required to make other statements "not misleading." Once this information has been subjectively determined critical, a duty arises.

The SEC contends that under 10b-5 "any" party to a security transaction has a primary duty to the investing public. This duty leaves the security lawyer obligated to the following actions: (1) prevent the closing from taking place;[44] *or* (2) absent this, withdraw from the case;[45]

42. The two sets of lawyers at a meeting on October 31, 1969, received information from Peat, Marwick, Mitchell & Co. regarding the financial statements of NSMC which stated, "[o]ur examination in connection with the year ended August 31, 1969 . . . disclosed . . . significant adjustments which in our opinion should be reflected retroactive to May 31, 1969." SEC Complaint at para. 48(a), SEC v. National Student Marketing Corp., Civ. No. 72-225 (D.D.C., filed Feb. 3, 1972).

White and Case were additionally informed by Peat, Marwick that Peat, Marwick wanted to add an additional pargraph to the comfort letter

> which would state that if the necessary adjustments had been made to NSMC's unaudited consolidated statement of earnings for the period ended May 31, 1969, then NSMC would have shown a net loss for that period and that the consolidated operations of the company as it existed at May 31, 1969, would show a break-even as to net earnings for the year ended August 31, 1969, instead of the $.77 per share recorded in the annual report.

SEC Complaint at par. 48(b).

43. The major transactions involved grew out of two areas of NSMC's business. First, sales had been recorded on the records of NSMC that were not backed by valid contracts, and write-offs of receivables were applied retroactively to prior years. SEC Complaint at paras. 31-33. The results of this practice led to the comfort letter. Second, sales of subsidiaries were included in the financials even though: (1) the sales had little hope of being paid for except with NSMC's own stock which was insufficient to cover the price; (2) NSMC guaranteed to the purchasers indemnification for any losses generated by these subsidiaries. SEC Complaint at para. 39 (Compujob, Inc., Collegiate Advertising, Ltd., and Strider Oceanic Corp.).

44. The SEC complaint charges the legal firms with participation in a "fradulent scheme" by their failure

> to refuse to issue their opinions referred to in subparagraphs (d) and (e) [opinion that all steps taken to consummate the merger had been validly taken and that NSMC & INC had incurred no violation of any federal or state statute or regulation] above and failed to insist that the financial statements be revised and shareholders resolicited. . . .

SEC Complaint at para. 48(i).

45. *Id.*

and (3) notify the commission of the information so acquired.[46] The complaint in this case places this duty upon the individual lawyer and his firm as well.

The factual setting of this case dramatizes the demands of the SEC and puts them in perspective for other concrete situations. One party to the merger is a rapidly expanding, heretofore successful conglomerate.[47] The other party was a more closely held small insurance company whose stock was narrowly traded.[48] Months of negotiations had culminated in agreement as to both principle and terms. Proxies had been solicited on the basis of promising financial statements and all had reached fruition except the final consumation. The publicity attendant such a merger had its appreciable effect on the respective prices of the two corporations' stock.[49] The parties assembled in the New York office of White and Case for the final closing. Condition precedent to the merger was the receipt by INC of the accountant's comfort letter which had not as yet arrived. During the final hour within which the merger was to be closed, a telephone call from the auditors, Peat, Marwick & Mitchell, disclosed to all present that the financials of NSMC, upon which proxies had

46. The SEC sought notification to "the plaintiff commission concerning the misleading nature of the nine month financial statements." SEC Complaint at para. 48(i).

47. NSMC reported operating revenues for 1965 of $160,000. By the end of 1970 the corporation reported revenues of $72,940,000. A large portion of this growth came as a result of the twenty-five mergers involved in the current case. In the period from February 1, 1969 to January 29, 1970 NSMC exchanged 9,068, 634 shares for the companies involved in these mergers out of a total capitalization of 12,000,0000 shares outstanding.

48. The merger is characterized by the SEC as a $37,000,000 merger. Further they cite information that INC had 1,200 public shareholders. The SEC claims further that, immediately following the closing, insiders of INC sold $3,000,000 of the newly acquired NSMC stock and were "disappointed" that they were unable to sell more. This was estimated at 25 percent of their holdings. Memorandum of the SEC in Opposition to the Motions of Defendants Lord, Bissell & Brook to Dismiss the Complaint for Failure to State a Claim Upon Which Relief Can Be Granted, SEC v. National Student Marketing Corp., Civ. No. 72-225 (D.D.C., filed Feb. 3, 1972).

49. "Before the announcement of the proposed merger in June 1969, INC shares were selling at about $14 per share. After the announcement the market price of INC stock promptly moved upward, reaching $26 per share by the end of June and more than $33 per share in October 1969." Memorandum in Support of Motions to Dismiss on Behalf of Defendants Lord, Bissell & Brook at 8, SEC v. National Student Marketing Corp., Civ. No. 72-225 (D.D.C., filed Feb. 3, 1972). NSMC shares prior to the announcement of the merger were selling at about $27. Memorandum in Support of Motions by Defendants White and Case to Dismiss, SEC v. National Student Marketing Corp., Civ. No. 72-225 (D.D.C., filed Feb. 3, 1972). At the closing of the merger on October 31, 1969 the shares were selling at $52. Memorandum of SEC in Opposition to the Motions of Defendants Lord, Bissell & Brook at 15.

been solicited, might not have been accurate,[50] and other financials might not have been as represented.[51] The officers of NSMC reassured the officers of INC that all was well financially and the officers of INC advised all present that they wished to go ahead with the merger on the basis of their assessment of the situation.

At this juncture the SEC maintains that the duty of White and Case, who represented NSMC, was to convince their clients to abandon the merger or, failing that, to withdraw. Lord, Bissell & Brook, whose clients wished to waive the condition precedent of the comfort letter, faced the same alternative. Apparently, whatever ethical duties a lawyer owes a client who will not heed his advice are overriden by the imperative duty to the public described as "any act, practice, or course of business . . . which would operate as a fraud or deceit. . . ."[52]

The second level of the SEC decree drives the conflict deeper. Mere knowledge of financial information regarding the affairs of a client "in connection with the purchase or sale of any security"[53] which a court might construe as a "material fact necessary in order to make the statements made . . . not misleading"[54] would require disclosure to the SEC.[55] This imperative must stand the scrutiny of precedent from three directions.

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50. The consolidated balance sheet of NSMC as of May 31, 1969 (included in the proxy statement mailed to stockholders September 27, 1969): (a) "overstates assets by approximately $2,100,000 . . .," (b) "understates accounts payable by approximately $300,000," (c) ". . . overstates accrued costs on contracts in progress by approximately $1,000,000 . . ." and (d) ". . . overstates sales by approximately $1,500,000 and overstates earnings before income taxes and extraordinary credit by approximately $1,800,000." SEC Complaint at para. 33.

51. The SEC contends that the final earnings figures for the year 1969 were attained only by virtue of these mergers.

> [A]lmost half of NSMC's reported income came from Interstate itself, and an additional third from companies whose earnings were not contemplated. . . . Without all these acquisitions and the back-dated sales of two subsidiaries NSMC as it existed on August 31, 1969, actually lost in excess of one-quarter of a million dollars for the year.

Memorandum of the SEC in Opposition to the Motions of Defendants Lord, Bissell & Brook at 14.

52. 17 C.F.R. § 240.10b-5 (1973). The SEC thus analyzes *knowledge* of misinformation regarding a client's affairs as a "practice . . . which would operate as a fraud. . . ." *Id.*

53. 17 C.F.R. § 240.10b-5 (1973).

54. 17 C.F.R. § 240.10b-5 (1973).

55. "[I]t is clear that all who were present at the closing abdicated their respective responsibilities towards the Interstate shareholders and the *public.*" Memorandum of the SEC in Opposition to the Motions of Defendants Lord, Bissell & Brook at 31 (emphasis added).

First, our legal system permits lawyers to serve their clients in an advisory capacity. The quality of that advice, perhaps especially within the confines of technical securities regulations, is a function of the full information available to the counsellor. Insecurity which will cause a client to withhold factual data, can only diminish the value of the advice in direct proportion to the withholding. Only where confidentiality is maximized can a sufficient amount of data be acquired to render advice in a competent manner.

Second, ancient legal precedent protects the client from enforced disclosure by his lawyer of narrowly defined information.[56] The client need not declare the "pledge of secrecy"[57] to qualify for the privilege. It will be protected

> (1) [w]here legal advice of any kind is sought (2) from a professional legal adviser in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) except the protection be waived.[58]

If the law will protect from forced disclosure in an evidentiary setting, the law must more strongly protect this information from voluntary disclosure in the regulatory scheme.[59]

Finally, if knowledge of critical, misleading information makes a lawyer a violator of 10b-5, the criminal sanctions of the Act[60] and the regulations promulgated thereunder apply. If there is indeed risk of criminal fraud, even in a civil setting,[61] the commission would require volun-

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56. Berd v. Lovelace, 88 Cary 100, 21 Eng. Rep. 33 (1576-77); Dennis v. Codrington, 143 Cary 100, 21 Eng. Rep. 53 (1579-80). Waldron v. Ward, 449 Style 450, 82 Eng. Rep. 853 (1654): "He is not bound to make answer for things which may disclose the secrets of his clients cause. . . ."

57. 8 J. WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW § 2292 (McNaughton rev. 1961). "The attorney and the barrister are under a solemn pledge of secrecy not less binding because it is implied and seldom expressed." *Id.*

58. *Id.*

59. This position is based on the SEC's reading of one of the American Bar Association's canons of ethics: ABA Code of Professional Responsibility Canon 4, DR 7— 102(B) reads:

> A lawyer who receives information clearly establishing that: (1) his client has in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal.

60. The Securities Act of 1933 § 32(a), 15 U.S.C. § 78ff(a) provides for a penalty of $10,000, two years in prison, or both. It was upheld under Rule 10b-5 in United States v. Shindler, 173 F. Supp. 393 (S.D.N.Y. 1959), and United States v. Re, 336 F.2d 306 (2d Cir.), *cert. denied*, 379 U.S. 904 (1964).

61. State v. Byington, 114 Utah 388, 200 P.2d 723 (1948).

tary disclosure of this information. The fifth amendment prevents compelling a person in a criminal case "to be a witness against himself."[62] Court decisions have widened this protection beyond the literal interpretation of testimony at one's own criminal trial to disclosure of self-incriminatory evidence before a congressional committee investigation,[63] grand jury,[64] denaturalization proceeding,[65] and from the directives of a statute requiring registration.[66] If one cannot be compelled to incriminate oneself prior to trial for a crime, it is difficult to understand the reasoning that would require "voluntary" disclosure of information to a regulatory agency to purge oneself of undisclosed knowledge of those facts.[67]

Setting aside all arguments as to the reasonableness of the SEC's interpretation of the commands of 10b-5, if the court upholds the requirement of this degree of disclosure by securities lawyers, the remedial action open to the court requires analysis. In *National Student Marketing* the SEC is demanding injunctive relief only against the lawyers and their firms.[68] The injunctive relief demanded, however, enjoins them from omitting "to state a material fact . . . concerning but not limited to: . . . financial conditions or result of operation . . . business operation, . . . contracts or agreements to which . . . [the] issuer . . . is . . . a party" or "any other issuer, making use of the means and instrumentalities of interstate commerce. . . ."[69]

Further, the grant of injunctive relief could deprive the defendant law firms of their right to practice before the SEC.[70] Finally, although in-

62. U.S. CONST. amend. V.

63. Emspak v. United States, 349 U.S. 190 (1955).

64. Rogers v. United States, 340 U.S. 367 (1951) (implied by waiver).

65. Miranda v. Arizona, 384 U.S. 436 (1966).

66. Albertson v. Subversive Activities Control Bd., 382 U.S. 70 (1965).

67. Actual knowledge as sufficient for *scienter* in a 10b-5 action had been found in the following cases: Pettit v. Am. Stock Exch., 217 F. Supp. 21, 28 (S.D.N.Y. 1963): "[K]nowing assistance of or participation in a fraudulent scheme under Section 10(b) gives rise to liability equal to that of the perpetrators themselves." *See also* Financial Indus. Fund, Inc., v. McDonnell Douglas Corp., 315 F. Supp. 42 (D. Colo. 1970); Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333 (S.D.N.Y. 1969); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964); Baron v. Shields, 131 F. Supp. 370 (S.D.N.Y. 1954).

68. SEC Complaint Prayer for Relief. The SEC requests a "final judgment of permanent injunction restraining defendants . . . White and Case . . . Lord, Bissell, and Brook . . . ."

69. *Id.*

70. "[T]he S.E.C.'s rules of practice bar an attorney who has been enjoined from violating the securities laws from practicing before the S.E.C." Memorandum in

junctive relief is not tantamount to liability,[71] the precedent of the issuance of injunctive relief somewhat illuminates the path to liability.[72]

Analysis of fraud in securities transactions must of necessity start with the presumption that the government's role is to protect the financially interested parties to the transaction. Maximum disclosure of accurate and non-misleading factual data is certainly the illumination that makes fraud most difficult. Basic to this hypothesis is that the parties who stand to gain from the fraudulent transaction, and who knowingly and willingly engage in it, are the parties who need the most vigorous regulations.[73] Once we go beyond the parties who benefit from the fraud and proscribe activities of non-beneficiaries, care must be taken in assessing their respective roles. The dealer in securities has a substantial vested financial interest in the sale of that security and by definition becomes a beneficiary of the fraud. Proscription and regulation of his activity falls logically within the ambit of the regulation. Independent accountants have a role which is based on disclosure to interested parties of the financial data of their clients. Regulation of their duty of investigation and disclosure falls directly within the boundaries of their role. Directors and officers of a corporation have a vested interest in both the economics of their own holdings of the corporation's securities and the corporation itself to a degree where regulation of their activities in the area of disclosure of inside information can be required.

However, the step envisioned by *National Student Marketing* to regulate the activities of the securities lawyer ignores his role in law and in society. If, in fact, the information he is privy to, in the process of advising his corporate clients, cannot be discovered and disclosed to the public except by requiring him to breach this confidential relationship with his client, then legislation with safeguards for clients' rights to secrecy and

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Support of Motions to Dismiss . . . on behalf of Defendants Lord, Bissell & Brook at par. 33.

71. Injunctive relief has not yet been held res judicata for liability or collateral estoppel to later damage suits. Rachal v. Hill, 435 F.2d 59 (5th Cir. 1970), *cert. denied*, 403 U.S. 904 (1971).

72. The injunctive remedy "does serve the additional function . . . of establishing policies and standards for private actions. . . ." Comment, *The Effect of SEC Injunctions in Subsequent Private Damage Actions*—Rachal v. Hill, 71 COLUM. L. REV. 1329 (1971). The first case for liability based on *NSMC* has already been filed: Natale v. National Student Marketing Corp., Civ. No. 721 (S.D.N.Y., filed April 4, 1972).

73. Most recent writers in the area of legal professionalism have dealt with the requirements of professionalism that are ignored by lawyers who become active participants in the fraudulent activity. For a very recent analysis *see* Sonde, *The Ressponsibility of Professionals Under the Securities Laws—Some Observations*, 68 NW. U.L. REV. 1 (1973).

lawyers' rights against self-incrimination might be necessary. These safeguards can be tested by the standards of our Constitution and our heritage of common law in the courts. Enforced disclosure without any safeguards runs afoul of all principles of justice and ethics.

In any case, the sitting judge, and perhaps the appellate courts, will have the initial responsibility to make this decision. One hopes they will not view this case in the narrow context of the misdeeds of the active defendants and permit a lead case to make bad law. Rather, one hopes they will see the potential precedent involved and weigh the value of confidentiality to the society they serve.

Gordon Shneider